Khuzami's Views on Counsel's Behavior During Investigations

In a recent speech given by Robert Khuzami, Director of Enforcement for the U.S. Securities and Exchange Commission ("SEC"), he highlighted concerns of overly-aggressive and obstructionist representation by counsel. While recognizing that counsel plays a crucial role in SEC investigations, Khuzami warned that obstructionist and "questionable investigative" practices could result in negative consequences to counsel and their clients.

Khuzami discussed delays in document production, defense counsel representing several parties simultaneously, witnesses testifying before the Commission claiming they have no recollection of relevant facts, counsel cueing clients during Commission testimony and other "questionable investigative" practices during internal investigations. In relation to internal investigations, he discussed the failure to acknowledge limited review scopes, overemphasis on exculpatory evidence while downplaying evidence indicating issues, assigning blame to lower-level employees while protecting senior management.

StoneTurn's Observations

The SEC does not have the time or resources to perform a thorough investigation of every possible accounting or financial reporting problem (especially in light of the 30,000 or so whistleblower reports they expect annually), and therefore it is typically worthwhile for a company and its advisors to perform a reasonable investigation before, or in parallel with, the SEC investigation. Even if an independent investigation team of outside counsel and forensic accountants are retained to gather the facts of the matter and provide guidance to the audit committee, the SEC will look to management's statements and internal processes in arriving at their public reporting decisions, and therefore their credibility. As part of the investigation process, one needs to bear in mind that the SEC also evaluates the scope of the investigation, the thoroughness of the work performed, the conclusions reached and the basis of those conclusions.

If an SEC registrant receives a whistleblower letter from an employee alleging financial statement irregularities and proceeds to perform only a very high level and cursory, limited scope internal investigation, the Audit Committee and management may increase the risk the whistleblower will inform the SEC. Even if the company subsequently retains independent counsel and forensic accountants to thoroughly investigate the matter, the company's initial limited scope investigation may impair the company's credibility with the SEC. Further, once the SEC becomes involved, the company runs the risk of losing control of the investigation. Proactive compliance programs and prompt responses to whistleblower hotline inquiries are the best practices in keeping whistleblowers internal.

Given the new whistleblower laws there is a strong possibility that the SEC will be informed of potential issues that companies and their audit committees previously may not have disclosed because of their immateriality. Accordingly, the Audit Committee must ensure internal investigations—whether they involve external assistance or not—are **thorough, objective, and conducted properly** in order to withstand reasonable outside scrutiny. As a best practice, the Audit Committee should assume that any whistleblower allegations involving public reporting irregularities will be forwarded to the SEC. Therefore, the parties

involved should consider how any investigative findings will be assessed by the SEC, and the potential ramifications of any "questionable tactics" utilized by counsel or management. The Audit Committee should ensure that the procedures performed are sufficient and documented, to be prepared for if and when the SEC (or other outside parties) contacts the company.

The SEC expects vigorous work to be performed during investigations and may take certain action given the use of such tactics discussed above, which may include declining requests for extensions and investigations by the SEC's Office of General Counsel.