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The Securities and Exchange Commission Announces New Cooperation Initiative

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Introduction

On January 13, 2010, the Securities and Exchange Commission (SEC or Commission) announced a series of new measures designed to encourage individuals and companies to cooperate in Enforcement Division (the Division) investigations and enforcement actions.

First, the Commission issued a policy statement setting forth for the first time formal guidelines to evaluate and potentially reward cooperation by individuals in investigations and enforcement actions. Second, the Commission authorized the use of a number of new "cooperation tools" designed to establish incentives for individuals and companies to cooperate with the Division. The enforcement staff is now authorized to execute formal written cooperation agreements, deferred prosecution agreements, and nonprosecution agreements with individuals and companies, although a formal witness proffer will be required in most cases before any of these new agreements may be used. These new measures are codified in a revised version of the Division's Enforcement Manual in Section 6, titled "Fostering Cooperation." [1]

The Commission's new cooperation incentives demonstrate the importance it places on individual and company cooperation in its enforcement efforts. In his public statement announcing these new measures, SEC Enforcement Director Robert Khuzami characterized them as a potential "game changer" for the Commission, and recognized that there is "no substitute for the insider's view into fraud and misconduct that only cooperating witnesses can provide."

Determining the value of cooperation with the enforcement staff has long been a major question for defense counsel. To date, there has been no predictable method of calculating how cooperation might translate into tangible benefits for individual or company clients that are the subject of a staff inquiry or investigation. Although the amount of credit that cooperators may receive remains at the discretion of the Commission and its enforcement staff, the Commission's cooperation initiatives are important and

[1] The full text of the Commission's release can be found at http://www.sec.gov/news/press/2010/2010-6.htm; the Commission's policy statement is set forth in Release No. 34-61340 (Jan. 13, 2010) at http://www.sec.gov/rules/policy.shtml; and the full text of the Division's Enforcement Manual can be found at http://www.sec.gov/divisions/enforce/enforcementmanual.pdf.

meaningful steps in the right direction toward providing more transparency and more options for defense counsel seeking more defined results for their clients' cooperation.

Framework for Evaluating Cooperation by Individuals

Rewarding cooperation is not a new concept for the Commission. In the Commission's 2001 "Seaboard Report," it set standards to evaluate cooperation by corporations.[2] Now, in its newly issued policy statement, the Commission has set forth, for the first time, the way in which it will evaluate whether, how much, and in what manner to credit cooperation by individuals.

In the policy statement, the Commission identifies four core factors to determine how to measure and reward on a case-by-case basis cooperation by individuals: (1) the assistance provided by the individual; (2) the importance of the underlying matter; (3) the societal interest in holding the individual accountable for his or her misconduct; and (4) the appropriateness of cooperation credit based upon the personal and professional profile of the cooperating individual. For each of these criteria, the Commission has set forth specific considerations that it and the enforcement staff will take into account.

Individual Assistance

In evaluating the individual's assistance, the Commission will assess, among other things, the value and nature of the individual's cooperation in its investigation. For example, the Commission will consider the timeliness of the cooperation (whether the individual was the first to report the misconduct to the Commission, and whether the cooperation was provided before he or she had knowledge of the investigation) and whether the cooperation was voluntary. The Commission will also consider whether the individual provided nonprivileged information not requested by the staff or that otherwise might not have been discovered. In addition, the Commission will assess whether the individual encouraged others to assist the staff who might not have otherwise participated in the investigation.

Importance of the Underlying Matter

In evaluating the importance of the underlying matter, the Commission will consider the character of the investigation, including whether the subject matter of the investigation is a Commission priority, the type of securities violations, the age and duration of the misconduct, the repetitive nature of the misconduct, and the amount and type of harm or potential harm to investors. The Commission will view most favorably cooperation in priority investigations that involve serious, ongoing, or widespread violations.

Interest in Holding the Individual Accountable

The Commission also will assess the societal interest in holding the individual fully accountable for his or her misconduct. The Commission will consider the severity of the misconduct within the context of the individual's knowledge, training, experience, and position of responsibility at the time of the violations, whether the individual acted with intent, and any efforts undertaken to remediate the harm caused by the misconduct. The Commission will also evaluate the degree to which the individual tolerated illegal activity, such as whether he or she took steps to prevent the misconduct from occurring or continuing (such as

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[2] Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934 and Commission Statement on the Relationship and Cooperation to Agency Enforcement Decisions, SEC Release Nos. 34-44969 and AAER-1470 (Oct. 23, 2001) (http://www.sec.gov/litigation/investreport/34-44969.htm) (the Seaboard Report). In the Seaboard Report, the Commission set forth four broad measures for evaluating cooperation by companies. These measures are: self-policing, self-reporting, remediation, and cooperation with law enforcement. The factors in the Seaboard Report are now formally incorporated into the Enforcement Manual as Section 6.1.2 (Framework for Evaluating Cooperation by Companies).

notifying the Commission or other law enforcement agency), or in the case of a business organization, whether he or she notified management not involved in the misconduct, the board of directors, or the auditors of the company.

Profile of the Individual

Finally, the Commission will consider the cooperating individual's personal and professional risk profile in determining whether it is in the public interest to award cooperation credit. Under this factor, the Commission will consider the individual's history of lawfulness, the individual's acceptance of responsibility for past misconduct, and the opportunity for the individual to commit future transgressions in light of his or her occupation (for example, whether he or she serves as a licensed professional, an associated person of a regulated entity, a fiduciary, officer or director of a public company, or a member of senior management).

Implications of the New Guidelines for Measuring Cooperation by Individuals

These guidelines will be a valuable tool for counsel in demonstrating to the staff that his or her client has provided meaningful cooperation to the staff in its inquiry or investigation and deserves proper credit for this cooperation. While useful, however, they do not solve the question of how to value cooperation, and indeed raise significant issues with respect to how the staff will apply them.

For example, credit for cooperation is discretionary. Whether and how much to credit an individual's cooperation will rest principally with the investigative staff. Thus, there is no guarantee that the staff will credit an individual's cooperation or recommend to the Commission that a cooperator receive credit, and the guidelines do little in the way of predicting whether a cooperator's efforts will result in any tangible benefit, such as reduced sanctions or the staff's recommending no enforcement action. In addition, Mr. Khuzami has made clear that the Commission intends to reward only "extraordinary cooperation" and does not intend to extend leniency or reward persons for simply complying with routine or expected requests.[3] However, "extraordinary cooperation" is undefined, and there is no clear guidance interpreting the term.[4] Historically, Commission settlements have communicated very little about how an individual's cooperation improved a settlement.[5]

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[3] *See* Mr. Khuzami's August 5, 2009 Remarks Before the New York City Bar at www.sec.gov/news/speech/2009/spch080509rk.htm.

[4] The Financial Industry Regulatory Authority (FINRA) has provided guidance on the meaning of "extraordinary cooperation" in its investigations. FINRA Regulatory Notice 08-70 (citing four factors that are considered for "extraordinary cooperation": (1) self-reporting before regulators are aware of the issue; (2) extraordinary steps to correct deficient procedures and systems; (3) extraordinary remediation to customers; (4) providing substantial assistance to FINRA's investigation). The Commission has never adopted FINRA's framework.

[5] *See*, *e.g.*, *In the Matter of Christopher Black*, Admin. Proc. File No. 3-13625 (Sept. 24, 2009) (order reflecting only that the Commission considered remedial acts promptly undertaken by Black and cooperation afforded the staff). Within the context of company cooperation, the Commission recently has been somewhat more transparent. *See, e.g.*, *SEC v. General Re Corp.*, No. 10-Civ.-458 (S.D.N.Y.), Litig. Release No. 21384 (Jan. 20, 2010) (citing the company's comprehensive, independent review, which was shared with the government, the company's substantial assistance in the government's successful civil and criminal actions against individuals, and internal corporate reforms); *see also In the Matter of NATCO Group, Inc.*, Exch. Act Release No. 61325 (Jan. 11, 2010) (Commission identified 11 remedial and cooperation factors it considered in determining to accept the settlement, including, among other things, the company's internal investigation and voluntary self reporting, appointment of a chief compliance officer, and employee termination and disciplinary actions); *see also* press release describing Apple, Inc.'s cooperation in *SEC v. Heinen*, No. 07-2214-HRL (N.D. Cal.), http://www.sec.gov/news/press/2007/2007-70.htm (despite pursuing charges against the general counsel and chief financial officer, no enforcement action against Apple based in part on its swift, extensive, and extraordinary cooperation).

The Commission's emphasis on the "timeliness" of an individual's cooperation (i.e., whether the individual was the first to report misconduct) also raises important concerns, particularly in light of Mr. Khuzami's remarks in the Commission's press release that "latecomers rarely qualify for cooperation credit."[6] The Commission's new guidelines do little to resolve the conundrum of when to approach the Commission to report a potential violation or make an offer to cooperate. A tension often exists among speed, completeness, and accuracy in the early stages of an inquiry or investigation. Premature self-reporting, or a too-hasty response to a Commission inquiry in an effort to be "timely" may result in crucial mistakes, including the provision of an incomplete or inaccurate description of the facts that, however inadvertent, may later be cited as a lack of candor. While it will be critical to quickly assemble facts, disclose them, and offer complete and "timely" cooperation to receive credit under the guidelines, counsel must take the time necessary to master those facts and determine their significance to the inquiry or investigation before making an offer to cooperate.

The new guidelines potentially complicate joint representations. First, the "race" for cooperation may create tension among different parties as to when to approach the Division. Second, the new guidelines credit individuals for recruiting others to participate in investigations. These incentives may lead to different interests among jointly represented individuals, and between companies and individuals.

In its policy statement, the Commission also recognizes that there exists "some tension between the objectives of holding individuals fully accountable for their misconduct and providing incentives to cooperate." The Commission attempts to strike a balance between these competing goals in the third (interest in holding the individual accountable) and fourth (personal and professional profile of the individual) factors. However, in many cases the witnesses who will be of most use to the Commission are those more senior officers, managers, and employees who are in the best position to know critical information. Thus, it is unclear how the Commission will resolve this "tension" given its particularly aggressive stance in naming key company individuals in enforcement actions and settlements, and its historic lack of flexibility in demanding industry bars from professionals who have violated the law.

Under the new guidelines, the likelihood that the Division would forego entirely seeking some sanction against a licensed professional is at best debatable, no matter how cooperative he or she has been during the course of the investigation. Counsel also may find him- or herself in the difficult position of having to prove to the staff, in a manner similar to an administrative cease and desist proceeding, that his or her client has accepted responsibility for any alleged misconduct and will not repeat that misconduct, particularly if the individual is active within the securities industry.[7] These arguments may prove particularly difficult in the early stages of an investigation where the investigative record is not fully developed.

New Cooperation Tools for Individuals and Companies

The Commission's cooperation initiative also arms the staff with new tools to encourage individuals and companies to report violations and provide assistance to the agency. These tools, which are in the revised version of the Enforcement Manual, authorize the staff to enter into formal written cooperation agreements, deferred prosecution agreements, and nonprosecution agreements.[8] The Department of

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6 See Speech by SEC Staff: Remarks at Press Conference by Robert S. Khuzami (Jan. 13, 2010), www.sec.gov/news/speech/2010/spch011310rsk.htm.

7 The staff's analysis with respect to the third and fourth factors is similar to its burden in seeking a cease and desist order in administrative proceedings. *See e.g., WHX Corporation v. SEC*, 362 F.3d 854 (Apr. 9, 2004) (standards include, among other things, respondent's state of mind, isolated or recurrent nature of the violation, respondent's recognition of wrongful nature of conduct, and respondent's opportunity to commit future violations).

8 The Commission also streamlined its process for obtaining immunity requests where a party is cooperating with the staff. Under its new process, the Commission has delegated authority to the Enforcement Director to make

Justice (DOJ) has regularly used these cooperation tools in criminal investigations and prosecutions; however, they have not been available to the Commission in enforcement matters until now.

Cooperation Agreements

Cooperation agreements are formal written agreements in which the Enforcement Director agrees to recommend to the Commission that a cooperator receive credit for cooperating in investigations or related enforcement actions. Under certain circumstances, the Enforcement Director may agree to make a specific enforcement recommendation. In exchange, the Division must conclude that the individual or company has provided or is likely to provide substantial assistance to the Commission such as full and truthful testimony and information, including producing all potentially nonprivileged documents and materials to the Commission. If the Division agrees to make a specific enforcement recommendation to the Commission, the cooperation agreement should include the specific recommendation and an agreement by the cooperating individual or company to resolve the matter without admitting or denying the alleged violations.

The Enforcement Manual instructs the staff that prior to seeking a cooperation agreement, the staff should require a potential cooperating individual or company to execute a proffer agreement and to make a detailed proffer of the information he or she is prepared to share with the staff.[9] In addition, the enforcement manual instructs the staff to consider the standard cooperation analysis with respect to individuals (Section 6.1.1) and companies (Section 6.1.2, the Seaboard Factors) when assessing whether to recommend that the Division enter into these agreements with an individual or company.

Deferred Prosecution Agreements

Deferred prosecution agreements are formal written agreements in which the Commission agrees to forego an enforcement action against a cooperator. These agreements are entered into only if the individual or company agrees, among other things, to cooperate fully and truthfully, including producing all potentially relevant nonprivileged documents and materials, and to comply with express prohibitions and undertakings during a period of deferred prosecution, which generally should not exceed five years.

Deferred prosecution agreements may require a cooperator to agree either to admit or not to contest underlying facts that the Commission could assert to establish a violation of the federal securities laws. The Enforcement Manual suggests an admission or agreement not to contest relevant facts underlying the alleged offenses is appropriate for licensed individuals (attorneys, accountants), regulated individuals, fiduciaries, officers and directors of public companies, and repeat offenders.

As with cooperation agreements, the staff should consider the standard cooperation analysis with respect to individuals (Section 6.1.1) and companies (Section 6.1.2, the Seaboard Factors), and require a potential cooperating individual or company to execute a proffer agreement before seeking authority for a deferred prosecution agreement.

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immunity requests directly to the Department of Justice. *See* http://www.sec.gov/rules/final/2010/34-61339.pdf. Previously, the staff was required to file a formal action memorandum with the Commission seeking a formal Commission order to make such a request.

[9] Proffer agreements are not a new tool to the Commission staff. 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 a subsequent proceeding. 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 may also share the information provided by the proffering individual with appropriate authorities in a prosecution for perjury, making a false statement, or obstruction of justice.

Nonprosecution Agreements

Nonprosecution agreements are formal written agreements, entered into under "limited and appropriate circumstances," in which the Commission 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.

The Enforcement Manual instructs the Staff that in virtually all cases, nonprosecution agreements will not be available for individuals who have previously violated the federal securities laws. Further, nonprosecution agreements should not be executed until the role of the cooperating individual or company and the importance of their cooperation to the staff become clear.

As with cooperation and deferred prosecution agreements, the Enforcement Manual instructs the staff to consider the standard cooperation analysis with respect to individuals (Section 6.1.1) and companies (Section 6.1.2, the Seaboard Factors), and to require a potential cooperating individual or company to execute a proffer agreement prior to seeking authority to enter into a nonprosecution agreement.

Although not part of its public announcement of the cooperation initiatives, the Commission's revised enforcement manual authorizes Assistant Directors, with approval of a supervisor at or above the Associate Director level, to orally inform an individual or company that the enforcement staff does not anticipate recommending an enforcement action against the individual or company based upon the evidence currently known to the staff. The Commission will, however, authorize these oral assurances only when the investigative record is adequately developed. [10]

Implications of New Cooperation Tools

These new agreements are useful because they provide more clarity as to what clients will have to do to receive credit for cooperation and how the Commission may reward their cooperation. However, counsel will face considerable challenges in determining whether and when to execute any one of these cooperation agreements.

The staff will undoubtedly demand significant "upfront" cooperation from an individual or corporation before offering a formal agreement, without assurance as to any particular benefit in return. For example, cooperation agreements are not binding on the Commission, and the Division cannot make any assurance as to whether or how the Commission may act on an enforcement recommendation. Nevertheless, to prove that the offered cooperation will be meaningful, the staff will expect a cooperating witness or company to provide a proffer (or multiple proffers) and substantial cooperation (early self-reporting, voluntary production of materials, etc.) that likely will include admissions and other concessions as to evidence essential to the staff's case.

Moreover, when seeking a cooperation agreement that includes a specific enforcement recommendation, counsel will effectively bear the evidentiary burden of persuading the Division that a specific recommendation is warranted. This burden may be particularly difficult to meet in the early stages of an investigation, yet the staff places a premium on "timely" cooperation.

Counsel should carefully balance the costs and potential benefits, if any, associated with obtaining a formal cooperation agreement, against permitting an inquiry or investigation to run its normal course.

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[10] *See* Section 6.2.1 *Proffer Agreements* (Enforcement Manual, Jan. 2010). The revised manual has eliminated a prior provision that permitted the staff in limited circumstance to provide a witness with a written assurance that the Commission does not intend to bring an enforcement action against him or her or an associated entity in exchange for the witness's agreement to testify and provide documents. *See* Section 3.3.5.3.1 *Witness Assurance Letters* (Enforcement Manual, Oct. 2008).

Counsel may more effectively argue for cooperation and leniency through a formal submission to the Commission as part of the Wells process.

Counsel will also face significant challenges when considering deferred prosecution and nonprosecution agreements. Here again, the staff will demand significant cooperation prior to seeking authorization for such agreements. With respect to deferred prosecution agreements, the staff likely will also require an express agreement by an individual or a company to admit or not to contest facts that the Commission could assert to establish a federal securities law violation. This practice is consistent with the DOJ practice of requiring a cooperator to admit certain facts and accept responsibility for violative conduct.

The revised Enforcement Manual also adopts the DOJ practice of making deferred prosecution agreements available to the public. In making a decision to enter into a deferred prosecution agreement that requires such admissions, counsel must bear in mind that the Commission routinely shares information with other regulatory agencies, including DOJ and other criminal authorities. Such formal admissions also may expose a cooperating individual or company to negative collateral consequences in private civil litigation.

The revised Enforcement Manual does not specifically require admissions of violations as a prerequisite for nonprosecution agreements. Prior to the announcement of these new cooperation tools, parties typically settled cases on a "neither admit nor deny" basis, thereby preserving their rights to contest criminal or private civil litigation. Counsel have a cogent argument that this practice should continue in the context of nonprosecution agreements because the Enforcement Manual provisions regarding nonprosecution agreements do not contain the same language as those regarding deferred prosecution agreements, for which an admission to relevant facts underlying the alleged offenses "generally is appropriate." Of course, the Division may take a different view, and it remains to be seen how this issue will be treated in practice.

In a recent financial fraud case, although the company admitted to certain facts under a nonprosecution agreement with DOJ, the same entity settled charges of manipulating and falsifying financial records with the Commission on a "neither admit nor deny" basis.[11] Importantly, both the Commission and DOJ recognized the significant cooperation that the company provided during the investigation, including a "comprehensive, independent review" of the company's operations, which was shared with the government, the company's "substantial assistance" in the government's successful civil and criminal actions against the individuals involved, and corporate reforms, in reaching their settlements.

Conclusion

The new guidelines for individual cooperation are helpful in providing some visibility into the types of factors that the staff will consider in valuing this type of cooperation. These factors by themselves, however, present many of the same problems that defense counsel faced in determining the value of corporate cooperation. The Commission staff still has significant room to exercise its own discretion under the guidelines, and it will remain difficult to predict in any given case whether cooperation will result in any tangible benefit to the individual.

The new "cooperation tools" that the Commission has authorized are also subject to the discretion of the enforcement staff. They do, however, have the benefit of providing a framework for defense counsel to use in attempting to make the value of cooperation more concrete. Whether and how the enforcement staff will use these tools in their effort to quickly and efficiently investigate and sanction violations of the securities laws remains to be seen.

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[11] *See, e.g., SEC v. General Re Corp.*, No. 10-Civ.-458 (S.D.N.Y.), Lit. Release No. 21384 (Jan. 20, 2010); http://www.justice.gov/opa/pr/2010/January/10-crm-053.html; http://sec.gov/news/press/2010/2010-10.htm; http://sec.gov/litigation/litreleases/2010/lr21384.htm.

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