



IMPORTANT DEVELOPMENTS IN FEDERAL ENFORCEMENT POLICY, AND RELATED DISCLOSURE CONSIDERATIONS

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April 24, 2019 In-House Counsel Conference

Presenters:

- Kate Pytlewski,
 - Vice President, Deputy General Counsel, EPAM Systems, Inc.
- Elizabeth A. Diffley
 - Partner, Drinker Biddle & Reath LLP, Corporate & Securities Group
- Mary P. Hansen
 - Former Assistant Director, Division of Enforcement, SEC
 - Was responsible for supervising investigations and litigation conducted by attorneys and accountants in the Division's Market Abuse and Municipal Securities and Public Pensions Units
- Antonio M. Pozos
 - Former Trial Attorney, Fraud Section, Department of Justice

Legal Proceedings Disclosure Requirement

- Regulation S-K, Item 103 (Required in Registration Statements, Forms 10-K and 10-Q):

“Describe briefly any material pending legal proceedings, other than ordinary routine litigation incidental to the business, to which the registrant or any of its subsidiaries is a party or of which any of their property is the subject. Include the name of the court or agency in which the proceedings are pending, the date instituted, the principal parties thereto, a description of the factual basis alleged to underlie the proceeding and the relief sought. Include similar information as to any such proceedings known to be contemplated by governmental authorities.”

Loss Contingencies – Accounting Requirement (ASC 450)

No accrual or disclosure is required for loss contingencies that are immaterial to the company's financial statements.

Likelihood loss will be realized	Reasonable Estimate	No Reasonable Estimate
Probable (likely to occur)	Accrue reasonable estimate. Disclose as necessary to avoid misleading financial statements. If reasonable estimate is a range, accrue best estimate in range; if none, accrue minimum	No accrual. Disclose contingency and state no reasonable estimate is possible.
Reasonably Possible	No accrual. Disclose contingency and estimated amount of possible loss or range of loss.	No accrual. Disclose contingency and state no reasonable estimate is possible.
Remote (slight chance of occurring)	No accrual or disclosure, unless guarantee.	No accrual or disclosure, unless guarantee.

Management's Discussion and Analysis

Regulation S-K, Item 303 (MD&A)

- Identify any known trends, demands, commitments, events or uncertainties that:
 - are reasonably likely to materially increase or decrease the company's liquidity;
 - would cause reported financial information not to be necessarily indicative of future operating results or future financial condition; and/or
 - any known material trends in its capital resources.
- The standard for materiality of known trends differs from the general materiality standard.

What is “Material”?

- Rule 405 of the Securities Act and Rule 12b-2 of the Exchange Act:
The term “material,” when used to qualify a requirement for the furnishing of information as to any subject, limits the information required to those matters to which there is a substantial likelihood that a reasonable investor would attach importance in determining whether to buy or sell the securities registered.
- Generally evaluated using the standard articulated in *TSC Industries, Inc. v. Northway, Inc.*, 426 U.S. 438 (1976), which looks at whether there is a substantial likelihood that a reasonable investor would consider the information important. In other words, there must be:
“a substantial likelihood that the disclosure . . . would have been viewed by the reasonable investor as having significantly altered the ‘total mix’ of information made available.”

SAB 99

- SEC Staff Accounting Bulletin on assessing materiality in financial statements
- Focused on materiality of misstatements, it is often applied in other contexts
- Rejects 5% “rule of thumb”
- Certain factors may render a quantitatively small misstatement material.

SAB 99 – Factors

Consider whether the misstatement:

- arises from an item capable of precise measurement or whether it arises from an estimate and, if so, the degree of imprecision inherent in the estimate;
- masks a change in earnings or other trends;
- hides a failure to meet analysts' consensus expectations for the enterprise;
- changes a loss into income or vice versa;
- concerns a segment or other portion of the registrant's business that has been identified as playing a significant role in the registrant's operations or profitability;
- affects the registrant's compliance with regulatory requirements;
- affects the registrant's compliance with loan covenants or other contractual requirements;
- has the effect of increasing management's compensation – for example, by satisfying requirements for the award of bonuses or other forms of incentive compensation; and
- involves concealment of an unlawful transaction.

Securities & Voluntary Self-Disclosures

- Enforcement Policies and U.S. Sentencing Guidelines Favor Voluntary Corporate Self-Disclosures of Misconduct
 - Potential Benefits:
 - Up to Declination with Disgorgement (DOJ)
 - Up to 5 Level Reduction Under U.S. Sentencing Guidelines
- No Bright Line Rules on How Quickly the Company Must Self-Disclose Violations to Obtain Maximum Credit
- But, Self-Disclosures Must Occur “Prior to an Imminent Threat of Disclosure or Government Investigation”
 - U.S.S.G. § 8C2.5(g)(1)
- Voluntary Self-Disclosures on Eve of Securities Filings Increases Risk that Company May Not Receive Full Credit for Voluntary Self-Disclosure

Disclosure Hypo #1

- ABC Company, a public SEC reporting company, receives a subpoena from the SEC's Division of Enforcement.
- The subpoena requests documents and information relating to ABC's revenue recognition practices, policies and procedures.
- The subpoena does not name any specific employees, but does request that ABC identify all employees responsible for revenue recognition.
- ABC management informs the General Counsel that they are unaware of any issues with revenue recognition.
- What are ABC's disclosure obligations?

Additional Considerations

- ABC is in the process of preparing to make a secondary offering.
- Certain executive officers intend to sell shares.
- ABC is in the process of finalizing a significant corporate transaction.
- ABC discovers that a former employee reported concerns about a certain revenue recognition practice to ABC's Ethics Hot Line prior to resigning.

Additional Considerations

- ABC terminated certain employees after discovering that they were not properly accounting for revenue recognition.
- ABC receives a call from DOJ indicating it is also interested in the Company's revenue recognition practices.
- ABC is a private company with investors.

Disclosure Hypo #2

- ABC Company receives a subpoena from the IRS asking for documentation relating to the CEO's compensation.
- The responsible IRS agent tells the GC that the IRS is concerned that the CEO did not report all non-cash compensation received from ABC.
- When the General Counsel informs the CEO about the subpoena, the CEO reveals that he has been the subject of an audit over the last few months.
- The General Counsel retains an outside law firm to conduct an internal investigation which reveals that the CEO caused ABC to purchase a \$150,000 piece of art which is hanging in his home.
- What are ABC's disclosure obligations?

Additional Considerations

- The CEO refuses to cooperate with the internal investigation.
- ABC identifies authorized purchases in excess of \$1 million.
- The internal investigation reveals that several executive officers have expensive pieces of art hanging in their homes that were purchased by ABC.
- The internal investigation reveals that the CEO threatened to terminate the staff accountant who challenged the purchase of the expensive painting.

Additional Considerations

- The internal investigation reveals that the CEO repaid ABC six months after the initial purchase.
- The internal investigation reveals that the CEO purchased the piece of art to give to the CEO of ABC's largest customer.
- Rather than the CEO, it was a non-management marketing department employee who was the subject of the IRS subpoena.

Recent Developments

- Revisions to DOJ Individual Accountability Policy
- September 2015: The “Yates Memo”
 - DOJ Prosecutors and Civil Enforcement Attorneys to Focus on Individual Cases, Not Just Companies
 - Cooperating Companies Must Disclose All Relevant Facts About Individuals “Involved in” Misconduct
- November 29, 2018: DOJ Announces Revisions
 - Criminal Cases:
 - Companies “Must Identify All Individuals Substantially Involved in or Responsible for the Misconduct at Issue ... and Provide to the Department all Relevant Facts Relating to that Misconduct”
 - Civil Cases: Companies May Receive:
 - “Some Credit” if they “Identify All Wrongdoing by Senior Officials,” Including Board and Senior Mgmt., and
 - “Maximum Credit” for Meeting the Higher Criminal “Substantially Involved in or Responsible for” Standard
 - Reasoning: Time and Delay Trying to Meet Original Yates Memo “Involved in” Standard
 - Revised Policies Incorporated Into Justice Manual, §§ 4-3.100(3), 9-28.700 & 9-47-120(3)(a)

Disclosure Hypo #3

- ABC, a medical device company, receives a grand jury subpoena seeking information about payments to a consultant in Country X.
- The DOJ Trial Attorney handling the case tells the General Counsel that the Government believes the funds are being used to bribe officials in Country X.
- ABC's sales to government entities in Country X account for 5% of ABC's revenues.
- ABC hires outside counsel to conduct an investigation. The DOJ Trial Attorney, however, requests that ABC not take any steps that might alert employees involved in the payments to the Government's investigation.

Recent Revisions to Criminal Division De-Confliction Policy

- “De-Confliction of Witness Interview and Other Investigative Steps”
 - **Requests that the Company NOT Interview Witnesses or Take Other Steps**
 - Designed to Control the Investigation, and Maintain Surprise
 - **DOJ Corporate/FCPA Policy Limitations:**
 - Requests Must Be For a “Limited Period of Time” and “Narrowly Tailored to a Legitimate Investigative Purpose”
 - Justice Manual, § 9-47.120(4).
 - **Poses Particular Challenges When:**
 - Company Must Act to Protect Itself (e.g., Restrict Access to Accounts, Sensitive Files, Terminations)
 - Company Must Act to Protect the Public (e.g., Health Care, Financial Services, Defense Contracting)
 - Company is Publicly Traded (Duties to Shareholders, Reporting Obligations)
- **New: March 2019 Revisions to Criminal Division Policy**
 - **Footnote Added to Clarify that DOJ May Not Take Any Steps to Affirmatively Direct a Company’s Internal Investigation Efforts**
 - **Whether Revision Signals Shift Towards Reducing Interference with Internal Investigations Remains to Be Seen**

Additional Considerations

- ABC's Managing Director for Country X approves a \$1 million payment to the consultant, that will be processed at the end of the week.
- DOJ expresses concern that ABC's devices are being used in medically unnecessary procedures.

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