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COOPERATION IN SEC ENFORCEMENT: THE CARROT BECOMES THE STICK

by

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In October 2001, just days after its staff launched an enforcement inquiry into the looming collapse of Enron Corporation, the Securities and Exchange Commission (“SEC” or “the Commission”) issued one of its most important pronouncements concerning its enforcement policies. It did so in a report explaining why it was declining to file charges against Seaboard Corporation after an investigation of accounting irregularities at that company. The report publicly detailed the many factors the SEC considers in determining whether, and to what extent, it grants leniency to investigated companies as a reward for cooperating with an SEC investigation and for practicing related acts of good corporate citizenship. *See 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*, SEC Release Nos. 34-44969 and AAER-1470 (Oct. 23, 2001) (the “*Seaboard Report*”) (available at <http://www.sec.gov/litigation/investreport/34-44969.htm>).

Partly due to its inopportune timing, the *Seaboard Report* was initially derided as proof that, under the leadership of then-Chairman Harvey L. Pitt, the SEC had become too cozy with corporate interests to ensure vigorous enforcement of the securities laws. Today, however, few people would seriously argue that *Seaboard* led to any weakening of the SEC’s enforcement approach toward companies. On the contrary, *Seaboard*’s carrot of offering leniency for cooperation has been transformed through subsequent cases into a powerful stick wielded against companies that do not fully cooperate with an SEC investigation and take other corporate action demonstrating contrition and penance. In the three years since the *Seaboard Report*, the Commission has publicly declined to charge only two other companies as a reward for full cooperation. During the same period, the Commission has sought and obtained multi-million dollar penalties against an increasing number of companies based on their *lack* of cooperation during investigative proceedings.

Prelude to Seaboard. The idea of granting leniency for cooperation was far from novel when the SEC issued its *Seaboard Report*, but the report was nevertheless seminal for at least two reasons. First, *Seaboard* represented the Commission’s first detailed, written guidance for investigated companies and their counsel concerning the benefits of cooperation. It thus removed a shroud of mystery that had previously beguiled all but the savviest of SEC enforcement practitioners.

Second, *Seaboard* demonstrated in a concrete way that a fully cooperative company could, under appropriate circumstances, spare itself from any enforcement charges. In the years leading up to *Seaboard*, cooperation rarely affected the question of *whether* a company would be charged — that was a given.

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At best, a company could, by fully cooperating with an investigation, ultimately convince the SEC to refrain from filing the most severe charges. Most often, that meant charging the company only with violating certain reporting and recordkeeping provisions of the Securities Exchange Act of 1934 (“Exchange Act”), rather than with the more serious offense of securities fraud. In addition, the Commission would often file its settlement with a cooperating company as an administrative proceeding rather than suing the company in federal court.

Seaboard and its Wake. The *Seaboard* Report resulted from an investigation of improper accounting entries that overstated Seaboard’s farming assets and understated its farming expenses. Ultimately, the SEC filed a relatively lenient settlement against the Seaboard employee deemed most responsible for the improper accounting, but it brought no charges against the company itself. Then, instead of inviting speculation about why it had not charged the company, the Commission took the unusual step of issuing a report under Exchange Act Section 21(a), which explained the charging decision and provided guidance for future cases.

In its report, the Commission lauded Seaboard for: promptly investigating and publicly disclosing its accounting errors; dismissing the responsible employee and two of his supervisors; providing “complete” cooperation with the SEC’s investigation of the matter (by, among other things, not asserting its attorney-client and other privileges); and strengthening its financial reporting process to prevent similar problems in the future. The Commission then itemized a non-exhaustive list of thirteen criteria it considers “in determining whether, and how much, to credit self-policing, self-reporting, remediation and cooperation.” The essential criteria include: the egregiousness and duration of the misconduct; the extent to which a lax corporate culture led to the misconduct; the extent of front-office responsibility; the extent of investor harm; the extent to which corporate internal controls failed to detect the misconduct; the promptness and effectiveness of the company’s response upon discovering the misconduct; the thoroughness and independence of the company’s internal inquiry into the misconduct; the company’s remedial actions to prevent recurrence of the misconduct; and the extent to which the company cooperated in the SEC’s investigation. With respect to the last criterion, the Commission noted that it considers the extent to which the investigated company shares the results of its internal inquiry with the SEC staff, voluntarily discloses relevant information not specifically requested by the staff, encourages its employees to cooperate, and refrains from asserting attorney-client privilege, work-product protection, and other privileges during the investigation.

Although the *Seaboard* Report was widely perceived as a harbinger of increasing leniency toward corporate wrongdoers, the SEC’s next public pronouncement concerning cooperation sent exactly the opposite message. In April 2002, the Commission announced a settlement with Xerox Corporation that not only charged Xerox in federal court with securities fraud violations, but also imposed a then-unprecedented civil penalty of \$10 million. In its press release announcing the settlement, the Commission also took the unusual step of explicitly characterizing the penalty as, “in part, a sanction for the company’s lack of full cooperation in the investigation.” SEC Press Release No. 2002-52 (Apr. 11, 2002) (available at <http://www.sec.gov/news/press/2002-52.txt>). Although the Commission did not elaborate on the extent to which Xerox’s lack of cooperation led to the penalty, it is worth noting that before *Xerox*, public companies rarely paid *any* civil monetary penalties when settling SEC accounting charges, and the highest previous penalty in such a case was only \$3.5 million.

In September 2002, the SEC filed two unrelated enforcement cases that further refined its conception of cooperation. First, the Commission settled a financial fraud case against Dynegy Inc. with a \$3 million civil penalty, explaining that the penalty reflected the Commission’s dissatisfaction with Dynegy’s cooperation in the early stages of the investigation. According to the Commission’s press release, Dynegy belatedly cooperated in the investigation and ultimately took appropriate remedial action, but initially dragged its heels in accurately disclosing the relevant accounting issues that led to the securities fraud charges. SEC Press Release No. 2002-140 (Sept. 24, 2002) (available at <http://www.sec.gov/news/press/2002-140.htm>). By contrast, a day after filing its settlement with Dynegy, the SEC publicly announced that it had declined to file any enforcement charges against Homestore, Inc., even though it had charged several former Homestore executives with securities fraud that day. As explained by the Commission, Homestore provided “swift, extensive, and extraordinary cooperation” in the SEC’s investigation, which included reporting the suspected misconduct after discovering it, conducting a thorough and independent investigation, sharing the fruits of the investigation with the government without asserting any privileges as to the written materials submitted,

terminating the employment of those found to have engaged in misconduct, and taking remedial action designed to prevent any recurrence of the accounting irregularities at issue. SEC Press Release No. 2002-141 (Sept. 25, 2002) (available at <http://www.sec.gov/news/press/2002-141.htm>).

Since its settlement with Homestore, most of the SEC's public messages about cooperation have taken the form of reprimands, sternly chastising companies for failing to live up to the Commission's expectations. In September 2003, for example, the Commission slammed American International Group, Inc. with fraud charges and a \$10 million civil penalty in a case resulting from improper accounting by one of its public company clients. In its press release announcing the settlement, the SEC went out of its way to criticize AIG's "woefully deficient document collection effort" and delay in producing a key document that the Commission considered highly relevant to the issues under scrutiny. The SEC also made clear that the unusually harsh settlement was directly tied to the Commission's frustration with AIG's conduct during the investigation. SEC Press Release No. 2003-111 (Sept. 11, 2003) (available at <http://www.sec.gov/news/press/2003-111.htm>).

Other recent cases demonstrate the SEC's intent to punish uncooperative conduct even when the underlying securities violation might not otherwise warrant a penalty. In March 2004, the Commission issued a settled order requiring Banc of America Securities LLC to pay a \$10 million civil penalty *solely* for its repeated failures to produce on a timely basis a range of documents requested during the SEC's still-pending investigation of potential securities trading violations. Because the firm is a broker-dealer registered with the SEC, the agency had statutory authority to penalize its lack of cooperation as a violation of the broker-dealer recordkeeping and access requirements of Exchange Act Sections 17(a) and 17(b), even without filing any substantive charges concerning the trades being investigated. In announcing the settlement, however, SEC Enforcement Director Stephen M. Cutler strongly suggested that the message of the case went beyond SEC-regulated firms, warning generally that the Commission "will not tolerate unreasonable delay in responding to our inquiries and will act aggressively to protect the integrity of the Commission's investigative processes." SEC Press Release No. 2004-29 (Mar. 10, 2004) (available at <http://www.sec.gov/news/press/2004-29.htm>).

In the months following its settlement with Banc of America Securities, the SEC has removed any lingering doubt about whether the agency thinks it can and should penalize companies that are not SEC-regulated entities — and thus are not subject to the provisions of Exchange Act Sections 17(a) and 17(b) — solely for uncooperative conduct during enforcement investigations. In settling accounting fraud charges against Lucent Technologies Inc., the Commission imposed a \$25 million civil penalty and explicitly stated in its press release that the penalty was "for [Lucent's] lack of cooperation." The release went on to itemize the conduct constituting Lucent's lack of cooperation, including ineffective document preservation measures; incomplete document productions; public statements made after reaching a settlement in principle with the SEC staff suggesting that the agreed-upon charges were unfounded; and voluntarily "expand[ing] the scope of employees that could be indemnified against the consequences of this SEC enforcement action." By expressly attributing the penalty to this conduct during the investigation, rather than to the underlying accounting fraud violations that were investigated and charged, the SEC press release made clear the Commission's view — thus far untested in court — that it has authority to seek or impose penalties against any entity solely for failing to cooperate with an investigation. SEC Press Release No. 2004-67 (May 17, 2004) (available at <http://www.sec.gov/news/press/2004-67.htm>). In August 2004, the Commission added an exclamation point by attributing a \$7.5 million penalty settlement with Halliburton Company to "lapses in conduct during the investigation" rather than the underlying conduct, which did not even result in a fraud charge. *See* SEC Press Release No. 2004-104 (Aug. 3, 2004) (available at <http://www.sec.gov/news/press/2004-104.htm>).

Lessons and Questions. The SEC's increasingly harsh approach toward companies that fail to meet its expectations of cooperation reveals several instructive lessons, harsh realities, and unresolved issues:

- The SEC apparently believes that it can and should impose monetary penalties against companies that fail to cooperate in investigations, regardless of whether or not the company is a regulated entity and regardless of whether or not a penalty would otherwise be warranted by the underlying conduct being investigated. If required to defend this position in court, the SEC likely would argue that because it has statutory authority to seek penalties for any violation of the federal securities laws, a non-cooperating company simply loses the benefit of a downward departure from the presumption that a penalty will be

sought. However, that argument is belied by both the SEC's public explanation of the penalties against Lucent and Halliburton and the Commission's pre-*Enron* practice of *rarely* imposing any penalties against public companies, even for violations involving fraud.

- In the current regulatory climate, public companies often have no rational choice but to cooperate fully and promptly with an SEC investigation. In nearly all cases, if the Commission ultimately determines that the company or its agents have violated the securities laws, the company will eventually decide to negotiate a settlement rather than endure the expense, uncertainty, and negative publicity associated with defending a lengthy SEC enforcement litigation. If there is a parallel criminal investigation, the stakes are even higher. Full and prompt cooperation with the investigation is often the best way to achieve a settlement that eliminates the company's criminal exposure while minimizing its financial exposure and any negative publicity. And although the SEC has not explicitly stated, in practice such cooperation typically is expected to include sharing some degree of investigative work product with the SEC and bearing the associate risk that such disclosure will later be deemed a broad waiver of applicable privileges.
- Companies should not assume that they can use litigation-style tactics during the early stages of an SEC investigation and subsequently mend fences by fully cooperating during the later stages. In at least four recent cases, the Commission acknowledged belated cooperation and good conduct but nevertheless demanded a harsh result, including monetary penalties, for uncooperative conduct during the early stages of investigations. These cases include the above-noted settlement in September 2002 with Dynegy along with more recent settlements in June 2004 with Symbol Technologies, Inc. (SEC Press Release available at <http://www.ssec.gov/news/press/2004-74.htm>), Del Global Technologies, Inc. (SEC Litigation Release available at <http://www.sec.gov/litigation/litreleases/lr18732.htm>) and Gemstar-TV Guide International, Inc. (SEC Press Release available at <http://www.sec.gov/news/press/2004-86.htm>).
- Although the SEC's settlements provide extensive guidance for *companies* regarding the benefits of cooperating in investigations, the Commission has provided relatively little help to *individuals* facing SEC scrutiny. In the few cases in which the Commission has publicly acknowledged an individual's cooperation with an investigation, the ostensible benefits from the cooperation have been minimal. For example, in one recent case, the cooperating individual received a ten-year bar from serving as an officer or director of any public company rather than a lifetime bar, but otherwise received the same result as those who did not cooperate; *See* SEC Press Release No. 2004-2 (Jan. 7, 2004) (available at <http://www.sec.gov/news/press/2004-2.htm>). In another instance, the cooperator avoided any monetary penalties but was still charged with securities fraud violations in an administrative proceeding. *See* SEC Litigation Release No. 18120 (Apr. 30, 2003) (available at <http://www.sec.gov/litigation/litreleases/lr18120.htm>).
- Even for public companies, the benefits of cooperating are sometimes imperceptible. For example, in recent settlements with Syncor International Corporation and ABB Ltd arising from violations of the Foreign Corrupt Practices Act, the SEC acknowledged the companies' cooperation in the investigations but still demanded and obtained monetary relief that went beyond previous FCPA settlements. *See* SEC Litigation Release No. 17887 (Dec. 10, 2002) (available at <http://www.sec.gov/litigation/litreleases/lr17887.htm>) and SEC Litigation Release No. 18775 (Jul. 6, 2004) (available at <http://www.sec.gov/litigation/litreleases/lr18775.htm>). Similarly, in a recent supervision and record-keeping case against Fidelity Brokerage Services, LLC, which included no allegations of fraud, the Commission acknowledged the company's prompt remedial action and cooperation — which included “immediately” conducting an internal investigation, terminating more than a dozen employees, and sharing its investigative findings with the SEC and the New York Stock Exchange — yet insisted on a relatively high \$1 million civil penalty to settle the matter. *See* SEC Release No. 34-50138 (Aug. 3, 2004) (available at <http://www.sec.gov/litigation/admin/34-50138.htm>). Finally, in a recent accounting fraud settlement with Royal Dutch Petroleum Company and certain affiliates, the SEC expressly acknowledged the company's cooperation and remedial actions while extracting one of the highest civil penalties ever paid for such violations. *See* SEC Press Release No. 2004-116 (Aug. 24, 2004) (available at <http://www.sec.gov/news/press/2004-116.htm>).