



JONES DAY
COMMENTARY

THE SEC'S FIRST DEFERRED PROSECUTION AGREEMENT INVOLVING AN INDIVIDUAL: QUESTIONS REMAIN

With much fanfare three years ago, the Securities and Exchange Commission (“SEC”) announced a Cooperation Initiative as part of an overall effort to strengthen its enforcement program. Modeled on the 2001 “Seaboard Report,” the Cooperation Initiative sought to encourage potentially culpable individuals to cooperate in SEC investigations in exchange for more lenient treatment by the agency. While offering cooperation agreements to a number of individuals, the agency only recently entered its first individual deferred prosecution agreement (“DPA”). The advantage of a DPA is the prospect of avoiding a formal SEC enforcement action altogether, rather than simply mitigating the charges and penalties in return for cooperation. Under the terms of the DPA, hedge fund manager Scott Herckis agreed to make certain admissions, including admitting to transferring money from a hedge fund to accounts owned and controlled by the general partner of the fund, and materially

overstating the fund’s monthly account statements and rates of returns.¹

When the SEC first announced its individual Cooperation Initiative, it touted the initiative as a “game-changer” for its enforcement efforts, capitalizing on the “insiders’ view into fraud and misconduct.”² The initiative offers an incentive to those with unclean hands to be proactive, report violations, and offer assistance to the SEC as it pursues those violations. In determining whether and to what extent it should credit an individual’s cooperation, the SEC will consider: (i) the assistance provided by the individual; (ii) the importance of the underlying matter; (iii) society’s interest in ensuring the cooperating individual is held accountable for misconduct; and (iv) whether cooperation credit is appropriate based on the individual’s risk profile (for example, whether he or she is a first-time offender).³

¹ Press Release, Securities and Exchange Commission, “SEC Announces First Deferred Prosecution Agreement With Individual” (Nov. 12, 2013).

² Press Release, Securities and Exchange Commission, “SEC Announces Initiative to Encourage Individuals and Companies to Cooperate and Assist in Investigations” (Jan. 13, 2010).

³ *Id.*

While the Herckis DPA is the first between the SEC and an individual, the SEC reached DPAs in two prior instances with corporate entities that were also required to admit to wrongdoing. In 2011, global manufacturer Tenaris admitted to bribing Uzbekistan officials for government contracts.⁴ After an internal investigation, Tenaris reported its violations to the SEC, and it agreed to cooperate with both the SEC and the Department of Justice in further investigations or proceedings. Tenaris also paid civil and criminal penalties and enhanced its internal compliance controls and policies. The SEC entered its second DPA in 2012 with Amish Helping Fund (“AHF”), a nonprofit organization that offers securities to fund home loans to Amish families.⁵ AHF admitted that its offering memorandum was not kept up to date and contained material misrepresentations about both AHF and the securities it offered. Unlike Tenaris, AHF did not self-report, though it immediately cooperated with the SEC and took certain remedial steps.

Although DPAs are legally different from a traditional SEC enforcement action, which typically culminates in a court injunction or administrative cease-and-desist order against future violations, the Herckis DPA suggests there can be little if any practical difference in terms of sanctions and the burden on the respondent. In addition to offering full cooperation with any investigation or other proceeding initiated by the SEC and paying more than \$50,000, Herckis agreed, by contract rather than by order of the SEC or a district court, to refrain from certain activities for five years, including: (i) associating with any broker, dealer, investment advisor, municipal securities dealer, municipal advisor, transfer agent, or nationally recognized statistical rating organization; (ii) serving or acting as an employee, officer, director, member of an advisory board, investment adviser, or depositor of, or principal underwriter for, a registered investment company or affiliated person of such investment adviser, depositor, or principal underwriter; and (iii) serving or acting

as, or providing services to, any hedge fund or registered investment company.

Although Herckis was able to avoid the collateral consequences that can be triggered by an injunction or administrative order, it is otherwise difficult to discern how this DPA is substantively different from a traditional SEC enforcement action. As described above, in terms of sanctions and remedies, this may be a distinction without a substantial difference. In addition, like Tenaris and AHF, Herckis was obliged to admit the SEC’s “findings” outlined in his DPA—including those detailing his involvement in fraudulent activity. These admissions can possibly be used against him by other governmental law enforcement agencies and private litigants. The SEC has indicated that, in contrast to its prior “no admit/no deny” policy, it will continue to seek these types of admissions—which have been required in *all* DPAs to date—in appropriate cases as it pursues its enforcement agenda.⁶

Another remaining question is what DPA-mandated cooperation will mean for individuals like Herckis. The Herckis DPA suggests that he is required to respond “fully and truthfully” to any inquiry—including those conducted by other law enforcement agencies—at the SEC’s instruction. He must testify at trials or other judicial proceedings if so directed by the SEC. In short, it appears that Herckis may be deemed to have forfeited his Fifth Amendment privilege against self-incrimination regarding any ongoing or subsequent criminal investigation related to the subject of the DPA.

Notwithstanding the uncertainties raised by the SEC’s limited use of DPAs to date and its overly general guidance on this subject, certain individuals and entities may find DPAs and other cooperation-oriented enforcement tools to be their best option. For example, individuals and entities in certain regulated industries, or those who engage in significant government procurement work, may find DPAs—even

4 Press Release, Securities and Exchange Commission, “Tenaris to Pay \$5.4 Million in SEC’s First-Ever Deferred Prosecution Agreement” (May 17, 2011).

5 Press Release, Securities and Exchange Commission, “SEC Announces Deferred Prosecution Agreement with Amish Fund” (July 18, 2012).

6 See, e.g., Mary Jo White, Chair, Securities and Exchange Commission, 5th Annual Judge Thomas A. Flannery Lecture, “The Importance of Trials to the Law and Public Accountability” (Nov. 14, 2013) (explaining why the SEC revisited its “no admit/no deny” policy, and noting her belief that “a public acknowledgment of the unlawful conduct” is “necessary to ... ensure greater public accountability”); see also Alison Frankel, “SEC Enforcement co-director: We’re bringing ‘swagger’ back” (Oct. 1, 2013), <http://blogs.reuters.com/alison-frankel/2013/10/01/sec-enforcement-co-director-were-bringingswagger-back/> (citing SEC Co-Director of Enforcement Andrew Ceresney’s comments on the agency’s use of deferred prosecution agreements to require admissions when “public airing of unambiguous facts serves an important public interest”).

with their flaws and ambiguities—preferable to traditional SEC enforcement actions that can trigger detrimental collateral consequences, such as government contractor debarment proceedings. It is critical that any individual or entity considering cooperation weigh both the benefits and risks of cooperation before deciding how to proceed.

Jones Day will continue to monitor developments regarding the SEC's implementation of its Cooperation Initiative.

LAWYER CONTACTS

For further information about the SEC's Cooperation Initiative or other SEC enforcement matters, please contact your principal Firm representative or one of the lawyers listed below. General email messages may be sent using our "Contact Us" form, which can be found at www.jonesday.com.

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