9

SEC-Imposed Monitors

*Jonny J. Frank**

The SEC often requires companies, broker-dealers, investment advisers, and others to engage a compliance monitor as part of a settled enforcement action. This chapter addresses SEC and DOJ guidance for determining whether to impose a monitor, the monitor's responsibilities, and other terms of the monitor's engagement.

* Brad Wilson, a partner at StoneTurn, also served as an author of this chapter.

Overview

Q 9.1 What is a monitor?

The SEC defines a monitor as "an independent third party who assesses and monitors a company's adherence to the compliance requirements of an agreement that was designed to reduce the risk of recurrence of the company's misconduct."[1] Monitors, in contrast to forensic investigators, typically look forward and assess whether a company's compliance program is adequate to guard against future misconduct. Monitors serve under various titles and can be an individual or firm.

There are generally two types of SEC-imposed monitors: an "independent compliance consultant" and an "independent compliance monitor." The basic difference between these two monitors is their scope of responsibility: independent compliance monitors have a more expansive role than independent compliance consultants. The differing scope and authority of each type of SEC-imposed monitor is discussed below in Q 9.4. An independent compliance consultant is generally imposed as part of the settlement of a stand-alone SEC enforcement action,[2] while an independent compliance monitor is generally imposed in parallel criminal and civil cases when the company simultaneously enters a plea, a deferred prosecution agreement, or a non-prosecution agreement with the DOJ.[3]

Q 9.2 What other agencies impose monitors?

In addition to the SEC, numerous federal and state government and quasi-government agencies use monitors as an enforcement remedy, including the Drug Enforcement Agency, the DOJ, the Environmental Protection Agency, the Federal Trade Commission, FINRA, the Department of Health and Human Services, the National Highway Traffic Safety Administration, the New York State Attorney General's Office New York State Department of Financial Services (NYSDFS) and the U.S. Department of State. Even foreign governments (Canada, France, Germany, South Africa); quasi-government agencies (World Bank); and self-regulatory organizations (FINRA, NCAA) impose monitors. These regulators refer to monitors variously as "Independent Review Organizations,"[4] "Financial Monitors,"[5] "Independent Compliance Auditors,"[6] and, in the U.K., "Skilled Persons."[7] Some regulators occasionally use monitors to supplement the agency's investigative resources.[8]

Q 9.3 When does the SEC impose monitors?

The SEC appoints monitors in resolutions of civil suits and administrative proceedings. The Exchange Act authorizes the SEC in civil actions to seek "any equitable relief that may be appropriate or necessary for the benefit of investors," which includes imposition of a monitor.[9] The SEC has been imposing monitors in settled enforcement actions since the early 1990s.[10] The SEC has imposed monitors to assess a wide range of matters, such as compliance programs relating to the issuance and transfer of securities,[11] the preparation of performance reports,[12] the underwriting of municipal securities,[13] anti-money laundering,[14] the application of generally accepted auditing standards,[15] the books and records provisions of the FCPA,[16] the disclosure of fees by investment advisors,[17] insider trading,[18]and even the calculation of credit ratings for mortgage backed securities.[19]

Although the SEC Enforcement Manual does not provide guidance on monitors, SEC guidance appears in the Resource Guide co-authored with the DOJ Criminal Division, which explains:

> Appointment of a monitor is not appropriate in all circumstances, but it may be appropriate, for example, where a company does not already have an effective internal compliance program or needs to

> establish necessary internal controls. In addition, companies are sometimes allowed to engage in self-monitoring, typically in cases when the company has made a voluntary disclosure, has been fully cooperative, and has demonstrated a genuine commitment to reform.[20]

The SEC and DOJ consider many of the same factors in deciding whether to impose a monitor as they do in determining whether to file criminal charges[21] or enforcement proceedings,[22] including the:

- Seriousness of the offense;
- Duration of the misconduct;
- Pervasiveness across geographic and product lines;
- Nature and size of organization;
- Quality of compliance program at time of misconduct; and
- Adequacy of the remediation and corrective measures.

After an investigation has begun, companies and counsel can affect only the final factor; that is, they cannot after the fact change the seriousness, duration, and pervasiveness of the misconduct, nor the nature and size of the company. Similarly, the company can seek to defend, although it cannot change, the pre-existing compliance program. The SEC's decision about whether to impose a monitor often depends on whether it trusts the company and its commitment to ethics and compliance. Accordingly, upon learning of misconduct or an investigation, it is essential for companies and counsel to address remediation rapidly and thoroughly. At the commencement of large investigations, some lawyers implement a separate remediation work stream.

Compliance, Remediation, and Self-Monitoring Programs

Q 9.3.1 How does the SEC assess "pre-existing" compliance programs?

The SEC may consider a company's pre-existing compliance program among the factors it considers in determining whether to file an enforcement action;[23] the SEC has implicitly adopted the DOJ's approach to give that factor consideration in the Resource Guide.[24]

DOJ policy requires federal prosecutors to consider "the existence and effectiveness of the corporation's pre-existing compliance program" in determining whether to bring charges, and negotiating plea or other agreements.[25] In February 2017, the DOJ issued guidance on how it assesses the quality of pre-existing compliance programs.[26] The guidance is organized into eleven sections[27] and draws from prior DOJ pronouncements, the Resource Guide, the U.S. Sentencing Guidelines, and a handbook co-authored by the Organization for Economic Co-operation and Development, the United Nations Office on Drugs and Crime, and the World Bank.

If an investigation is underway, a company should assess its pre-existing compliance program. Misconduct does not necessarily mean that the compliance program is ineffective. Timely detection of misconduct may demonstrate that the program was effective.

Compliance program deficiencies typically occur in one or more of three areas: (1) failure of the risk assessment to identify the potential risk; (2) overreliance on ineffective controls; and (3) failure to investigate risk indicators and red flags. Organizations can minimize the impact of any deficiencies by seeking credit for strengths in the compliance program existing at the time of the misconduct (*e.g.*, strong tone at the top, effective risk assessment, compliance training, and forensic auditing programs).

Q 9.3.2 What are the attributes of an effective remediation program?

Effective and timely remediation is essential if there is any chance of an organization avoiding imposition of a monitor in the wake of serious, lengthy, and pervasive misconduct.[28] Neither the SEC nor the DOJ has issued detailed standards for effective remediation, although some guidance appears in DOJ and SEC settlement agreements' reference to remediation as a basis for a reduced penalty.

In April 2019, the DOJ Criminal Division guidance relating to the evaluation of corporate compliance programs.[29] Regarding remediation, the guidance directs prosecutors to evaluate whether the remediation included a (i) root cause analysis; (ii) consideration of control deficiencies; (iii) analysis of how the company funded the misconduct; (iv) vendor management; (v) prior opportunities to detect the misconduct; (vi) corrective measures; and (vii) discipline and accountability.[30]

Company and counsel must demonstrate to the government the effectiveness of the remediation and corrective measures. Some companies bring a senior business person or audit executive to explain the remediation program. A recent development is for the government or corporation to hire an independent third party to audit the remediation and compliance program.

Q 9.3.3 How do companies use "self-monitoring" to avoid an SEC-imposed monitor?

In lieu of an independent monitor, the SEC sometimes allows companies to either engage in self-monitoring or appoint as an independent consultant a third-party firm that assesses the company's program before the SEC settlement.[31] This outcome follows the U.S. Sentencing Guidelines, which recommend that companies consider using "an outside professional advisor to ensure adequate assessment and implementation of any modifications" to the ethics and compliance program.[32]

In the SEC's enforcement action against Barclays Capital, for example, the SEC noted that Barclays Capital's remediation included engaging an independent third-party consultant to review Barclays Capital and permitted the company to continue with the same consultant in lieu of appointing another.[33] The SEC's order requires the consultant to make findings and recommendations and opine on "whether the revised policies, procedures, and practices and their implementation and enforcement by Respondent and Respondent's auditing of the implementation and enforcement of those policies, procedures, and practices are reasonably designed to ensure compliance with the federal securities laws."[34] Similarly, the U.K.'s Serious Fraud Office allowed Rolls-Royce to avoid a government-imposed monitor because it had hired an expert to "conduct an independent review of its ethics and compliance procedures and to act on an ongoing basis as a 'quasi-monitor' of its compliance programme."[35]

The SEC applied a hybrid approach in its enforcement action against LAN Airlines. The SEC's order imposes an independent compliance monitor for a twenty-seven-month term that terminates and moves into a self-reporting period if the monitor determines that the company's anti-corruption program is effective.[36] During the self-reporting period, the company must submit written reports to the SEC and self-disclose "any credible evidence that corrupt or otherwise suspicious transactions occurred, or payments of things of value were offered, promised, or provided to foreign officials, that it learns of that occurred after the date of this Consent."[37] More recently, the DOJ and SEC entered into a Non-Prosecution Agreement (NPA) with Fresenius Medical Care AG & Co. KGaA relating to payments to publicly employed health and/or government officials in Angola and Saudi Arabia.[38] The NPA provides for a two-year monitorship followed by one year of self-reporting by the company.[39]

Q 9.3.4 Will the Benczkowski Memo Impact SEC Decision to Impose a Monitor?

The Benczkowski Memo refers to an October 2018 memo from Brian Benczkowski, DOJ Assistant Attorney General for the Criminal Division, to Criminal Division personnel entitled "Selection of Monitors in Criminal Division Matters" ("Benczkowski Memo").[40] The SEC has not formally adopted the memo, nor has it issued equivalent guidance. The Benczkowski memo, however, likely received considerable attention from the white collar criminal bar and likely will impact joint SEC/DOJ investigations.

The Benczkowski Memo supplements a string of Deputy Attorney General memos relating to corporate monitors, beginning with the 2008 memo from Acting Deputy Attorney General Craig Morford (the "Morford Memo").[41] The Morford Memo instructs prosecutors to "be mindful of both: (1) the potential benefits that employing a monitor may have for the corporation and the public, and (2) the cost of a monitor and its impact on the operations of a corporation."[42] The Benczkowski Memo provides supplemental guidance to these two criteria.

Potential Benefits to Corporation and Public. Regarding potential benefits to the corporation the public, the Benczkowski Memo instructs Criminal Division attorneys to consider whether the misconduct:

- Involved the manipulation of corporate books and records;
- Exploited an inadequate compliance program or internal control systems;
- Pervaded across the business organization; and
- Was approved or facilitated by senior management.[43]

The Benczkowski Memo also instructs Criminal Division attorneys to consider whether the company improved its corporate compliance program and internal control systems, and tested the effectiveness of corrective measures and internal controls to prevent and detect similar misconduct. Criminal Division prosecutors must also consider whether changes in the compliance environment or corporate leadership are adequate to safeguard against recurrence of misconduct.

Cost and Impact of Monitor. On cost and impact on company operations, the Benczkowski Memo instructs Criminal Division attorneys to "consider not only the projected monetary costs to the business organization, but also whether the proposed scope of a monitor's role is appropriately tailored to avoid unnecessary burdens to the business's operations."[44]

It is too early to assess the impact of the Benczkowski Memo on SEC monitorships. The guidance makes clear the importance of getting an early start on remediation of the misconduct and compliance program improvements. The guidance also emphasizes the importance of demonstrating to the SEC the effectiveness of efforts to prevent and detect recurrence of similar misconduct.[45]

Scope and Authority

Q 9.4 What is the scope and authority of an SEC-imposed monitor?

As noted above in Q 9.1, the role of an SEC-imposed monitor differs depending on whether the SEC requires an independent compliance