LATHAM & WATKINS

Number 1018 April 21, 2010

Client Alert

Latham & Watkins Litigation Department

The SEC Cooperation Initiatives: New Risks for Public Companies

Introduction

Over the last few months, the US Securities & Exchange Commission's (SEC) Division of Enforcement has begun to implement a number of initiatives designed to induce cooperation from individuals who participated in (or at least knew of) violations of the federal securities laws. These initiatives, if successful, could create powerful incentives for employees of public companies to blow the whistle on corporate wrongdoing directly to the Commission. This Client Alert discusses the SEC's new cooperation regime as outlined by Enforcement's leadership, highlights the risks this regime presents to public companies and provides tips on how those companies may avoid or manage those risks.

"The new cooperation regime increases the odds that senior management or the board will first learn of misconduct at the company not through a hotline or internal audit report, but in a telephone call from SEC Enforcement."

The New Cooperation Regime

In January, the SEC issued new guidelines for evaluating and rewarding individual cooperation.[1] These guidelines enumerate the criteria the SEC will consider when determining how to allocate credit to individuals cooperating in an investigation. In conjunction with the cooperation guidelines, the SEC unveiled new tools — proffer agreements, cooperation agreements and deferred-prosecution and non-prosecution agreements — that formalize the process by which individuals and companies obtain cooperation credit. Together, these initiatives are designed to provide would-be cooperators some assurance that they will obtain credit in exchange for cooperation with the SEC.

Additionally, Congress is currently considering legislation that would require the SEC to award whistleblowers no less than 10 percent and up to 30 percent of the sanctions levied in matters to which they alerted the SEC.[2] While the myriad implications of these initiatives remain uncertain, it is clear that they generally work to encourage early "whistleblowing out" to the SEC.

Whether the cooperation initiatives will be effective remains to be seen. Indeed, many experienced SEC defense counsel question whether the cooperation initiatives will attract additional whistleblowers. For instance, some doubt whether the benefits of cooperation — potentially *reduced* sanctions — will be attractive to securities industry professionals, who generally view *any* SEC enforcement proceeding against them as career-ending or at least career-threatening.

However, according to recent statements by SEC Deputy Director of Enforcement Lorin Reisner, professionals have already sought to take advantage of the new initiatives.

Defense counsel have also pointed out that the SEC's cooperation initiatives are unlikely to secure cooperation in very many instances unless and until individuals feel comfortable that the Commission itself will abide by the Enforcement Staff's commitments in this regard, and also that cooperators will be treated more gently than before by other potentially interested authorities, such as the Department of Justice (DOJ), state attorneys general, self- regulatory organizations and state boards of accountancy. Confronted with that objection, Deputy Director Reisner noted that the Division of Enforcement enjoys a close and cooperative relationship with the DOJ and that US Attorney's Offices have already expressed support for the new cooperation initiatives. Ultimately, Deputy Reisner's comments reveal an understanding that the Staff will win over skeptics only by demonstrating over a period of time, in a number of cases, that it can deliver on the promises of the new initiatives.

The initiatives as formally announced contain a number of exceptions that the Division of Enforcement has realized could undermine the attractiveness of the cooperation program. To avoid that, senior members of the Division have made public statements indicating that these exceptions will not be enforced, as noted below.

- *Whistleblowing is Encouraged in All Matters, Small and Large*: The January guidelines suggested that cooperation in small matters might not receive the same credit as cooperation in large matters. However, Scott Friestad, an Associate Director of Enforcement, has clarified publicly that initiatives will apply to cooperators even in matters of less significance.
- *Even Culpable Parties May Participate*: The January guidelines suggested that individuals who were especially culpable would have difficulty obtaining cooperation credit from the SEC. Deputy Director Reisner has since stated publicly that even individuals who engaged in misconduct with scienter (intent or reckless disregard) will not be disqualified from participating in the cooperation program. The initiatives will apply to such culpable cooperators so long as their cooperation is useful.
- *Whistleblowers Accepted: Early and Perhaps Later*: Rob Khuzami, SEC Director of Enforcement, has suggested that early whistleblowing, even being first in the door, is important to obtaining cooperation credit. Statements made subsequently by Enforcement officials suggest that the initiatives will likely apply to cooperators who are not first in the door, so long as their cooperation proves useful.

Company Risks Under the New Cooperation Regime

The new cooperation regime reflects the background of the current senior leadership of the Division of Enforcement. The Division Director and Deputy Director (as well as the heads of the New York and Atlanta Regional Offices) are alumni of the United States Attorney's Office for the Southern District of New York, and therefore come from an environment where reliance on cooperating witnesses is necessary to build complex cases — whether those cases involve street crimes or white collar crimes. It is therefore not surprising that they would seek to provide meaningful incentives to come forward for those involved in the complex securities frauds that the SEC faces frequently.

At the same time, the new cooperation regime increases the odds that senior management or the board will first learn of misconduct at the company not through a hotline or internal audit report, but in a telephone call from SEC Enforcement. Companies that learn of misconduct after it has been raised to the SEC face serious challenges:

- *Potential Loss of Cooperation Credit*: Almost a decade ago, the SEC's *Seaboard Report* outlined four major criteria the SEC considers when giving companies credit for their cooperation during an investigation, and the Commission continues to rely on those criteria. One of them — self-reporting — will be lost if a whistleblower approaches the SEC initially or contemporaneously. Another — cooperation — may be undercut by whistleblowing out, because in a whistleblower case, Enforcement is more likely to issue subpoenas immediately rather ask the company to provide information and documents voluntarily.
- *Losing Control of the Storyline*: Companies that self-report potential misconduct benefit from the opportunity to present a complete factual scenario to the Staff, especially if they have had the opportunity to fully investigate prior to self-reporting. If the SEC succeeds in encouraging whistleblowing, the Enforcement Staff will more often learn of potential issues from individuals who lack a complete understanding of the facts and who may even be unhinged from reality. Companies will more often find themselves trying to overcome the Staff's initial misimpressions.
- *Loss of the Attorney-Client Privilege*: Protecting attorney-client privilege is important for companies facing potential litigation. Individual whistleblowers may not fully appreciate the company's interest in preserving the privilege, and those with the capacity to waive the privilege — directors, officers, and other high-level employees acting in their authorized roles — may at times feel free, if not obligated, to provide privileged information to the Staff. The costs of waiving the privilege can be severe.

Strategies for Staying in Front and Catching Up

One recent study suggests that, even in the absence of financial incentives for blowing the whistle, employees might be more effective than any other type of actor in identifying financial fraud in a manner that led to government enforcement action. Researchers who analyzed 216 cases of alleged corporate fraud between 1996 and 2004 concluded that employees were the whistleblowers in 17 percent of the cases. The researchers concluded further that the SEC detected only 6.6 percent of the fraud cases, ranking behind analysts (13.8 percent) and short sellers (14.5 percent).[3] Because the SEC's new cooperation initiatives put a premium on whistleblowing out, and significant financial incentives for whistleblowing out may soon be enacted by Congress, employee whistleblowing is likely to increase, and those employee whistleblowers will now have a greater incentive to go directly to the government without reporting internally. Therefore public companies should redouble their efforts to maximize the chances that an employee will report concerns first to company personnel.

Here are some tips for achieving that goal:

- From the highest levels of the company, regularly emphasize to all employees the company's desire to address potential wrongdoing and to make it easy for potential whistleblowers to report concerns to the relevant company personnel. Sarbanes-Oxley (SOX) Section 301 already requires audit committees to establish complaint systems to facilitate the receipt, retention and

treatment of whistleblower reports, and SOX Section 806 protects whistleblowers who use those internal complaint systems.
The SEC's new initiatives may encourage employee whistleblowers to skip companies' internal complaint systems and dial the SEC directly, so it is important to reinforce and improve your company's existing SOX messages to employees.

- Offer training on the whistleblower policy and procedures so that employees know the process and appreciate the roles of the people involved.
- Make sure that employees understand that retaliation for reporting legitimate concerns of potential misconduct will not be tolerated.
- Ensure that whistleblower allegations made anonymously are taken as seriously and investigated as thoroughly as allegations made by named sources.[4]
- Evaluate whistleblower complaints expeditiously.
- To the extent possible, inform internal whistleblowers of the progress of the investigation.
- If appropriate, from time to time reiterate to the whistleblower the company's commitment to seeing the investigation to its end.
- Document the company's evaluation and response to each complaint.
- Emphasize the importance of appropriately publicizing results and corrective action taken regarding investigations where wrongdoing is found.
- Unless it is obvious that the situation can be handled internally, do not delay in bringing in outside counsel experienced in dealing with the issues involved (including SEC Enforcement). If your regular outside counsel might be implicated in the internal problem, consider bringing in unimpaired outside counsel.

Endnotes

[1] The SEC Press Release is available at http://sec.gov/news/press/2010/2010-6.htm.

[2] The "Restoring American Financial Stability Act of 2010" is currently under consideration in the Senate.

[3] *See* Alexander Dyck, Adair Morse and Luigi Zingales, "Who Blows the Whistle on Corporate Fraud," Working Paper No. 08-22, Chicago Booth School of Business. Available online at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=891482.

[4] A study based on an experiment involving 83 highly experienced audit committee members concluded that if a whistleblower reports anonymously, audit committee members evaluating the report are likely to treat the report as less credible, and investigate it less thoroughly, compared to reports made by a named source. Hunton, James and Jacob Rose. "Effects of Anonymous Whistle-Blowing and Perceived Reputation Threats on Investigations of Whistle-Blowing Allegations by Audit Committee Members," available online at http://www.unh.edu/news/cj_nr/2010/mar/lw25whistle.cfm.

If you have any questions about this *Client Alert*, please contact one of the authors listed below or the Latham attorney with whom you normally consult:

William R. Baker III
+1.202.637.1007
william.baker@lw.com
Washington, D.C.

Lawrence A. West
+1.202.637.2135
lawrence.west@lw.com
Washington, D.C.

Brian E. Kowalski
+1.202.637.1064
brian.kowalski@lw.com
Washington, D.C.

Scott C. Jones
+1.202.637.3316
scott.jones@lw.com
Washington, D.C.
