

39TH ANNUAL ROCKY MOUNTAIN SECURITIES CONFERENCE

SEC ENFORCEMENT ACTIONS: COOPERATION AFTER THE SEABOARD REPORT

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by
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I. INTRODUCTION

In October 2001, the Securities and Exchange Commission (“SEC” or “Commission”) issued what is now commonly referred to as the Seaboard Report.² The Seaboard Report sets forth criteria the Commission considers in determining whether, and how much, to credit self-policing, self-reporting, remediation and cooperation when attempting to resolve enforcement actions.³ This article focuses on cooperation, the factor that has received the most attention from commentators and, arguably, the Commission.

In enforcement actions post-Seaboard, the Commission has stated that it will credit companies that cooperate and severely penalize those that do not.⁴ This article discusses the criteria set forth in the Seaboard Report and analyzes subsequent enforcement

actions where the Commission credited a company for its cooperation or penalized a company for its lack of cooperation.

This article’s purpose is twofold: first, to warn companies and their counsel of the possible consequences of their failure to cooperate; and second, to enlighten companies and their counsel about what they can expect to receive – and what they should seek to obtain – in return for cooperation.

II. SEABOARD AND THE SEABOARD REPORT

The Seaboard Report arose out of an SEC enforcement action against an employee of a subsidiary of the Seaboard Corporation.⁵ In this action, the SEC settled a proceeding against the employee, alleging inaccurate books and records and misstated periodic reports, but took no action against the parent company “given the nature of the conduct and the company’s responses.”⁶ Specifically, the Commission noted that Seaboard (1) had its internal auditors perform a preliminary review;

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² *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*, Exch. Act Rel. No. 34-44969; Accounting and Auditing Enforcement Rel. No. 1470 (Oct. 23, 2001).

³ *Id.*

⁴ See Sections III.A. and B., *supra*.

⁵ *In the Matter of Gisela de Leon-Meredith*, Exch. Act Rel. No. 44970 (Oct. 23, 2001).

⁶ *Id.*



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(2) retained an outside law firm to conduct an investigation; (3) terminated the controller and two other employees for their roles in the financial fraud; (4) disclosed publicly and to the Commission that its financials would be restated; (5) produced the details of its internal investigation to the Commission; (6) did not invoke any privileges with respect to the investigation; and (7) strengthened its financial reporting process.⁷

The Commission issued the Seaboard Report the same day of the settlement. The Commission argued that public investors benefit and government and shareholder resources are preserved when a company discovers violations, aggressively investigates them, promptly discloses them to the public and the Commission, corrects them, voluntarily strengthens its internal controls and systems, and fully cooperates with the Commission.⁸ To this end, the Commission identified four broad categories it will consider when deciding what credit, if any, a company will receive in its enforcement decisions: self-policing, self-reporting, remediation and cooperation.⁹

The Seaboard Report sets forth specific criteria for each of the four categories listed above. The Commission identified the following specific criteria relating to cooperation:

- Whether the company shares the results of its review, as well as all relevant documentation, with the staff;
- Whether the company discloses information to the staff that was not requested and otherwise might not have been discovered;
- Whether the company shares information that is thorough and reliable so the staff may use it to facilitate prompt enforcement actions against those who may have violated the law;

- Whether the company memorializes the results of the internal investigation in a writing and shares it with the staff in a format that can be used by the staff in an enforcement proceeding; and
- Whether the company encourages its employees to cooperate with the staff's investigation and whether efforts are made to secure such cooperation.¹⁰

III. ENFORCEMENT ACTIONS FOLLOWING THE SEABOARD REPORT

A. The Commission Begins Penalizing Companies for Failing to Cooperate

In enforcement actions settled after the Seaboard Report, the Commission has demonstrated that it will severely penalize a company that does not cooperate.

1. Xerox

In April 2002, the Commission announced a settlement with Xerox Corporation.¹¹ The Commission charged the company in federal court with securities fraud resulting from accounting practices that, from at least 1997 through 2000, resulted in Xerox disguising "its true operating performance from investors."¹² The Commission imposed a then unprecedented penalty of \$10 million. The Commission publicly announced that the penalty reflects "in part, a sanction for the company's lack of full cooperation in the investigation."¹³

2. Dynegy

In September 2002, the Commission settled fraud charges with Dynegy Inc. and imposed a \$3 million penalty.¹⁴ The Commission publicly announced the penalty's direct relation to Dynegy's lack of cooperation and issued the following warning:

⁷ Seaboard Report, *supra* n.2.

⁸ *Id.*

⁹ *Id.*

¹⁰ *Id.*

¹¹ *Xerox Settles SEC Enforcement Action Charging Company With Fraud*, Release No. 2002-52 (April 11, 2002).

¹² *Id.*

¹³ *Id.*

¹⁴ *Dynegy Settles Securities Fraud Charges Involving SPEs, Round-Trip Energy Trades*, Release No. 2002-140 (September 24, 2002).

Just as the Commission is prepared to reward companies that cooperate fully and completely with agency investigations, *the Commission will also penalize those who do not. If companies wish to receive the maximum benefit from their cooperation, the cooperation must be complete and meaningful from the outset.* Companies would be well advised to familiarize themselves fully with the Commission's [Seaboard Report].¹⁵

3. AIG

In September 2003, the Commission charged American International Group, Inc. ("AIG") with fraud and imposed a \$10 million penalty in a case resulting from improper accounting by one of AIG's public clients.¹⁶ In its press release, the Commission made clear that AIG's penalty was directly related to its non-cooperative conduct during the investigation. To this end, the Commission detailed AIG's "woefully deficient document collection" and its decision "to withhold a key document."¹⁷

4. Banc of America

In March 2004, the Commission penalized Banc of America Securities LLC \$10 million in a settlement relating to repeated document production failures during a pending securities fraud investigation.¹⁸ Because Banc of America is a registered broker-dealer, the Commission had authority to penalize its lack of cooperation as a violation of broker-dealer record keeping and access requirements without filing any charges relating to the underlying transactions being investigated. In other words, the broker-dealer was penalized for its non-cooperation as distinct from any non-cooperation related to any underlying misconduct. The Commission issued the following warning: "Today's action makes clear that we will not tolerate

unreasonable delay in responding to our inquiries and will act aggressively to protect the integrity of the Commission's investigative processes."¹⁹

5. Lucent

In August 2004, four months after the SEC imposed a \$10 million penalty on Banc of America, the Commission made clear it will penalize non-cooperative conduct, apparently apart from any other alleged misconduct, during enforcement investigations regardless of whether the company is a registered broker-dealer.²⁰ The Commission announced a \$25 million penalty against Lucent for its "lack of cooperation."²¹ The press release itemized Lucent's lack of cooperation, including ineffective document preservation measures, incomplete document productions, public statements following settlement with the SEC contradicting the agreed-upon terms, and voluntarily "expanding the scope of employees that could be indemnified against the consequences of this SEC enforcement action."²²

6. Haliburton

In August 2004, the Commission penalized Haliburton \$7.5 million for "lapses in the company's conduct during the course of the Commission's investigation."²³ "The penalty against Haliburton serves as yet another reminder that the Commission will not tolerate lapses by companies that serve to delay or hinder the Commission's investigative processes."²⁴ An interesting note about the Haliburton action is that the underlying conduct being investigated did not result in a fraud charge.²⁵

¹⁵ *Id.* (emphasis added).

¹⁶ *SEC Charges American International Group and Others in Brightpoint Securities Fraud*, Release No. 2003-111 (September 11, 2003).

¹⁷ *Id.*

¹⁸ *SEC Brings Enforcement Action Against Banc of America Securities for Repeated Document Production Failures During a Pending Investigation*, Release No. 2004-29 (March 10, 2004).

¹⁹ *Id.*

²⁰ Some commentators have questioned the SEC's ability to impose a penalty against a non-registered entity solely for failing to cooperate with an investigation. See Russell G. Ryan, *Cooperation in SEC Enforcement: The Carrot Becomes the Stick*, Legal Backgrounder, Vol. 19, No. 33 (October 1, 2004). To date, the authors are unaware of any pending action challenging the SEC's authority to impose such a penalty.

²¹ *Lucent Settles SEC Enforcement Action Charging the Company with \$1.1 Billion Accounting Fraud*, Release No. 2004-67 (May 17, 2004).

²² *Id.*

²³ *SEC Charges Haliburton and Two Former Officers for Failure to Disclose a 1998 Change in Accounting Practice*, Release No. 2004-104 (August 3, 2004).

²⁴ *Id.*

²⁵ *Id.*

B. The Commission Takes No Action or Asserts Only Non-Fraud Violations Against Companies Because of Their Cooperation

In the following matters, the SEC brought no action, or settled on non-fraud charges, based at least in part on the companies' cooperation during the investigations.

1. Homestore

In the Homestore investigation, the Commission filed no charges against Homestore Inc. even though it had charged several former senior executives with fraud. Specifically, the Commission charged the company's COO, CFO and a VP with "securities fraud, lying to the auditors, [and] falsifying Homestore's reporting and record-keeping violations."²⁶ The Commission elected not to bring any enforcement action against the company itself because of Homestore's "swift, extensive and extraordinary cooperation in the Commission's investigation."²⁷ The Commission deemed Homestore's behavior cooperative because it: (1) "report[ed] its discovery of possible misconduct to the Commission immediately upon the audit committee's learning of it"; (2) "conduct[ed] a thorough and independent internal investigation"; (3) "shar[ed] the results of that investigation with the government"; (4) did "not assert any applicable privileges and protection with respect to written materials furnished to the Commission staff"; (5) "terminat[ed] responsible wrongdoers"; and (6) "implement[ed] remedial actions designated to prevent the recurrent of fraudulent conduct."^{28, 29}

2. Electro Scientific Industries

Similarly, in Electro Scientific Industries, the Commission brought fraud charges against the CFO, COO, CEO and Controller alleging they "improperly

inflate[d] ESI's financial results" which led to a restatement of two quarters.³⁰ Despite bringing fraud enforcement actions against the former ESI executive officers, the Commission decided "that it would not bring any enforcement action against ESI because of its swift, extensive, and extraordinary cooperation in the Commission's investigation."³¹ The Commission then listed the same cooperative criteria it listed in the Homestore matter to justify its decision.³²

3. Putnam

In the Putnam Fiduciary Trust Company investigation, the Commission charged six former Putnam officers with fraud, but brought no enforcement action against the company "because of its swift, extensive and extraordinary cooperation in the Commission's investigation of the transactions that are the subject of the Commissioner's complaint."³³ Although the Commission determined that those officers engaged in fraudulent misconduct arising "out of PFTC's one-day delay in investing certain assets of a defined contribution client, Cardinal Health, Inc.," Putnam cooperated with the investigation.³⁴ Such cooperation "consisted of prompt self-reporting, an independent internal investigation, sharing the results of that investigation with the government (including not asserting any applicable privileges and protections with respect to written materials furnished to the Commission staff), terminating and otherwise disciplining responsible wrongdoers, providing full restitution to its defrauded clients, paying for the attorneys' and consultants' fees of its defrauded clients, and implementing new controls designed to prevent the recurrence of fraudulent conduct."³⁵ The Deputy Director of the Division of Enforcement and District Administrator of the Commission's Boston District Office specifically commented that:

²⁶ *SEC Files Financial Fraud Case Charging Three Former Homestore Executives*, Release No. 2002-141 (Sept. 25, 2002).

²⁷ *Id.*

²⁸ *Id.*

²⁹ Whether or not the government, in assessing a company's cooperation for Seaboard purposes, criminal charging or sentencing reasons, or for any other purpose, is ever justified in requiring or even crediting a company for waiving the attorney-client privilege is debatable at best. It creates a dangerous slippery slope. But it is a topic beyond the reach of this article other than to advise that privilege waiver should be approached cautiously by companies and their counsel.

³⁰ *SEC Charges Former Executives of Electro Scientific Industries, Inc. with Financial Reporting Fraud*, Release No. 18896 (Sep. 24, 2004).

³¹ *Id.*

³² *Id.*

³³ *SEC Charges Six Former Officers Of Putnam Fiduciary Trust Company with Defrauding Clients of \$4 Million*, Release No. 2006-2 (Jan. 3, 2006).

³⁴ *Id.*

³⁵ *Id.*

Although the conduct alleged here was egregious, PFTC's cooperation in this investigation, and the remedial steps taken, were extraordinary. In recognition of the company's actions, the Commission has determined it appropriate to not bring any enforcement action against PFTC in connection with the charges we are announcing today. *We hope the Commission's actions here will encourage those who become aware of wrongdoing to do the right thing – stop the wrongful conduct, promptly report it to the Commission staff, and cooperate fully in any subsequent investigation of the conduct.*³⁶

4. Premier Financial Bancorp

In the Premier Financial Bancorp investigation, the Commission charged the CEO of a subsidiary of the company with securities fraud; however, the Commission accepted an Offer of Settlement in an administrative proceeding against Premier Financial Bancorp based on non-fraud violations of the books and records and internal control provisions of the Exchange Act.³⁷ The Commission acknowledged that Premier undertook a series of "voluntary remedial actions," including retaining counsel and auditors to conduct an investigation.³⁸ The "Commission considered the remedial acts promptly undertaken by Premier . . . and cooperation afforded the Commission staff by [Premier]."³⁹ Note that the "cooperation credit" given the companies in Homestore, Electro Scientific Industries and Putnam took the form of no charges being brought against the companies, whereas in Premier Financial Bancorp and the other matters discussed below the companies were credited by receiving settlements based upon non-fraud charges.

5. Gemstar-TV Guide

The Gemstar-TV Guide investigation is another example of where high-level executives were charged with fraud, but the company itself was allowed to set-

tle the case by paying a fine and agreeing to a permanent injunction against future books and records, internal controls and reporting violations.⁴⁰ The Commission noted that Gemstar, after initially conducting an inadequate investigation and failing to take remedial action after presented with "specific evidence of fraudulent conduct," later restructured its corporate governance (replaced its CEO, CFO and General Counsel) and adopted extensive internal controls.⁴¹ Gemstar then initiated a comprehensive investigation and re-audit of its financials, "provided extensive and valuable assistance to the Commission," and agreed to not make certain severance payments to its former CEO and former CFO.⁴²

6. Rite Aid

In Rite Aid, the Commission stated that the company's former senior management team "engaged in a financial fraud that materially overstated the Company's net income" for three years and failed to disclose material information.⁴³ The Commission accepted an Offer of Settlement from the company based on non-fraud violations of "the reporting, books and records, and internal controls provisions of the Exchange Act."⁴⁴ Although the company recorded a \$2.3 billion restatement of pre-tax income (at the time, the largest restatement ever recorded), in settling the charges the Commission "note[d] that Rite Aid cooperated in the Commission's investigation of this matter, including declining to assert its attorney-client privilege with regard to various matters relevant to the investigation and voluntarily providing the Commission staff with full access to an internal investigation conducted by Rite Aid's counsel."⁴⁵

7. Northwestern

In the Northwestern Corporation matter, the Commission charged the former president and two former vice-presidents of a subsidiary of the company

³⁶ *Id.* (emphasis added).

³⁷ *Order Instituting Cease-and-Desist Proceedings, Making Findings, and Imposing A Cease-and-Desist Order Pursuant to Section 21C of the Securities and Exchange Act of 1934*, Release No. 52370 (Aug. 31, 2005).

³⁸ *Id.*

³⁹ *Id.*

⁴⁰ *Gemstar-TV Guide International Agreement to Settle SEC Enforcement Action Charging the Company with Overstating Its Revenues*, Release No. 18760 (June 23, 2004).

⁴¹ *Id.*

⁴² *Id.*

⁴³ *In re: Rite Aid Corporation, Order Instituting Public Proceedings Pursuant to Section 21C of the Securities Exchange Act of 1934, and Imposing a Cease-and-Desist Order*, Release No. 46099 (June 21, 2004).

⁴⁴ *Id.*

⁴⁵ *Id.*

with securities fraud relating to their role in allegedly misstating past financial results of the subsidiary.⁴⁶ The Commission, however, accepted an Offer of Settlement in an administrative proceeding against Northwestern based upon non-fraud violations of the books, records and internal control provisions of the Exchange Act.⁴⁷ The Commission stated that “[i]n determining to accept the Offer, the Commission considered remedial acts undertaken by [Northwestern] and cooperation afforded the Commission staff.”⁴⁸

IV. PRACTICAL CONSIDERATIONS

1. It is difficult to imagine a scenario where a public company facing an SEC investigation would choose not to cooperate in the Seaboard sense. At least some of the public policy reasons advanced for doing so are persuasive (e.g., cooperation is in the interests of the company’s shareholders to the extent it helps ferret out wrongdoing and wrongdoers more quickly and efficiently). Additionally, as seen above, the cooperation credit that a company receives can be significant and the penalty for not doing so severe.
2. At the outset of an investigation, the company should commit to cooperation and determine the steps it will take to manifest that cooperation. Importantly, company counsel, and typically independent counsel for the audit committee if it is investigating alleged wrongdoing, should meet with the staff and convey the company’s and audit committee’s intent to cooperate. It is important to try at the outset to create an atmosphere of trust between the company and the enforcement staff.
3. Throughout the course of the investigation, counsel should reiterate to the staff the company’s policy of cooperation. Counsel should flatly ask the staff, at various times throughout the investigation, if the staff believes the company is doing all the staff believes it can and should be doing from a cooperation standpoint. Do not wait until the Wells process begins to learn that your view of cooperation differs from the staff’s.
4. Do not confuse cooperation with capitulation on the merits. Because you cooperate does not mean you will not vigorously defend your company’s interests. As company counsel, you may believe there is little to no merit to the staff’s concerns about possible wrongdoing in the company. That does not mean, however, that the company should not cooperate in the Seaboard sense. In situations where the staff’s concerns about wrongdoing are unfounded, it is critical that company counsel vigorously “cooperate” in the sense of conveying to the staff the evidence that exculpates the company.
5. A company under SEC investigation should not make officers and employees into scapegoats, under the pretense of cooperation, where the facts do not support such action. In their haste to show “cooperation” and receive better treatment, a company should not unfairly and inappropriately offer up officers and employees by, for example, terminating them. This will unfairly taint the officers and employees, almost guarantee they will be charged, place them in a difficult position as they try to defend themselves and likely destroy their reputations.
6. A company’s commitment to cooperation should not prevent it from pushing back against what it honestly perceives as overreaching by Commission staff during an investigation. If done professionally and in good faith, this should not undermine the company’s cooperation efforts. For example, the staff is now requesting companies to stipulate that all documents produced voluntarily or in response to a subpoena constitute “business records” for evidentiary purposes under Rule 803(6) of the Federal Rules of Evidence. Particularly in cases where thousands, if not millions, of documents are produced, the cost to a company of determining whether each document satisfies the criteria for qualifying as a business record can be prohibitive.

⁴⁶ *SEC Charges Five Former Employees of a Northwestern Corporation Subsidiary with False Financial Reporting*, Litigation Release No. 19932 (December 4, 2006).

⁴⁷ *Order Instituting Cease-and-Desist Proceedings, Making Findings and Imposing a Cease-and-Desist Order Pursuant to Section 21C of the Securities and Exchange Act of 1934*, Release No. 55416 (March 7, 2007).

⁴⁸ *Id.*

Moreover, the strategic implications of blindly stipulating at the investigatory stage that all produced documents constitute business records can be severe if the case is litigated. Professionally conveying such concerns to the staff will most often result in a similarly professional acknowledgement by the staff that such concerns are well-founded. Company counsel and the staff can then identify other approaches to addressing the issue.

7. Company counsel should maintain a log of their cooperation activities. This will position you to more effectively argue at the appropriate time that the company is entitled to cooperation credit.

8. As you attempt to negotiate a settlement with the staff, understand that cooperation credit takes many forms. The Commission may conclude that no charges whatsoever should be brought against the company in light of its cooperation and despite wrongdoing by company officers and employees.⁴⁹ Second, where claims are brought and settled against the company, the company may avoid fraud charges.⁵⁰ Third, the claims may be settled through an administrative cease and desist proceeding rather than through an injunctive action in federal court.⁵¹ Finally, cooperation credit may manifest itself in a lower or no financial penalty.⁵²

⁴⁹ See *Homestore*, *Electro Scientific Industries* and *Putnam* matters discussed in Sections III.B.1, 2 and 3, *supra*.

⁵⁰ See *Premier Financial Bancorp*, *Gemstar*, *Rite Aid* and *Northwestern* matters discussed in Sections III.B.4, 5, 6 and 7, *supra*.

⁵¹ See *Premier Financial Bancorp*, *Rite Aid* and *Northwestern* matters discussed in Sections III.B.4., 6 and 7, *supra*.

⁵² On January 4, 2006, the SEC issued its *Statement of the Securities and Exchange Commission Concerning Financial Penalties*, Release No. 2006-4 (January 4, 2006) (“Statement on Penalties”). The purpose of the Statement on Penalties was to provide guidance to the public on the factors the SEC considers when determining whether or not to seek financial penalties from companies in enforcement actions. The Statement on Penalties provides that the appropriateness of a penalty on a corporation “turns principally on two considerations: [1] *The presence or absence of a direct benefit to the corporation as a result of the violation.* . . . [and] [2] *The degree to which the penalty will recompense or further harm the injured shareholders.*” *Id.* (emphasis in original). It also stated, however, that the Commission will consider additional factors in determining whether to impose a penalty, including the extent of cooperation during the investigation and remedial steps taken by the company upon learning of the misconduct. *Id.* In enforcement actions following issuance of the Statement on Penalties, the Commission has considered a company’s remediation and cooperation in deciding to impose a lower or no financial penalty. See *Collins & Aikman Corporation Settles with SEC*, Release No. 2007-53 (March 26, 2007) (Collins & Aikman settled fraud charges but avoided a penalty because of its “remediation and cooperation”); *SEC Charges AIG with Securities Fraud*, Lit. Release No. 19560 (Feb. 9, 2006) (AIG settled fraud charges and agreed to pay a \$100 million penalty that the Commission stated “takes into account AIG’s substantial cooperation during the Commission’s investigation”).



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