

The SEC's Cooperation Framework: How Reliable a Roadmap?

The Securities and Exchange Commission announced on January 13, 2010 an initiative intended to encourage cooperation from companies and individuals involved in the Commission's investigations.¹ The new guidelines authorize the Staff to use certain cooperation tools that have long been standard in criminal practice. The Commission expects that the use of these tools will provide an incentive to those potentially subject to enforcement actions to come forward with first-hand evidence of potential violations. The SEC hopes that such cooperation will lead to more efficient and effective investigations, and notably better results.

The newly-available tools include cooperation agreements, deferred prosecution agreements and non-prosecution agreements. Robert Khuzami, the Director of the Division of Enforcement, in announcing the initiative, described these tools as a "potential game-changer" for the SEC Staff. In addition, the Commission has described an analytical framework that it and the Staff will use in evaluating, and potentially rewarding, the cooperation provided by individuals. This analytical framework, which examines whether the individual's cooperation was timely and important to the Staff's case, is an extension of the guidelines that have been used by the Staff for many years in evaluating cooperation by corporations during SEC investigations.

As a general proposition, the new guidelines appear helpful. They provide a detailed framework as to the factors the Staff and the Commission will consider in determining the value of an individual's cooperation. They also provide a means for both corporations and individuals to memorialize their and the Staff's mutual expectations as to what may be obtained through the cooperation process. Of course, the true value of this framework for all sides will be determined by the manner in which it is implemented. This is especially the case because the framework leaves the Staff with significant discretion as to how to weigh the relevant factors in any given situation. In particular, because several of the factors are outside the control of any potential defendant, a cooperator is at risk that his, her or its efforts may be overwhelmed by, to cite one example from the guidelines, "the societal interest in ensuring that the cooperating individual is held accountable for his or her misconduct." Other factors, described below, are similarly amorphous.

The SEC's initiative suggests that, in matters where the key to the investigation lies in obtaining cooperation, the SEC staff will be more proactive with the use of techniques traditionally used by criminal authorities, will be less deferential to the Department of Justice in pursuing investigations and charges, and will be more aggressive about seeking immunity for cooperating witnesses. Indeed, because the new procedures streamline the process whereby the SEC requests that the DOJ consider affording witnesses immunity from criminal prosecution, and because the current most senior officials in the Division of Enforcement learned their craft as criminal prosecutors, we expect that the SEC and DOJ will develop an even more robust working relationship.

¹ See Press Release, SEC Announces Initiative to Encourage Individuals and Companies to Cooperate and Assist in Investigations (Jan. 13, 2010), available at <http://www.sec.gov/news/press/2010/2010-6.htm>.

New Cooperation Tools

To implement the new guidelines, the Division of Enforcement has updated its Enforcement Manual to include a policy statement issued by the Commission. This statement describes a “wide-spectrum of [non-exclusive] tools available to the staff for facilitating and rewarding cooperation in its investigations and related enforcement actions.”² The updated Enforcement Manual also includes a section titled “Cooperation Tools.” The tools include proffer agreements, which have been used for many years. Such agreements provide that statements provided in a proffer by a potential witness may not be used against that witness in certain subsequent proceedings. The updated Enforcement Manual describes a number of additional tools, available to the Division for the first time:

- *Cooperation Agreements.* A written agreement between the Division of Enforcement and a potential cooperating individual or company whereby the cooperating party agrees to provide substantial assistance, including information and testimony, to the Staff’s investigation and related enforcement actions. In exchange, the Staff agrees to recommend to the Commission that the cooperating party receive credit for that cooperation and may agree to make a specific enforcement recommendation to the Commission if the agreement is otherwise satisfied by the cooperating party.
- *Deferred Prosecution Agreements.* A written agreement between the Division of Enforcement and an individual or company in which the Commission agrees to forgo an enforcement action if the cooperating party agrees to: (1) cooperate truthfully and fully; (2) enter into a long-term tolling agreement; (3) comply with express prohibitions or undertakings; and (4) under certain circumstances, agree to admit to or not contest underlying facts the Commission could assert to establish a violation of the federal securities laws.

² See SEC Enforcement Manual, SEC Division of Enforcement, Office of Chief Counsel (updated Jan. 13, 2010), available at <http://www.sec.gov/divisions/enforce/enforcementmanual.pdf> (hereafter, “Enforcement Manual”). The Enforcement Manual is promulgated by the Division of Enforcement. The portion of the revised manual that sets forth cooperation guidelines is promulgated by the Commission itself, published in the Code of Federal Regulations. See 17 C.F.R. § 202.12.

- *Non-Prosecution Agreements.* A written agreement between the Division of Enforcement and an individual or company in which the Commission agrees not to pursue an enforcement action against the individual or company, as long as the cooperating party agrees to cooperate truthfully and fully and complies with express undertakings, among other requirements. (Deferred Prosecution and Non-Prosecution Agreements are very similar, differing primarily in terms of the representations and undertakings required of the cooperating party. Non-Prosecution Agreements represent the greatest credit available to a cooperating party whom the Commission believes has violated the law.)

Evaluating Cooperation

In addition to introducing these new tools, the Commission also issued a policy statement concerning cooperation credit for individuals.³ The SEC’s statement explains that the Commission intended the new framework to serve two purposes: (1) promoting the fair and effective exercise of discretion; and (2) enhancing confidence, on the part of both the investing public and cooperating individuals, that decisions regarding cooperation will be made in an appropriate and consistent manner. The new cooperation framework for individuals can best be viewed as an extension of the established cooperation framework for crediting companies that has been applicable for much of the past decade.

In 2001, the SEC issued a report, commonly referenced as the Seaboard Report, pursuant to Section 21(a) of the Securities Exchange Act of 1934, which included a statement by the Commission on the relationship of cooperation by corporations to agency enforcement decisions.⁴ In issuing the Seaboard Report, the SEC explained that it would not take action against the parent company in large part due to the “complete cooperation” given to the Staff. The SEC reasoned that crediting such corporate behavior would benefit both its investigative staff, by easing their burden, and investors, by

³ See Policy Statement Concerning Cooperation by Individuals in its Investigations and Related Enforcement Actions, SEC Rel. No. 34-61340 (Jan. 13, 2010) (to be published at 17 C.F.R. § 202).

⁴ See 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, SEC Rel. No. 34-44969 (Oct. 23, 2001); available at <http://www.sec.gov/litigation/investreport/34-44969.htm> (hereafter “Seaboard Report”).

reducing the resources spent by the company in responding to the investigation.

The Seaboard Report also set forth the criteria the Staff would consider in determining whether to give credit, and how much credit to give, for self-policing, self-reporting, remediation and cooperation, with the caveat that particular facts and circumstances could be grounds for declining to apply the criteria and that no corporation should expect an enforceable “right” after providing cooperation. Similarly, the SEC’s newly-issued cooperation framework for individuals notes that, “[s]ince every enforcement matter is different, this analytical framework sets forth general principles but does not limit the Commission’s broad discretion to evaluate every case individually, on its own unique facts and circumstances.”⁵

In the Seaboard Report, the SEC explained that it would consider: (1) the nature of the misconduct; (2) how the misconduct arose; (3) the knowledge of senior management and the relationship to the corporate culture; (4) the duration of the misconduct; (5) the harm inflicted on investors; (6) how the misconduct was detected; (7) how soon the wrong was remedied; (8) the actions of the company after learning of the misconduct; (9) the process the company used to resolve the issue; (10) the commitment the company made to learning the full truth; (11) the report provided to the SEC by the company; (12) the assurance that the conduct was unlikely to recur; and (13) the changes to the company since the occurrence of the misconduct.⁶ As recently as January 11, 2010, the SEC Staff used this framework in acknowledging the cooperation and remedial efforts of NATCO Group Inc. in a Foreign Corrupt Practices Act investigation.⁷

In the new cooperation framework for individuals, the SEC states that it will consider factors that mirror the Seaboard framework. The SEC will consider, among other, non-enumerated factors: (1) the value of the assistance provided, measured in the quality and timeliness of the help; (2) the nature of the assistance provided, whether it was voluntary and included unrequested, but helpful information; (3) the nature and importance of the misconduct; (4) the length of the misconduct; (5) the harm inflicted on investors; (6) the in-

⁵ See Enforcement Manual at § 6.1.

⁶ Seaboard Report.

⁷ See In the Matter of NATCO Group, Inc. Admin. File No. 3-13742 (Jan. 11, 2010) (available at <http://www.sec.gov/litigation/admin/2010/34-61325.pdf>).

terest in holding the individual accountable for severe and culpable misconduct or toleration of illegal activity; (7) the efforts undertaken by the individual to prevent or report the misconduct and to remediate the harm; (8) sanctions imposed on the individual by other authorities; and (9) the personal and professional profile of the individual, regarding historical behavior and the risk of recidivism. Although the framework does not describe how these sometimes disparate factors will be weighed, statements by Mr. Khuzami and other SEC officials suggest that the greatest credit will be afforded to those who, in the vernacular of the criminal process, are “first in the door,” and provide the Staff with an early, detailed roadmap for the investigation.

Positive Aspects of the New Framework

As the policy statement contained in the Commission’s Seaboard Report did with respect to corporations, the Commission’s recent pronouncements seek to incentivize cooperation by individuals and thereby allow the Staff to gain access to information more efficiently than it could otherwise. The expansion of the application of these guiding principles to individuals should be viewed as a positive development, as it should provide additional structure for those individuals contemplating the implications of an SEC investigations. Similarly, cooperation, non-prosecution and deferred prosecution agreements provide a measure of clarity and certainty for both individuals and corporations.

We emphasize the following:

Cooperation Credit May Be More Certain and More Meaningful

Prior to the new cooperation framework, as an investigation entered its final stages, cooperating companies or individuals often found that they had nothing more than an amorphous promise from the Staff that their cooperation would be a factor considered in the Staff’s recommendation to the Commission. The new tools permit the Staff and the cooperating corporation or individual to enter into written agreements as to what consideration will be extended if the corporation or individual fulfills its part of the bargain. Having such a writing in hand may give a cooperating corporation or individual more confidence that their good deed will result in meaningful, specific credit.

The Principle of “Extraordinary Cooperation” Is Now Clear

The application of the Seaboard Report’s framework over the last decade makes it clear that cooperation is meant to describe and reward only “extraordinary” cooperation from corporations. This will likely be the standard the SEC uses in evaluating individual cooperation. Merely producing documents or agreeing to testify voluntarily is unlikely to earn credit under the guidelines.

Those considering what will be required to qualify for cooperation credit might look to the November 2008 Financial Industry Regulatory Authority (“FINRA”) Regulatory Notice 08-70.⁸ This notice served as a reminder to FINRA (then NASD) members about the benefits of “extraordinary cooperation.” FINRA’s use of the phrase “extraordinary cooperation” reflected that FINRA members are required to “cooperate” with the Authority in the normal course. We expect that the SEC, in applying the new guidelines, will take a similar approach.

The Means of Cooperation Are Likely to Expand

The new guidelines, intended to elicit cooperation at the earliest opportunity, are likely to dovetail with the SEC’s expansion of investigative tools from retrospective trading analysis to tools more traditionally used by criminal law enforcement, such as confidential informants, surveillance, live recordings, and introductions of undercover agents. The SEC’s use of some of these techniques in recent cases, such as the recent Galleon Group insider trading case, may herald a new era where the SEC’s methodology in conducting investigations, enhanced by the use of early cooperators, resembles that of DOJ and the evidence at trial is less historical and more compelling.

Negative Aspects of the New Framework

As discussed, much will depend on how the Commission and the Division of Enforcement implement the new guidelines. We are concerned that:

The Standards Remain Amorphous

Although both the Seaboard Report and the individual cooperation framework state that a cooperating party can expect credit, substantial discretion is left to the

Staff in applying the guidelines in any particular investigation. Although the Commission and the Staff have publicly acknowledged cooperation from corporations under the Seaboard Report’s framework, there is a lack of transparency as to how, exactly, that credit has affected the ultimate result. When the cooperation is acknowledged in a press release that also includes enumeration of significant violations and the payment of substantial monetary penalties, the juxtaposition can raise doubt as to what cooperation actually accomplished.

Oral Assurances May Provide Little Comfort

The new guidelines state that the Staff may provide “Oral Assurances” to those involved in an investigation that the Staff does not anticipate recommending an enforcement action against that person or entity. Although one can expect that the Staff will act in good faith in providing such assurances, the assurances certainly will be limited. The Staff will retain the ability to revisit its decisions and even to re-evaluate facts of which it was aware at the time of such decisions. The lack of written documentation raises further questions about the usefulness or benefit of such oral communications between the Staff and counsel.

Apparent Inconsistencies in the Framework

Certain factors, both in the Seaboard Report and in the new cooperation guidelines, are inconsistent. For example, although the guidelines state that witnesses who provide substantial information about important, on-going frauds will receive greater credit, they also state that the Staff has a significant interest in seeing that those involved in such important, on-going frauds be held accountable for their misconduct. Those who are contemplating whether to cooperate may well be in doubt about which of these factors will control.

The Potential for Greater Penalties Against “Non-Cooperators”

In light of this initiative, the Commission may seek to demonstrate that it is providing meaningful credit for cooperation, especially as to monetary penalties. We are concerned that this may result in greater penalties against companies and individuals who do not choose to, or who are not in a position to, “cooperate.” The cooperation framework is intended as a “carrot;” we are concerned that it may be applied as a “stick.”

⁸ See Financial Industry Regulatory Authority, Regulatory Notice 08-70, November 28, 2008 (available at <http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p117452.pdf>).

Parallel Proceedings and Private Litigation

To the extent that the Staff seeks an agreement from the cooperating party to admit to certain facts in order to obtain a deferred prosecution or non-prosecution agreement, one must consider the potential impact on parallel criminal proceedings and private litigation.

Decisions Will Need To Be Made Before All the Facts and Circumstances are Known

The decision to seek to obtain a “cooperation card” to be played during the final stages of an investigation will need to be made well before that moment, when some indication of problematic conduct first arises. At that stage, details will usually be few and corporate officers, other individuals and their counsel will need to make important decisions on the basis of incomplete and imperfect information.

One such decision, made more murky by the new guidelines, is whether a potential cooperator should contact the SEC or DOJ in the first instance. While the threat of DOJ’s criminal sanctions has traditionally meant that an individual’s willingness to share any potentially inculpa- ble information with the SEC would hinge on DOJ’s will- ingness to grant immunity, the new guidelines introduce a new dynamic, wherein the SEC, if persuaded of a co- operator’s importance, can bring its weight and credibil- ity to make that request for immunity to DOJ. Depend- ing on the circumstances of the case, this may provide an added incentive for a potential cooperator to ap- proach the SEC in the first instance.

New Complications in Multiple Representations

The expansion of the cooperation framework to ex- pressly reward individuals, when viewed with the SEC’s stated hope that potential defendants will race to coop- erate, could place corporate counsel at odds with the counsel for corporate insiders, or reduce the ability of counsel to represent both the corporation and individu- als, or multiple individuals.⁹ Any decisions as to repre- sentation may need to be revisited as the situation evolves.

Conclusion

Whether to seek to position oneself as a “cooperator” is one of the most important decisions an individual or corporation must make in the early stages of an investi- gation. The new guidelines potentially recalibrate that equation. Although many variables remain, the guidance provides a measure of additional clarity. The factors described in the new cooperation framework will guide the Division of Enforcement as it pursues its mandate. Successful navigation of an SEC investigation will re- quire detailed consideration of how this new framework interacts with the existing realities of SEC investigations.

⁹ Mr. Khuzami made this point explicitly in a recent speech. See Speech by SEC Staff: Remarks at AICPA National Conference on Current SEC and PCAOB Developments, Dec. 8, 2009 (available at http://www.sec.gov/news/speech/2009/spch_120809rsk.htm).

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