

COMPLIANCE WEEK

A Weekly Newsletter On Corporate Governance, Risk And Compliance

Settlement Puts GC On Compliance Hot Seat

By Paul J. Martinek, Compliance Week — November 7, 2006

A recent settlement forestalling criminal prosecution over allegations of market timing by a subsidiary of Prudential Financial has introduced a new twist to enforcement actions: placing responsibility for monitoring compliance with the settlement directly on the shoulders of the company's general counsel.

Typically, the Department of Justice insists that in return for entering into a deferred-prosecution or non-prosecution agreement, the company must retain an outside monitor. But the settlement with Prudential, concluded in late August but publicly disclosed late last month, gives General Counsel Susan Blount personal responsibility to oversee the compliance function.

The Prudential arrangement "is very different from what I've been seeing for the last few years," says Rick Wolf, the former chief compliance officer at Cendant Corp. and now head of consulting firm Lexakos. "It's put the general counsel in a tricky position: putting them on the hot seat without an [independent] monitor."

But, while the general counsel herself may have assumed a heavy load, the arrangement is potentially a plus for the company.



Ascher

"You have to compare this agreement to what you might otherwise have," which probably would be an outside law or accounting firm monitoring the company, says Stephen Ascher, a partner with the law firm Jenner & Block in New York. As a practical matter, the general counsel has ultimate responsibility for compliance efforts anyway, but an outside monitor may be bound by compliance agreements subject to interpretation and dispute. "[T]hen you have somebody looking at your business who does not know it as well as the general counsel would," he says.

Personal Ownership Imposed

U.S. Attorney Michael Sullivan of Boston, whose office handled the Prudential case, told Compliance Week in a statement that a "separate compliance overlay made little sense in this case" since the part of the business that engaged in the wrongdoing was sold prior to the investigation of the conduct, and for reasons unrelated to the wrongdoing.

Still, Sullivan said, the government wanted to make sure that the parent company improved its oversight of its subsidiaries. Prudential's agreement requires the company to continue with a new compliance regime it instituted in 2004, and to make the general counsel responsible for reporting directly to the DoJ twice a year for five years on the compliance program.

Arthur Ryan, Prudential Financial's chief executive, released a statement at the time of the settlement noting that the company had "strengthened [its] compliance programs." But the statement did not address the obligations imposed on its general counsel.



Finder

Lawrence Finder, a former federal prosecutor and now partner with the law firm Haynes and Boone, notes that the settlement as a whole is "pretty one-sided" in favor of the government—requiring, among other things, payment of a \$600 million fine.

In a typical situation, Finder says, the government demands that a compliance monitor be brought in at the company's expense. "Basically you have an adjunct of the government working inside the company. Here, [Prudential] gets to keep a little more control over it; the general counsel is in effect the compliance monitor," he says. "There's not an outsider looking over the shoulder of the people who work there."



Stamboulidis

But the arrangement isn't entirely positive for Prudential. "Cosmetically, it might appear to be something that might be appealing to a company; they don't necessarily have to have additional oversight," says George Stamboulidis, a partner with the law firm Baker Hostetler. "But I would think that if you're the general counsel who's going to be held personally responsible, you would be more comforted by having, if not a government imposed monitor, than a privately retained monitor."

William Michael, a former federal prosecutor now at the law firm Dorsey & Whitney, says the settlement achieves one important point: imposing personal ownership of the problem onto senior management. "It's a concept that sends a resounding message to Corporate America that senior management has to take ownership in establishing good corporate citizenship," he says. "They're effectively creating a junior G-man within the corporation."

In The Line Of Fire



Wolf

Wolf, however, argues that making the general counsel responsible for compliance in this fashion makes it more difficult for him or her to act as a trusted adviser for the company. While supposedly providing frank legal advice, the counsel now also must be the person responsible for assessing risks, identifying gaps and providing remediation planning. "Lawyers aren't wired that way," he says. "It's a role that most lawyers are not intimately comfortable with. It can affect the performance of the compliance function overall."

Bill Mateja, of the law firm Fish & Richardson, says the Prudential agreement "is putting the general counsel in the line of fire even more than they were before. Increasingly general counsel are being scrutinized for criminal or regulatory violations. People are looking to general counsel to ensure that compliance measures being put in place are not just window dressing."

And Michael notes that having the general counsel in charge of compliance "effectively eliminates" any claims of attorney-client privilege. "It will be significantly more difficult, if not impossible, to later claim any privilege surrounding misconduct," he says.

Stamboulidis, who has worked as a government-appointed and privately hired compliance monitor, also worries about the possible effects on attorney-client and work-product privileges. “Anything the general counsel tells the government is going to waive the privilege,” he says. “On the other hand, in many companies the compliance unit reports to the general counsel already.”

Something To Consider?

Other companies that find themselves negotiating deferred- and non-prosecution agreements with federal prosecutors may want to consider asking for a similar arrangement, says Mateja, noting that the Prudential settlement could have influence in other U.S. attorney offices around the country.



Mateja

A company facing charges “could make a pretty favorable pitch,” says Mateja. “The company could say, ‘Hey, we want to clean up our act. We’ll bring in a new general counsel, a new chief compliance officer.’ That kind of pitch has real teeth.”

Finder agrees that the Prudential settlement creates “some precedent” for other companies to point to. “But I don’t expect [this] to be *de rigueur*—I don’t expect anything to be *de rigueur*. There’s no cookie-cutter for these deferred prosecution agreements.”

Stamboulidis sees the Prudential settlement as somewhat an extension of the Sarbanes-Oxley Act’s “tone at the top” insistence on responsibility. “We want people at the highest levels in the executive seats at a company being held personally accountable,” he says.

Then again, whether the arrangement is one the government would consider in other situations also will depend on whether the general counsel is someone whom the prosecutors trust. The Prudential agreement “suggests a level of trust that the DoJ has with that [particular] general counsel,” Michael says. “If there was no trust there, [the department] would insist on an independent monitor.”

The settlement “definitely show[s] that U.S. Attorney Sullivan has faith in the current general counsel,” Stamboulidis says. “That’s something the board of Prudential would likely take comfort in. But it’s also a fair assumption that if the compliance blew up and a major incident occurred, that wouldn’t bode well for the person in charge.”

Background (sidebar)

An excerpt from a press release U.S. Attorney Michael Sullivan’s office released indicating that Prudential’s general counsel will be responsible for monitoring the company’s compliance with the terms of the settlement agreement follows:

The Justice Department announced that PRUDENTIAL EQUITY GROUP, LLC, (“PEG”), a broker-dealer subsidiary of PRUDENTIAL FINANCIAL, INC. (“PRUDENTIAL”), has entered an agreement in which PEG has admitted to criminal wrongdoing in connection with deceptive market timing trading in mutual fund shares and has agreed to a payment of \$600,000,000 in fines, restitution and penalties. This is the largest resolution of a market timing case.

The Justice Department has also entered into a separate compliance agreement with PEG’s parent company, PRUDENTIAL. Under the terms of that compliance agreement, PRUDENTIAL will also

cooperate with the Justice Department in its ongoing investigation and will maintain policies and procedures relating to the integrity of the compliance functions across its various affiliated entities. The compliance agreement provides that the General Counsel of PRUDENTIAL shall make periodic reports to the Prudential Board of Directors Audit Committee as to the appropriateness and effectiveness of the compliance plan. It also requires the General Counsel to provide the reports to the United States Attorney in the District of Massachusetts, along with a certification that the reports include all material information bearing on the effectiveness of the compliance plan.

According to the Statement of Facts, from 1999 through June 2003, a number of brokers at PEG's predecessor entity, PRUDENTIAL SECURITIES, INC. ("PSI"), engaged in a scheme to defraud mutual funds and their shareholders by using deceptive practices to place thousands of prohibited market timing trades on behalf of the brokers' clients, which were typically sophisticated hedge funds. The brokers were able to place these trades, thereby generating commissions for themselves and illicit profits for their clients, by manipulating trade information sent over the automated mutual fund trading system PSI used to communicate trades to mutual funds. Through the automated system, brokers were able to defeat efforts by the mutual funds to block their abusive market timing trading, by placing their trades in multiple accounts, often with multiple identities, to make it appear that the trades were coming from many different, unrelated brokers representing many different, unrelated clients.

During the relevant period, one group of former PSI brokers based in its Boston branch office ("Boston Brokers"), used at least fourteen FA numbers and 183 customer accounts, for only seven clients, to circumvent these blocks and avoid new blocks. The Boston Brokers' use of these devices in connection with market timing allowed group members to continue to place trades in funds that had taken steps to preclude them from further trading. Their scheme created the impression that transactions originated from many brokers and represented many different customers. What appeared to the mutual funds to be thousands of separate transactions submitted by many brokers for many unrelated customers was actually a systematic pattern of market timing by group members on behalf of their hedge fund clients.

In addition to the Boston brokers, at least two dozen other brokers throughout the PSI system were involved in deceptive mutual fund market timing. From 2001 through 2003, these brokers generated in excess of \$50 million in commissions and in excess of \$100 million in profits for their hedge fund clients. Some of these brokers, including the head of the Boston Brokers, were among the highest producing brokers at PSI.

Related Resources:

[DoJ's Press Release Announcing Settlement With Prudential \(Aug. 28, 2006\)](#)

Related Coverage:

[Cutting Deals: KPMG & Deferred Prosecution Agreements \(Aug. 30, 2005\)](#)

[Case Highlights Use Of Deferred Prosecution Agreements \(June 28, 2005\)](#)

['We're All In Trouble'; Why The Andersen Case Matters \(May 3, 2005\)](#)