

The New Era in SEC Enforcement: Fostering Cooperation

The SEC's "Cooperation Initiative," announced in mid-January, is perhaps the most important and dramatic change in SEC enforcement practice in decades. It represents a fundamental departure from prior SEC practice and is likely to reshape the work of SEC defense counsel.

I. Until Recently, The SEC Placed Little Emphasis on Rewarding Cooperation

Prior to the Cooperation Initiative, the SEC's enforcement program placed little emphasis on encouraging cooperation. The Enforcement Manual in effect until the spring of 2009, when new leadership took over the Division of Enforcement, mentions cooperation only in passing and in many cases describes the tools available to encourage cooperation as available only "in limited circumstances." In sharp contrast, the revised Enforcement Manual, published on January 13, 2010, devotes an entire chapter to cooperation. That chapter, entitled "Fostering Cooperation," begins by declaring that "[t]he staff should carefully consider the use of cooperation by individuals and companies to advance its investigations and related enforcement actions."

Why wasn't fostering cooperation emphasized more by the SEC in the past? This may be explained by the fact that the SEC has powerful tools to compel cooperation without rewarding it. Entities, and the individuals who work for them, that are subject to SEC inspection powers or oversight by self-regulatory organizations have to cooperate as a condition of keeping their licenses. This includes investment companies, advisers, broker-dealers, transfer agents, and most accountants. For these persons, non-cooperation results in swift and serious penalties. Criminal prosecutors do not have similar information gathering powers—inspections and inquiries by self-regulatory organizations—which is one likely reason why criminal prosecutors turned to rewarding for cooperation before the SEC.

Moreover, even when targets are not subject to SEC inspection or self-regulatory obligations to cooperate, not cooperating with a request from the SEC for information makes little sense. Such non-cooperation only results in a subpoena enforcement action, a public proceeding that the target is almost certain to lose and that barely slows down the progress of the investigation. The Commissioners first delegated the power to institute subpoena enforcement actions to the staff and subsequently delegated the power to enter formal orders, thus giving the SEC staff the power to issue subpoenas and causing any possibility of delay through non-cooperation to essentially disappear.

Most important, in SEC actions, unlike criminal actions, the fact finder can draw an adverse inference from the target's assertion of the Fifth Amendment privilege against self-incrimination. This creates an exceedingly strong incentive to cooperate by testifying rather than refusing to testify based on the Fifth Amendment privilege against self-incrimination. "Taking the Fifth" is viewed as virtually guaranteeing defeat in an enforcement action where the SEC can obtain disgorgement, fines, bars, other harsh ancillary relief, and adverse publicity. Such remedies can be imposed very quickly if the SEC elects to prosecute in an administrative proceeding, which is almost always available to the SEC. This drawback for the civil litigant stands in sharp contrast to the downside faced by a criminal target where there is virtually no penalty imposed on asserting the Fifth Amendment privilege against self-incrimination.

As explained in detail below, because of the SEC's perception that it did not need to reward cooperation to obtain it, there was little emphasis placed on rewarding cooperation in the past. That view has radically changed.

II. How Cooperation Is Defined

Prior to the publication of the January 13, 2010 Enforcement Manual, the only clear statement defining cooperation was the SEC's 2001 Section 21(a) Report, known as the Seaboard Report. The Report was itself viewed as something of a revolutionary change in SEC enforcement practice when it was issued, but it has several limitations. First, it applies only to entities, suggesting that individuals would not be rewarded for cooperation. Second, it contains a long list of factors the SEC considers in evaluating whether an entity would receive credit for cooperation. Some practitioners read these factors to suggest that credit for cooperation would never be given where the underlying conduct was serious. Other practitioners feared that slight deviations from the detailed factors would result in the loss of credit for cooperation.

Most important, it was unclear what credit the SEC actually gave for cooperation under the Seaboard factors. The Seaboard factors were barely mentioned in the Enforcement Manual in existence prior to January 2010, and many practitioners doubted the SEC gave any real credit for cooperation.

The January 13, 2010 Enforcement Manual represents a radical departure from this approach in three respects. First, individuals are now expressly offered credit for cooperation. Credit is offered individuals based on a relatively simple list of factors:

1. The assistance provided by the cooperating individual in the Commission's investigation or related enforcement actions;
2. The importance of the underlying matter in which the individual cooperated;
3. The societal interest in ensuring that the cooperating individual is held accountable for his or her misconduct; and
4. The appropriateness of cooperation credit based upon the profile of the cooperating individual.

Second, although the 2010 Enforcement Manual does not overrule the Seaboard Report, it offers a simplified list of factors suggesting an entity has cooperated:

1. Self-policing prior to the discovery of the misconduct, including establishing effective compliance procedures and an appropriate tone at the top;
2. Self-reporting of misconduct when it is discovered, including conducting a thorough review of the nature, extent, origins and consequences of the misconduct, and promptly, completely and effectively disclosing the misconduct to the public, to regulatory agencies, and to self-regulatory organizations;
3. Remediation, including dismissing or appropriately disciplining wrongdoers, modifying and improving internal controls and procedures to prevent recurrence of the misconduct, and appropriately compensating those adversely affected; and
4. Cooperation with law enforcement authorities, including providing the Commission staff with all information relevant to the underlying violations and the company's remedial efforts.

Removed is a long list of intimidating factors, which some practitioners read as suggesting that cooperation would never be rewarded when the underlying conduct was serious or when some procedural step was skipped.

Third, the January 13, 2010 Enforcement Manual offers a clear list of rewards available for cooperation. Many of these tools have never been available before; others have been used so infrequently they were considered virtually useless.

III. The Rewards for Cooperation

A. Proffer Agreements

As defined in the January 13, 2010 Enforcement Manual, “[a] proffer agreement is a written agreement providing that any statements made by a person, on a specific date, may not be used against that individual in subsequent proceedings, except that the Commission may use statements made during the proffer session as a source of leads to discover additional evidence and for impeachment or rebuttal purposes if the person testifies or argues inconsistently in a subsequent proceeding. The Commission also may share the information provided by the proffering individual with appropriate authorities in a prosecution for perjury, making a false statement or obstruction of justice.”

The October 6, 2008 Enforcement Manual mentioned proffer agreements, in what was considered an innovation for the SEC at the time, but made clear that such agreements should be used only “in limited circumstances” and that “proffer agreements should not be granted without serious consideration and consultation with supervisors since doing so may potentially impact the staff’s ability to bring a case against the witness.” In sharp contrast, the January 13, 2010 Enforcement Manual encourages the use of proffer agreements: “Proffers by attorneys and cooperating individuals are an important vehicle used by the staff to assess the probable value of cooperation by individuals and companies and for those individuals and companies to initiate discussions regarding the benefits that may be available if they cooperate. Proffer agreements are regularly used by the staff to facilitate proffer sessions.”

A form of a proffer agreement appears in the October 6, 2008 Enforcement Manual but not in the January 13, 2010 Enforcement Manual.

B. Assurance of Non-Prosecution

In what was viewed as a major innovation at the time, the October 6, 2008 Enforcement Manual indicated that “in very limited circumstances” a witness could be provided with a letter assuring that the SEC would not prosecute. However, these letters had to be authorized in advance by the SEC Commissioners. The form for such a letter appears in the October 6, 2008 Enforcement Manual.

The January 13, 2010 Enforcement Manual changes this practice in three respects. First, the cautionary language about how rarely such assurances will be given is deleted. Second, such assurances can be oral. Third, it is no longer necessary for the SEC staff to obtain approval from the SEC Commissioners before giving such assurances. All of these changes seem intended to expand the use of assurances of non-prosecution.

C. Cooperation Agreements

Cooperation agreements are a completely new innovation in the SEC’s enforcement program. The following is a description of such agreements from the January 13, 2010 Enforcement Manual: “A cooperation agreement is a written agreement between the Division of Enforcement and a potential cooperating individual or company prepared to provide substantial assistance to the Commission’s investigation and related enforcement actions. Specifically, in a cooperation agreement, the Division agrees to recommend to the Commission that the individual or company receive credit for cooperating in its investigation and related enforcement actions and, under certain circumstances, to make specific enforcement recommendations.” The Director of the Division of Enforcement has authority to enter into such agreements without approval of the SEC Commissioners. Although a form for a

cooperation agreement does not appear in the January 13, 2010 Enforcement Manual, the Manual identifies provisions that should be included in such agreements.

The January 13, 2010 Enforcement Manual also notes that, “[e]ven in the absence of a cooperation agreement, the staff may take into account an individual or company’s cooperation in connection with recommending sanctions or charges associated with the alleged misconduct and, under certain circumstances, forgoing enforcement actions against a cooperating individual or company.”

The January 13, 2010 Enforcement Manual also mentions, for the first time, that cooperating persons may request that the SEC send letters to courts and other prosecutors describing the person’s cooperation, so-called Cooperation Letters. This apparently does not require prior approval by the SEC Commissioners.

D. Deferred Prosecution Agreements

A deferred prosecution agreement is another innovation of the January 13, 2010 Enforcement Manual. As described in the Manual:

A deferred prosecution agreement is a written agreement between the Commission and a potential cooperating individual or company in which the Commission agrees to forego an enforcement action against the individual or company if the individual or company agrees to, among other things: 1) cooperate truthfully and fully in the Commission’s investigation and related enforcement actions; 2) enter into a long-term tolling agreement; 3) comply with express prohibitions and/or undertakings during a period of deferred prosecution; and 4) under certain circumstances, agree either to admit or not to contest underlying facts that the Commission could assert to establish a violation of the federal securities laws. If the agreement is violated during the period of deferred prosecution, the staff may recommend an enforcement action to the Commission against the individual or company without limitation for the original misconduct as well as any additional misconduct. Furthermore, if the Commission authorizes the enforcement action, the staff may use any factual admissions made by the cooperating individual or company to file a motion for summary judgment, while maintaining the ability to bring an enforcement action for any additional misconduct at a later date.

Deferred prosecution agreements must be approved by the SEC Commissioners. Interestingly, the January 13, 2010 Enforcement Manual suggests that in some cases these agreements will *not* be public. Although a form for a deferred prosecution agreement does not appear in the January 13, 2010 Enforcement Manual, the type of provisions that generally should appear in such agreements are set forth.

E. Non-Prosecution Agreements

In another innovation, the January 13, 2010 Enforcement Manual describes non-prosecution agreements. According to the Manual:

A non-prosecution agreement is a written agreement between the Commission and a potential cooperating individual or company, entered in limited and appropriate circumstances, that provides that the Commission will not pursue an enforcement action against the individual or company if the individual or company agrees to, among other things: 1) cooperate truthfully and fully in the Commission’s investigation and related enforcement actions; and 2) comply, under certain circumstances, with express undertakings. If the agreement is violated, the staff retains its ability to recommend an enforcement action to the Commission against the individual or company without limitation.

Non-prosecution agreements must be approved by the SEC Commissioners. The suggested terms for such agreements are set forth in the January 13, 2010 Enforcement Manual.

The January 13, 2010 Enforcement Manual continues the practice outlined in the October 6, 2008 Enforcement Manual of sending notice when the enforcement staff has determined not to prosecute a person. The form for such a letter appears in the October 6, 2008 Enforcement Manual.

F. Immunity

For decades, the SEC has occasionally requested that the Department of Justice approve the granting of immunity from criminal prosecution. However, as the October 6, 2008 Enforcement Manual makes clear, “immunity orders are granted in limited circumstances.” Moreover, approval by the SEC Commissioners was required before permission to grant such orders could be requested from the Department of Justice.

The January 13, 2010 Enforcement Manual changes the prior practice in two key respects. First, such requests will now be made “in appropriate circumstances,” signaling a more liberal standard for requesting immunity. Second, such requests to the Department of Justice may now be made by the Director of the Division of Enforcement without approval from the SEC Commissioners, greatly streamlining the process.

G. Publicizing the Benefits of Cooperation

In the past, it was not uncommon for the SEC to make no mention of cooperation in either its enforcement actions or associated press releases. This has now changed. According to the January 13, 2010 Enforcement Manual, “[i]n most cases, the Commission’s enforcement program is enhanced by publicizing the benefits associated with cooperating in a Commission investigation or related enforcement actions.”

IV. Lessons for the Practitioner

Unless a tactical decision is made not to cooperate, defense counsel should make a conscious effort to obtain as many benefits as possible for cooperation. At each stage of the enforcement process, the new, or liberalized, rewards available for cooperation should be sought. Defense counsel should track the cases where cooperation is rewarded and make every effort to tailor the defense to take advantage of the rewards for cooperation.

In the end, for the reasons set forth above, most witnesses have always cooperated with SEC investigations and will continue to do so. The SEC’s efforts to foster cooperation are nonetheless commendable because they acknowledge and reward conduct that should be so recognized. The challenge for the SEC will likely arise as it recognizes that cooperation would have occurred even in the absence of rewards. This may cause the SEC to become ever more reluctant to reward cooperation, leading to an ever-rising standard to obtain credit for cooperation.

For more information, please contact your Ropes & Gray attorney.