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Phone: +1 646 783 7100 | Fax: +1 646 783 7161 | customerservice@law360.com

SEC Cooperation Is Still More Art Than Science

Law360, New York (January 23, 2014, 1:36 AM ET) -- The quest for individual cooperation credit from the U.S. Securities and Exchange Commission is more of an art than a science, involving outcomes based largely on subjective judgments and a process that resists definition and standardization. Indeed, those who seek cooperation credit necessarily take a risk. But that risk comes with the tantalizing prospect of significant rewards — namely, the possibility of avoiding the SEC's increasingly aggressive enforcement efforts.

Take the example of Philip Falcone. On June 27, 2012, the SEC filed securities fraud charges against Falcone and his advisory firm, Harbinger Capital Partners, alleging that Falcone "used fund assets to pay his taxes, conducted an illegal 'short squeeze' to manipulate bond prices, [and] secretly favored certain customers at the expense of others" and that Harbinger Capital Partners "unlawfully bought equity securities in a public offering, after having sold short the same security during a restricted period."[1] In May 2013, Falcone tentatively agreed to pay $4 million and accept a two-year investment adviser ban.[2] However, incoming SEC Chairwoman Mary Jo White felt the deal was too lenient, and the commissioners scrapped it, forcing renegotiation.

Chairwoman White announced that going forward, the SEC would require admissions of guilt in certain cases.[3] Consequently, on Aug. 19, a settlement was reached in which Falcone and Harbinger Capital Partners admitted various wrongdoings, including Falcone's admission that he siphoned off $113.2 million of fund assets to pay his taxes and pay customer redemptions to favored clients.[4] Falcone also agreed to pay $11.5 million of his own money and accept a five-year ban from the securities industry.[5]

The Falcone settlement signals the SEC's commitment to aggressive enforcement and an increase in the use of its new admissions policy going forward. The admissions policy can have far-reaching and unpredictable consequences for defendants. For instance, soon after Falcone admitted wrongdoing, the New York Department of Financial Services used his admission to ban Falcone from any role running a state-licensed insurance company for seven years.[6] With Falcone as a guidepost, witnesses in SEC matters should proceed with caution and consider cooperating with the regulator in order to minimize the sting of a potential enforcement action.

The Cooperation Program

The Cooperation Program — unveiled in the wake of the Bernie Madoff scandal by then-SEC Enforcement Director Robert Khuzami during a press conference on Jan. 13, 2010, and subsequently formalized on Jan. 19, 2010[7] — allows the Division of Enforcement to recommend that the commission reduce the standard package of relief when individuals provide substantial cooperation. The goal is to incentivize individuals to cooperate fully and truthfully with SEC investigations.

When announced, Khuzami called the Cooperation Program a potential "game-changer."[8] Indeed, the program may be a win-win for both the government and potential defendants and respondents in securities fraud cases, with the former achieving greater efficiency and better cases and the latter — in theory — gaining incentives to cooperate. For the reasons below, it remains to be seen whether the Cooperation Program will appeal to individuals caught in the SEC's crosshairs and live up to its early promise.

The Cooperation Program in Action

The Cooperation Program received attention on Nov. 12, 2013, when the Enforcement Division announced its first deferred prosecution agreement ("DPA") with an individual. That DPA, involving hedge fund administrator Scott J. Herckis, arose from an enforcement action against a hedge fund and its manager who allegedly misappropriated more than $1.5 million from the fund and overstated its performance to investors. The SEC said it entered into the Herckis DPA because Herckis voluntarily produced voluminous documents and described to the SEC how the fund manager perpetrated the fraud.

Herckis avoided the charge of aiding and abetting securities laws violations. The Enforcement Division stated that the DPA — which requires Herckis to disgorge $50,000 and bars him from serving as a fund administrator or providing services to any hedge fund for five years — demonstrates its commitment to rewarding proactive cooperation and strikes a balance between holding Herckis accountable for his part in the alleged misconduct and giving him credit for reporting the fraud.[9]

The Cooperation Program was also front-and-center in February 2013, when the SEC announced its simultaneous complaint and cooperation agreement with William G. Reeves for his role as in-house counsel to We The People Inc. We The People, a purported charitable organization, allegedly defrauded senior citizens and exaggerated the contributions made to charity. Reeves agreed to a suspension from appearing or practicing as an attorney before the SEC for at least five years and consented to a non-scienter-based antifraud injunction. The settlement left open the prospect of a future financial penalty against Reeves.[10]

Some may perceive the Reeves resolution to be more appropriate for a noncooperator than for a cooperator, but Reeves was an attorney with a front row seat to the fraud, and his settlement is more lenient than another recent SEC case charging a lawyer with fraud. In that matter, Bruce Haglund, an escrow attorney allegedly responsible for aiding a fraudulent investment scheme by wiring investors' funds in and out of his trust account, was charged with scienter-based fraud, assessed a penalty equal to the disgorgement plus prejudgment interest, and barred from acting as an officer or director of any public company.[11]

And in March 2012, the SEC stated publicly that based on an individual's cooperation, it was not taking enforcement action against an unnamed retired senior executive ofAXA Rosenberg, an institutional money manager and SEC-registered investment adviser. The executive provided timely and valuable information revealing that AXA Rosenberg Group LLC and Barr M. Rosenberg concealed a material error in the computer code of the model used to manage client assets, resulting in about $217 million in losses.[12] The executive gleaned this information from his position in the organization, his relationship with charged parties, and his intimate knowledge of the quantitative investment models. In granting the executive the holy grail of cooperation credit — the complete pass — the SEC likely took into account that he had retired and was unlikely to commit future violations.

The scarcity of published accounts of individual cooperation makes it difficult to predict when the SEC will reward a cooperator with a complete pass. However, SEC actions and statements to date suggest that similarly situated individuals may be treated differently based on how they interface with SEC staff during an investigation, with cooperators generally receiving preferential treatment as compared to noncooperating co-conspirators. Beyond allowing cooperators to settle to less severely charged and worded complaints and administrative orders, the SEC is often more generous in the calculation of monetary relief due from cooperators. For example, in August 2010, the SEC did not seek financial penalties against a senior official of Innospec Inc., who was allegedly culpable in the company's Foreign Corrupt Practices Act violations, due to "his extensive and ongoing cooperation in the investigation."[13]

Similar leniency has benefitted members of insider trading rings who stepped up early and told their stories to the SEC. In a December 2012 insider trading case, the SEC announced that tippee-trader Kenneth Wrangell received a lesser penalty than two co-conspirators, noting that Wrangell's cooperation "saved the SEC time and resources and himself a larger penalty."[14] Similarly, in an action filed in August 2012 against an insider trading ring, the SEC said it was crediting the "cooperation and substantial assistance" of one of the traders, Jeffrey Rooks, whose penalty equaled one quarter of his trading profit — a far departure from the SEC's standard practice of assessing a penalty equal to the economic benefit received.[15] While these are the most recent examples of individuals accused of insider trading being granted leniency in return for their cooperation, there are two earlier examples of the same.[16]

How Cooperation is Valued

The January 2010, policy statement, SEC press releases, and remarks of enforcement officials suggest that when evaluating cooperation, the SEC considers: (1) whether the assistance substantially helped the investigation; (2) whether it was "timely" (i.e., the first to be reported, or provided, before the SEC expended resources to obtain the same information elsewhere); (3) whether the investigation itself was based on, or substantially assisted by, the cooperator's information; (4) whether the SEC saved time and resources as a result of the assistance; (5) whether the cooperator is likely to commit future violations; and (6) whether the cooperation was voluntary.

Another element affecting the evaluation of information received is the individual's placement or relative position in the organization targeted by the investigation, along with how important he or she is to the investigation itself. For example, the SEC noted that the AXA Rosenberg executive who received a complete pass was particularly helpful by virtue of his position and his relationship to the parties. The SEC also suggested that without the information provided by hedge fund manager Herckis, it would not have been able to file its emergency enforcement action. The corollary is that the assistance of a witness considered of marginal value to the enterprise might not justify cooperation credit. On the other hand, the SEC might not devote its scarce resources to enforcement against a truly marginal participant in a fraudulent scheme, regardless of his cooperation.

With few formal statements reflecting how the SEC values and treats cooperators, individuals are often at the mercy of the Division of Enforcement and the commission, the ultimate arbiters of cooperation and its rewards. The cases noted above demonstrate that the SEC does not use a scientific or quantitative method to calculate cooperation credit. The defendants involved played different roles in the alleged wrongdoings and provided varying degrees of assistance to the SEC. Despite the factors enumerated by the SEC in its 2010 policy statement, the statement reinforces the SEC's discretion vis-à-vis cooperation credit. Review of previous cases and other agencies' cooperation programs may inform a

strategy on interacting with SEC staff to benefit from the Cooperation Program, but ultimately, cooperators take a leap of faith in the hope that the SEC will value and reward information.

Risks to the Cooperator

While the cases noted above send an encouraging signal to potential cooperators, individuals should be mindful of the risks of cooperation. First and foremost, cooperation credit is not assured until after an individual has assisted with the investigation.

Second, the SEC is the sole arbiter of the value of the assistance provided. The cooperating witness is unlikely to have knowledge of the agency's evidence, so information deemed valuable by the witness may be considered less valuable by the government. For example, information may have reduced value if the SEC gets it first from someone else, or if the information itself is considered unimportant or insignificant to the case, even if it was not previously known to the SEC. Further, other intangibles, such as witness credibility, also rely on subjective judgments by SEC staff. For these reasons, one should discern the SEC's evaluation of the witness before deciding to cooperate.

Third, the information provided may not be considered timely. Delayed cooperation, despite being full and truthful, may gain little "credit" for the witness. In his January 2010 remarks, the SEC's Khuzami warned that "latecomers rarely will qualify for cooperation credit," since others may have come forward earlier with the same information. Furthermore, even if multiple witnesses provide similar information, SEC staff may recommend only one for cooperation credit if it believes one is more crucial to the investigation. On Aug. 21, 2012, in a matter involving two whistleblowers, the SEC announced an award of $50,000 to one and nothing to the other because the latter whistleblower's information was deemed insufficiently valuable.[17] The Enforcement Division is likely using a "weigh and balance" approach to competing witnesses in deciding on cooperation credit for investigations with multiple cooperators. This first-in-line approach is consistent with the U.S. Department of Justice Antitrust Division's Leniency Program, which provides that the "Division grants only one corporate leniency per conspiracy, and in applying for leniency, the company is in a race with its co-conspirators and possibly its own employees who may also be preparing to apply for individual leniency."[18]

Another cooperation risk is that information revealed by a witness may be used against him or her by criminal enforcement authorities, even if the witness's cooperation is rewarded in a civil investigation.[19] The extent of coordination between the SEC and law enforcement authorities is not addressed by the Cooperation Credit policy statement or in the press releases involving Herckis, AXA Rosenberg and Reeves. While the SEC has publicly acknowledged self-regulatory organizations such as Financial Industry Regulatory Authority and the Options Regulatory Surveillance Authority for their assistance in enforcement actions involving cooperators[20], it is less clear under what circumstances the SEC has been assisted by criminal authorities in cooperation-aided SEC investigations. Thus, how much exposure a cooperator and the cooperator's information will have to criminal law enforcement authorities is largely unknown. However, under the terms of the Herckis DPA, Herckis acknowledged that the agreement "does not bind other federal, state or self-regulatory organizations."[21] Whether SEC cooperation credit can advance an individual's position vis-à-vis criminal authorities thus remains speculative and is likely to turn on the facts of a particular matter.

Individuals considering cooperating must consider the possibility that their assistance may become public, with consequences for their personal reputations, professional licenses, or livelihoods. Even so, the fallout from public disclosure may be more easily controlled through cooperation than the messy and damaging upheaval of civil litigation.

Finally, despite the encouraging signals to cooperators in previous enforcement actions, it is impossible to determine if the SEC's prior decisions can be used to predict similar outcomes in future investigations. Specific facts and circumstances, the role of the individuals involved, their culpability, whether they resigned from the entities charged in the underlying matters, and whether they were the first to come forward all bear on the outcome. While they may not be predictive, the earlier cases document potential rewards of cooperation and strongly counsel consideration of that approach if an experienced legal advisor believes that the "cooperation" stars have aligned.

The Decision to Cooperate

Before deciding whether and to what extent to pursue a cooperative posture with the SEC, a witness or potential witness should consult with someone adept at understanding the SEC's investigative process to discern whether cooperation credit is likely in light of the particular nature and status of the investigation and the assistance that the witness will be expected to provide to be seriously considered as a candidate for cooperation credit. If a decision to cooperate (or even blow the whistle pursuant to the Dodd-Frank Whistleblower provisions) is made, the individual must be ready to communicate all relevant information to the SEC with complete candor. Moreover, information needs to be revealed at the appropriate stage of an investigation. Information shared informally and earlier in the process will be valued more than if provided for the first time during on-the-record, subpoenaed testimony. Cooperators must be careful about speculating and should tell the staff when they are sharing known facts and when they are speculating.

While the Cooperation Program allows for formal written cooperation agreements between the Division of Enforcement and witnesses, these agreements are not a prerequisite for cooperation credit.[22] The AXA Rosenberg executive, for example, was lauded by the SEC for providing substantial assistance "without conditions," which "enhanced his credibility by showing that he had not been promised any specific outcome in exchange for his truthful testimony."[23] How and when to insist upon a formal agreement beforehand is a delicate calculus that may ultimately turn on the witness's value to the case and other intangibles such as an assessment of the personal dynamic and relationships formed with SEC staff. In short, even with experienced navigators by their sides, potential cooperators must leap before they look when voluntarily sharing what they know in a bid for leniency.

—By Thomas A. Sporkin and Pavitra Bacon, BuckleySandler LLP

Thomas Sporkin, a partner in BuckleySandler's Washington, D.C., office, previously served as a senior U.S. Securities and Exchange Commission enforcement official. He currently represents individuals and entities in matters before the SEC, self-regulatory organizations and other federal and state agencies.

Pavitra Bacon, an associate in the firm's Washington office, represents financial services industry clients in a wide range of litigation matters, including class actions, internal investigations and government enforcement actions.

[1] Press Release, SEC, Philip A. Falcone and Harbinger Charged with Securities Fraud (June 27, 2013) (online at http://www.sec.gov/News/PressRelease/Detail/PressRelease/1365171482856).

[2] Peter J. Henning, An S.E.C. Settlement That Seems to Favor Falcone, N.Y. Times Dealbook, May 13, 2013, http://dealbook.nytimes.com/2013/05/13/an-s-e-c-settlement-that-seems-to-favor-falcone/?_r=0.

[3] Dave Michaels, SEC Says It Will Seek Admission of Wrongdoing More Often, Bloomberg, June 19, 2013, http://www.bloomberg.com/news/2013-06-18/sec-to-seek-guilt-admissions-in-more-cases-chairman-white-says.html.

[4] Press Release, SEC, Philip Falcone and Harbinger Capital Agree to Settlement (Aug. 19, 2013) (online at http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370539780222).

[5] Emily Flitter, Philip Falcone Settles With SEC, Agrees to Two-Year Ban, CNBC, May 9, 2013, http://www.cnbc.com/id/100610853.

[6] Alexandra Stevenson and Ben Protess, Legal Side Effect in Admission of Wrongdoing to the S.E.C., N.Y. Times Dealbook, Oct. 7, 2013, http://dealbook.nytimes.com/2013/10/07/new-york-regulator-bans-falcone-from-insurance-business/.

[7] 17 C.F.R. § 202.12.

[8] Robert Khuzami, Director, Division of Enforcement, Remarks at News Conference Announcing Enforcement Cooperation Initiative and New Senior Leaders, Washington DC (Jan. 13, 2010) (online at http://www.sec.gov/news/speech/2010/spch011310rsk.htm).

[9] Press Release, SEC, SEC Announces First Deferred Prosecution Agreement With Individual (Nov. 12, 2013) (online at http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370540345373).

[10] Press Release, SEC, SEC Charges Husband and Wife in Florida with Defrauding Seniors Investing in Purported Charity (Feb. 4, 2013) (online at https://www.sec.gov/News/PressRelease/Detail/PressRelease/1365171512714).

[11] Litigation Release, SEC, SEC Obtains Significant Relief in Summary Judgment Win Against Defendants Charged with Defrauding Investors in Fictitious Offerings (Jan. 15, 2013) (online at http://www.sec.gov/litigation/litreleases/2013/lr22594.htm).

[12] Litigation Release, SEC, SEC Credits Former Axa Rosenberg Executive for Substantial Cooperation during Investigation (Mar. 19, 2012) (online at http://www.sec.gov/litigation/litreleases/2012/lr22298.htm).

[13] Press Release, SEC, SEC Charges Two Individuals for Roles in Innospec FCPA Scheme (Aug. 5, 2010) (online at http://www.sec.gov/news/press/2010/2010-141.htm).

[14] Press Release, SEC, SEC Charges Three in North Carolina With Insider Trading (Sept. 20, 2012) (online at http://www.sec.gov/News/PressRelease/Detail/PressRelease/1365171484866).

[15] Press Release, SEC, SEC Charges Eight in Georgia-Based Insider Trading Ring (Aug. 28, 2012) (online at http://www.sec.gov/News/PressRelease/Detail/PressRelease/1365171484100).

[16] See Litigation Release, SEC, SEC Charges Eight Individuals with Making $450,000 from Insider Trading in Vital Signs, Inc. (Dec. 21, 2011) (online at http://www.sec.gov/litigation/litreleases/2011/lr22205.htm) (issuing a reduced civil penalty to alleged insider John Easmon compared to several co-conspirators in return for "his substantial assistance in its investigation and anticipated cooperation in its pending enforcement action"); Litigation Release, SEC, SEC Files Settled Insider Trading Action Involving XTO Energy Securities (Sept. 24, 2010) (online at http://www.sec.gov/litigation/litreleases/2010/lr21665.htm) (absolving cooperator Vlasich of paying a civil penalty altogether based on his cooperation, while forcing his co-conspirator to pay a penalty of $100,000).

[17] Jessica Holzer, SEC Pays $50,000 in First Whistleblower Award, The Wall Street Journal, Aug. 21, 2012, http://online.wsj.com/news/articles/SB10000872396390443855804577603320771833802.

[18] Department of Justice, Frequently Asked Questions Regarding the Antitrust Division's Leniency Program and Model Leniency Letters (Nov. 19, 2008) (online at http://www.justice.gov/atr/public/criminal/239583.htm).

[19] Notably, the Rules of Evidence that protect settlement discussions in civil litigation do not generally apply to talks with the SEC at the investigation stage. There are ways to try to protect your conversations, for example, via an attorney or witness proffer.

[20] See, e.g., Press Release, SEC, SEC Charges Eight in Georgia-Based Insider Trading Ring (Aug. 28, 2012) (online at http://www.sec.gov/News/PressRelease/Detail/PressRelease/1365171484100); Litigation Release, SEC, SEC Charges Eight Individuals with Making $450,000 from Insider Trading in Vital Signs, Inc. (Dec. 21, 2011) (online at http://www.sec.gov/litigation/litreleases/2011/lr22205.htm).

[21] SEC, Deferred Prosecution Agreement (Nov. 8, 2013) (online at http://www.sec.gov/news/press/2013/2013-241-dpa.pdf).

[22] The SEC enforcement manual also permits assistant directors, with the approval of a supervisor, to make oral assurances to an individual or company that the Division does not anticipate recommending an enforcement action when the available evidence indicates that an individual or company has not violated the federal securities laws.

[23] Litigation Release, SEC, SEC Credits Former Axa Rosenberg Executive for Substantial Cooperation during Investigation (Mar. 19, 2012) (online at http://www.sec.gov/litigation/litreleases/2012/lr22298.htm).
