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# Analysis

## SEC Enforcement

### Courting Cooperators: The SEC's Effort to Motivate Individual Cooperation

BY MARK K. SCHONFELD

In August of this year, the Securities and Exchange Commission's Director of Enforcement, Robert Khuzami, announced an initiative to provide greater incentives to individuals to cooperate in enforcement investigations. This is not the first effort by the Enforcement Division to motivate individual cooperators, though it may be its most public effort. However, trying to mirror in the civil enforcement context a practice more widely used in the criminal context will face substantial hurdles. In the end, how the SEC implements its policies in specific cases over an extended period of time will determine its ability to motivate individual cooperators.

#### Background

Given his prior experience as a criminal prosecutor, it is not surprising that Mr. Khuzami understands the importance of cooperating witnesses and his desire to increase their availability in SEC enforcement investigations. Acknowledging the resource limitations the SEC confronts, Mr. Khuzami stated in his August speech, "It is thus critical that we leverage our limited resources by incentivizing cooperation by individuals, which is often the source of some of the most credible and valuable evidence." Implicit in Mr. Khuzami's statements is a recognition that individuals in the best position to provide meaningful cooperation are those who had some involvement in misconduct that would be of interest to the SEC.

Mr. Khuzami outlined a number of specific steps underway to foster greater individual cooperation:

- creating a "Seaboard Report" for individuals—that is, a public policy statement that will set forth standards under which to evaluate an individual's cooperation;
- expediting the process by which the Division Director is delegated authority to submit immunity requests to the Department of Justice;
- exploring ways to provide witnesses early on in appropriate cases an oral assurance that the Division does not intend to file charges against them; and
- recommending to the Commission, where appropriate, that the SEC enter into Deferred Prosecution Agreements, in which the Commission agrees to forego an enforcement action against a party subject to certain terms, including cooperation, waiver of statute of limitations, and compliance with undertakings.

Emphasizing that the goal is to incentivize cooperation that significantly advances investigations, Mr. Khuzami added that this does not mean "rewarding persons for simply complying with routine or expected requests," but rather that "the purpose of these tools is primarily to reward extraordinary cooperation."

#### Challenges to Incentivizing

The concept of trying to incentivize individuals to cooperate in SEC investigations is not new. One can find sporadic examples of SEC administrative orders or litigation releases that acknowledge an individual's cooperation as a factor in the

SEC's decision to accept a particular settlement.<sup>1</sup> Occasionally, SEC orders recite an undertaking by the individual to continue to cooperate in the SEC's ongoing investigation or litigation of that matter.<sup>2</sup> However, these outcomes typically reflect retrospective acknowledgement of cooperation, rather than a proactive effort to obtain the cooperation of an individual in return for a particular outcome. The use and development of cooperating witnesses in civil SEC investigations has not occurred nearly to the extent it has in the criminal context, largely due to fundamental differences between the two proceedings and their respective consequences for individuals.

**Incentives.** One of the difficulties the SEC faces as a civil regulatory agency is the inability to provide sufficient incentives to cooperate. The SEC has the ability to seek in enforcement actions the imposition of disgorgement of ill-gotten gains, monetary penalties, and professional bars. To be sure, these can have serious financial and professional consequences for an individual. However, the SEC lacks the substantial leverage that comes from the threat of prison posed by criminal prosecutors. Put simply, the threat of prison is a far greater motivator than the threat of financial sanctions.

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<sup>1</sup> See, e.g., Matter of Christopher A. Black, Admin. Proc. 3-13625 at 5 (Sep. 24, 2009) ("In determining to accept the Offer, the Commission considered remedial acts promptly undertaken by Black and cooperation afforded the Commission staff.").

<sup>2</sup> See, e.g., Matter of Frank S. LaForgia, CPA, Admin. Proc. No. 3-13567 at 12 (July 31, 2009) ("LaForgia undertakes to cooperate fully with the Commission in any and all investigations, litigations or other proceedings relating to or arising from the matters described in this Order.").

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**Flexibility.** Related to the difference in severity of the sanctions, criminal prosecutors also have a greater flexibility to negotiate outcomes that can provide substantial incentives to cooperate. Criminal prosecutors have a wider range of potential charges from which to choose, the number of counts to charge, and a corresponding ability to reduce meaningfully, or even eliminate entirely, a period of incarceration for a cooperator. This provides a powerful incentive to cooperate. In contrast, because the SEC has a relatively narrow range of potential charges and sanctions, the SEC lacks flexibility in negotiating settlements that could provide a meaningful incentive to cooperate.

This is a particular issue for individuals employed in the securities industry, such as brokers and investment advisers, or engaged in practice before the SEC, such as public company auditors. In general, the SEC has inflexibly demanded industry bars from individuals who allegedly engaged in misconduct even despite their cooperation in an investigation. This posture leaves individuals who are in a position to cooperate with little incentive to do so.

Thus it will remain to be seen whether the SEC will show a greater flexibility on industry bars in order to incentivize cooperation. Perhaps Mr. Khuzami's reference to the use of deferred prosecution agreements could provide a means to more flexible and creative outcomes that could motivate cooperation.

**Collateral Consequences.** Another substantial barrier to individual cooperation is the risk of collateral exposure that could follow from cooperating with the SEC. Of greatest concern is the risk of potential criminal prosecution by prosecutors at both the state and federal level. This is a particular risk in this era of regulatory competition among various jurisdictions. The SEC is not in a position to provide individuals with guaranteed protection from prosecution.

Perhaps anticipating this issue, Mr. Khuzami identified the potential for more frequent and expedited efforts to obtain immunity from the Department of Justice. This procedure has been used in the past, on a relatively limited basis, typically for low level employees in an organization where misconduct was committed by more senior individuals within the organization. It remains to be seen

whether the SEC and Department of Justice will be able to make use of this process on a more frequent basis. Moreover, even assuming the risk of criminal exposure can be alleviated, cooperating individuals also risk opening themselves up to civil liability to various stakeholders, such as shareholders and clients.

**Reconciling With "Neither Admit Nor Deny" Settlements.** Another issue the SEC will need to consider is how to reconcile the concept of cooperation with the SEC's longstanding policy of settling cases on a "neither admit nor deny" basis. Presumably, the SEC envisions individual cooperators who would, as in the criminal context, testify to the involvement of others in unlawful conduct and, in the process, admit to their own involvement in the misconduct. However, every SEC settlement allows the defendant to agree to settle without admitting nor denying the allegations in the charging document.

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The "neither admit nor deny" policy also permits defendants to settle with the SEC, but preserve their ability to litigate and deny their liability in parallel private civil litigation. This creates the potential for an ironic result in which a cooperator who admits to misconduct during a proceeding could put themselves in a worse position than a non-cooperating individual who settles without admitting or denying.

**Transparency.** Another barrier to motivating cooperators is the lack of transparency to SEC settlements which makes it extremely difficult for the public to perceive the benefit an individual receives from cooperating. As noted above, there have been settlements previously in which the SEC has given individuals credit for cooperation. However, this is reflected in the administrative order or litigation release with nothing

more that a statement to the effect that in determining to accept the settlement offer, the SEC considered the individual's cooperation. The settlements communicate little, if anything, about how an individual improved their settlement outcome by cooperating.

This is in contrast to the criminal context where there is typically a clear difference between the charges and sanctions cooperators receive and the charges and sanctions sought and obtained against those who do not cooperate. The lack of transparency to SEC settlements makes it difficult to counsel a client on the benefits of cooperating with the SEC.

In his speech, Mr. Khuzami disclosed that the SEC is working on a "Seaboard Report" for individuals. The original Seaboard Report<sup>3</sup> provided guidelines to public companies on cooperating with SEC investigations, comparable to similar pronouncements by the Department of Justice. Seaboard was written in the context of a company that the SEC determined not to charge with any violation based, in part, on its cooperation.

Conceivably, a comparable pronouncement for individuals will identify an example of an individual who is not charged based, at least in part, on his or her cooperation. This will be helpful, but will not solve the need for ongoing transparency that will enable defense counsel to identify the benefits of cooperation.

## Conclusion

As a general matter, it is helpful for the SEC to show flexibility. Historically, the agency's settlement posture has been relatively rigid. In the name of consistency, the agency tends to shy away from crafting unique settlements that might make sense in a particular set of circumstances, including rewarding cooperation.

To the extent this latest initiative signals a willingness to entertain alternative resolutions, that alone could be helpful in providing greater incentives than currently exist to motivate individuals to cooperate.

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<sup>3</sup> 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, Exchange Act Release No. 44,969 (Oct. 23, 2001).