

# CORPORATE THERAPEUTICS AT THE SECURITIES AND EXCHANGE COMMISSION

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## I. INTRODUCTION

Who sets the norms for the ways in which American public companies are governed? There are, of course, many answers to this question: the Delaware Supreme Court, influential scholars and other norm entrepreneurs, members of Congress through well-intentioned legislation, the New York Stock Exchange and NASDAQ through their listing standards, the Business Roundtable through its lobbying and litigation, institutional investors, and the "market" generally.

Plaintiffs' lawyers, too, have become influential in shaping corporate governance norms. Class counsel have resolved many derivative suits and shareholder class actions in recent years with what are known as "therapeutic" settlements.<sup>1</sup> These are settlements in which corporate defendants agree to restructure their boards, reconfigure their governance arrangements, hire additional staff, and improve their legal compliance programs.<sup>2</sup> Therapeutic settlements in private litigation have also included provisions for annual, rather than staggered, elections of directors; shareholder access to the proxy ballot; and creation of the position of lead director.<sup>3</sup>

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<sup>1</sup> The use of the term "therapeutics" derives from the use of the term "corporate therapeutics" in *Mills v. Electric Auto-Lite Co.*, 396 U.S. 375, 396 (1970) (citing *Murphy v. N. Am. Light & Power Co.*, 33 F. Supp. 567, 570 (S.D.N.Y. 1940)).

<sup>2</sup> See, e.g., Harry R. Webber, *Home Depot Settling Several Shareholder Suits, Attorneys to Get \$14.5M*, Law.com, Apr. 4, 2008, <http://www.law.com/jsp/article.jsp?id=900005561185> (noting defendant's agreement to adopt several corporate governance practices as part of a settlement agreement); Mary Pat Gallagher, *Plaintiffs Lawyers Split \$9.5M Fee in Shareholder Suit Against Schering-Plough*, Law.com, Jan. 15, 2008, <http://www.law.com/jsp/article.jsp?id=1200305133047> (noting defendant's agreement to create a staggered board, change the compensation scheme for directors, and centralize global compliance and audit functions); Ashby Jones, *Firms Settle Backdating Suits—Some Private Cases End in Agreements; More Deals Ahead?*, WALL ST. J., Nov. 19, 2007, at A15 (noting that Barnes & Noble had adopted fifteen governance changes in response to a lawsuit).

<sup>3</sup> Phyllis Plitch, *Governance at Gunpoint: To Get Companies to Change Their Rules, Shareholders are Dangling a Powerful Carrot: Litigation*

Prosecutors in federal criminal cases have also influenced corporate governance norms. Through the use of deferred prosecution agreements which often impose structural obligations on corporate defendants, Department of Justice lawyers, like plaintiffs' lawyers, have engineered many "deep governance reforms."<sup>4</sup> These reforms have included the appointment of an independent monitor,<sup>5</sup> the implementation of a detailed legal compliance program,<sup>6</sup> specific prescriptions regarding management's communications with outside auditors,<sup>7</sup> splitting the positions of CEO and Chairman,<sup>8</sup> and the appointment of additional outside directors.<sup>9</sup>

The Securities and Exchange Commission (SEC), too, has been tinkering with corporate governance norms. It accomplishes this mission in the course of settling its civil enforcement actions.<sup>10</sup> For many years, the Commission has

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*Settlement*, WALL ST. J., Oct. 17, 2005, at R6. Other settlements include a ban on the use of stock options to compensate directors and replacement of the Chairman and CEO. See E. Scott Reckard, *Homestore to Settle Suit by Investors*, L.A. TIMES, Aug. 14, 2003, at Bus. 1; Daniel Wagner & Kristina Fiore, *DHB Deal Means Chief's Ouster*, NEWSDAY, July 14, 2006, at A48.

<sup>4</sup> Brandon L. Garrett, *Structural Reform Prosecution*, 93 VA. L. REV. 853, 853 (2007).

<sup>5</sup> Twenty-one of the thirty-five deferred prosecution agreements adopted by the DOJ from January 2003 – January 2007 included the appointment of an independent monitor. *Id.* at Appendix A. "The monitors may become involved in uncovering and remedying new criminality totally unrelated to the agreement." *Id.* at 898.

<sup>6</sup> *Id.* ("These compliance programs are often sweeping, affecting both top management and low level employees.").

<sup>7</sup> See Christopher J. Christie & Robert M. Hanna, *A Push Down the Road of Good Corporate Citizenship: The Deferred Prosecution Agreement Between the U.S. Attorney for the District of New Jersey and Bristol-Myers Squibb Co.*, 43 AM. CRIM. L. REV. 1043, 1051 (2006) (describing the terms of the agreement, including a requirement that the CEO, CFO, General Counsel, and Chief Compliance Officer meet with the auditors at least quarterly).

<sup>8</sup> *Id.* at 1052.

<sup>9</sup> *Id.* at 1053.

<sup>10</sup> See Donald C. Langevoort, *On Leaving Corporate Executives "Naked, Homeless and Without Wheels": Corporate Fraud, Equitable Remedies, and the Debate Over Entity Versus Individual Liability*, 42

settled cases with therapeutic provisions called "undertakings." In recent years, these undertakings have required the creation of new management positions, adoption of new accounting and reporting practices, reconfiguration of corporate training programs, and establishment of specific board-level committees and procedures.<sup>11</sup> Sometimes, the terms of SEC settlements require boards of directors to replace senior-level managers, engage and empower outside consultants, and overhaul a variety of financial and business practices.<sup>12</sup>

One might ask whether the SEC has the expertise to design desirable corporate governance changes or whether the therapeutic provisions the Commission has demanded are the right ones or the best ones for the corporate defendants in question. (Similar questions have been asked about the expertise of plaintiffs' lawyers and their clients and the value, if any, of the therapeutic settlements achieved in shareholder class actions.<sup>13</sup> The same questions have been asked quite aggressively about the expertise of federal prosecutors dealing with allegations of organizational crime.)<sup>14</sup> One might also ask if the widespread reliance by the SEC on compliance consultants—a costly and intrusive practice—has become a matter of habit whose cost exceeds its benefits. Recent press coverage suggests that the use of such consultants may be a boondoggle—a way to reward former government staffers with lucrative contracts of little value to investors.<sup>15</sup>

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WAKE FOREST L. REV. 627, 654 (2007) ("The SEC has too few resources for all the work it is asked to do, and hence seeks settlement rather than continued litigation of its enforcement actions.").

<sup>11</sup> See *infra* Part II.

<sup>12</sup> *Id.*

<sup>13</sup> Louis Lavelle, *Smoke, Mirrors, and Shareholder Settlements*, BUS. WK., Sept. 6, 2004, at 75.

<sup>14</sup> Garrett, *supra* note 4, at 933-35.

<sup>15</sup> See Dan Eggen, *Ashcroft Defends Contract for His Firm; Democrats Questioning No-Bid Deal*, WASH. POST, Mar. 12, 2008, at A3; Carrie Johnson, *Ex-Officials Benefit From Corporate Clean-Up*, WASH. POST, Jan. 15, 2008, at A1. The issue of cronyism in the selection of consultants (called "monitors") in criminal cases was aired in Congressional hearings

This Article explores the use by the SEC of corporate therapeutics as a remedial tool. I will begin by examining the kinds of “therapeutics” the Commission currently favors<sup>16</sup> as well as the process by which therapeutic settlements are reached.<sup>17</sup> I will then explore the question of agency expertise.<sup>18</sup> Does the SEC really add value to companies whose governance structures and procedures it alters? It is one thing for the SEC to demand structural changes at regulated entities such as brokerage firms or stock exchanges where it arguably has industry-specific expertise. It is quite another to imagine that the SEC has unique insights into the optimum governance practices of companies in *every* industry.

Apart from the question of expertise there is the question of ultimate efficacy. Research suggests that most corporate governance arrangements have little or no impact on shareholder value.<sup>19</sup> Many legal compliance programs, too, may provide atmospherics but in fact do very little to improve a company’s value.<sup>20</sup> Some compliance programs are a farce.<sup>21</sup> So, why does the SEC insist upon these arrangements? And what evidence do we have that therapeutic settlements like those favored by the SEC have the intended effect of protecting investors or maximizing wealth?

In addition to exploring the theory behind therapeutic settlements, this Article will explore some of the strategic considerations surrounding the use of therapeutic sanctions. How do SEC enforcement lawyers construct a menu of therapeutic options when they enter into settlement discussions? Is the list custom-tailored or cut-and-pasted from prior cases? (Or, are therapeutic provisions a product

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in March, 2008. The Department of Justice has now issued guidelines governing selection of monitors. See Steven R. Peikin, *New Guidelines for Corporate Monitors*, N.Y.L.J., Mar. 27, 2008, at 4.

<sup>16</sup> See *infra* Part II.

<sup>17</sup> See *infra* Parts III & IV.

<sup>18</sup> See *infra* Part VI.

<sup>19</sup> See *infra* Part VII.

<sup>20</sup> *Id.*

<sup>21</sup> See *infra* Part VIII.

of the *defendant's* initiative?) How does the SEC approach the tradeoff between monetary payouts and therapeutic sanctions? This Article incorporates the results of confidential interviews with several lawyers who handle SEC enforcement actions, both on the defense side and in the Enforcement Division of the SEC. Their comments provide useful insight into the priorities of the Enforcement staff as well as the strategies of corporate clients.

The conclusion of this Article is a policy prescription.<sup>22</sup> The SEC has been admirably forthcoming in articulating its policies regarding the imposition of civil penalties against corporations.<sup>23</sup> I will propose that the SEC similarly articulate its policies regarding the use of therapeutic sanctions.

## II. THE SEC'S USE OF CORPORATE THERAPEUTICS

The SEC in recent years has often negotiated therapeutic settlements addressing corporate governance and operational arrangements. These settlements may be placed on an "intrusiveness" continuum as follows:

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<sup>22</sup> See *infra* Part X.

<sup>23</sup> See Statement of the Securities and Exchange Commission Concerning Financial Penalties (Jan. 4, 2006), <http://www.sec.gov/news/press/2006-4.htm> [hereinafter Statement Concerning Financial Penalties] (describing the framework for determining civil penalties).

<b>Least Intrusive</b>				<b>Most Intrusive</b>
Cease-and-desist order	Defendant must undertake remedial efforts, then report on the results to the SEC	Defendant must hire new executives and staff and initiate new programs and practices	Defendant must engage a consultant approved by the SEC staff; the consultant will make findings and recommendations for future programs and practices; defendant must adopt and implement the consultant's recommendations	Appointment of a Monitor with broad oversight authority

Working from the least intrusive to the most intrusive provisions,<sup>24</sup> we begin with settlements like that involving Cummins, Inc.<sup>25</sup> In that case, the SEC alleged that Cummins had failed in some details of its accounting practices, resulting in a restatement of its financials for the preceding three years. Citing the company's self-reporting of its violations and voluntary remedial efforts (which are not described), the SEC settled the case by requiring Cummins to cease-and-desist from further violations of specified SEC rules.<sup>26</sup>

At the next point on the scale, we have the settlement in a case involving Bear, Stearns & Company, a financial services company regulated by the SEC. In this case, the

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<sup>24</sup> Some settlements, of course, include no therapeutic provisions for reasons that will be discussed in Part IV. See, e.g., Federal Home Loan Mortgage Corp. ("Freddie Mac"), Litigation Release No. 20,304, 2007 SEC LEXIS 2277 (Sept. 27, 2007) (describing settlement of a major fraud case for a \$50 million civil penalty with no accompanying therapeutic sanctions); *In re Raytheon Co.*, Exchange Act Release No. 54,057, 2006 SEC LEXIS 1501 (June 28, 2006) (noting a settlement by payment of a \$12 million civil penalty).

<sup>25</sup> *In re Cummins, Inc.*, Exchange Act Release No. 53,236, 2006 SEC LEXIS 246 (Feb. 7, 2006).

<sup>26</sup> *Id.* at \*13-14. See also *In re Consulting Servs. Group, LLC*, Exchange Act Release No. 56,612, 2007 SEC LEXIS 2354 (Oct. 4, 2007) (detailing the defendant's voluntary remedial efforts, then imposing a cease-and-desist order).

SEC alleged violations of the "gun-jumping" rule, when Bear, Stearns brokers sent unauthorized e-mails to their clients during IPO "quiet periods."<sup>27</sup> Bear, Stearns was alleged to have failed to provide adequate supervision of its brokers and to have insufficient control systems to detect and deter the sending of the unauthorized e-mails. The settlement required only that Bear, Stearns review its procedures and "certify to the Commission in writing that it has completed its review and that it has established procedures . . . which are reasonably expected to prevent and detect, insofar as practicable, [future] violations of Section 5."<sup>28</sup> There was no cease-and-desist order and no financial penalty.

At the center of the intrusiveness scale, we have the *Qwest Communications* settlement. In October 2004, the SEC charged Qwest with fraudulently recognizing over \$3.8 billion in revenue in a "multifaceted fraudulent scheme to meet optimistic and unsupportable revenue and earnings projections."<sup>29</sup> In settling the case, Qwest agreed to pay a \$250 million civil penalty. It also agreed to create a new position of Chief Compliance Officer (CCO) whose charge would be to ensure the company complies with the federal securities laws. The CCO would report directly to a committee of outside directors.<sup>30</sup>

The *McAfee* settlement offers an example at the next point on the scale. In January 2006, the SEC charged McAfee, Inc. with overstating its revenue and earnings by hundreds of millions of dollars. The complaint specifically alleged that, during the period 1998-2000, McAfee inflated its cumulative net revenues by \$622 million.<sup>31</sup> In settling the case, McAfee agreed to pay a \$50 million civil penalty and

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<sup>27</sup> *In re Bear, Stearns & Co., Inc.*, Securities Act Release No. 8756, Exchange Act Release No. 54,806, 2006 SEC LEXIS 2701, at \*2 (Nov. 21, 2006).

<sup>28</sup> *Id.* at \*20.

<sup>29</sup> *Qwest Commc'ns Int'l, Inc.*, Litigation Release No. 18,936, 2004 SEC LEXIS 2403 (Oct. 21, 2004).

<sup>30</sup> *Id.*

<sup>31</sup> *McAfee, Inc.*, Litigation Release No. 19,520, 2006 SEC LEXIS 2360 (Jan. 4, 2006).



submit to the entry of an "obey-the-law" injunction.<sup>32</sup> In addition, McAfee agreed to engage an independent consultant to examine and recommend improvements to McAfee's internal accounting controls.<sup>33</sup>

Finally, the *WorldCom* case offers an example of a settlement of a civil enforcement action at the "most intrusive" point on the scale. The settlement in *WorldCom* resulted in the appointment of a full-service monitor with exceptional powers.<sup>34</sup> Typically, as happened here, full-service monitors are appointed only in cases involving concurrent criminal charges brought by the Department of Justice.<sup>35</sup>

These settlements, among scores involving therapeutic provisions, illustrate the types of options available in settlement negotiations with the SEC Enforcement Division. Let us look for a moment more specifically at some of the most common therapeutic prescriptions demanded by the SEC staff in recent years.

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<sup>32</sup> *Id.* An "obey-the-law" injunction is one that directs the defendant to observe the requirements of certain enumerated statutes or regulations (e.g., the defendant shall not violate Rule 10b-5). Some courts have questioned the legitimacy of such injunctions. *SEC v. Smyth*, 420 F.3d 1225, 1233 (11th Cir. 2006) ("[T]his court has held repeatedly that 'obey-the-law' injunctions are unenforceable.").

<sup>33</sup> McAfee, Inc., Litigation Release No. 19,520, 2006 SEC LEXIS 2360 (Jan. 4, 2006).

<sup>34</sup> See Jennifer O'Hare, *The Use of the Corporate Monitor in SEC Enforcement Actions*, 1 BROOK. J. CORP., FIN. & COM. L. 89, 94-99 (2006) (describing the appointment and activities of the WorldCom monitor, Richard Breeden).

<sup>35</sup> See Vikramaditya Khanna & Timothy L. Dickinson, *The Corporate Monitor: The New Corporate Czar?*, 105 MICH. L. REV. 1713 (2007) (describing the use of corporate monitors in criminal cases, including cases involving the SEC); Sue Reisinger, *Someone to Watch Over You*, CORP. CSL., Sept. 20, 2007, available at <http://www.law.com/jsp/inc/PubArticleIHC.jsp?id=1190192571246> (describing the use of monitors in 28 criminal cases).

## A. New Management Structures and Personnel

Sometimes, as in the *Qwest* settlement,<sup>36</sup> the SEC insists upon the creation of new compliance bureaucracies. Often, this means simply the creation of a new senior management position. Minuteman International, Inc., for example, agreed to create the position of Chief Accounting Officer.<sup>37</sup> Charter Communications, Inc. agreed to create a position known as Corporate Director of Credit and Collections.<sup>38</sup> It may also, however, involve the creation of complete departments and new reporting structures.

An extreme example involves Columbia Management Advisors. In response to allegations that the company had favored certain mutual fund clients and permitted them to engage in "market timing," Columbia's settlement with the SEC included the creation of a completely new "Compliance and Oversight Structure."<sup>39</sup> The settlement required the creation of a Code of Ethics Oversight Committee comprised of senior executives who would meet quarterly; the creation of an Internal Compliance Controls Committee; the creation of a new full-time senior-level position to address conflicts of interest; the establishment of an employee-ombudsman position; and a commitment by the chief compliance officer to make quarterly reports to the fund's outside directors (known in this case as "independent trustees").<sup>40</sup> The settlement also required a biennial outside review of the defendant's compliance programs.<sup>41</sup>

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<sup>36</sup> See *Qwest Commc'ns Int'l, Inc.*, Litigation Release No. 18,936, 2004 SEC LEXIS 2403 (Oct. 21, 2004).

<sup>37</sup> *In re Minuteman Int'l, Inc.*, Exchange Act Release No. 47,894, 2003 SEC LEXIS 1228, at \*16 (May 21, 2003).

<sup>38</sup> *In re Charter Commc'ns, Inc.*, Exchange Act Release No. 50,098, 2004 SEC LEXIS 1589, at \*15 (July 27, 2004).

<sup>39</sup> *In re Columbia Mgmt. Advisors, Inc.*, Securities Act Release No. 8534, Exchange Act Release No. 51,164, Investment Company Act Release No. 26,752, 2005 SEC LEXIS 289, at \*8, 48-62 (Feb. 9, 2005).

<sup>40</sup> *Id.* at \*49-52.

<sup>41</sup> *Id.* at \*62.

Other SEC settlements have required the creation of senior-level compliance or oversight committees,<sup>42</sup> check-and-balance procedures to guard against improper professional conduct,<sup>43</sup> and specific assignments and day-to-day practices designed to minimize risk.<sup>44</sup> In a handful of cases involving accounting firms, the settlement terms have also included revision of the defendant's business model and withdrawal from certain markets.<sup>45</sup>

## B. New Board-Level Structures and Board Practices

In addition to new management structures and personnel assignments, the SEC occasionally also requires the creation of board-level committees and new board procedures. Recent settlements have included provisions for creation of

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<sup>42</sup> See, e.g., *In re Bear, Stearns & Co., Inc.*, Securities Act Release No. 8668, Exchange Act Release No. 53,490, Investment Company Act Release No. 27,262, 2006 SEC LEXIS 623, at \*81-82 (Mar. 16, 2006). *In re Millennium Partners, L.P.*, Securities Act Release No. 8639, Exchange Act Release No. 52,863, Investment Company Act Release No. 27,172, 2005 SEC LEXIS 3078, at \*27 (Dec. 1, 2005).

In at least one settlement, the composition of the compliance committee was specified: "to be chaired by the Vice President, Securities Compliance of Hartford Life, [and to include] senior business leaders from the Investment Products Division, at least one member of Hartford Life's legal department and at least one member of the Disclosure Review Committee." *In re Hartford Inv. Fin. Servs., LLC*, Securities Act Release No. 8750, Exchange Act Release No. 54,720, Investment Company Act Release No. 27,549, 2006 SEC LEXIS 2571, at \*21 (Nov. 8, 2006).

<sup>43</sup> *In re KPMG LLP*, Exchange Act Release No. 50,564, 2004 SEC LEXIS 2388, at \*42 (Oct. 20, 2004) (requiring the firm's auditors to consult with the Department of Professional Practice under enumerated circumstances, and to have the Department of Professional Practice review and approve documents for certain clients).

<sup>44</sup> *In re PKF*, Securities Act Release No. 8675, Exchange Act Release No. 53,633, 2006 SEC LEXIS 833, at \*44 (Apr. 12, 2006) (requiring the firm to involve a Quality Control and Compliance Partner in all audit engagements of "high risk" clients).

<sup>45</sup> *Id.* (prohibiting the firm from taking on any new U.S. public company audit clients for a period of one year); *In re Grant Thornton LLP*, Exchange Act Release No. 50,148, 2004 SEC LEXIS 1703, at \*50 (Aug. 5, 2004) (prohibiting the firm from engaging in joint audits for a period of five years).

temporary committees to select the outside consultants who will devise corrective post-settlement measures,<sup>46</sup> creation of permanent committees to oversee ongoing compliance activities,<sup>47</sup> and specific tasks for compliance and audit committees.<sup>48</sup> Settlements frequently call for enhancements to training programs for members of the board.<sup>49</sup> They sometimes also require expansion of the board and even may include a statement of qualifications for board membership.<sup>50</sup>

In rare cases (typically those also involving criminal prosecution), we find more intrusive provisions at the board level: the separation of the positions of Chairman and CEO;<sup>51</sup> the amendment of bylaws to create term limits for outside directors;<sup>52</sup> and the appointment of an "Inspector General" who reports directly to the Audit Committee.<sup>53</sup> In a few

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<sup>46</sup> *In re Akorn, Inc.*, Exchange Act Release No. 48,546, 2003 SEC LEXIS 2276, at \*13 (Sept. 25, 2003).

<sup>47</sup> *Computer Assocs. Int'l, Inc.*, Litigation Release No. 18,891, 2004 SEC LEXIS 2157, at \*7 (Sept. 22, 2004) (creating a new Compliance Committee of the Board of Directors).

<sup>48</sup> *In re Hartford Inv. Fin. Servs. LLC*, Securities Act Release No. 8750, Exchange Act Release No. 54,720, Investment Company Act 27,549, 2006 SEC LEXIS 2571, at \*21 (Nov. 8, 2006) (requiring an annual presentation to the board's Compliance Committee, including a thorough review of the company's revenue sharing arrangements); *In re Coca Cola Co.*, Securities Act Release No. 8569, Exchange Act Release No. 51,565, 2005 SEC LEXIS 861, at \*23 (Apr. 18, 2005) (requiring the Audit Committee to generate a set of criteria for use in the preparation of the Management Discussion and Analysis (MD&A) section of the company's public filings).

<sup>49</sup> *In re Applix, Inc.*, Securities Act Release No. 8651, Exchange Act Release No. 53,049, 2006 SEC LEXIS 8, at \*14 (Jan. 4, 2006).

<sup>50</sup> *In re Microstrategy, Inc.*, Exchange Act Release No. 43,724, 2000 SEC LEXIS 2764, at \*21 (Dec. 14, 2000) (requiring the appointment of an additional independent board member who shall have prior experience as a Chief Financial Officer of a public company or as a member of a public company Audit Committee).

<sup>51</sup> *Parmalat Finanziaria, S.p.A.*, Litigation Release No. 18,803, Accounting & Auditing Release No. 2065, 2004 SEC LEXIS 1631, at \*5 (July 28, 2004).

<sup>52</sup> *Id.*

<sup>53</sup> *HealthSouth Corp.*, Litigation Release No. 19,280, 2005 SEC LEXIS 1480, at \*2 (June 23, 2005).

cases involving regulated entities, we find additional provisions aimed at the board of directors: a requirement that the chairman be an independent director with no prior involvement in the allegations brought by the SEC;<sup>54</sup> a limitation on the number of incumbent directors who may continue to serve as members of the board;<sup>55</sup> and a requirement that future decisions receive a majority vote of independent directors.<sup>56</sup> Generally though, and especially in cases involving public issuers, we rarely see “deep governance reforms”<sup>57</sup> incorporated into SEC civil settlements. Indeed, the Commission expressly disclaims any interest in intruding into high-level corporate governance decisions in cases involving public issuers.<sup>58</sup>

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<sup>54</sup> *In re Banc of Am. Capital Mgmt., LLC*, Securities Act Release No. 8538, Exchange Act Release No. 51,167, Investment Company Act Release No. 26,756, 2005 SEC LEXIS 291, at \*61 (Feb. 9, 2005); *In re Columbia Mgmt. Advisors, Inc.*, Securities Act Release No. 8534, Exchange Act Release No. 51,164, Investment Company Act Release No. 26,752, 2005 SEC LEXIS 289, at \*43 (Feb. 9, 2005).

<sup>55</sup> *In re Banc of Am. Capital Mgmt., LLC*, Securities Act Release No. 8538, Exchange Act Release No. 51,167, Investment Company Act Release No. 26,756, 2005 SEC LEXIS 291, at \*60 (Feb. 9, 2005); *In re Columbia Mgmt. Advisors, Inc.*, Securities Act Release No. 8534, Exchange Act Release No. 51,164, Investment Company Act Release No. 26,752, 2005 SEC LEXIS 289, at \*43 (Feb. 9, 2005).

<sup>56</sup> *In re Banc of Am. Capital Mgmt., LLC*, Securities Act Release No. 8538, Exchange Act Release No. 51,167, Investment Company Act Release No. 26,756, 2005 SEC LEXIS 291, at \*62 (Feb. 9, 2005); *In re Columbia Mgmt. Advisors, Inc.*, Securities Act Release No. 8534, Exchange Act Release No. 51,164, Investment Company Act Release No. 26,752, 2005 SEC LEXIS 289, at \*44 (Feb. 9, 2005).

<sup>57</sup> See Garrett, *supra* note 4 and accompanying text.

<sup>58</sup> See Cedric Kushner Promotions, Inc., Litigation Release No. 19,485, 2005 SEC LEXIS 3124, at \*3 (Dec. 5, 2005).

The remedial undertakings [in this case] include appointment of new Chief Executive and Financial Officers, creation of an independent audit committee and majority independent board of directors, and retention of an independent consultant to analyze the company's internal accounting controls, recommend improvements and oversee implementation of those improvements. *These undertakings represent an unusual departure from the*

### C. Employee Training Programs

Often, the problem giving rise to systemic fraud is exacerbated by the lack of appropriate training and feedback for employees, especially professional employees involved in a company's finance or reporting functions. Thus, many SEC settlements call for the development of employee training programs. In settlements involving the accounting firms Grant Thornton and Ernst & Young, for example, the firms were required to provide their audit professionals with fraud detection training conducted by the Association of Certified Fraud Examiners.<sup>59</sup> A settlement with KPMG required re-training for all of the firm's partners and managers.<sup>60</sup> A settlement with the Boston Stock Exchange required the Exchange to provide re-training for its regulatory staff.<sup>61</sup>

### D. Engagement of Compliance Consultants

One of the most common therapeutic sanctions in SEC settlements is an order to hire an outside consultant to guide

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*Commission's policy of limited intrusion into corporate governance, but were required by the unique facts of this case: the company's current two person board of directors consists of its Chairman, President and CEO Kushner who will not be barred from serving as an officer or director of any public company, and its Principal Financial and Accounting Officer James DiLorenzo who is a defendant litigating similar charges of fraud brought by the Commission. Further, Kushner and DiLorenzo collectively are beneficial owners of 45% of the company's outstanding voting shares.*

*Id.* (emphasis added).

<sup>59</sup> *In re Grant Thornton LLP*, Exchange Act Release No. 50,148, 2004 SEC LEXIS 1703, at \*50 (Aug. 5, 2004); *In re Ernst & Young Chartered Accountants*, Exchange Act Release No. 56,104, 2007 SEC LEXIS 1593, at \*29 (July 19, 2007).

<sup>60</sup> *In re KPMG LLP*, Exchange Act Release No. 50,564, 2004 SEC LEXIS 2388, at \*41 (Oct. 20, 2004).

<sup>61</sup> *In re Boston Stock Exch., Inc.*, Exchange Act Release No. 56,352, 2007 SEC LEXIS 1961, at \*17 (Sept. 5, 2007). *See also In re Am. Stock Exch. LLC*, Exchange Act Release No. 55,507, 2007 SEC LEXIS 535, at \*35 (Mar. 22, 2007) (requiring re-training for all floor staff).

the company in improving its financial reporting procedures. This type of sanction has been praised by some scholars as an ideal bridge between self-regulation and traditional, command-and-control regulation.<sup>62</sup> The theory is that engagement of a consultant to devise remedial strategies creates “a temporal, structural, and dialogical space for trying to work through stubborn cultural problems.”<sup>63</sup>

In a case alleging that ConAgra had under-reported its tax liabilities by \$105 million, for example, the SEC required that ConAgra engage an independent consultant to review the company's policies and procedures with respect to reporting certain reserve accounts and prescribe a menu of operational reforms.<sup>64</sup> In a case involving Akorn, Inc., the SEC required engagement of an independent consultant to review the company's policies and procedures with respect to accounts receivable.<sup>65</sup>

Consultants may address a broad range of issues affecting a company's accounting and reporting practices—the adequacy of a company's compliance resources (including staffing and compensation),<sup>66</sup> the adequacy of procedures for handling inventory valuation,<sup>67</sup> the relationship between sales and finance employees in revenue recognition

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<sup>62</sup> David Hess & Cristie L. Ford, *Corporate Corruption and Reform Undertakings: A New Approach to an Old Problem*, CORNELL INT'L L. J. (forthcoming) (manuscript at 6), available at <http://ssrn.com/abstract=1029849> (arguing that when undertaken with care, independent monitoring provides the best available means for addressing problems of organizational culture).

<sup>63</sup> *Id.* (manuscript at 41).

<sup>64</sup> ConAgra Foods, Inc., Litigation Release No. 20,206, 2007 SEC LEXIS 1610, at \*6 (July 25, 2007). In addition, ConAgra had to pay a \$45 million civil penalty and consent to an obey-the-law injunction. *Id.* at \*5.

<sup>65</sup> *In re Akorn, Inc.*, Exchange Act Release No. 48,546, 2003 SEC LEXIS 2276, at \*13 (Sept. 25, 2003).

<sup>66</sup> *In re Boston Stock Exch., Inc.*, Exchange Act Release No. 56,352, 2007 SEC LEXIS 1961, at \*17 (Sept. 5, 2007) (requiring the defendant to retain an independent auditor to evaluate the adequacy of the company's resources, including staffing and compensation, related to surveillance, investigation, examination, and disciplinary programs).

<sup>67</sup> *In re Warnaco Group, Inc.*, Exchange Act Release No. 49,675, 2004 SEC LEXIS 955, at \*38 (May 11, 2004).

determinations,<sup>68</sup> the mechanics of signing and dating sales contracts and purchase orders and the generation of sales invoices to customers,<sup>69</sup> and a company's practices with respect to disclosure generally.<sup>70</sup>

Consultants may also address other systemic issues. They have been charged with designing procedures for avoiding liability for foreign payments under the Foreign Corrupt Practices Act,<sup>71</sup> procedures governing the misuse of non-public information,<sup>72</sup> regulations governing travel and entertainment expenses,<sup>73</sup> systems for receipt and retention of e-mail communications,<sup>74</sup> and even pricing policies.<sup>75</sup> Once adopted, the consultants' recommendations themselves become subject to periodic review by other consultants.<sup>76</sup>

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<sup>68</sup> *In re Applix, Inc.*, Securities Act Release No. 8651, Exchange Act Release No. 53,049, 2006 SEC LEXIS 8, at \*14 (Jan. 4, 2006).

<sup>69</sup> *In re Aspen Tech., Inc.*, Securities Act Release No. 8827, Exchange Act Release No. 56,170, 2007 SEC LEXIS 1656, at \*23 (July 31, 2007).

<sup>70</sup> *Cardinal Health, Inc.*, Litigation Release No. 20,212, 2006 SEC LEXIS 1622, at \*4 (July 26, 2007) (in addition to paying a \$35 million civil penalty, the company agreed to retain an independent consultant to conduct a review of its disclosure practices).

<sup>71</sup> *In re Statoil, ASA*, Exchange Act Release No. 54,599, 2006 SEC LEXIS 2321, at \*21 (Oct. 13, 2006).

<sup>72</sup> *In re Hutchens Inv. Mgmt. Inc.*, Investment Advisers Act of 1940 Release No. 2514, 2006 SEC LEXIS 1039, at \*15 (May 9, 2006).

<sup>73</sup> *In re Jeffries & Co.*, Exchange Act Release No. 54,861, 2006 SEC LEXIS 2813, at \*12 (Dec. 1, 2006).

<sup>74</sup> *In re Kaplan & Co. Sec., Inc.*, Exchange Act Release No. 55,954, Investment Company Act Release No. 27,601, 2006 SEC LEXIS 2946 at \*19 (Dec. 18, 2006); *In re Morgan Stanley*, Litigation Release No. 19,693, 2006 SEC LEXIS 1052 at \*2 (May 10, 2006).

<sup>75</sup> *In re Kelmoore Inv. Co., Inc.*, Securities Act Release No. 8774, Exchange Act Release No. 55,123, Investment Company Act Release No. 27,667, 2007 SEC LEXIS 101, at \*4 (Jan. 18, 2007).

<sup>76</sup> *In re Federated Inv. Mgmt. Co.*, Exchange Act Release No. 52,839, Investment Company Act Release No. 27,167, 2005 SEC LEXIS 3038 at \*27 (Nov. 28, 2005) (requiring a Periodic Compliance Review at least once every three years); *In re Invesco Funds Group, Inc.*, Exchange Act Release No. 50,506, Investment Company Act Release No. 26,629, 2004 SEC LEXIS 2318, at \*37 (Oct. 8, 2004) (requiring a Periodic Compliance Review at least every other year).



Typically, settlements calling for the use of a compliance consultant require approval of the consultant by the SEC staff,<sup>77</sup> a timeline for submission of the consultant's report(s),<sup>78</sup> and a promise that the defendant will adopt the consultant's recommendations even in the event of a principled disagreement.<sup>79</sup> Defendants do not have the authority to terminate the independent consultant without prior permission of the SEC staff.<sup>80</sup> They must authorize the consultant to share information with the staff; all privileges must be waived.<sup>81</sup> And, finally, the consultant is barred from providing any ancillary services to the defendant and its

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<sup>77</sup> *In re* Gen. Am. Life Ins. Co., Securities Act Release No. 8832, Exchange Act Release No. 56,229, Investment Company Act Release No. 27,925, 2007 SEC LEXIS 1767, at \*14 (Aug. 9, 2007) ("General American shall retain, within 90 days of the date of entry of the Order, the services of an Independent Compliance Consultant not unacceptable to the staff of the Commission.").

<sup>78</sup> *In re* Dunham & Assocs. Holdings, Inc., Securities Act Release No. 8740, Exchange Act Release No. 54,489, Investment Company Act Release No. 27,495, 2006 SEC LEXIS 2099, at \*11 (Sept. 22, 2006) ("At the end of the review, which in no event shall be more than 150 days after the date of this Order, [the defendant] shall require the Independent Consultant to submit to [the defendant] and to Briane Nelson Mitchell or another designated representative of the Commission's Pacific Regional Office in Los Angeles an Independent Consultant's Report. The Independent Consultant's Report shall describe the review performed and the conclusions reached and shall include any recommendations deemed necessary to make the policies and procedures adequate and address the deficiencies identified in [a previous section of this] Order.").

<sup>79</sup> *In re* Schnitzer Steel Indus., Inc., Exchange Act Release No. 54,606, SEC LEXIS 2332, at \*5 (Oct. 16, 2006) ("[The defendant] shall adopt all recommendations in the report of the Compliance Consultant; provided, however, [reference here to a mediation procedure]. In the event [the defendant] and the Compliance Consultant are unable to agree . . . [the defendant] shall abide by the determinations of the Compliance Consultant.").

<sup>80</sup> *In re* A.G. Edwards & Sons, Inc., Exchange Act Release No. 55,692, 2007 SEC LEXIS 891, at \*6 (May 2, 2007).

<sup>81</sup> *Id.* ("[The defendant] shall not be in and shall not have an attorney-client relationship with the Independent Consultant and shall not seek to invoke the attorney-client privilege or any other doctrine or privilege to prevent the Independent Consultant from transmitting any information, reports or documents to the Commission or the Commission's staff.").

managers for a period of two years following completion of the consultant's final report.<sup>82</sup>

The scope of the consultant's work varies in these settlements. Sometimes, the range of issues to be considered by the consultant is broad;<sup>83</sup> at other times, the assignment

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<sup>82</sup> See, e.g., *In re Aspen Tech., Inc.*, Securities Act Release No. 8827, Exchange Act Release No. 56,170, 2007 SEC LEXIS 1656, at \*26 (July 31, 2007) ("... [F]or the period of engagement and for a period of two years from completion of the engagement, the Independent Consultant shall not enter into any employment, consultant, attorney-client, auditing or other professional relationship with [the defendant], or any of its present or former affiliates, directors, officers, employees, or agents, respectively, acting in their capacity as such.").

<sup>83</sup> See, e.g., *In re Vertical Capital Partners, Inc.*, Exchange Act Release No. 55,177, Investment Advisers Act of 1940 Release No. 2586, 2007 SEC LEXIS 150, at \*13 (Jan. 25, 2007) (authorizing the consultant to conduct "a comprehensive review of Vertical's supervisory, compliance, and other policies and procedures designed to prevent and detect conflicts of interest, breaches of fiduciary duty, and federal securities law violations by Vertical and its employees. This review shall include, but shall not be limited to, a review of Vertical's policies and procedures in the areas of trade processing, compensation of registered representatives, and the training of registered and unregistered staff"); *In re Fred Alger Mgmt. Inc.*, Exchange Act Release No. 55,118, Investment Company Act Release No. 27,663, 2007 SEC LEXIS 100 (Jan. 18, 2007) at \*29 (authorizing the consultant to conduct a "comprehensive review of Respondents' supervisory, compliance, and other policies and procedures designed to prevent and detect breaches of fiduciary duty, breaches of the Code of Ethics and federal securities law violations by Respondents and their employees. This review shall include, but shall not be limited to, a review of Respondents' market timing controls, Respondents' sales and distribution practices, a review of the Alger funds' pricing practices that may make those funds vulnerable to market timing, a review of the Alger funds' utilization of short term trading fees and other controls for deterring excessive short term trading"); *In re Banc of Am. Capital Mgmt., LLC*, Securities Act Release No. 8538, Exchange Act Release No. 51,167, Investment Company Act Release No. 26,756, 2005 SEC LEXIS 291, at \*82 (Feb. 9, 2005) (authorizing the consultant to conduct "a comprehensive review of BAS's supervisory, compliance, and other policies and procedures designed to prevent and detect conflicts of interest, breaches of fiduciary duty, breaches of the Code of Ethics and federal securities law violations by BAS and its employees related to the retail sale and retail brokerage order processing of mutual funds").

is narrowly drawn.<sup>84</sup> Sometimes, and wisely, the detailed scope of work is left to be worked out between the defendant and the consultant, subject to the SEC's approval.<sup>85</sup> Though there is little public information about the costs of these arrangements (or the identity of the consultants selected), the fees for a consultant may run as high as millions of dollars each year.<sup>86</sup>

### E. Micromanagement By Consent

In some cases, SEC settlements prescribe changes in corporate practices with remarkable specificity. For example, the SEC alleged that Charter Communications, Inc., a cable provider, had ignored customer requests to

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<sup>84</sup> See, e.g., *In re Aspen Tech. Inc.*, Securities Act Release No. 8827, Exchange Act Release No. 56,170, 2007 SEC LEXIS 1656, at \*23 (July 31, 2007) (authorizing the consultant "to review Aspen's financial and accounting policies and procedures relating to: (i) revenue recognition on software licensing agreements, including the consideration of SOP 97-2 and documentation of that consideration; (ii) the signing and dating of material sales contracts and purchase orders and the retention by Aspen's corporate finance organization of all such contracts and purchase orders; (iii) written documentation that all sales contingencies have been met in material revenue transactions; (iv) the generation and issuance to customers of sales invoices; and (v) the preparation and review of accounts receivable confirmations. Aspen shall require the Independent Consultant to also consider, based on his/her review, the nature and extent of Aspen's Board of Directors training required to minimize the possibility of future violations of the federal securities laws by Aspen, acting through its finance and accounting employees").

<sup>85</sup> See *In re E\*Trade Clearing LLC*, Exchange Act Release No. 58,250, 2008 SEC LEXIS 1793, at \*9 (July 30, 2008) ("E\*Trade will require the consultant, within sixty (60) days of the Consultant's engagement, to develop a written plan of sufficient scope and detail to achieve the regulatory review objectives set forth in Paragraph 14.d below.").

<sup>86</sup> See Reisinger, *supra* note 35 (noting that one consultant, a former federal judge, had submitted bills over a 16-month period totaling \$7.2 million); Philip Shenon, *Ashcroft Deal Brings Scrutiny in Justice Dept.*, N.Y. TIMES, Jan. 10, 2008, at A1 (describing arrangement by which former Attorney General John Ashcroft was appointed as monitor in a criminal case, resulting in a contract worth between \$28 million and \$52 million).

discontinue service.<sup>87</sup> This permitted Charter to overstate its subscriber base and thereby inflate its financial statements. Charter's settlement of the case included detailed undertakings on the subject of handling requests to discontinue service.<sup>88</sup> It also specified the mechanism for record-keeping for customers who were late in paying their bills.<sup>89</sup> It prescribed a "bottom up" rather than a "top down"

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<sup>87</sup> *In re* Charter Commc'ns, Inc., Exchange Act Release No. 50,098, 2004 SEC LEXIS 1589 (July 27, 2004).

<sup>88</sup> *Id.*

[The company will] adopt a zero tolerance policy on holding or managing disconnects in order to inflate subscriber numbers and terminate employee found to be managing or holding disconnects for this purpose. In addition, Charter's Chief Executive Officer will issue quarterly written reminders to all employees regarding Charter's zero tolerance policy for holding or managing disconnects in order to inflate subscriber numbers.

*Id.* at \*5.

<sup>89</sup> *Id.*

[The company will] institute a formal written policy that details disconnect procedures for terminating the service of delinquent paying subscribers. This policy will require that delinquent paying customers' service be terminated 60 to 75 days after their account balance becomes past due ("termination date") and that their balances be written off to bad debt 90 to 110 days after their account balances become past due ("write off date"). Charter may specifically identify a few categories of subscribers that, for historical business reasons, Charter permits to remain as active subscribers for more than 75 days after a bill becomes past due. Any exceptions Charter makes to allow a delinquent paying customer to remain an active subscriber after 75 days of non-payment shall be documented, reviewed and approved by Key Market Area management personnel at or before the close of each billing cycle . . . .

*Id.*

budgeting process for the company.<sup>90</sup> It even specified revisions to the method of setting employee compensation.<sup>91</sup>

This kind of micromanagement often occurs in cases involving regulated entities. In a case involving misrepresentations by Edwards D. Jones & Co. about its representatives' compensation in the sale of so-called 529 plans (investments for future educational costs), the settlement included detailed undertakings governing the marketing of these plans.<sup>92</sup> In a case against Bear, Stearns involving late trading and market timing, the settlement included a provision addressing the specifics of a new compliance program.<sup>93</sup>

Presumably, all these undertakings were approved by the defendants' lawyers. Still, prescribing these practices so

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<sup>90</sup> *Id.* at \*6.

<sup>91</sup> *Id.*

<sup>92</sup> *In re* Edward D. Jones & Co., L.P., Securities Act Release No. 8520A, Exchange Act Release No. 50,910A, 2007 SEC LEXIS 1547, at \*7 (July 13, 2007).

<sup>93</sup> *In re* Bear, Stearns & Co., Inc., Securities Act Release No. 8668, Exchange Act Release No. 53,490, Investment Company Act No. 27,262, 2006 SEC LEXIS 623, at \*88 (Mar. 16, 2006).

Respondents shall establish, within 30 days after the entry of this Order, a Compliance Hotline and appoint an appropriate compliance or legal officer(s) to be available to answer questions, on an anonymous basis, about business practices or ethical issues and to receive complaints from employees regarding any conduct that may be a cause for concern. Employees shall be provided with the email address and telephone number for the Compliance Hotline. Respondents will also provide all employees with quarterly compliance alerts identifying areas of interest and providing the email and telephone numbers for the Compliance Hotline . . . .

*Id.*; see also *In re* Banc of Am. Securities LLC, Exchange Act Release No. 55,466, 2007 SEC LEXIS 492, at \*47-66 (Mar. 24, 2007) (detailing dozens of items to implement the separation of market analysis from investment banking); *In re* Putnam Inv. Mgmt. LLC, Investment Company Act Release No. 26,788, 2005 SEC LEXIS 675, at \*21-25 (Mar. 23, 2005) (detailing procedures governing the selection of broker-dealers through which the defendant may trade).

narrowly may stifle mid-course correction and leave managers wondering where to go for permission to adjust arrangements that do not work. Defendants would undoubtedly prefer a “blank check” approach, in which they undertake merely to find their own solution to a problem and report the results to the SEC staff.<sup>94</sup>

### III. THE EVOLUTION OF THERAPEUTIC UNDERTAKINGS

In preparing this Article, I interviewed eight lawyers who either work in the SEC’s Enforcement Division or represent defendants in SEC enforcement proceedings.<sup>95</sup> Most of the defense lawyers are also former SEC lawyers, so they were able to describe the negotiation process from both sides of the table. I promised each of these sources anonymity and found them to be not only generous with their time but also candid and thoughtful in their comments. What follows is a compilation of their observations, highlighting issues upon which they did not always agree.

First, two of the sources offered a historical perspective on the use of corporate therapeutics by the SEC. The practice began during the tenure of former Enforcement Chief Stanley Sporkin.<sup>96</sup> Sporkin particularly liked to require the appointment of consultants in cases involving regulated entities—his thought was that putting a consultant in place had the effect of “extend[ing] the power of the Enforcement staff.”<sup>97</sup> In Sporkin’s view, the consultant

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<sup>94</sup> See, e.g., *In re Bear, Stearns & Co., Inc.*, Securities Act Release No. 8756, Exchange Act Release No. 54,806, 2006 SEC LEXIS 2701, at \*2 (Nov. 21, 2006).

<sup>95</sup> These interviews were conducted as follows: Source #1 (Sept. 26, 2007; Nov. 15, 2007); Source #2 (Sept. 27, 2007); Source #3 (Oct. 1, 2007); Source #4 (Oct. 2, 2007); Source #5 (Oct. 2, 2007); Source #6 (Oct. 15, 2007); Source #7 (Oct. 22, 2007); Source #8 (Oct. 22, 2007).

<sup>96</sup> Judge Sporkin was director of the division from 1974-1981. John F. Berry, *An SEC Legacy: Sporkin Known As Tough, Open*, WASH. POST, Apr. 22, 1981, at E1.

<sup>97</sup> Source #1.

was there to serve as the “eyes and ears” of the staff and to “complete their investigation from the inside.”<sup>98</sup>

Later, the Enforcement Division broadened the use of compliance consultants and other therapeutic sanctions to cases involving public issuers.<sup>99</sup> Sporkin’s staff became “very aggressive” in their use of therapeutic settlement terms—requiring “audit committees, different kinds of directors, [and] restructurings.”<sup>100</sup> Settlements then, as now, were “heavily negotiated.”<sup>101</sup>

### A. The Enforcement Staff’s Approach to Therapeutic Undertakings

Today, the Enforcement staff decides early on if it intends to seek therapeutic sanctions. Three factors are important in this determination: (1) whether the company’s wrongdoing was a product of “dismal internal controls” or was an isolated incident; (2) what the company has done proactively since the discovery of the wrongdoing to remediate the problem; and (3) how fast the settlement discussions proceed.<sup>102</sup> (Ironically, a quick settlement may be more likely to include therapeutic provisions than a settlement that comes later, after the company has cleaned up its own mess.)

In most cases that have arisen since passage of the Sarbanes-Oxley Act,<sup>103</sup> the defendant had already adopted various types of compliance programs.<sup>104</sup> Most well-lawyered companies, upon learning of the SEC’s interest, have also conducted an internal investigation and their audit committees have adopted some form of remediation plan.<sup>105</sup>

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<sup>98</sup> *Id.*

<sup>99</sup> *Id.*

<sup>100</sup> Source #3.

<sup>101</sup> *Id.*

<sup>102</sup> Source #2.

<sup>103</sup> Public Company Accounting Reform and Investor Protection (Sarbanes-Oxley) Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (codified as amended in scattered sections of 15, 18 U.S.C.).

<sup>104</sup> Source #3.

<sup>105</sup> The template for a remediation plan is the so-called “Seaboard Report.” See *infra* notes 169-70 and accompanying text.

So, "by the time the staff gets to [the negotiation phase], much of the correction has already been done."<sup>106</sup> In the worst cases, moreover, old management has been replaced.<sup>107</sup>

The task for the Enforcement staff, then, is to determine whether further corrective steps are required, in addition to the steps already taken "voluntarily."<sup>108</sup> There are resources available for making this determination—the Enforcement staff lawyer's own experience in other cases, lawyers in the Corporation Finance division, the Chief Accountant's office, and sometimes consultants engaged by the Commission.<sup>109</sup> "Hopefully, Enforcement consults within the Commission," but that may not always occur.<sup>110</sup> As noted below, much depends on who the lawyers are during the investigatory phase. The process is particularly unpredictable when it involves the regional offices rather than the Enforcement Division's main office in Washington, D.C.<sup>111</sup> (The regional offices are said by my sources to be "quite independent.")<sup>112</sup>

## B. Negotiating the Settlement Terms

Once it is clear that Enforcement wants to impose some type of therapeutic sanction, the Enforcement staff typically presents a first draft of a settlement agreement, cut-and-pasted from earlier settlements.<sup>113</sup> (The Enforcement staff does not like it when the defendant submits a first draft.)<sup>114</sup> The draft has typically been prepared by the junior-most person on the Enforcement team. Sometimes, the draft is "over the top" and "doesn't reflect the fact that a settlement has been [or is likely to be] reached."<sup>115</sup> Often, the first draft

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<sup>106</sup> Source #3.

<sup>107</sup> Source #4.

<sup>108</sup> See *infra* Part IV.

<sup>109</sup> Source #3.

<sup>110</sup> *Id.*

<sup>111</sup> Source #4.

<sup>112</sup> Source #1.

<sup>113</sup> *Id.*

<sup>114</sup> *Id.*

<sup>115</sup> *Id.*



includes a proposal for the appointment of a full-service compliance monitor.<sup>116</sup>

Then, the defense lawyers chip away at the proposed therapeutic provisions, both by exchange of “mark-ups” of the document and by in-person meetings with the Enforcement staff.<sup>117</sup> Defense lawyers try to avoid the most burdensome provisions—appointment of a monitor with broad supervisory powers, appointment of any form of compliance consultant, and a requirement that the company hire new people, in that order.<sup>118</sup>

The issue of compliance consultants is often a stumbling block because “everybody hates them.”<sup>119</sup> Not only are they expensive and disruptive, many clients believe that inclusion of a consultant in the terms of an SEC settlement agreement sends an adverse signal to the market.<sup>120</sup> For market-watchers who are paying attention, the staff’s insistence on inclusion of a consultant provision in a settlement involving

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<sup>116</sup> *Id.*

<sup>117</sup> *Id.*

<sup>118</sup> Source #2. They also try to avoid the inclusion in the settlement of an obey-the-law injunction. Clients believe such injunctions send an adverse market signal. They also may have significant collateral consequences, especially for regulated entities. Source #1.

<sup>119</sup> Source #1. The resistance to the use of compliance consultants was a common theme in my interviews with defense counsel. Consultants are “very intrusive; companies hate them.” Source #4. Their presence is “painful, time-consuming, and colossally expensive.” Source #2. Even where consultants generate good recommendations, “the cost usually far outweighs the benefit.” Source #8. One lawyer reports that a consultant for one of his clients “ran up a nine-figure bill with no discernible benefit to the company or the shareholders.” *Id.* Another concedes “you do hear stories of consultancies that have lost their way.” Source #7. Some consultants feel they “must justify themselves” so, after 18 months of investigation, they “come up with a bunch of busy work for people to do” in order to make their work seem valuable. *Id.* As a result, “firms are [often] forced to do things that don’t make sense.” Source #1. The prevailing view among my sources was that “few [law or consulting firms] can do this work well.” *Id.*

<sup>120</sup> Source #8.

a public issuer "often signal[s] continued mistrust by the staff of someone in senior management."<sup>121</sup>

In these discussions, any thought of a full-service monitor virtually always disappears<sup>122</sup> and, in Foreign Corrupt Practices Act ("FCPA") cases, the "consultant" provision almost never disappears. That is, FCPA settlements requiring the engagement of a compliance consultant are now "routine."<sup>123</sup> In other cases, however, insistence on the inclusion of therapeutic provisions depends largely on the Enforcement Division's lawyers' sense of the defendant's current corporate culture. "If the staff thinks the company is rotten, they'll be more insistent" on therapeutic sanctions.<sup>124</sup> Often the outcome hinges on the key question—"who did you fire?"<sup>125</sup>

The settlement process is often idiosyncratic. "Different staff people have different issues."<sup>126</sup> That is, some Enforcement lawyers "think [therapeutic provisions] are very important" and are inclined to want to "micromanage" the defendant.<sup>127</sup> Other Enforcement lawyers care much less about these items and view them largely as "window dressing."<sup>128</sup> To the second group, undertakings may "look good" but are unlikely to have much effect on the company. These lawyers prefer to seek entry of an obey-the-law injunction—the "crown jewel" of SEC settlement

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<sup>121</sup> Source #1.

<sup>122</sup> As noted above, full-service monitors are usually appointed only in cases involving criminal charges. *See supra* note 35.

<sup>123</sup> Source #2.

<sup>124</sup> Source #1. A former SEC lawyer who reviewed this Article mentioned a related scenario that might give rise to a demand for therapeutic sanctions. Not only do SEC lawyers react to what they perceive to be untrustworthiness on the part of corporate executives, they may also react to what they consider disrespect from the company's lawyers. "Sometimes it's personal." *Id.*

<sup>125</sup> Source #3. *See also infra* Part V.

<sup>126</sup> Source #3.

<sup>127</sup> Source #2.

<sup>128</sup> *Id.*

negotiations<sup>129</sup>—and leave the details of future compliance to the company.<sup>130</sup>

So, the outcome of settlement discussions may depend in part on the specific staff lawyers involved. And, it is sometimes necessary to take remedial issues “up the chain” within the Enforcement Division to the senior staff. Experienced defense lawyers have found that senior level staffers are often “[more] sensitive to invading state law issues.”<sup>131</sup> They are also “[more] mindful of imposing undertakings.”<sup>132</sup> They’re willing to offer “a lot of due process”<sup>133</sup> and sometimes substitute their judgment for that of the over-eager junior staff lawyers.<sup>134</sup> Overall, however, “there is not a lot of central direction on this kind of thing.”<sup>135</sup>

There are often other issues on the table. For example, there is the question of the size of the civil penalty. That is, just as negotiations proceed on the subject of therapeutic sanctions, they also proceed on the amount of the penalty.<sup>136</sup> Tradeoffs are never explicit—the SEC staff would “recoil at the thought that defendants could buy their way out” of a penalty simply by accepting more intrusive undertakings.<sup>137</sup>

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<sup>129</sup> Source #4.

<sup>130</sup> See, e.g., Veritas Software Corp., Litigation Release No. 20008, 2007 SEC LEXIS 341 (Feb. 21, 2007) (noting that the defendant had agreed to pay a \$30 million civil penalty and submit to entry of an obey-the-law injunction); Tenet Healthcare Corp., Litigation Release No. 20067, 2007 SEC LEXIS 610, at \*1-2 (Apr. 2, 2007) (a \$10 million penalty and an obey-the-law injunction).

<sup>131</sup> Source #1.

<sup>132</sup> *Id.*

<sup>133</sup> *Id.*

<sup>134</sup> *Id.* “When you get up high enough—past the people who are wedded to the case”—a lawyer can often soften the terms of a settlement. This may include denial of the lower-level staff’s “emotional demands for scalps.” *Id.*

<sup>135</sup> Source #4.

<sup>136</sup> Under current procedures, the Commission must set the parameters for a civil penalty before settlement negotiations begin. Thomas O. Gorman & William McGrath, *A Guide for Avoiding Liability: Understanding Key SEC Enforcement Policies and Priorities*, CORP. GOV. ADVISOR, July/Aug. 2008, at 21.

<sup>137</sup> Source #2.

But many companies are just “desperate for closure.”<sup>138</sup> So, there *are* tradeoffs. And “sometimes corporate governance undertakings are way down the list.”<sup>139</sup> That is, a firm may be anxious to reduce its penalty from, say, \$150 million to \$100 million, and if the cost of that is the acceptance of intrusive therapeutic provisions, including the appointment of a consultant or consultants, the company will willingly sign off.<sup>140</sup>

### C. Selection of the Compliance Consultant

Where a compliance consultant is part of the settlement package, the identity of the consultant is negotiable with the staff but is rarely contested.<sup>141</sup> That is, the company comes up with a suggested name or names.<sup>142</sup> The staff then spends some time talking with the person(s) selected.<sup>143</sup> The focus of the interview is primarily on two issues—the consultant’s “independence” and “perspective” on enforcement issues.<sup>144</sup> The staff takes the interview process “very seriously.”<sup>145</sup> Thus, well-advised companies know to turn to former SEC or

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<sup>138</sup> Source #1.

<sup>139</sup> *Id.*

<sup>140</sup> Another consideration sometimes on the table during settlement negotiations is whether the defendant will be charged with a violation of Rule 10b-5. Such charges, even if settled, “virtually guarantee a class action, [preclude] the use of the PSLRA safe harbor for forward looking statements for 3-5 years, and make the issuer ineligible for the ‘well known seasoned issuer’ (WKSI) offering procedures. Much mischief is done trying to avoid a fraud charge -- [payment of] higher fines, terminations of key employees, agreeing to findings of iffy reporting violations, re-styling an SEC antifraud injunction as an order enforcing NASD rules, etc.” E-mail from source to author, Nov. 13, 2007 (on file with the author).

<sup>141</sup> Source #4.

<sup>142</sup> Typically, the names are generated by the company’s outside counsel. From their perspective, the characteristics of a good consultant are (1) someone who will act responsibly—“they will recognize that the shareholders are paying their bill” and (2) someone with credibility with the SEC. Source #8.

<sup>143</sup> Source #6.

<sup>144</sup> *Id.*

<sup>145</sup> *Id.*

DOJ staffers as their candidates—"somebody [the staff lawyers] trust."<sup>146</sup>

It is also important, though, that the company can live with the consultant it has chosen, especially one with a broad remit. It is critical, therefore, to find a consultant who not only will be acceptable to the SEC staff,<sup>147</sup> but who also will "get" the defendant's business.<sup>148</sup> The consequences of making a bad selection—and having to live with unhelpful recommendations—can be costly.<sup>149</sup> So, the company has to be "very careful" in choosing its consultant.<sup>150</sup>

The consultant's scope of authority is also an issue for negotiation. Regulated entities are generally very familiar with these issues and have certain priorities for the text of their settlements. The principal priority is flexibility in adopting a compliance consultant's recommendations.<sup>151</sup> Companies want to be able to tweak those recommendations and, if necessary, seek relief from the staff. Public issuers may have less incentive to negotiate the details. Moreover, "[i]f the staff is insisting on a [compliance consultant] for [such a defendant], the alternatives by that point are far, far worse, and the company is simply at the mercy of the staffer."<sup>152</sup>

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<sup>146</sup> Source #4. The selection of SEC alumni as consultants may involve more than backscratching. A company may select an SEC (or DOJ) alum as its consultant because "they know what's likely to matter to the staff." Source #6.

<sup>147</sup> Actually, the language of SEC settlements is that a consultant be "not unacceptable" to the staff. *See supra* note 77.

<sup>148</sup> Source #6.

<sup>149</sup> Dealing with consultants—even good consultants—can be "enormously frustrating and time-consuming." Source #1. Most consultants "over-investigate." *Id.* They are also distracting—their presence month after month "can cripple the Controller's office." *Id.*

<sup>150</sup> Source #6.

<sup>151</sup> Source #1.

<sup>152</sup> *Id.*

## D. The Compliance Consultant In Action

Once the consultant is appointed, he or she is likely to maintain contact with the SEC staff while doing the work. This may involve exchange of documents or other information. Consultants try to keep the staff informed of how the work is going and extract some "general feedback" on the adequacy of their work.<sup>153</sup> The nature of these conversations, like the form of settlement, is often idiosyncratic to the lawyers involved. It may also depend on the prior relationship, if any, between the consultant and the Enforcement Division staff member(s) assigned to the case. (Many consultants have close personal friends within the agency.)

As noted above, most defense counsel believe that compliance consultants "milk" their clients by running up hours.<sup>154</sup> One of my sources who has served as a consultant conceded as much: "[when acting as a consultant,] I might as well do a really thorough job—no one will second-guess me."<sup>155</sup>

When the consultant submits his or her final report, the SEC's response depends on who's on the staff.<sup>156</sup> A few staff lawyers routinely like to "send them back and ask for more. [With other lawyers, the reports] just go into the drawer."<sup>157</sup>

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<sup>153</sup> Source #6. Sometimes this feedback is very directive. "Have you interviewed this person? Why not? Have you looked at this issue? Why not?" Source #8. The staff does have influence over the tasks the consultant takes on. They often seem to defense counsel to be "more the client than the client." *Id.*

<sup>154</sup> See *supra* note 119 and accompanying text.

<sup>155</sup> Source #8.

<sup>156</sup> Source #4.

<sup>157</sup> *Id.* Source #6 disagrees with Source #4's perception. She doubts these reports go "into the drawer" and insists that "the staff takes these remedies seriously." Still, the report and recommendations would have to be "pretty bad" for the staff to ask for revisions or further work. A consultant who has maintained contact with the staff should not end up with that problem. Source #6.

And, often, of course, the staff lawyer most knowledgeable about the case has moved on.<sup>158</sup>

Interestingly, there are few repeat players serving as compliance consultants.<sup>159</sup> Rather, the work is “very spread out.”<sup>160</sup> And some qualified people turn down the opportunity to serve as consultants. “[One has to] be careful which ones to take—there is a penalty.”<sup>161</sup> (That is, in most SEC settlements, anyone serving as a consultant is disqualified from providing any additional services to the defendant for a period of two years.)<sup>162</sup>

### E. Therapeutic Sanctions Today

Depending on whom one asks, SEC demands for therapeutic sanctions may be on the rise<sup>163</sup> or may have peaked.<sup>164</sup> (At least one lawyer believes the SEC staff is tiring of the use of compliance consultants, especially in cases involving regulated entities.<sup>165</sup> Another believes that the SEC staff is “less adventuresome across-the-board” today than it was just three years ago.<sup>166</sup>) Still, the SEC staff continues to insist upon therapeutic provisions in many SEC cases.

## IV. STRATEGIES FOR MINIMIZING THERAPEUTIC SANCTIONS

The conventional wisdom is that defendants can minimize both the breadth and depth of therapeutic sanctions through a series of corrective gestures prior to and during settlement discussions. Specifically, “if you can say ‘management has

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<sup>158</sup> Source #1.

<sup>159</sup> Source #6.

<sup>160</sup> *Id.*

<sup>161</sup> *Id.*

<sup>162</sup> See *supra* note 82.

<sup>163</sup> Source #6.

<sup>164</sup> Source #7.

<sup>165</sup> Source #1.

<sup>166</sup> Source #7.

turned over, we have a new board, etc.,' [you] may avoid [therapeutic] terms."<sup>167</sup>

The template (or "Bible"<sup>168</sup>) for making an argument like this is found in the "Seaboard Report" issued by the Commission in 2001.<sup>169</sup> The Seaboard Report sets out the factors that the Commission will take into account in deciding "whether to bring an enforcement action, pursue reduced charges, seek lighter sanctions, or include mitigating language in any SEC release and/or resolution of enforcement actions."<sup>170</sup> Some of the considerations set out in the Seaboard Report include whether the company conducted a thorough investigation, employed outside experts to conduct the investigation, adopted new internal control procedures, and removed the people responsible for the misconduct.<sup>171</sup>

Sometimes, Seaboard-type efforts result in a settlement that does not include any therapeutic provisions. For example, Coca-Cola Company engaged in significant corrective activities during the course of an SEC enforcement proceeding in which the company was alleged to have engaged in a version of "channel stuffing" in order to meet its earnings targets.<sup>172</sup> Coke's management established an Ethics and Compliance Office to administer its Code of Business Conduct, created a Disclosure Committee to assist the Chief Executive Officer and Chief Financial Officer in fulfilling their obligations under the Sarbanes-Oxley Act, and arranged for the Board's audit committee to employ

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<sup>167</sup> Source #1.

<sup>168</sup> Source #4.

<sup>169</sup> Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934 and Commission Statement on the Relationship of Cooperation to Agency Enforcement Decisions, Exchange Act Release No. 44,969, 2001 SEC LEXIS 2210 (Oct. 23, 2001).

<sup>170</sup> Christopher A. Wray & Robert K. Hur, *Corporate Criminal Prosecution in a Post-Enron World: The Thompson Memo in Theory and Practice*, 43 AM. CRIM. L. REV. 1095, 1109 (2006).

<sup>171</sup> *Id.* "Everybody knows [the Seaboard factors] by heart." Source #7.

<sup>172</sup> *In re Coca-Cola Co.*, Securities Act Release No. 8569, Exchange Act Release No. 51,565, 2005 SEC LEXIS 861, at \*4 (Apr. 18, 2005).



experienced legal counsel.<sup>173</sup> The resulting settlement consisted simply of a cease-and-desist order.<sup>174</sup>

Royal Dutch Petroleum Company similarly engaged in corrective activities following allegations that the company had materially misstated its international petroleum reserves.<sup>175</sup> It conducted an internal investigation, reported its findings to the SEC, significantly enhanced its audit function, restructured some of its subsidiaries (including their boards), and improved its training programs worldwide.<sup>176</sup> The result, in addition to payment of a \$120 million civil penalty, was an agreement that Royal Dutch would spend a further \$5 million to develop and implement a "comprehensive internal compliance program under the direction and oversight of [the defendant's] Legal Director . . . . Shell [further proposed] to report to the Commission staff within twelve months on the expenditure of the funds and the status of the compliance program."<sup>177</sup>

In many other cases, however, significant remedial efforts have failed to avert the inclusion of therapeutic sanctions in SEC settlements. In the *Millennium Partners* case, the defendants in the period leading up to the settlement had created the positions of Chief Legal Officer and Chief Compliance Officer, and had retained an independent consultant whose recommendations the company had adopted.<sup>178</sup> The Enforcement Division nevertheless insisted on appointment of a compliance consultant approved by the Commission.<sup>179</sup>

Cardinal Health, Inc., too, "hired a new chief financial officer, chief accounting officer and controller, and enhanced

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<sup>173</sup> *Id.* at \*22-23.

<sup>174</sup> *Id.* at \*25.

<sup>175</sup> *In re* Royal Dutch Petroleum Co., Exchange Act Release No. 50,233, 2004 SEC LEXIS 1832, at \*38 (Aug. 24, 2004).

<sup>176</sup> *Id.* at \*38-40.

<sup>177</sup> *Id.* at \*2, 45-46.

<sup>178</sup> *In re* Millennium Partners, L.P., Securities Act Release No. 8639, Exchange Act Release No. 52,863, Investment Company Act Release No. 27,172, 2005 SEC LEXIS 3078, at \*21-22 (Dec. 1, 2005).

<sup>179</sup> *Id.* at \*29.

its Finance staff to support the size and growth of Cardinal Health. The company also created the position of chief ethics and compliance officer . . . .<sup>180</sup> Here, too, however, the SEC staff insisted on appointment of a compliance consultant.<sup>181</sup>

Indeed, there are many cases in which the pre-settlement remediation efforts of the defendant are noted—sometimes at length—but the SEC nevertheless insists on intrusive therapeutic sanctions.<sup>182</sup> What distinguishes these cases from those cases in which the defendant's remedial efforts are persuasive in avoiding therapeutic sanctions? The sources interviewed for this Article made clear that it is difficult to answer this question and therefore to advise their clients on "how much remediation is enough."<sup>183</sup> It will not suffice, however, simply to claim "we've cleaned up our own house." Apparently, something more is needed.

According to my sources, the challenge for defense lawyers is to persuade the staff that their clients' remedial actions have been (or are likely to be) sufficient to protect investors, whatever that means. One way to try to satisfy

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<sup>180</sup> *Cardinal Health Announces Resolution of SEC Investigation; U.S. Attorney's Office Closes Related Inquiry*, PHARMA INVESTMENTS, VENTURES & LAW WEEKLY, Aug. 12, 2007, at 684.

<sup>181</sup> Cardinal Health, Inc., Litigation Release No. 20,212, 2007 SEC LEXIS 1622, at \*4 (July 26, 2007).

<sup>182</sup> See, e.g., *In re Fidelity Mgmt. Research Co., Investment Company* Act Release No. 28,185, 2008 SEC LEXIS 507, at \*81-83, 85 (Mar. 5, 2008) (noting that the defendant company had disciplined approximately two dozen employees, changed several of its policies and procedures, and reorganized the management of its equity trading operations, and the company's parent had substantially increased its ethics office's funding for technology and personnel, but the staff still required the engagement of a compliance consultant); *In re RS Inv. Mgmt., Inc., Investment Company* Act Release No. 26,627, 2004 SEC LEXIS 2299, at \*12-13, 23 (Oct. 6, 2004) (detailing defendant's extensive remedial efforts then concluding settlement with the appointment of a compliance consultant); *In re PA Fund Mgmt. LLC*, Exchange Act Release No. 50,384, Investment Company Act Release No. 26,598, 2004 SEC LEXIS 2085, at \*26, 33 (Sept. 15, 2004).

<sup>183</sup> "How much remediation is enough? Great question. I think . . . much depends on what [the Enforcement lawyers] ate for breakfast." Source #1. "Is the staff moved by [remedial efforts]? I'm not sure. . . . I'm not sure [what] works." Source #8.

the SEC is to “brag . . . about how much money [the company has] spent” on remediation.<sup>184</sup> Another is to preemptively hire an outside consultant known to the SEC.<sup>185</sup> The key, though, is to build the staff’s trust in the company’s current management.<sup>186</sup> That means defense counsel must try to persuade the staff either that the case involved a “bad apple in a good barrel . . . ; or a couple of bad apples but we have been able to spin off or close down that part of the operation.”<sup>187</sup> When those narratives are unavailable, the next best option is to convince the staff that “we’ve identified the problem and we’ve identified the solution.”<sup>188</sup> That is, part of the defense counsel’s job is to persuade the staff that the problem giving rise to the violation of the securities laws was “relatively easy to describe and relatively easy to ameliorate.”<sup>189</sup> Then, counsel can make the case that there is no need for any additional forms of “imposed reform.” Rather, the company should be permitted to design its own solution that fits its particular business. There is no need to hire a consultant who will “drop in from the sky.”<sup>190</sup>

If all these narratives are implausible, and the cause of the problem was indeed complex and systemic, then defense counsel has a more challenging (and possibly insurmountable) task. She must assure the staff that the client has identified and reorganized faulty systems, removed complicit participants in the scheme, and meaningfully changed the corporate culture. She must, in short, persuade the staff that the changes claimed are real and not merely atmospheric. And if that fails, she at least must be able to argue “(1) we take you [the SEC] seriously

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<sup>184</sup> Source #2.

<sup>185</sup> Source #8.

<sup>186</sup> Source #7.

<sup>187</sup> *Id.* Hess and Ford caution that “bad apple” arguments like this are inherently suspect. In many cases, they suggest, such claims of reform are not to be believed. Hess & Ford, *supra* note 62 (manuscript at 38).

<sup>188</sup> Source #7.

<sup>189</sup> *Id.*

<sup>190</sup> *Id.*

and (2) we're acting responsibly and we really want to do the right thing."<sup>191</sup>

## V. A WORD ON FIRING SENIOR EXECUTIVES

Several of the sources for this Article suggested that a key factor in avoiding or minimizing therapeutic sanctions is a decision to remove top-level executives. Indeed, sometimes the Enforcement staff lawyers "make it clear that there will be no settlement unless so-and-so is fired. (This is never in writing.)"<sup>192</sup> "They always want to be briefed on personnel changes" and they respond to these reports with informative body language.<sup>193</sup> In these cases, "the staff doesn't care about [the details of remedial efforts]. They certainly don't care about corporate governance or whether someone can move up 10 rungs on the ISS rankings. They care about bad people. They signal their concerns [about those they regard as bad people] loud[ly] and clear[ly]—even people they're not willing to sue."<sup>194</sup>

One of my sources suggested that, sometimes, replacing senior management officials may be a higher priority for defense lawyers than for the SEC staff. According to this lawyer, immediately after the passage of the Sarbanes-Oxley Act, the settlement process often included "an unfortunate tendency [on the part of defense counsel] to assume the only way to mollify the staff was to fire senior managers whether they deserved it or not."<sup>195</sup> "People are less fearful now," he says, and the defenestration of top managers in anticipation of settlement is less common than it was just two years ago.<sup>196</sup>

Still, some negotiations stall on this issue. And many SEC investigations are known to have resulted in the removal of senior executives. The *AIG* settlement, for

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<sup>191</sup> Source #8.

<sup>192</sup> Source #1.

<sup>193</sup> *Id.*

<sup>194</sup> *Id.*

<sup>195</sup> Source #7.

<sup>196</sup> *Id.*

example, noted the removal of the company's CEO and CFO as among the company's remedial measures.<sup>197</sup> The boards at Putnam Investments, Hollinger International, and Royal Ahold, among others, are also understood to have forced the resignations of their CEOs and others before settling with the SEC. Many of these removals may in fact have been market-driven. On the other hand, the staff's insistence may have played a key role. It is impossible to know how much influence SEC negotiations had in any one of these cases. It is also impossible to know to what degree the Commission supports the staff's hard-ball position, given its protestations about not wishing to "intrude" into the board's prerogatives.<sup>198</sup>

## VI. AGENCY EXPERTISE

We have seen in the foregoing sections evidence of the widespread use of therapeutic sanctions in SEC settlements. One might fairly question whether the SEC Enforcement staff has the expertise to craft such provisions. Lawyers typically have little or no organizational leadership experience, and this is especially true of lawyers working in law enforcement agencies.<sup>199</sup> Their inexperience can lead to three types of errors in prescribing guidelines for organizational change: (1) over-intrusiveness; (2) under-intrusiveness; and (3) problems associated with delegating authority, especially to largely unaccountable outside compliance consultants.

It might be one thing to expect SEC staffers to have a detailed understanding of the needs and limitations of SEC-regulated entities. We find many therapeutic provisions in

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<sup>197</sup> American Int'l Group, Inc., Litigation Release No. 19,560, 2006 SEC LEXIS 277, at \*5 (Feb. 9, 2006).

<sup>198</sup> See *supra* note 58.

<sup>199</sup> See, e.g., Wray & Hur, *supra* note 170, at 1185 ("Prosecutors know their way around a courtroom and a grand jury investigation but are unlikely to have developed meaningful expertise in the reform of highly regulated industries . . . Business organizations are right to be leery of the potential consequences of well-meaning but unsophisticated advice from criminal prosecutors on how best to ensure legal compliance.").

settlements reached with such firms. Interestingly, many of these settlements include the appointment of compliance consultants,<sup>200</sup> which may reflect either fatigue or risk aversion (or both) on the part of the staff. These settlements may also reflect special enforcement objectives—and a willingness to be less mindful of state law prerogatives—in dealing with regulated entities.<sup>201</sup>

But what about complex non-regulated firms (public issuers)? Redesigning the managerial structures and operating rules, let alone the cultures, of such firms is a highly-sophisticated, time-consuming task. Redesigning the rules in an organization that has engaged in unlawful behavior is certain to be more challenging.

Consider the types of therapeutic provisions I have catalogued here: new compliance structures, new accounting systems, new board procedures, and new training programs from the top to the bottom of the corporate hierarchy. Are these the kinds of projects that SEC lawyers can reasonably design? And, assuming the designs are really the product of the *defendants'* lawyers, or consultants who themselves are frequently lawyers, can SEC lawyers really tell the difference between a good corrective plan and a poor one?<sup>202</sup>

Lawyers often misjudge reform programs because they overestimate the importance of “process” rather than

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<sup>200</sup> See, e.g., *In re Morgan Stanley & Co.*, Exchange Act Release No. 56,634, 2007 SEC LEXIS 2331, at \*10 (Oct. 10, 2007) (requiring engagement of a consultant to confirm that failures with respect to the preparation of trading confirmations have been eliminated); *In re Morgan Stanley & Co.*, Exchange Act Release No. 55,726, 2007 SEC LEXIS 982, at \*24 (May 9, 2007) (requiring engagement of a consultant to examine the defendant's retail order handling practices); *In re A. G. Edwards & Sons, Inc.*, Exchange Act Release No. 55,692, 2007 SEC LEXIS 891, at \*12 (May 2, 2007) (requiring engagement of a consultant to examine practices relating to “market timing”).

<sup>201</sup> Source #7. According to this lawyer, the SEC staff “tend to be more prescriptive for regulated entities [than for public issuers].” With regulated entities, they are “somewhat less shy” about intervening. *Id.*

<sup>202</sup> See Donald C. Langevoort, *The Behavioral Economics of Corporate Compliance With Law*, 2002 COLUM. BUS. L. REV. 71, 112-13 (noting that neither administrative agencies nor judges are likely to be “particularly adept” at evaluating corporate reform proposals).

focusing on true behavioral change.<sup>203</sup> They also consistently underestimate the full range of costs associated with the implementation of reform programs.<sup>204</sup> These costs are both direct and indirect and include a rising level of mistrust within the firm, a decline in activity that is motivated by loyalty or reciprocity, and a decline in productivity.<sup>205</sup> “Reform” agendas imposed from the outside are especially suspect—they often breed employee cynicism and may even generate more deception.<sup>206</sup>

One might argue that the SEC enforcement lawyers have been quite restrained in seeking (or, at least, achieving) therapeutic changes in the governance and management of public companies. As a general rule, SEC settlements have been less intrusive than the settlements in many private lawsuits.<sup>207</sup> The extensive (and expensive) monitoring that sometimes occurs in criminal cases simply does not exist in plain-vanilla SEC civil settlements.<sup>208</sup>

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<sup>203</sup> Lawrence A. Cunningham, *Evaluation and Response to Risk by Lawyers and Accountants in the U.S. and the E.U.: The Appeal and Limits of Controls to Fight Fraud, Terrorism, Other Ills*, 29 IOWA J. CORP. L. 267, 308-10 (2004); see also Susan Sturm, *Second Generation Employment Discrimination: A Structural Approach*, 101 COLUM. L. REV. 458, 476 (2001) (noting that lawyers often view corporate problems as “potential legal claims, rather than as problems in need of systemic resolution”).

<sup>204</sup> Langevoort, *supra* note 202, at 74.

<sup>205</sup> *Id.* at 96.

<sup>206</sup> See New Arthur Andersen Study Shows How to Develop an Ethics Program That Works, PREVENTING BUSINESS FRAUD, May, 1999, at 1.

An ethics/compliance program that employees perceive as having been created to help guide behavior, as well as to establish and reinforce a shared set of company values rooted in the company culture, will be significantly more successful than a program that employees believe was designed primarily for purposes of compliance. A program that is perceived to have been developed to prevent, detect, and punish violations of laws and regulations, or simply to improve the company's image will be far less successful.

*Id.*

<sup>207</sup> See *supra* notes 2-3 and accompanying text.

<sup>208</sup> See Khanna & Dickinson, *supra* note 35.

Still, the SEC's haphazard approach to the terms of these settlements is problematic, as is the likelihood that the Enforcement staff lawyers often do not really know what they are asking the parties to do.<sup>209</sup> It is not enough, moreover, to say that negotiated settlement terms are likely to be better than court-ordered sanctions<sup>210</sup> or one-size-fits-all regulation.<sup>211</sup> Expensive and intrusive mandates such as those incorporated into SEC settlements should be based on more than uninformed or idiosyncratic preferences.<sup>212</sup>

As I will discuss below, the Enforcement staff should be guided by principles consistently applied. For example, imposition of a consultant should be regarded as "an extreme measure warranted [only] when it appears that the [defendant] will not, or cannot, take remedial action on its own initiative."<sup>213</sup> And, decisions regarding the use of therapeutic sanctions should be centralized and the staff assigned to the task should have a deep understanding of the complexities and nuances of organizational reform.<sup>214</sup>

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<sup>209</sup> As just one example, one of my sources in the Enforcement Division opined that management "may not mind" the presence of a compliance consultant. He added "that's just a guess." Source #5.

<sup>210</sup> See, e.g., ROSS SANDLER & DAVID SCHOENBROD, *DEMOCRACY BY DECREE: WHAT HAPPENS WHEN COURTS RUN GOVERNMENT* (2003) (describing the ineffectiveness of courts in balancing the needs of complex organizations).

<sup>211</sup> See generally Orly Lobel, *The Renew Deal: The Fall of Regulation and the Rise of Governance in Contemporary Legal Thought*, 89 MINN. L. REV. 342, 396 (2004) (noting the advantages of "designing institutions that rely on self-discipline and self-surveillance" rather than relying on government supervision).

<sup>212</sup> See Edward L. Rubin, *Images of Organizations and Consequences of Regulation*, 6 THEORETICAL INQUIRIES 347, 348 (2005) ("[Corporations] come in many different forms, and most of them are complex organizations that are often barely understood, even by those who spend their entire lives in them. To determine how these organizations are likely to respond to different stimuli, we need some systematic knowledge that goes beyond mere intuition.").

<sup>213</sup> *In re Raymond James Fin. Servs., Inc.*, Initial Decisions Release No. 296, 2005 SEC LEXIS 2368, at \*211 (Sept. 15, 2005).

<sup>214</sup> It appears, for example, that "older" companies are less adaptable to reform than "younger" companies. Additionally, companies with diverse



## VII. INVESTOR PROTECTION

In addition to questioning the SEC's expertise in corporate governance, one might also ask whether there is any value to corporate therapeutics. That is, what benefit accrues to a corporation and its shareholders when, as part of a settlement with the SEC, the company undertakes to change its governance practices? Recent studies have concluded that only a handful of corporate governance reforms—typically *not* those incorporated into SEC settlement documents—are demonstrably related to corporate performance.<sup>215</sup> “[T]he empirical evidence [on most

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workforces are more adaptable than companies with culturally homogeneous workforces. Juan D. Carrillo & Denis Gromb, *Cultural Inertia and Uniformity in Organizations*, 23 J. L. ECON. & ORG. 743, 745 (2007). These findings would suggest that the format and emphasis of training programs should vary from defendant to defendant and be more intense in change-resistant firms.

<sup>215</sup> Bebchuk *et al.* argue that only six governance items—staggered boards, limits on shareholder bylaw amendments, supermajority requirements for mergers, supermajority requirements for charter amendments, poison pills and golden parachutes—are demonstrably related to shareholder value. (Each correlates to a *reduction* in shareholder value.) Lucian Bebchuk, Alma Cohen & Allen Ferrell, *What Matters in Corporate Governance?*, Harvard Law School John M. Olin Center Discussion Paper No. 491 (2004), [http://papers.ssrn.com/abstract\\_id=593423](http://papers.ssrn.com/abstract_id=593423). Brown and Caylor confirm that the absence of a staggered board and the absence of poison pills are positively related to firm value. Lawrence D. Brown & Marcus L. Caylor, *Corporate Governance and Firm Valuation*, 25 J. ACCT. AND PUB. POL'Y 409, 412 (2006). They also find that five additional items—no option re-pricing within the past three years; option grants averaging less than 3% of the shares outstanding within the past three years; strong directorial attendance records (all directors attended at least 75% of the meetings or had a valid excuse for non-attendance); governance guidelines in the annual proxy statement; and stock ownership requirements for directors—are “key drivers” of firm valuation. *Id.* at 411.

In a related paper, Brown and Caylor identify five items that are significantly and positively related to both return on assets (ROA) and return on equity (ROE): a nominating committee comprised solely of independent outside directors; lack of authorization to issue blank check preferred stock; non-employees (e.g., outside directors) do not participate in company pension plans; at least one member of the board has

governance reforms'] correlation with shareholder value is limited or mixed or both, and does not prove decisively that they cause increases in value."<sup>216</sup>

There are also grave doubts whether many corporate compliance programs are effective in transforming corporate cultures. Here, too, recent studies conclude that "little evidence exists to support [the] assumption that internal compliance structures reduce the incidence of prohibited conduct within organizations."<sup>217</sup> Indeed, the "most recent and methodologically sound studies [find] no significant correlation between the most widely used internal compliance structures and reduced organizational misconduct."<sup>218</sup> In other words, most compliance programs, especially those endorsed by government regulators, may be "largely window-dressing."<sup>219</sup>

If these programs were cost-free, or even if they were costly but otherwise harmless, it might not matter. But we now understand that therapeutic sanctions are *not* free and *not* harmless. As noted above, governance interventions can have unintended and even harmful consequences.<sup>220</sup> And, unfortunately, no one to date has done a thoughtful cost-benefit analysis of the therapeutic sanctions the SEC

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participated in an ISS-accredited director education program; and average options granted in the past three years as a percentage of shares outstanding did not exceed three percent. Lawrence D. Brown & Marcus D. Caylor, *Corporate Governance and Firm Operating Performance* (2007), available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1072384](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1072384).

<sup>216</sup> Robert Charles Clark, *Corporate Governance Changes in the Wake of the Sarbanes-Oxley Act: A Morality Tale for Policymakers Too*, 22 GA. ST. U. L. REV. 251, 303 (2005). See also Jeffrey Sonnenfeld, *Good Governance and the Misleading Myths of Bad Metrics*, 18 ACAD. OF MGMT. EXEC. No. 1, at 108 (2004) (many so-called "reforms" are based on "Wall Street superstitions" and "clichés and myths, rather than on genuine research").

<sup>217</sup> Kimberly D. Krawiec, *Cosmetic Compliance and the Failure of Negotiated Governance*, 81 WASH U. L.Q. 487, 491 (2003).

<sup>218</sup> Kimberly D. Krawiec, *Organizational Misconduct: Beyond the Principal-Agent Model*, 32 FLA. ST. U. L. REV. 571, 591 (2005).

<sup>219</sup> Krawiec, *supra* note 217, at 513.

<sup>220</sup> See *supra* note 205 and accompanying text.

employs.<sup>221</sup> Nevertheless, the Enforcement staff keeps insisting upon these sanctions, as if “more board meetings, more audit committee meetings, longer meetings, longer meetings still, more certifications, more internal controls, new, often untried documentation of those controls, added auditing devices, beefed up gatekeepers, new gatekeepers, [etc.]”<sup>222</sup> were proven remedies for corporate wrongdoing. They are not.

### VIII.A CAUTIONARY TALE

In thinking about the problems presented by therapeutic sanctions, consider the story of Bristol-Myers Squibb. In 2004, the company was charged by the SEC with falsifying its financial statements through mechanisms including “channel-stuffing” and other manipulative accounting devices.<sup>223</sup> In settling the case, the company agreed to various remedial undertakings, including “the appointment of an independent advisor to review, assess, and monitor Bristol-Myers’ accounting practices.”<sup>224</sup> The “advisor” was a former U.S. Attorney and a retired federal judge who pressed the company to hire new senior financial executives, create the position of chief compliance officer, and “adopt[] a healthy new attitude toward being a good corporate citizen.”<sup>225</sup> Nevertheless, the company soon found itself in trouble for inflating its drug prices on bills to insurers and government agencies. Then, it got into even deeper trouble for engineering (and then lying about) a secret non-compete

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<sup>221</sup> See *infra* Part IX, SEC Recommendation #2.

<sup>222</sup> Douglas M. Branson, *Too Many Bells? Too Many Whistles? Corporate Governance in the Post-Enron, Post-WorldCom Era*, 58 S.C. L. REV. 65, 66 (2006).

<sup>223</sup> Press Release, Bristol-Myers Squibb Company Agrees to Pay \$150 Million to Settle Fraud Charges, <http://www.sec.gov/news/press/2004-105.htm> (last visited Dec. 3, 2008).

<sup>224</sup> *Id.*

<sup>225</sup> Sue Reisinger, *Doctor's Orders*, CORP. CSL., Oct. 1, 2007, available at <http://www.law.com/jsp/cc/PubArticleFriendlyCC.jsp?id=900005491068>.

agreement with another drug company to enhance its position in the generic drug market.<sup>226</sup>

Even though, unlike most consultants, the Bristol-Myers advisor had prior experience as a monitor,<sup>227</sup> and even though he had spent thirty-seven months on the job, the Bristol-Myers advisor was "stunned" by these developments.<sup>228</sup> Perhaps this is explained by the fact that, by the time the company was deeply in trouble, the advisor was eighty-seven years old. Or, perhaps it is explained by the mindset with which the advisor approached his work: "[Judge] Lacey said he found the work exhilarating. He hadn't wielded this much power in years. He attended executive committee meetings, talked with any individual he chose, and sent a team of [his law firm colleagues] to attend dozens of other meetings and report back to him."<sup>229</sup>

Even though this story is not typical of SEC civil enforcement actions,<sup>230</sup> it illustrates some of the problems of therapeutic interventions: (1) consultants are often selected more for who they know than what they know; (2) consultants paid by the hour (as most of them are) have both the opportunity and motive to run up large bills without regard to whether their work is valuable to the company; and (3) to make their work look meaningful, consultants have to unearth facts and make recommendations. However, to have any lasting impact on the company, they must work closely with senior management and develop strong ties of trust. The first course of action may be costly and fruitless. The second may make the consultant so comfortable that he becomes ineffective in bringing about change.

The Bristol-Myers Squibb case also suggests another important lesson. The process of selecting consultants and "advisors" should be undertaken with care. The current practice of appointing former SEC staffers looks,

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<sup>226</sup> *Id.*

<sup>227</sup> *Id.*

<sup>228</sup> *Id.*

<sup>229</sup> *Id.*

<sup>230</sup> All three of the allegations against Bristol-Myers Squibb included Department of Justice charges of criminal violations.

unfortunately, like a protection racket. It ultimately may discredit the Commission and its staff. Or, as seems likely to occur with the Department of Justice, it may invite legislative intervention.<sup>231</sup>

## IX. RECOMMENDATIONS

This Article has examined the use by the SEC of therapeutic sanctions in civil enforcement actions. With surprising frequency, we have found Enforcement Division staff lawyers in these actions negotiating for removal of senior executives, alteration of board practices, new reporting relationships, delegation of key decisions to consultants, and significant expenditures of shareholders' funds.

Any discussion of the use of therapeutic sanctions has to take place in a larger context. The settlement of SEC charges involves a balancing of many factors: the nature of the charges (fraud or non-fraud); the pendency of other actions (criminal and civil); the burdens of a cease-and-desist order versus the burdens of an injunction; the size of the civil penalty; the reaction of the market and stakeholders; and the necessity of a speedy resolution, among others. No one factor will drive every settlement. Right now, however, the Enforcement staff seems to be free-lancing its way through discussions of governance and management issues. The judgments of boards of directors are being displaced by those of lawyers with little appreciation for how businesses grow.

The SEC should give some serious thought to the issues raised by the persistent use of therapeutic sanctions. Recognizing the value of "clarity, consistency, and predictability" in sanctioning policy,<sup>232</sup> the Commission should adopt a set of written guidelines governing the use of therapeutic sanctions. These guidelines should include the following general provisions:

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<sup>231</sup> See Pedro Ruz Gutierrez, *Democrats Move to Regulate Corporate Monitors*, LAW.COM, July 15, 2008, <http://www.law.com/jsp/article.jsp?id=1202422975044>.

<sup>232</sup> Statement Concerning Financial Penalties, *supra* note 23.

(1) as a general rule, therapeutic sanctions should be included in a settlement only where supported by clear and convincing evidence that intervention is needed—the default position for prospective relief should be non-intervention;

(2) the Enforcement Division ought not seek therapeutic sanctions unless that demand is authorized in advance by the Commission;

(3) the Enforcement Division should require the creation of new board practices, governance arrangements, and management structures only with the active involvement of the independent members of the defendant's board;

(4) compliance consultants should be used sparingly and only where it is clear that the problem is a result of (a) systemic, multi-location, or multi-unit failures requiring extensive oversight and rehabilitation and (b) unwillingness or inability of management to address the systemic, multi-location or multi-unit problem;

(5) the scope of work for compliance consultants should be carefully and narrowly defined in advance, and include a good-faith estimate of the time required to complete the work;

(6) the Enforcement Division should insist upon budgets and fee caps for compliance consultants—the open-ended arrangements now in place encourage abuse and over-billing.

In addition to written sanction guidelines, the SEC should consider the following recommendations:

(1) the SEC staff should centralize its knowledge and institutional memory concerning the use of therapeutic sanctions;

(2) the Government Accountability Office (GAO) should conduct a comprehensive cost-benefit analysis of the SEC's recent use of therapeutic sanctions in civil cases and the findings of this report should (a) be made public and (b) inform all future settlement negotiations;

(3) Enforcement Division lawyers should receive direction and training on the appropriate use of therapeutic sanctions, with periodic updates on emerging knowledge about corporate governance practices and the efficacy of compliance programs;

(4) the SEC staff should identify a cadre of professional compliance consultants rather than leaving it to defendants to select whomever they wish. The current set-up ensures that many first-time consultants re-invent the wheel. There is also an appearance of impropriety involved in the consistent appointment of compliance consultants who are SEC alumni;

(5) the SEC should commission a study of alternatives to therapeutic sanctions. These might include disclosure-based alternatives (periodic reporting of progress toward governance reform), collaborative engagement between the SEC staff and companies' audit committees, periodic unannounced SEC "examinations" of companies with non-compliance histories, or other processes designed to enhance adherence to the rule of law;

(6) the SEC should insist upon transparency regarding the use of compliance consultants in settled cases; at a minimum, their identity and a report of their annual and total compensation should be available to the public;

(7) compliance consultants should be required to submit an "after-action" report to the SEC staff after each engagement, detailing "lessons learned;"

(8) the performance of compliance consultants should be measured by common metrics; their reports should be produced "in a form that makes it possible to compare experiences across firms."<sup>233</sup>

At a more fundamental level, the Commission should consider whether the use of its enforcement powers to supplant the prerogatives of corporate boards and those who elect them is either legitimate or desirable. This is not a new question.<sup>234</sup>

## X. CONCLUSION

Roberta Karmel recently suggested that board composition and structure, and corporate governance

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<sup>233</sup> Hess & Ford, *supra* note 62, manuscript at 51.

<sup>234</sup> See generally ROBERTA S. KARMEL, REGULATION BY PROSECUTION: THE SECURITIES AND EXCHANGE COMMISSION V. CORPORATE AMERICA (1982).

generally, are issues that “the SEC has been angling to regulate for some time.”<sup>235</sup> She had in mind the new provisions of the Sarbanes-Oxley Act, but might as easily have pointed to the actions of the Enforcement Division in resolving civil cases with therapeutic settlements.

This Article examines the SEC’s use of therapeutic settlements, both with regulated entities and with public companies. It questions the effectiveness of these settlements and the role of the SEC in shaping corporate governance norms.

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<sup>235</sup> Roberta S. Karmel, *Realizing the Dream of William O. Douglas—The Securities and Exchange Commission Takes Charge of Corporate Governance*, 30 DEL. J. CORP. L. 79, 81 (2005).