

# The Complete Compliance and Ethics Manual 2022 Independent Investigations Overseen by the Audit Committee: Procedures and Guidance

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## Introduction

Since the 2008 financial crisis, the discovery of the massive Bernie Madoff Ponzi scheme, and the enactment of the sweeping Dodd-Frank financial regulatory reform legislation, the Department of Justice (DOJ), the Securities and Exchange Commission (SEC), the Financial Industry Regulatory Authority (FINRA), and state attorneys general have increased their oversight and enforcement of white-collar criminal and securities laws. The SEC, for example, brought 862 enforcement actions in fiscal year (FY) 2019 and obtained approximately \$4.349 billion in penalties and disgorgement.<sup>[2]</sup> In addition to regulators, the plaintiffs' securities bar, often assisted by whistleblowers, has been eager to bring cases against banks, financial services companies, and large corporations.

In this environment of increased scrutiny from both regulators and shareholders, corporate management and directors are under greater pressure to react quickly and decisively at the first indication of malfeasance or fraud. Failure to be proactive in the face of allegations of corporate misconduct can be financially devastating to a company and may expose management and directors—even independent directors—to personal liability.

## Assessing the Situation

When faced with such allegations, the best defense is a mastery of the facts, which can be gleaned only from a full investigation of the problem. What happened? Who was involved? Was management at fault, either directing the misconduct or willfully turning a blind eye to it? Are policies and procedures in place to keep this from happening again?

To answer these questions and many others, a company typically has two choices:

1. To conduct an internal investigation overseen by management and led by in-house or outside corporate counsel
2. To conduct an independent, internal investigation overseen by the audit committee or special committee of the board of directors, using outside counsel that has not previously represented the company

Although an investigation overseen by management may be appropriate in certain situations, an independent investigation is the preferred, and often required, course to investigate suspected misconduct by management or potential violations of federal criminal or securities laws that could subject the company to a regulatory enforcement action.

## Regulatory Standards

With scarce resources and increasing demands placed on them, government agencies such as the DOJ and SEC may show leniency for companies that conduct independent investigations overseen by an audit committee or a

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special committee of the board. Frequently, one of the first questions a DOJ or SEC Division of Enforcement lawyer will pose to a company under investigation for serious misconduct is, “Does the company plan to conduct an independent investigation?” For government agencies, an independent investigation is viewed as more trustworthy than an investigation overseen by management. The independent directors on an audit committee or special committee—those overseeing an independent investigation—have fiduciary obligations to the shareholders to identify and remediate violations of laws, even if those violations occurred at senior levels in the company. Moreover, to be considered independent, the investigation set up by the audit committee or special committee must retain counsel that has not done work previously at the direction of the management of the company. In other words, the counsel conducting the independent investigation must have no perceived bias toward management that might be viewed as potentially interfering with their judgment.

## **Other Considerations**

There is no doubt that an investigation, whether internal or independent, can be costly, time-consuming, and distracting in the near term. Any conduct warranting an independent investigation correspondingly requires a more expansive investigation. The ultimate cost is tied to the nature and pervasiveness of the misconduct and the requisite scope of the independent investigation. Beyond the financial costs to the company, in the form of fees for legal and other expert services, an independent investigation could prove distracting and uncomfortable for management, depending on the conduct being investigated.

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