

# Protecting the company in high-risk investigations

*Legal experts say the best defense is a good offense*

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In a post-Enron world, federal investigations are a fact of life for energy companies and commodity trading desks. Often, these investigations focus on violations of technical matters, such as compliance with the Federal Energy Regulatory Commission's rules governing the transfer of gas pipeline capacity rights. Yet, with increasing frequency, investigators have focused on suspected fraud, market manipulation, abusive trading, false reporting, and other forms of unlawful trading conduct.

These investigations are costly and time-intensive, and pose significant risks, from large fines to criminal sanctions. But, contrary to conventional wisdom, high-risk investigations can also provide a company with an opportunity to enhance its standing among regulators. It all depends on how the company responds to the inquiry.

Under the conventional approach to handling investigations, energy companies usually adopt a defensive approach. Typically, this means that the company provides only the information specifically requested by investigators – it volunteers nothing. In some cases, the company may even resist the scope of the government's inquiry. The result is often a protracted, costly investigation (and litigation) that erodes the company's credibility with regulators and poisons employee morale. Moreover, the process can create additional legal risk, especially if investigators conclude that a company failed to display adequate candor or cooperation with investigators.

There is another way. Instead of playing defense, companies should consider mounting a solid offense by handling high-risk investigations proactively. How? By offering to conduct a comprehensive internal investigation of matters and presenting federal investigators with a complete report of their findings. Although this level of candor may fly in the face of conventional wisdom, our experience suggests that being upfront and frank with federal investigators ultimately minimizes the time and expense of high-risk investigations, and ensures that the company remains ahead of any decisive facts or documents, thereby reducing its risk. Handled properly, an investigation can be an opportunity to gain—not lose—credibility with regulators. Think of this as “Regulatory Jujutsu.”

The enforcement staffs of FERC and the Commodity Futures Trading Commission, along with various other

energy regulators like the Federal Trade Commission, have been increasingly active in pursuing claims under their respective anti-manipulation and fraud rules, all of which require a minimal showing of proof. Beyond colossal fines, these cases can result in a wide variety of additional sanctions, including, disgorgement, suspension or revocation of trading authority, criminal referral, and ongoing compliance monitoring and reporting obligations. What's more, the target of an investigation must manage the public relations aspects of a case amidst unsympathetic sentiment among investors and the general public.

Regulated companies embroiled in high-stakes investigations generally have the same goal: to resolve the matter quickly and cost-effectively, while preserving



the company's credibility with the regulator. For savvy members of the regulated-community, the risk of a long, drawn-out battle to refute the government's case is simply not worth it.

As an initial matter, the chances of refuting a reasonably well-supported manipulation/fraud claim are slim. Simply put, the rules are written in the government's favor. Case in point, when Congress recently enacted the Dodd-Frank Wall Street Reform and Consumer Protection Act, it authorized a new fraud-based anti-manipulation authority for the CFTC after it recognized that the agency's ability to bring cases of actual (i.e. not attempted) manipulation was hampered under its existing rules.

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Second, the "scorched earth" defense is a non-starter in the context of regulatory inquiries where it is imperative that the company preserve its standing among agency staff. For FERC-regulated energy companies, an investigation is only a small part of a broader relationship with their chief regulator, so it is imperative that the company's defense strategy does not imperil its broader reputation within the agency.

Finally, the public relations fallout from a protracted investigation and adjudication can have deleterious effects on investor and customer sentiment, to say nothing about the impact that an investigation can have on employee morale.

Despite these shortcomings, many energy and commodities trading outfits under investigation take a defensive posture. This usually means doing the bare minimum to respond to investigators' requests. As a consequence, investigators issue so-called "all documents" requests that are expansive in scope, and which cause company lawyers to spend countless hours reviewing irrelevant records.

Instead of working toward resolving the matter quickly and efficiently, targets of investigations spend their resources fighting over the scope of requests or submission deadlines. It is no surprise, then, that investigations last for years and generate thousands of billable hours.

In many cases, this approach can create new legal risks for companies and managers, as frustrated investigators

expand their information collection efforts. And rather than ensuring that the government has a complete and accurate portrayal of events, companies take the risk of investigators reaching their own conclusions based on incomplete information and mistaken assumptions. Even worse, the government may interpret the company's defensive posture as obstructionist behavior.

Experience suggests that companies that manage an investigation proactively (i.e. by playing offense) achieve better results. That is, they reach resolution of the matter more quickly and cost-effectively, while shoring-up their credibility with the agency and its staff. To accomplish this, companies at the beginning of an investigation should meet with government investigators and offer to conduct a comprehensive, independent investigation of the facts, based on the government's input.

For the sake of ensuring objectivity, the internal investigation should be conducted by a third-party, which might be outside counsel, an economic consultant, or forensic accountants, depending on the circumstances. Based on the findings of the internal investigation, the company then produces a comprehensive, confidential report to the agency identifying and analyzing all of the relevant facts, personnel, and documents.

To be clear, this is an exercise in demonstrating utmost candor, so the report must contain the unvarnished truth from the independent investigation – this includes the good, the bad, and even the ugly. Accompanying this report should be an appendix containing copies of relevant documents and any data analysis supporting the report's findings. Companies should also expect to make available any raw data relevant to the report's findings.

In order to employ an offense-oriented strategy, the company and its counsel must first persuade investigators to let the company conduct its own review in the first place. Make no mistake; this can be a tricky conversation. Naturally, it helps to make contact with investigators early, especially before they begin reviewing documents and data. Propose to staff that you intend to instruct outside counsel (or another third party) to conduct a thorough investigation and to submit a confidential report of its findings and analysis, free of any substantive editing by the company.

In some cases, government lawyers may insist that the outside counsel submit its report to the company and the government simultaneously. In any event, be sure to seek staff's input on the scope of the investigation. Remember that staff will reserve the right to follow-up with additional discovery or depositions.

Compared to the conventional defensive approach to handling investigations, the proactive approach offers numerous benefits. Chief among these is reduced risk. When the company directs the investigation, it can quickly identify the issues and respond to them appropriately. This means ceasing unlawful behavior, if necessary. It also means identifying incriminating evidence

and having the opportunity to develop the relevant facts and circumstances before suspicious-looking documents are presented to the government.

An offense-oriented approach also leads to reduced costs. One of the most expensive aspects of an investigation is the cost of “discovery,” a legal term which refers to the gathering and review by lawyers of thousands of pages of records, email messages, instant messages, reports, and other documentation.

It is a truism that discovery is expensive. However, discovery is even more expensive when it is directed by government attorneys who typically send expansive “all documents” requests that require counsel to review thousands of pages of irrelevant material in order to find responsive documents. With unfettered access to personnel and records, a company’s counsel directing an internal investigation can better focus its investigative efforts to identify key documents and personnel quickly and efficiently, without wasting time on clearly irrelevant information.

A proactive approach better positions a company to earn so-called “cooperation credit,” which can be used to offset the severity of a fine issued by FERC or the CFTC. To get cooperation credit, it is not sufficient to simply respond to government data requests on time. Companies must go above and beyond.

In its simplest terms, cooperation credit requires doing things that demonstrably make investigators’ jobs easier. Being proactive and conducting a comprehensive review – based on staff’s input – is a reliable way to get cooperation credit, should you need it.

In a December 2011 enforcement order involving allegedly fraudulent releases of natural gas pipeline capacity rights, FERC took the unusual step of providing a detailed explanation for why a company earned cooperation credit. According to FERC, the company “hired outside counsel and an independent outside entity to assist the company’s examination” involving dozens of employee interviews, the review of relevant employees’ documents, an analysis of transactional data across numerous pipeline systems, and the production of extensive analysis and data. FERC added that the company “presented a very complete report to staff and supplemented the report with additional data presented in a way that facilitated staff’s understanding of the scope of [the] activity and to reduce the time required by staff to confirm relevant information.”

Importantly, an offense-oriented approach may enable a company to enhance its credibility and standing among agency staff. Whether we are talking about FERC, CFTC, or the FTC, a company that takes a proactive approach to a high-risk investigation by conducting its own comprehensive internal investigation builds its credibility with staff. Particularly with regulatory agencies like FERC and the CFTC, which have broad regulatory authority, the benefits of establishing and preserv

ing a reputation as a company truly dedicated to compliance is absolutely critical given the regulatory scrutiny of energy markets.

Finally, the proactive approach may soon become the norm, since the enforcement staffs of energy regulators are increasingly populated by former prosecutors and lawyers with backgrounds in securities and white collar criminal law, where the practice of conducting internal investigations is already standard practice. So, as white-collar prosecutors and securities enforcement lawyers migrate to FERC, the CFTC, and the FTC, one can only conclude the expectations in their enforcement departments will change, too.

In short, experience confirms that any company can go through the enforcement gauntlet and come out

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without expending unnecessary time and resources, all while enhancing its credibility with agency staff. The way to accomplish this is by dropping the conventional defensive approach in favor of a proactive strategy that often better suits the interests of the company and its personnel. **OGFJ**

#### **About the authors**

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