

Client Alert

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Cooperating with the SEC: Agency Announces First Publicly Disclosed Individual Cooperation Deal

In the wake of the recent financial meltdown and revelations about Bernard Madoff and other high-profile frauds, the Securities and Exchange Commission (SEC) adopted a "get tough" attitude that included naming a former criminal prosecutor, Robert Khuzami, as its new enforcement chief. Among various changes implemented by the new regime was a 2010 program designed to incentivize corporations and individuals to cooperate with the SEC.

While cooperation agreements have long been a part of the criminal prosecutor's arsenal, their use in the civil enforcement realm has been more recent. Indeed, in an era of limited agency resources and increasingly complex frauds on a widening regulatory landscape, the SEC more and more has come to rely on corporate and individual cooperation to discover, understand and prosecute conduct that is becoming more sophisticated and international. At the same time, the agency has lacked the tools needed to assure cooperators that their cooperation would be properly valued and rewarded. As a result, the SEC often ended up riding the coattails of criminal prosecutors who could offer more flexibility and certainty in cooperation arrangements.

That changed in 2010, when the SEC took a page from the criminal handbook and implemented a "Cooperation Initiative" designed to encourage cooperation from both corporations and individuals. As incorporated in the SEC's Enforcement Manual, the Cooperation Initiative reiterated previous positions regarding the scope of cooperation, added a policy statement concerning cooperation by individuals and authorized the use of new cooperation tools. These tools included formal cooperation agreements, deferred prosecution agreements (DPA) and non-prosecution agreements (NPA), all of which may be used with both companies and individuals.¹ The Commission's goal was to strike the right balance between, on the one hand, encouraging and rewarding cooperation and, on the other, protecting and compensating investors and punishing those who break the law, a balancing process familiar to prosecutors.² The benefits of cooperation can be significant, from reduced charges, to lighter sanctions, to mitigating language in documents resolving the matter, to the avoidance of an enforcement action altogether.

While the SEC's policy statement set out what factors it would consider, it did not say how it would consider them, and the lack of publicly disclosed agreements has hindered parties' efforts to gauge how the SEC has weighed those factors in specific

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cases. In March 2012, however, the SEC announced that, under the Cooperation Initiative, it had declined to prosecute an individual on account of his "substantial assistance." Coupled with the prior announcements of a corporate NPA and DPA, certain factors are beginning to emerge as significant in the SEC's decision-making process.

The Evolution of the SEC's Views on Cooperation

The SEC has always had the ability to consider a party's cooperation in exercising its enforcement discretion, but it was not until the 2001 "Seaboard Report" that the SEC formally identified factors that it would consider in evaluating corporate cooperation.³ The Report's 13 non-exclusive factors reflect four "broad measures" of cooperation: self-policing prior to the discovery of the misconduct, prompt self-reporting, remediation and cooperation with law enforcement. In the decade following the release of the Seaboard Report, the SEC continued to publish, expand and clarify its views on cooperation in formal statements by the Commission and in numerous speeches by individual Commissioners and the Staff.⁴

The Cooperation Initiative expanded and formalized these views by authorizing the SEC to enter into written cooperation agreements with both corporations and individuals and to use NPAs and DPAs where appropriate.

Cooperation Agreements. In exchange for a party's full and truthful cooperation in an SEC investigation, the SEC may agree in writing that an individual or company receive credit for cooperation. In some cases the Division of Enforcement may agree to make a specific recommendation to the Commission, including that it decline to charge the cooperating party, as long as the party abides by the terms of the agreement.⁵ While the SEC has always had the ability to exercise its discretion and refrain from suing a company or an individual in recognition of that party's cooperation, this new policy enables the SEC to do more than provide the hope or unspoken understanding that the party would not be charged.

To be sure, no cooperation agreement provides a "free pass." Even if the SEC declines to bring charges, it could require disgorgement or other payment as part of the agreement. Moreover, "substantial assistance," particularly for corporations, can be onerous, time-consuming, lengthy and expensive. "Cooperation" could require an acceptance of responsibility, which might result in admissions of liability that could impact private civil cases. Nor does the SEC's decision not to prosecute bind other federal or state agencies that may be investigating the same conduct.

The factors the SEC will consider in evaluating corporate cooperation remain those set out in the Seaboard Report. See SEC Enforcement Manual § 6.1.2. In addition, and for the first time, the SEC has provided guidelines to assess individual cooperation. Those factors are (1) the assistance provided, (2) the importance of the underlying matter, (3) the interest in holding the individual accountable and (4) the individual's profile. *Id.* § 6.1.1.

Each of these individual factors includes a number of components. For evaluating the assistance provided by the individual, the SEC will examine, among other things, the voluntary nature of the assistance, the types of assistance provided and whether the individual encouraged others to cooperate. In weighing the importance of the underlying matter, the SEC will consider whether the investigation's subject matter is an agency "priority," the type and number of the violations and the extent of harm. Unsurprisingly, the factors to be considered in assessing the societal interest in holding the individual accountable balance the severity of the misconduct and the culpability of the individual against factors such as the individual's

knowledge, education, training, experience and position. The Commission is also interested in the efforts the individual took to remediate the harm. The individual's profile assesses the public's interest in rewarding cooperation and looks to the individual's history and likelihood of future violations. While there is considerable overlap between the factors considered for individual and corporate cooperation, the Policy Statement includes more detail about the relevant factors the SEC will consider for individuals, and certain factors appear to apply more directly in the individual calculation. These include the individual's own culpability, sanctions imposed on the individual by other agencies and industry organizations, the degree to which the individual has accepted responsibility for her conduct and the extent to which her occupation will provide future opportunities to violate the federal securities laws.

Non-Prosecution Agreements. Under an NPA the SEC agrees to forego an enforcement action, but that agreement is conditioned not only upon the party's cooperation but also upon its compliance with various undertakings, which may or may not be limited in duration. The undertakings can include straightforward cooperation tasks such as producing documents, responding to inquiries, appearing for interviews and providing testimony. They may also include periodic reporting requirements, the imposition of a monitor, or payment of disgorgement or a penalty. The SEC agrees that it will not pursue any enforcement action if the conditions are satisfied, although the SEC can institute proceedings in the future if the party does not comply with the provisions set out in the NPA.

Deferred Prosecution Agreements. A deferred prosecution agreement likewise results in the SEC foregoing prosecution, but it comes with significantly more strings than an NPA. While requiring full and truthful cooperation, the SEC also usually demands (1) tolling the statute of limitations; (2) compliance with certain conditions during a period of deferred prosecution, which can last several years; (3) disgorgement or penalty payments and, (4) under certain circumstances, an agreement to admit or not to contest facts that would establish a violation of the federal securities laws. A party's failure to comply with the conditions imposed can allow the SEC to assert charges. In addition, the admissions required in a DPA — which are generally set out in the agreement — can be detailed and extensive. On top of the public relations problems they can cause, there are open questions as to the effect of such admissions in parallel criminal or private actions. Ironically, whereas a party's obligations under a DPA, which is generally viewed as more onerous than an NPA, expire at the end of the deferred prosecution period, those under an NPA may have no set duration.

Cooperation in Practice

Since releasing the Cooperation Initiative in 2010, the SEC has had few occasions to announce any agreements with corporate cooperators, and until this spring had not announced any cooperation agreements with individuals.

The Corporate NPA

The SEC first announced an NPA in 2010 in its investigation of improper revenue recognition at Carter's, Inc. stemming from the company's 2009 restatement. The SEC's press release highlighted both that the underlying conduct was carried out by a single rogue employee and that Carter's prompt and extensive cooperation allowed the SEC to complete its investigation and bring an enforcement action against the individual in a little more than a year after Carter's initial disclosure of the fraud, an unusually short time frame.⁶ According to the SEC, the agreement

reflected the “relatively isolated nature of the unlawful conduct,” Carter’s “prompt and complete self-reporting of the misconduct,” its “exemplary and extensive cooperation in the investigation” (including undertaking a comprehensive internal investigation) and its “extensive and substantial remedial actions.”

Specifically, the agreement required Carter’s to cooperate fully and truthfully “in an official investigation or proceeding by any federal, state, or self-regulatory organization.” In other words, the company’s cooperation obligations were not limited to cooperating with the SEC in civil matters, but extended to other agencies and to criminal investigations. The agreement spelled out that cooperation included producing all non-privileged documents, appearing for interviews and testifying at trial as requested.

The agreement also limited the company’s ability to issue public statements about the matter. Using language typically found in SEC Consent Decrees, the NPA prohibits Carter’s from “denying, directly or indirectly, the factual basis of any aspect” of the SEC’s allegations, although the prohibition does not apply in any legal proceedings not involving the SEC.

Under the agreement, the SEC agreed not to bring any enforcement action against Carter’s arising from the investigation. The agreement did not bind any agency or organization other than the SEC. Nevertheless, if the SEC determines that the company breached the agreement, such as by failing to cooperate or by making a prohibited statement, the SEC could bring an enforcement action. Whether the company has any recourse in that regard is an open question. Under the NPA, the Division of Enforcement may recommend that the Commission bring an enforcement action, and that recommendation is “in [the division’s] sole discretion and not subject to judicial review.” But whether Carter’s would have grounds to fight that determination after the filing of the complaint is not addressed, and it does not appear that that question has ever been litigated.

The Corporate DPA

The following year, the SEC announced its first DPA, this time with Tenaris in connection with violations of the Foreign Corrupt Practices Act. Tenaris was alleged to have made \$5 million in profits from the Uzbekistan government in connection with pipeline supply contracts tainted by bribes. Tenaris, which discovered the wrongdoing as part of an internal review, immediately informed the SEC and thereafter reviewed its control and compliance measures and enhanced its anti-corruption policies and practices. In addition to agreeing to cooperate further with the SEC and DOJ, Tenaris agreed to pay \$5.4 million in disgorgement and prejudgment interest. In a separate NPA with the DOJ, the company also agreed to pay a \$3.5 million criminal penalty.

The Tenaris DPA highlights the difference between an NPA and a DPA. The Tenaris DPA had many of the same features as the Carter’s NPA, including full cooperation, a limitation on public statements and the ability of the SEC to file suit in the event that it determines that Tenaris breached the agreement. For its part, the SEC agreed not to bring any enforcement action against Tenaris arising from this investigation after the conclusion of a two-year deferral period as long as Tenaris complied with the terms of the agreement during that period. (By contrast, Carter’s obligations and the SEC’s rights and promises are not limited by time under the NPA.)

Two aspects of the DPA, however, are significantly different. First, Tenaris agreed to pay a penalty and implement various remedial steps. Whereas the Carter's NPA included no monetary or other sanction, Tenaris agreed to pay \$5.4 million, provide a written certification of compliance with the agreement, annually review and update its Code of Conduct, require various personnel to certify compliance with the Code of Conduct and conduct "effective training regarding anticorruption and compliance with the FCPA" for a broad range of employees.

Second, the DPA outlined in detail an extensive chronology of facts and events that underlay the SEC's investigation, including that Tenaris sales personnel had knowingly employed an agent who had bribed an Uzbekistani official to obtain certain specified contracts, that Tenaris failed to make and keep books and records that accurately and fairly reflected the transactions with the agent, that Tenaris' system of internal controls had failed, and that its FCPA policies, procedures and training needed further strengthening. Tenaris agreed that, if it breached the agreement, it would not contest or contradict any of these factual statements in any subsequent SEC enforcement proceeding. While the DPA also provided that that factual statement was "made pursuant to settlement negotiations" and was "not binding against Tenaris in any other legal proceeding," no court has yet been called upon to rule on the extent to which this language protects what are arguably admissions from being used against Tenaris in any other proceedings.

The Individual Cooperation Agreement

According to the SEC, since the announcement of its Cooperation Initiative the agency has entered into cooperation agreements with 37 individuals.⁷ However, it was not until March 2012 that the agency publicly announced such an agreement.⁸ Significantly, the SEC did not require a DPA or NPA: the individual simply was not charged.

AXA Rosenberg, an institutional money manager that specialized in quantitative investment strategies, encountered an error in a 2007 quantitative investment model used to manage client portfolios.⁹ Although an employee discovered the error in June 2009, it was not corrected until September 2009. An internal investigation followed, and the error was disclosed to the SEC in March 2010. AXA Rosenberg and several related entities eventually settled enforcement actions with the SEC, paying \$217 million in investor losses, \$27.5 million in penalties, and agreeing to hire an independent consultant to advise them on their compliance and control procedures.¹⁰

Notably, the SEC did not name the individual cooperator other than to refer to him as a "senior executive." In a Litigation Release, the SEC pointed to a number of factors that allowed the individual to avoid prosecution.

- *Assistance provided.* The senior executive was the first to offer his cooperation, and he specifically asked to be considered under the Cooperation Initiative. The "timeliness and quality" of his cooperation were important in allowing the SEC to conserve its resources. The SEC praised him as "forthcoming" with "truthful, complete, and reliable information." In particular, his position within the company, relationship with the parties, and knowledge of the investment models allowed him to provide "detailed and credible" information that was important to the investigation. Significantly, he agreed to cooperate without condition, including any promise of a specific outcome in exchange for his cooperation.

- *Importance of the underlying matter.* Fortunately for the individual, the concealment of errors within quantitative investment models is a “priority area” for the SEC. The enforcement action was a first-of-its-kind and fully addressed the harm caused by the wrongdoing.
- *Interest in holding the senior executive accountable.* The SEC emphasized that, although he was involved in the concealment, the senior executive’s role in the concealment was limited and he in fact advocated to disclose the error to the CEO. It was others who directed the concealment of the error and made material misrepresentations to clients. The senior executive’s cooperation facilitated a “quick and successful resolution” of the enforcement entities.
- *The Senior Executive’s Profile.* The senior executive had no prior history, resigned from his positions, and retired from the investment industry. He was not associated with a regulated entity, was not a fiduciary, and was not an officer or director of a public company. As the SEC emphasized, he was not in a position to commit future violations.

What Matters?

Numerous factors come into play in determining a cooperator’s fate, but three factors appear to be most significant in the SEC’s balancing process. Perhaps most obvious is the party’s culpability. Not surprisingly, more serious conduct, such as intentional fraud, will warrant more onerous terms, all other things being equal. This is especially true when the conduct is not limited to a single transaction, stretches over a period of time, or is the product of what the SEC perceives to be a company’s culture or lack of controls. There well may be situations where the conduct is sufficiently culpable that no amount of cooperation can avoid charges, but that cooperation credit is reflected in lesser terms.

By the time a party is confronted with the decision of whether and how to cooperate, however, there is generally little that it can do about its culpability. The deed has been done. Nevertheless, two key factors remain within the control of a party considering cooperation. The first is the extent of the cooperation provided. It is no surprise that more and better cooperation means better terms for the cooperator. In a nutshell, cooperation means helping the SEC — and frequently the DOJ and other agencies — to investigate a party’s own conduct. At a minimum, it requires turning over all information and relevant documents that the party has gathered.¹¹ You can also expect the SEC to ask a corporate cooperator to search for and produce additional documents — often requiring large database searches and the production of vast amounts of material — and to investigate and explain additional issues or transactions, perhaps some that previously warranted little attention. Corporate parties can also be asked to make employees available for interviews, which can require the same amount of preparation needed for a deposition. Individuals can be asked to turn over inculpatory information about, and sometimes testify against, family, friends and co-workers, and may be asked to record conversations with others who are subject to government investigation. Once a party begins to cooperate, regular and repeated requests for documents, information and interviews can last for years. Cooperation can be a long, distracting and expensive process.

The other factor is speed. Indeed, speed may be the most significant variable. Especially in the corporate context, the SEC wants to hear about the matter from the corporation first. This need for speed is driven by several considerations. Earlier cooperation saves the SEC the time, effort and resources needed to conduct an investigation without insider guidance. It also may allow the SEC a better chance to recover assets before they can be moved overseas or dissipated and to obtain evidence before it can be hidden, destroyed or lost. Later cooperation thus may provide less value to the SEC and less benefit to the cooperator.

More practically, early cooperation minimizes the chance that someone else will get to the SEC first. Information is less valuable to the SEC if others have already provided it — especially if those others are pointing fingers at you. This consideration is especially keen in light of the Dodd-Frank Whistleblower provisions and the SEC's 2011 rules implementing them.¹² Putative cooperators are now competing not just against other cooperators who are similarly weighing the prospect of an enforcement action against the benefits of cooperation, but also against whistleblowers who may have no exposure and the incentive of receiving up to 30 percent of what the SEC recovers. These factors put a premium on making an early determination whether or not to cooperate.

Conclusion

The decision to cooperate should not be undertaken without careful consideration of all of the pros and cons. For parties that determine cooperation is in their best interest, understanding the SEC's decision-making criteria, including the "market" set by past cooperation agreements, will be crucial in taking advantage of the SEC's Cooperation Initiative and achieving the best possible result.

Endnotes

- ¹ The SEC's Cooperation Initiative is discussed at <http://www.sec.gov/spotlight/enfcoopinitiative.shtml> (last accessed May 2, 2012).
- ² The Department of Justice's Manual for United States Attorneys discusses the role of corporate and individual cooperation in charging decisions and provides factors for prosecutors to consider in deciding whether to charge. See United States Attorney's Manual §§ 9-27.220, *et seq.* (individual); 9.28.300 (cooperation); see also *id.* §§ 9.27-600, *et seq.* (the government may enter into a non-prosecution agreement in exchange for cooperation when "the person's timely cooperation appears to be necessary to the public interest and other means of obtaining the desired cooperation are unavailable or would not be effective").
- ³ Exchange Act Release No. 44969 (October 23, 2001) (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) (the "Seaboard Report") available at <http://www.sec.gov/litigation/investreport/34-44969.htm>. The Seaboard Report is now incorporated into the SEC Enforcement Manual at Section 6.1.2. Securities and Exchange Commission Division of Enforcement, Enforcement Manual ("Enforcement Manual") § 6.1.2, available at <http://www.sec.gov/divisions/enforce/enforcementmanual.pdf>.
- ⁴ See, e.g., SEC Press Release 2006-4 (Jan. 4, 2005) (Statement of the Securities and Exchange Commission Concerning Financial Penalties) (discussing role of cooperation in determining appropriateness of corporate penalty) available at <http://www.sec.gov/news/press/2006-4.htm>.
- ⁵ A cooperation agreement is between a cooperator and the Division of Enforcement. The Commission is not bound by the recommendation of the Enforcement Staff. See SEC Enforcement Manual § 6.2.2 ("The staff should advise potential cooperating individuals or companies that cooperation agreements entered into with the Division do not bind the Commission and that the Division cannot, and does not, make any promise or representation as to whether or how the Commission may act on enforcement recommendations made by the Division."). The Commission is a party to NPAs and DPA, however, and is bound by their terms. See *id.* §§ 6.2.4, 6.2.5.
- ⁶ SEC Press Release No. 2010-252 (Dec. 20, 2010).
- ⁷ David Bergers, Director of the SEC's Boston Regional Office, at March 2, 2012 "SEC Speaks" Conference.
- ⁸ The SEC does not ordinarily disclose non-cooperation declinations. The 1:37 post-Cooperation Initiative ratio suggests that the SEC plans to publicize cooperation agreements only rarely. That said, if an investigation already has been made public, a party under scrutiny may in some circumstances prefer a public announcement by the SEC that it will not prosecute, although there is nothing to prevent that party from making a public announcement if the SEC does not.
- ⁹ AXA Rosenberg Group LLC, *et al* File No. 3-14224 Corrected Order Instituting Administrative and Cease-And-Desist Proceedings Pursuant to Section 8A of the Securities Act of 1933, Section 9(b) of the Investment Company Act of 1940, and Sections 203(e), 203(f), and 203(k) of the Investment Advisors Act of 1940, Making Findings, and Imposing Remedial Sections and a Cease-And-Desist Order
- ¹⁰ Litigation Release 22298, March 19, 2012 available at <http://www.sec.gov/litigation/litreleases/2012/lr22298.htm>.
- ¹¹ The SEC can no longer ask a party to waive the attorney-client privilege as part of cooperation, at least without prior approval from the highest levels. See SEC Enforcement Manual § 4.3. A party that volunteers to waive privilege can argue that it has provided "more" cooperation, although waiver to the SEC likely means waiver as to all other parties. See, e.g., *In Re Pacific Pictures Corporation*, ___ F.3d ___, 2012 WL 1640627 (9th Cir. Apr. 17, 2012) (rejecting selective waiver doctrine).
- ¹² 17 CFR Parts 240 and 249 (August 12, 2011).

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