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THE SEC OPENS ITS TOOLBOX: NON-PROSECUTION AND DEFERRED PROSECUTION AGREEMENTS

August 21, 2011 by Brad Hamilton[1]

Last year the SEC announced[2] it was adopting new procedures to encourage greater cooperation in its enforcement investigations, including the use of **cooperation agreements**, **non-prosecution agreements** and **deferred prosecution agreements**. Non-prosecution agreements and deferred prosecution agreements are typically used in criminal proceedings to encourage cooperation by important witnesses and provide fair and specific treatment of cooperating witnesses. To understand their use by the SEC it is helpful to understand how these tools developed under federal practice.

The Department of Justice has used these agreements for years in corporate fraud cases. The infamous "Thompson Memorandum"[3], written by Larry Thompson of the DOJ in 2003 to help federal prosecutors decide whether to charge a company with criminal offenses, required that a company must

(1) turn over materials from internal investigations,
(2) waive attorney-client privilege, and
(3) not provide targeted executives with company-paid lawyers,

before the company could claim credit for cooperating with the DOJ. In other words, a company might provide extensive cooperation to the DOJ, but would not get any credit for that cooperation unless it expressly gave up its rights and breached its indemnification contracts. Nearly every public company has indemnification agreements with its directors and officers, and indemnification is provided in the corporation statutes of Delaware, Colorado, and most other states. Although eviscerating the constitutional rights to counsel and against self-incrimination, and the statutory right and contractual obligation to indemnification, the Thompson Memo also provided for the use of non-prosecution agreements for companies that waived their constitutional rights.

The Thompson Memorandum was replaced in December 2006 by the more reasonable "McNulty Memorandum"[4], which provided some relief from the most offensive portions of the Thompson Memorandum by requiring prosecutors to go through certain procedural requirements and obtain approval from senior supervisors before demanding a waiver of the attorney-client privilege.

[1] http://bradhhamilton.wordpress.com/author/bradhhamilton/
[2] http://www.sec.gov/news/press/2010/2010-6.htm
[3] http://www.justice.gov/dag/cftf/corporate_guidelines.htm
[4] http://www.justice.gov/dag/speeches/2006/mcnulty_memo.pdf

The McNulty Memorandum was revised in 2008 (the "Filip Memo"[5]) to prohibit the Department of Justice from coercing companies to breach their indemnification agreements with their directors and officers, to allow credit for cooperation to companies that do not waive the attorney-client privilege or do not disclose attorney-client work product, and to prohibit prosecutors from demanding attorney-client communications or attorney work product.

In contrast to the Department of Justice, the SEC does not have criminal enforcement powers, only civil enforcement powers, and must refer criminal cases to the Department of Justice. However, over the years the SEC has sought greater cooperation from companies and people under SEC civil investigation. For example, the SEC's equivalent of the Thompson/McNulty/Filip Memorandums is the 2001 "Seaboard Report"[6] describing the criteria it will consider in determining whether, or how much, credit it will give to companies who self-police, self-report, take corrective action or cooperate with the SEC. Never mind that the "Seaboard Report" is neither about "Seaboard" nor a "report", it stated that cooperation can result in reduced charges, lighter sanctions or mitigating language in settlements.

Despite the SEC's more reasonable approach to the rights of companies under investigation, the Seaboard Report, and the SEC's approach to giving credit for cooperation, were vague, and often applied after-the-fact. In many cases, a company never really knows where it stands with the SEC, and whether it is actually receiving credit for cooperation, until after the investigation is complete. While the Justice Department's rules were originally offensive, at least a defendant signing a non-prosecution or deferral agreement knows exactly what to do, and exactly what treatment it will receive in return for cooperation.

To encourage the type of cooperation the SEC wants, it needed to provide the same type of certainty and fairness to potential witnesses as the DOJ, and so last year the adopted the new procedures[7] for rewarding cooperation.

The SEC entered its first **non-prosecution agreement** in December 2010 with Carter's Inc. In the Carter's case the EVP of Sales, Joe Elles, allegedly gave substantial discounts to the company's largest customer and hid them from the company. Because the company didn't know, it did not recognize the discounts until later reporting periods, which caused the company's results for the quarters in which the discounts were given to be artificially inflated. The SEC brought an action against Elles[8], but entered into a non-prosecution agreement with Carter's. The SEC identified the following factors as relevant to its decision not to bring an action against Carter's: (1) the "relatively isolated nature" of the unlawful conduct; (2) the company's "prompt and complete" self-reporting of the misconduct to the SEC; and (3) the company's "exemplary and extensive" cooperation in the inquiry, including a "thorough and comprehensive" internal investigation. The SEC did not require Carter's to waive its attorney-client privilege.

The SEC recently announced[9] its first use of a **deferred prosecution** agreement, with Tenaris S.A., a manufacturer of steel pipe products from Luxemburg, listed on the New York Stock Exchange. A world-wide internal investigation conducted by Tenaris' outside counsel revealed Foreign Corrupt Practices Act violations in Uzbekistan, where Tenaris allegedly bribed Uzbek officials and made $5

[5] http://www.justice.gov/opa/documents/corp-charging-guidelines.pdf
[6] http://www.sec.gov/litigation/investreport/34-44969.htm#P16_499
[7] http://www.sec.gov/spotlight/enfcoopinitiative.shtml
[8] http://www.wlrk.com/docs/comp21784.pdf
[9] http://www.sec.gov/news/press/2011/2011-112.htm

million in profits from pipeline contracts. The company self-reported to the SEC and the Department of Justice, cooperated with the government, and made extensive efforts at correcting the violations.

The SEC said that Tenaris was an appropriate candidate for the first deferred prosecution agreement because of its "immediate self-reporting, thorough internal investigation, full cooperation with SEC staff, enhanced anti-corruption procedures, and enhanced training."

Under the deferred prosecution agreement[10], the SEC will not bring civil charges against Tenaris unless the SEC determines that the company has not complied with its obligations under the agreement. Although Tenaris shared the results of its internal investigation with the government, the agreement does not require it to waive the attorney-client privilege. Tenaris agreed to pay $5.4 million in disgorgement and interest.

By eliminating the Hobson's choice[11] of either cooperating and not knowing what will happen, or not cooperating and not knowing what will happen, the certainty provided by deferment and non-prosecution agreements will allow lawyers to better advise their clients on the consequences of self-reporting and corrective actions, and should make it easier for the SEC to secure cooperation from companies and individuals on a fair and reasonable basis.

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[10] http://www.sec.gov/news/press/2011/2011-112.htm
[11] http://en.wikipedia.org/wiki/Hobson%27s_choice