

SEC Enters Into First Nonprosecution Agreement as Part of Its New Cooperation Initiative

December 22, 2010

On December 20, the Securities and Exchange Commission (SEC or the Commission) announced that it had entered into the first nonprosecution agreement under its year-old cooperation initiative.¹ The SEC's agreement is with Carter's, Inc., a children's clothing marketer, and follows Carter's 2009 discovery of accounting improprieties. This first nonprosecution agreement adds much-anticipated flesh to the skeleton of the cooperation regime that Robert Khuzami, Director of the SEC's Enforcement Division (the Division), implemented in order to encourage greater cooperation by individuals and companies in SEC investigations.

Companies, particularly those that are also regulated by other agencies or organizations, should take note of some of the collateral consequences of the Carter's nonprosecution agreement. Also of note is the SEC's clarification of some important procedural questions, such as what happens if a cooperator violates its agreement, that were not addressed when the cooperation initiative was announced.

Background of the Enforcement Cooperation Initiative

On January 13, 2010, the SEC announced a series of new measures designed to encourage individuals and companies to cooperate in its investigations and enforcement actions. These measures include the ability of the Division to recommend that the SEC enter into nonprosecution agreements with cooperators. Nonprosecution agreements are formal written agreements in which the SEC agrees not to pursue an enforcement action against a cooperator if the individual or company agrees, among other things, to cooperate fully and truthfully in investigations and related enforcement proceedings (including producing all potentially relevant nonprivileged documents and materials), and to comply with express undertakings.

In tandem with the announcement of the cooperation initiative, the Division also revised its Enforcement Manual to add a section on nonprosecution agreements. This section of the Enforcement Manual contains a general description of when nonprosecution agreements may be appropriate and what the agreements should contain, such as an agreement to cooperate truthfully and fully "in investigations and

¹ See Morgan Lewis White Paper, "The Securities and Exchange Commission Announces New Cooperation Initiative" (Jan. 2010), available online at http://www.morganlewis.com/pubs/WP_SECAnnouncesNewCooperationInitiative_Jan2010.pdf.

enforcement proceedings” and a provision allowing for enforcement action in the event the cooperator violates the agreement. The recent Carter’s nonprosecution agreement supplies some of the detail that was lacking in those general pronouncements.

The Carter’s Investigation

Much of the background of the Carter’s investigation is described in the civil complaint filed by the SEC on December 20, 2010 against a former Carter’s executive, Joseph M. Elles (the Elles Complaint). The Elles Complaint alleges that Elles provided unauthorized, deferred discounts to a significant Carter’s customer in order to increase sales to that customer, and concealed these discounts from Carter’s accounting personnel.

The Elles Complaint states that Carter’s discovered Elles’s alleged fraud in or about October 2009, and began an internal investigation shortly thereafter. By January 2010, Carter’s had filed amended Forms 10-K and 10-Q for periods as far back as its 2005 fiscal year. In its press release announcing the enforcement action against Elles and its nonprosecution agreement with Carter’s, the SEC stated that Carter’s self-reported the misconduct, offered “exemplary and extensive cooperation in the investigation, including undertaking a thorough and comprehensive internal investigation,” and took other remedial actions.

One possible measure of the extent of Carter’s cooperation and the degree to which it factored into the SEC’s decision to enter into a nonprosecution agreement in lieu of an enforcement action is the speed with which the Division was able to complete its investigation. Accounting investigations are typically complex and lengthy, sometimes taking years to complete. However, based on the timeline set forth in the Elles Complaint, Carter’s cooperation appears likely to have helped the Division complete its investigation and bring an enforcement action in just over a year.

The Carter’s Nonprosecution Agreement

According to the SEC’s press release, Carter’s received a nonprosecution agreement based on its apparently extensive cooperation as well as the “relatively isolated nature of the unlawful conduct.” The nonprosecution agreement contains several important terms:

Application to “Other Proceedings.” One of the key details of the Carter’s agreement is its requirement that Carter’s cooperate truthfully and fully, not only with the SEC, but “in an official investigation or proceeding by any federal, state, or self-regulatory organization.” The agreement refers to these as “Other Proceedings.” Many of the cooperation provisions listed below apply equally to SEC investigations and to Other Proceedings.

Document and Information Production. Carter’s is required to produce, “in a responsive and prompt manner,” all nonprivileged documents, information, and other materials as requested by the Division.

Testimony/Interviews. Carter’s is obliged to use its best efforts to secure the full, truthful, and continuing cooperation of current and former directors, officers, employees, and agents for interviews and the provision of testimony in SEC proceedings and in Other Proceedings. This section also applies to trials and other judicial proceedings, including those initiated by other federal, state, or self-regulatory organizations.

Nond denial. Importantly, the Carter’s agreement contains a provision, modeled largely after the standard language in settled enforcement actions, that prohibits Carter’s from denying, directly or indirectly, the factual basis of any aspect of the agreement but does not require an admission as to any facts. In fact, the agreement permits Carter’s to deny the allegations in any legal proceeding in which the SEC is not a party. The agreement also requires Carter’s to offer the Division the opportunity to approve any press release issued by Carter’s concerning the agreement.

Procedures in the Event of Violation. If Carter’s violates the agreement, including in connection with Other Proceedings, the Division may recommend that the Commission bring an enforcement action against Carter’s. Before doing so, the Division will offer Carter’s the opportunity to make a Wells submission.

Cooperation Letters. As with nonprosecution agreements issued by the Department of Justice (DOJ), the agreement provides the SEC with discretion, based on a request from Carter’s, to issue a letter to any other federal, state, or self-regulatory organization detailing Carter’s cooperation.

Application to Purchasers/Successors. If Carter’s is later sold, the agreement requires Carter’s to include a provision in any sales contract, merger agreement, or asset transfer agreement binding the purchasers or successors to the terms of the nonprosecution agreement. In addition, the protections arising from the nonprosecution agreement will not apply to purchasers or successors unless such purchasers or successors “enter into a written agreement, on terms acceptable to the Division, agreeing to assume all the obligations” contained in the nonprosecution agreement.

Takeaways from the Carter’s Agreement

As the first nonprosecution agreement issued under the cooperation initiative, the Carter’s agreement offers several valuable takeaways for entities that face an SEC investigation.

First, it is significant that the SEC’s press release emphasized the “relatively isolated nature of the unlawful conduct.” The Elles Complaint further details that Elles acted alone and without the knowledge of Carter’s accounting personnel. In announcing its cooperation initiative earlier this year, the SEC set forth a spectrum of possible cooperation tools, including cooperation agreements that offer lesser sanctions in an enforcement action, deferred prosecution agreements, and, at the highest level, nonprosecution agreements. The isolated nature of the executive’s misconduct may have tipped the scales in favor of a nonprosecution agreement in Carter’s case, whereas more pervasive misconduct may have resulted in a lesser reward, or none at all. The SEC’s press release is also silent on whether Carter’s waived its attorney-client privilege during the course of the investigation; the agreement does not require the company to waive any applicable privileges. The absence of this requirement continues the SEC’s and DOJ’s recent trend away from considering waivers in evaluating a corporation’s level of cooperation.

Second, the application to “Other Proceedings,” which was not clearly set forth in earlier SEC pronouncements, presents significant questions for regulated entities, such as broker-dealers and other financial institutions. Because Carter’s is a public company in the clothing business, its accounting misconduct presumably raises few other regulatory challenges for the company. However, an entity that is regulated by multiple agencies, such as a broker-dealer that is a FINRA member or a bank subject to various regulatory regimes, would be required under this form of nonprosecution agreement to cooperate in investigations by those other regulators if requested to do so by the Division. Although FINRA has

issued its own cooperation guidelines,² other regulators are unlikely to offer the same clarity as the SEC with respect to the rewards for cooperation. The prospect of enforcement actions by those other regulators, or at least the uncertainty over whether cooperation in those Other Proceedings will be rewarded by those regulators, could diminish the value of the SEC nonprosecution agreement. The application of the agreement to “Other Proceedings” also appears broader than the scope of DOJ agreements, which typically require cooperation only with DOJ and other agencies that the DOJ designates.

Third, the inclusion of a somewhat standard nondenial clause in the agreement is a positive development, and may signal a significant departure from DOJ agreements. Some who have analyzed the cooperation initiative have speculated that, as frequently happens in DOJ matters, the SEC may require cooperators to admit or acknowledge the accuracy of certain allegations that form the basis of a cooperation agreement. DOJ agreements typically also contain or attach statements of admitted facts, which the Carter’s agreement does not do. Although the Carter’s agreement does not rule out such a requirement in the future, the SEC and the Division have made clear that an admission is not required in order to obtain a nonprosecution agreement.

Fourth, the agreement is notable for other departures from standard DOJ practice. Unlike typical DOJ agreements, the SEC’s agreement with Carter’s does not require that the company enhance its corporate compliance program. The absence of this undertaking may be due to Carter’s “extensive and substantial remedial actions” noted in the press release, and it remains possible that future agreements will impose such requirements. Moreover, the SEC imposed no sanctions whatsoever on Carter’s, whereas DOJ agreements typically include payment of a monetary penalty.

Fifth, if the Carter’s nonprosecution agreement serves as a template for future agreements, the application of certain parts of the agreement to Other Proceedings, combined with the nondenial clause in the agreement, creates some questions about an entity’s ability to defend itself in a non-SEC proceeding. On one hand, the agreement requires an entity to cooperate fully in any investigation by another federal, state, or self-regulatory organization. On the other hand, the agreement appears to allow the entity to deny the allegations that form the basis for the agreement in litigation in which the SEC is not a party, which presumably includes actions brought by another federal, state, or self-regulatory organization. Therefore, it is unclear whether the SEC would view a cooperator’s denial of another agency’s allegations as a violation of the nonprosecution agreement. Although the Carter’s matter is unlikely to raise the question of which of these provisions trumps the other, future actions may require the SEC to resolve the tension between these two provisions.

Finally, the Carter’s agreement provides the Division with the relatively unusual opportunity to involve itself in certain corporate activities. The agreement allows the Division to approve corporate press releases relating to the agreement and the terms of agreements with successors relating to the obligations set forth in the agreement. In particular, the successor provision could expose successors to uncertainty as they await Division approval of agreements that govern the successors’ ability to benefit from the predecessor’s cooperation.

² See FINRA Regulatory Notice 08-70; see also Morgan Lewis LawFlash, “FINRA Provides Guidance on Obtaining Credit for Extraordinary Cooperation” (Dec. 5, 2008), available online at http://www.morganlewis.com/pubs/Securities_LF_ExtraordinaryCooperation_05dec08.pdf.

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