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The SEC's Enforcement Cooperation Initiative: Another Weapon In The Fight Against Financial Fraud And Corporate Abuse

Stephen M. Plotnick

STERN & KILCULLEN, LLC

In a letter to the shareholders of Berkshire Hathaway, Inc., Warren Buffett famously quipped that “you only find out who is swimming naked when the tide goes out.” The tide-going-out phenomenon is well illustrated by many of the practices that have come to light in the wake of the current global economic crisis. They have exposed several flaws in our systems of regulation and enforcement, and highlighted the importance of changing with the times and finding new approaches to ferreting out sophisticated corporate fraud and financial schemes. The United States Securities and Exchange Commission (“SEC”) recently announced one such approach. On January 13, 2010, the SEC announced its Enforcement Cooperation Initiative (the “Initiative”). The Initiative is a series of new measures that the SEC intends to employ to help strengthen its enforcement program by encouraging greater cooperation from individuals and companies in connection with SEC investigations and enforcement actions.¹ The measures comprising the Initiative have the potential to change dramatically the way SEC staff interacts with individuals and companies that are in the cross-hairs of an investigation or enforcement action.

The SEC's Policy Statement On Cooperation

The SEC has a history of pursuing all individuals who engaged in wrongdoing and of seeking the full array of available sanctions, regardless of the extent to which those individuals may have cooperated with SEC staff. But the Initiative represents a fundamental shift in philosophy by recognizing the importance and benefits of cooperation by insiders with knowledge of key facts. Indeed, as part of the Initiative, the SEC issued a policy statement acknowledging that “[c]ooperation by individuals and entities in the Commission's investigations and related enforcement actions can contribute significantly to the success of the agency's mission,” and recognizing that cooperation can “enhance the Commission's ability to detect violations of the federal securities laws, increase the effectiveness and efficiency of the Commission's investigations, and provide important evidence for the Commission's enforcement actions.”²

At its essence, the SEC's policy statement announced an analytical framework



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that the SEC will use to evaluate cooperation by individuals – including whether, how much, and in what manner to credit cooperation. The purpose of the framework, according to the policy statement, is to “promote[] the fair and effective exercise of discretion by the Commission, and ... enhance[] confidence on the part of the public and cooperating individuals that decisions regarding cooperation in the Commission's investigations and related enforcement actions will be made in an appropriate and consistent manner.”³ In other words, the Initiative attempts to resolve the “tension between the objectives of holding individuals fully accountable for their misconduct and providing incentives for individuals to cooperate with law enforcement authorities.”⁴

According to the policy statement, the SEC will assess cooperation based on four factors: (1) the assistance provided by the cooperating individual, (2) the importance of the underlying investigation, (3) the societal interest in holding the individual accountable, and (4) the appropriateness of cooperation credit based on the individual's risk profile. But the SEC also emphasized that these four factors are only general considerations, and that “the evaluation of cooperation requires a case-by-case analysis of the specific circumstances presented.”⁵ Moreover, the policy statement is careful to caution that it does not create or recognize any legally enforceable rights for any person, and that “some of the principles may not be applicable or may deserve greater weight than others.”⁶ Thus, the assessment of the four factors, and its impact and applicability in connection with any enforcement action, remains as always within the discretion of the SEC.

The SEC's New Cooperation Tools

As part of the Initiative, the SEC also revised its enforcement manual to make available to its staff a wide spectrum of “new cooperation tools, not previously available to the SEC.” Although the SEC is a civil enforcement agency, these tools are modeled closely upon those used traditionally by federal prosecutors in criminal investigations. The SEC's release even notes specifically that “similar cooperation tools have been regularly and suc-

cessfully used by the Justice Department in its criminal investigations and prosecutions.”⁷ The cooperation tools now available to the SEC include each of the following:

Cooperation Agreements: Written agreements in which the Division of Enforcement agrees to recommend to the Commission that a cooperator receive credit for cooperating in investigations or related enforcement actions if the cooperator provides substantial assistance, such as full and truthful testimony.

Deferred Prosecution Agreements: Written agreements in which the Commission agrees to forego an enforcement action against a cooperator if the individual or company agrees, among other things, to cooperate fully and truthfully and to comply with express prohibitions and undertakings during a period of deferred prosecution.

Non-Prosecution Agreements: Written agreements in which, under limited and appropriate circumstances, 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 and to comply with express undertakings.

Additionally, the SEC has streamlined the process for submitting witness immunity requests to the Department of Justice for witnesses who have the ability to assist the SEC in its investigations and related enforcement actions. The Director of the Division of Enforcement now has the authority to make immunity requests directly to the Department of Justice, thereby eliminating the need for approval by the Commission.

New Specialized Enforcement Units

The SEC also announced the creation of five new national specialized enforcement units. Each of the new enforcement units will “use enhanced training, hiring of and consultation with individuals with industry experience or specialized skills, targeted investigative approaches, and in some cases new technology, to conduct more efficient and comprehensive investigations.”⁸ The five units include each of the following: (1) The Asset Management Unit, which will focus on investment companies and advisors, mutual funds, hedge funds, and private equity funds; (2) The Market Abuse Unit, which will focus on large-scale and organized insider trading and market manipulation cases; (3) The Structured and New Products Unit, which will cover structured products such as credit default swaps, collateralized debt obligations, and other securitized instruments and new products; (4) The Foreign Corrupt Practices Unit, which will cover investigations of corporate bribery of foreign officials; and (5) The Municipal Securities and Public Pension Unit, which, as the name suggests, will focus on misconduct in the municipal securities market and in public pension funds.

Conclusion

The SEC's Director of the Division of Enforcement, Robert Khuzami, has appropriately referred to the Enforcement

Cooperation Initiative as “a potential game-changer.” Its underlying policy recognizes that “there is no substitute for an insider's view into fraud and misconduct that only cooperating witnesses can provide.”⁹ The publication by the SEC of a formal framework is quite likely to encourage individuals to report wrongdoing early on in an investigation by providing them with a greater degree of certainty concerning the potential benefits of cooperation.

The new cooperation tools available to the SEC, such as cooperation agreements, deferred prosecution agreements, and non-prosecution agreements, also have the potential to increase the efficiency and effectiveness of investigations. But they may also add a new layer of complexity to cooperation and settlement negotiations as they move the SEC closer to a criminal enforcement model. As a civil enforcement agency, the SEC is not used to having the benefit of these new cooperation tools, and it is likely that the SEC will, at least initially, look towards the Department of Justice on how to use them.

Similarly, the creation of the five new specialized enforcement units moves the SEC away from its more traditional, generalist model. Having these specific units to focus on targeted areas in which the SEC did not previously have specialists may very well enable the SEC to identify more quickly potential violations in complex areas of the securities laws and capital markets.

Ultimately, there can be little doubt that the Initiative, taken as a whole, has the potential to impact dramatically SEC investigations and enforcement actions. Individuals have the prospect of greater certainty that they may not be prosecuted, and companies are encouraged even more than ever to respond promptly and thoroughly to allegations of wrongdoing. The Initiative may very well increase the speed and effectiveness of SEC investigations and strengthen many of its cases, but many of its specific aspects will become known only in practice. How the SEC assesses specific instances of cooperation, including the extent of cooperation required and the nature of the credit provided, remains to be seen.

¹ “SEC Announces Initiative to Encourage Individuals and Companies to Cooperate and Assist in Investigations,” Release No. 2010-6 (Jan. 13, 2010). Available at <http://www.sec.gov/news/press/2010/2010-6.htm>.

² 17 C.F.R. § 202.12.

³ Id.

⁴ Id.

⁵ Id.

⁶ Id.

⁷ “SEC Announces Initiative to Encourage Individuals and Companies to Cooperate and Assist in Investigations,” Release No. 2010-6 (Jan. 13, 2010).

⁸ Robert S. Khuzami, Director, Division of Enforcement, “Remarks at News Conference Announcing Enforcement Cooperation Initiative and New Senior Leaders” (Jan. 13, 2010). Available at http://www.sec.gov/news/speech/2010/spch011310_rsk.htm.

⁹ “SEC Announces Initiative to Encourage Individuals and Companies to Cooperate and Assist in Investigations,” Release No. 2010-6 (Jan. 13, 2010).

Stephen M. Plotnick is a Partner in the litigation department of the law firm of Stern & Kilcullen, LLC. His practice involves representing corporations and individuals in connection with litigation, arbitration, regulatory inquiries and enforcement proceedings, and internal investigations. Stephen's experience includes counseling and representing clients who are the subject of regulatory agency attention.

Please email the author at splotnick@sgklaw.com with questions about this article.