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DPAs In SEC Enforcement Investigations

Law360, New York (September 15, 2009) -- Robert Khuzami, the director of the U.S. Securities and Exchange Commission's Division of Enforcement, recently announced a series of significant reforms designed to foster increased cooperation with SEC investigations.[1]

A former federal prosecutor, he borrowed most of them from the criminal process playbook: seeking immunity for witnesses from the U.S. Department of Justice, providing witnesses with early oral assurances that the SEC will not take action against them, and entering into deferred prosecution agreements (DPAs) with individuals and entities.[2]

This article focuses on the last of these techniques, DPAs. As Mr. Khuzami implicitly noted in his speech, to be effective in the civil SEC enforcement context, the DPA should not be imported whole cloth from the criminal justice system.

This article reviews the basic elements of traditional DPAs and nonprosecution agreements (NPAs) and discusses how, in our view, they should be tailored to best help the SEC speed up its investigations and target the most significant cases and the most culpable wrongdoers.

Criminal DPAs and NPAs: A Primer

Federal criminal prosecutors rely extensively on evidence from cooperating witnesses.

In exchange for their testimony, prosecutors may offer cooperators leniency in sentencing (through 5K1.1 letters to the sentencing judge seeking a reduction in prison time), immunity from prosecution, a DPA or an NPA.

These tools, together with others, provide a wide array of incentives and techniques that prosecutors can deploy to investigate and build their cases for trial.

The U.S. Department of Justice's use of DPAs began with individuals. The deferred prosecution system was conceived as an alternative to prosecution that diverts individual offenders out of the criminal justice system into a program of supervision and services administered by the U.S. Pretrial Services Office.

Typically, these agreements are used to identify first-time, nonviolent offenders early in the criminal justice process, generally prior to indictment, who are deemed susceptible to rehabilitation.

These offenders commonly are charged by prosecutors in a criminal complaint and then sign a DPA, which is reviewed and approved by the court. For defendants who successfully complete the program, the charges are dismissed.

If a defendant does not complete the program, the prosecutor can proceed to trial on the information or seek broader charges from a grand jury.[3]

The terms of DPAs vary; often they include admissions of wrongdoing; regular reporting to Pretrial Services; maintaining employment; obeying the law; and refraining from publicly discussing the case. If the case goes to trial, the defendant generally cannot contest any admitted facts.

Since the post-indictment collapse of Arthur Andersen, business entities have increasingly entered into DPAs or NPAs with the government in an effort to avoid the potential consequences of a broad indictment or criminal conviction.

In a typical DPA, the Justice Department publicly files the agreement along with an information, but agrees to hold the charges in abeyance pending the company's successful satisfaction of the DPA.

There is only minimal judicial review of the terms of a DPA and only the prosecutor determines whether the company has successfully met them.

If the government is satisfied, the charges are dismissed; otherwise, the prosecutor commonly seeks broader charges from a grand jury and takes the case to trial.

The terms of an entity DPA, which commonly are in place for a year or more, may include payment of restitution, admission of wrongful conduct, ongoing cooperation with the government's investigation (including making employees available for interviews or testimony), new or enhanced compliance programs, and internal reforms ranging from changes in corporate governance structure to personnel actions.[4]

The government may also request other terms, including waivers of potential defenses, limits on public statements, restrictions on business practices and monitoring.

An NPA differs from a DPA in several critical respects. When the Department of Justice enters into an NPA with an entity, no charges are brought; the agreement is not filed

with the court; and there is no judicial involvement. If the company complies with the agreement, that is essentially the end of the matter.

If the Justice Department concludes that the company has fallen short of its obligations under an NPA, the prosecutor will present the case to a grand jury and proceed to trial, as with a DPA.

An NPA would typically contain the same sort of cooperation and remediation provisions as a DPA, but would not include any admission of wrongdoing.

Both NPAs and DPAs thus offer companies a way to avoid the consequences of serious criminal charges, conviction and potentially related civil litigation exposure, while providing the government with ongoing oversight of the company's efforts to reform itself.

The SEC's Traditional Approach to Encouraging Cooperation

Cooperation has long been a conundrum for the SEC. As a civil enforcement agency, the SEC inherently has less to offer potential cooperators than the Justice Department, since the SEC cannot put people in jail or destroy companies simply by indicting them.

Moreover, since the SEC is held only to a preponderance-of-the-evidence burden of proof, it may have felt that cooperating witnesses were not as essential as they are viewed by criminal prosecutors, who must prove their cases beyond a reasonable doubt.

Yet the SEC has also long recognized that it does not have the resources to investigate every case from scratch; to have the greatest deterrent effect, it needs cooperators to bring potential violations to its attention and voluntarily provide key pieces of evidence.

The result of these competing considerations has been a relatively stinting approach to cooperation. The SEC has not had a process analogous to a DPA, where it would bring a case but hold it in abeyance pending cooperation.

To individuals, in "some very limited circumstances," the SEC in theory could offer a "witness assurance letter," which forbears all charges in exchange for testimony.[5]

It could also extend, in very rare cases and with the permission of the attorney general, immunity from criminal prosecution.[6] In recent years, however, the SEC has made little use of these techniques.[7]

With respect to corporations and other entities, the SEC's cooperation policy has, since 2002, been governed by the so-called Seaboard Report.[8]

Under that policy, a timely internal investigation, followed by prompt self-reporting, cooperation with the SEC staff's requests for documents and witnesses, discipline of the

individuals responsible and establishment of controls designed to prevent future misconduct would weigh in a company's favor under a sliding scale of cooperation.

A company like Seaboard, which provided "complete cooperation" to the SEC, might be granted the "extraordinary step of taking no enforcement action."[9]

If an entity provided less complete cooperation, or if the nature of the misconduct was more egregious, the SEC might take some form of reduced enforcement action.

For example, it might bring fewer or less serious charges, set a smaller fine, or refrain from imposing a corporate monitor or placing the company in receivership.

If the SEC believed that an entity failed to meet the terms of cooperation embodied in a settlement agreement, there is little the SEC has been able to do on its own; its remedy has been to turn to the courts for contempt proceedings.

Many defense counsel and their clients take the view that the traditional SEC approach to cooperation has offered inadequate incentives to self-report and provide other forms of extraordinary cooperation.

Although the SEC does not generally publicize when it gives cooperators a complete pass, a common view in the defense bar is that it is too infrequent and overly influenced by subjective and unpredictable assessments of cooperation by the particular SEC staff conducting the investigation.

Moreover, reduced fines or charges may not make much of a difference to many companies or individuals, who still must suffer the negative publicity caused by the announcement of an SEC enforcement action. Such reputational injury is often of much greater concern to would-be cooperators than the financial burden of a fine.

In balancing these potential risks and rewards, many potential cooperators have no doubt decided to gamble on lying low, in hopes that the SEC will never catch them, rather than face a likely public smirching of their reputation and damage to their career or business.

Tailoring the DPA for the SEC: "The Non-Enforcement Agreement"

In creating additional incentives for cooperation, Mr. Khuzami appears to be attempting to address these concerns. As noted above, DPAs are one of the tools Mr. Khuzami has said the Division will deploy.

In his recent speech, he briefly described how he sees the contours of an SEC DPA:

"The division will be prepared to recommend to the commission that the SEC enter into Deferred Prosecution Agreements, in which we agree in the appropriate case to forgo an enforcement action against an individual or entity subject to certain terms, including

full cooperation, a waiver of statutes of limitations, and compliance with certain undertakings."[10]

Despite the reference to DPAs, this description more closely resembles a traditional NPA — since rather than filing charges and holding them in abeyance, the SEC would bring no charges at all against the entity or individual entering into the agreement.

To unmoor these agreements from traditional criminal practice and encourage the SEC staff to be flexible in adapting them to the dynamics of civil law enforcement, we suggest that they be called "non-enforcement agreements."

We think using non-enforcement agreements makes good sense in the SEC enforcement context. As discussed above, for many would-be cooperators with the SEC, the greatest concern is the mere filing of an enforcement action, which can result in immediate negative news coverage and reputational damage.

The filing can instantly destroy an individual's career. Or, in the case of an entity, it can do long-lasting or permanent damage to a business, depending on the reaction of customers, suppliers, lenders and other regulators.

This damage often cannot be undone, even if the SEC or a court later dismisses the action. Thus, an agreement that contemplated the public filing of an SEC enforcement action would do little to encourage cooperation.

Mr. Khuzami did not say in his speech whether or not the division or the commission would publicly announce these agreements. To provide a truly effective incentive to cooperate, we would urge the SEC to keep them nonpublic to the extent practicable.

This approach would give companies and individuals the opportunity to own up to aberrational securities — law violations, take effective remedial action, reform themselves, implement measures to prevent future violations and help the SEC build cases against noncooperative wrongdoers — without risking unnecessary and potentially irreversible reputational harm.

By fashioning salutary undertakings and monitoring compliance with non-enforcement agreements, the SEC could make efficient use of its resources while ensuring that the investing public is fully protected.

Finally, to enable the SEC to determine whether to enter into non-enforcement agreements, especially with individuals, we would recommend that the SEC staff make greater use of proffer agreements than it has historically.

Under these agreements, witnesses are interviewed by the staff off the record with a grant of limited use immunity.

In our experience, the proffer session is generally a better way than formal testimony for an individuals to provide information and for the SEC staff to assess the quality of cooperation.

Conclusion

We applaud Mr. Khuzami's decision to use a variety of techniques borrowed from the criminal process, including DPAs, to create additional incentives for individuals and entities to cooperate with SEC investigations.

In our view, the traditional criminal DPA should be tailored to the civil SEC enforcement process and the SEC staff should be given flexibility, in appropriate cases, to use proffer agreements and negotiate customized non-enforcement agreements that fit the nature of the case, the degree and quality of cooperation, and the particular circumstances of the cooperator.

If used judiciously, we believe these techniques could help the SEC better deploy its limited resources and better protect the investing public.

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The opinions expressed are those of the authors and do not necessarily reflect the views of Portfolio Media, publisher of Law360.

[1] Robert Khuzami, Remarks Before the New York City Bar: My First 100 Days as Director of Enforcement, Aug. 5, 2009, available at www.sec.gov/news/speech/2009/spch080509rk.htm

[2] See id.

[3] See United States Attorneys' Manual Section 9-22.000, available at www.usdoj.gov/usao/eousa/foia_reading_room/usam/title9/22mcrm.htm#9-22.000.

[4] Eugene Illovsky, Corporate Deferred Prosecution Agreements: The Brewing Debate, Criminal Justice (Summer 2006), 36-38.

[5] See SEC Enforcement Division Manual, Section 3.3.5.3.1, available at www.sec.gov/divisions/enforce/enforcementmanual.pdf, at 80-81.

[6] Id. at 83-84.

[7] For a more extensive discussion of SEC witness assurance letters, see Alex Lipman, Dusting Off SEC Cooperation Rules for Individuals, SecuritiesLaw360, July 13, 2009, available at securities.law360.com/articles/109341.

[8] Exchange Act Release No. 44969 (the “Seaboard Report”), Oct. 23, 2001, available at http://www.sec.gov/litigation/investreport/34-44969.htm; see also SEC Enforcement Division Manual, available at www.sec.gov/divisions/enforce/enforcementmanual.pdf, at 80-81.

[9] Id.

[10] Khuzami Remarks, supra note 1.