To Our Clients and Friends

Memorandum

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The First SEC Non-Prosecution Agreement: Another Arrow in the Quiver

The SEC announced its first non-prosecution agreement last week,[1] a four-page agreement with a children's clothing marketer, Carter's Inc., on December 17, 2010.[2] This first glimpse at one of the SEC's new cooperation tools appears to be a departure from the prior so-called Seaboard standards for cooperation set forth in the SEC's Section 21(a) report in September 2001.[3] Although the availability of non-prosecution agreements signals a potentially attractive opportunity for resolving cases without enforcement action, corporate issuers approaching the end of an SEC enforcement investigation would typically prefer for the matter to close with no agreement at all. The SEC's statements thus far about the Carter's Inc. Agreement offer little insight concerning when, in the SEC's view, a non-prosecution agreement is more appropriate than concluding an investigation with no action against an entity.

More insight may be forthcoming, however. The SEC announced its cooperation program last January and seems committed to making it a success.[4] The agency is poised to list additional public cooperation-related agreements on its web site, having created a new web page and posted the Carter's Inc. Agreement as the first.[5] The Commission also announced the non-prosecution Agreement simultaneously with the filing of its complaint against a former Carter's Inc. Executive Vice President of Sales, Joseph M. Elles. The Elles Complaint alleges that, "from at least 2004 through March 2009," Mr. Elles committed fraud and aided and abetted Carter's violations of the SEC's reporting and books and

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1 See SEC Charges Former Carter's Executive With Fraud and Insider Trading (Dec. 20, 2010), http://www.sec.gov/news/press/2010/2010-252.htm.

2 See Non-Prosecution Agreement between the SEC's Division of Enforcement and Carter's Inc., http://www.sec.gov/litigation/cooperation/2010/carters1210.pdf .

3 See Report of Investigation pursuant to Section 21(a) of the Securities and Exchange Act of 1934 and Commission Statement on the Relationship of Cooperation to Agency Enforcement Decisions, Exchange Act Release No. 44969 and Accounting and Auditing Enforcement Release No. 1470 (Oct. 23, 2001) http://www.sec.gov/litigation/investreport/34-44969.htm (hereinafter the "Seaboard Report"). Although the company's name was never mentioned in the report, it has become the shorthand reference for the cooperation analysis.

4 See SEC Announces Initiative to Encourage Individuals and Companies to Cooperate and Assist in Investigations (Jan. 13, 2010), http://www.sec.gov/news/press/2010/2010-6.htm.

5 See Cooperation Program Agreements, a page providing a link to public cooperation-related agreements, http://www.sec.gov/litigation/cooperation.shtml.

records provisions in connection with discounts provided to the company's largest wholesale customer. Mr. Elles, who is litigating the charges, issued a press statement challenging the accuracy of the SEC's allegations, alluding to "substantial evidence" that members of senior management at Carter's were aware of Mr. Elles' activities, and asserting that "one of the issues to be determined in the litigation" is "why the SEC has decided to selectively pursue claims against Mr. Elles." Until more information emerges in the litigation or otherwise, the SEC's release, the Agreement itself and the Elles Complaint against Mr. Elles provide some fodder for consideration among those currently involved in SEC enforcement investigations.

Future SEC non-prosecution agreements may differ somewhat in language and restrictions, as each agreement will be individually negotiated (and will be "construed as if drafted jointly by the parties," according to the Carter's Inc. form). But just as most non-prosecution agreements entered into by the United States Department of Justice contain similar language,[6] it is likely future SEC non-prosecution agreements will look similar to the Carter's Inc. Agreement released this week. With that in mind, we offer a few observations:

1. Non-Prosecution is Not No Prosecution. Carter's Inc. had to restate its financial reports for five fiscal years and three fiscal quarters, so the fact that the complaint against Mr. Elles asserts indirectly that Carter's Inc. had books and records and reporting violations should not be startling. Even so, in other somewhat similar situations, the SEC sometimes determines that entities with securities law violations should not be charged at all and closes investigations without action against, or public statement involving, the entity. One example of this was the 2001 enforcement case against a former employee of Seaboard, Inc. in which Seaboard itself was not charged. Instead, using Seaboard as an example, the SEC attempted to set forth a framework for how the SEC and its Staff analyze relevant circumstances when evaluating whether to charge a company in a report of investigation known now as the Seaboard Report. The Seaboard Report was issued in 2001 and did not contemplate public non-prosecution agreements, which are a creature of the 2010 cooperation initiative. Notably, the SEC did not announce, either at the beginning of 2010 when the initiative was released or at the end of the year when the Carter's Inc. Agreement became public, that Seaboard no longer applies to guide companies toward the potential result of no prosecution at all. While the agency has not clarified its view as to when closing an investigation as to an entity without action, rather than a non-prosecution agreement, would be the best resolution, comparing the Carter's Inc. facts to the Seaboard facts may provide some insight.

First, it appears at a minimum that the Seaboard factors remain relevant in evaluating when the Commission should determine not to charge an entity for securities fraud allegedly committed by an employee. Many Seaboard factors appear in the SEC's Carter's Inc. press release and the Elles Complaint. The release notes, for example, that Carter's Inc. identified Mr. Elles' conduct, reported the circumstances to the SEC, conducted an internal investigation using outside counsel supervised by the Audit Committee, and restated its earnings for the affected periods. The Elles Complaint states that his employment was terminated by Carter's Inc. "as of March 2009," but does not specify whether the termination occurred in connection with the internal review of its accounting for margin support provided

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[6] For a helpful compilation of federal organizational prosecution agreements, see http://lib.law.virginia.edu/Garrett/prosecution_agreements/home.suphp. Although the non-prosecution agreements of criminal prosecutors typically take the form of a letter to counsel, rather than an agreement form such as the Carter's Inc. agreement released this week by the SEC, they are signed by the represented parties as well as the government and are referred to, including within the letters themselves, as agreements.

to its wholesale customers, which the company first disclosed to the public in late October 2009. The release also notes the "relatively isolated nature of the unlawful conduct," which according to the complaint lasted over five years and involved the company's largest wholesale customer but occurred through circumvention of the company's internal controls. Finally, the SEC's release commends Carter's, Inc.'s "extensive and substantial remedial actions," which are laid out in more detail in the company's filings and included personnel, corporate governance and internal controls changes.[7] These factors provide some information about why the non-prosecution agreement, rather than an enforcement action, was deemed appropriate.

Moving to the question of why the SEC and Carter's Inc. determined that a non-prosecution agreement, rather than a termination letter, was the appropriate resolution for this matter, no express answer lies in the disclosures issued by the SEC, or those issued by the company (which were required to be approved by the SEC). Some details in the Seaboard Report may distinguish it from the Carter's Inc. situation, however, and may be helpful in identifying circumstances when a termination letter remains the right result. For example, Seaboard's stock price did not decline after the company's announcement and restatement were published, while the Elles Complaint says Carter's stock price "fell after each disclosure, ranging from a decline of 23.8% after one disclosure to a decline of 2.9% after a subsequent disclosure." This might suggest the Carter's Inc. situation involved greater harm to investors, therefore supporting a decision to enter into a non-prosecution agreement. In addition, the time periods of the misstated financials appear similar, about five years in each instance,[8] but the Seaboard situation does not appear to have involved insider trading while the Elles Complaint expressly alleges it. As another example, the Seaboard Report states that one factor supporting cooperation credit would be a corporate culture of compliance with strong internal control systems. Although it is not clear from publicly available documents, it is possible, given the extensive remedial measures the company announced, that this factor was not present at Carter's Inc. before the problems came to light. Also, Mr. Elles is litigating, while the Seaboard former controller alerted the company about her activities and settled with the SEC simultaneously with the issuance of the Seaboard Report. The ongoing need for Carter's Inc.'s cooperation may therefore have inspired the Division of Enforcement to secure it with the Agreement, although it seems likely, given its conduct to date, that Carter's Inc. would have cooperated fully anyway, without an agreement requiring it to do so.

Another factor distinguishing Carter's Inc. from Seaboard could be the attorney-client privilege. The Seaboard Report notes that Seaboard "did not invoke the attorney-client privilege, work product protection or other privileges or protections with respect to any facts uncovered in the investigation," while the Agreement expressly anticipates that Carter's Inc. will produce only non-privileged documents and does not suggest any privileges are expected to be waived. The SEC's current Enforcement Manual states that, "***The staff should not ask a party to waive the attorney-client privilege or work product protection without prior approval of the Director or Deputy Director."***[9] While this suggests there are situations where such a request may occur, SEC Staff members have previously confirmed that waiver is

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[7] See Carter's Inc. Press Release (Dec. 23, 2009), http://phx.corporate-ir.net/phoenix.zhtml?c=135392&p=irol-newsArticle&ID=1439730&highlight, and Carter's Inc. Form 8K (Dec. 23, 2009), http://sec.gov/Archives/edgar/data/1060822/000106082209000024/form8_k.htm.

[8] See In the Matter of Gisela de Leon-Meredith, Securities Exchange Act Release No. 44970 (Oct. 23, 2001), http://www.sec.gov/litigation/admin/34-44970.htm. Ms. de Leon-Meredith was Seaboard's controller.

[9] Enforcement Manual, SEC Division of Enforcement (Mar. 3, 2010) ("Enforcement Manual") at Section 4.3, http://www.sec.gov/divisions/enforce/enforcementmanual.pdf.

not necessary to get full cooperation credit as long as a company shares all relevant facts with the SEC.[10] Nothing about the Carter's Inc. Agreement suggests that the SEC's decision to use a non-prosecution agreement rather than decline any action turned on whether a privilege waiver occurred.

2. Public vs. Private Resolutions. The non-prosecution Agreement enables Carter's Inc. to provide clarity to its shareholders because this Agreement is public. The SEC's new web page for Cooperation Agreements, however, specifically notes that it includes postings of "public" agreements, implying that some non-prosecution agreements will not be made public by the agency. It would be sensible for the SEC to have non-public non-prosecution agreements, although then issuers would have to analyze whether they had a separate obligation to make disclosure. In situations where the Commission determines not to charge an entity and does not enter into a non-prosecution agreement, the entity may still determine to make a disclosure of the result, depending in large part on its prior disclosures. Given the Division of Enforcement's policy to provide notice to an issuer when it has determined not to recommend enforcement action, a termination letter could be useful in supporting the disclosure.[11]

3. Continued Cooperation Obligations. The Agreement requires Carter's Inc., the "Respondent," to provide "full, truthful and continuing cooperation" in the future including, but not limited to, making witnesses available, producing non-privileged documents, responding to inquiries and providing testimony at trial and other judicial proceedings, all at the behest of the Division of Enforcement. The agreement also requires the Respondent to clear any press release about the Agreement with the SEC Staff and prohibits the company from permitting anyone speaking for the company (other than in certain government proceedings) to deny "the factual basis of any aspect of this Agreement." If Carter's Inc. violates the Agreement, the SEC will notify it and provide an opportunity for the company to make a Wells Submission. No limitations period will apply that had not already been triggered before the date of the Agreement.

An SEC decision not to charge a company at all, while not expressly tied to an ongoing agreement of cooperation, often would arise in a situation where the company had voluntarily provided the sort of cooperation described by the Agreement. Such a decision would not, however, be accompanied by a tolling agreement.

4. Only the SEC is Bound. The Agreement expressly provides that other federal, state or self-regulatory organizations are not bound by the SEC's decision not to bring an enforcement action. It notes that, in the SEC's discretion and upon a written request from Carter's Inc., the SEC may issue a letter to

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[10] See, e.g., Remarks by Former Director, Division of Enforcement Linda Chatman Thomsen Before the 27th Annual Ray Garrett, Jr. Corporate and Securities Law Institute 2007 (May 4, 2007) ("First, we do not — indeed we cannot – require waiver of the attorney/client privilege. Second waiver of a privilege or a protection is not a pre-requisite to obtaining credit in a Commission investigation. The credit given is based on, among other things, the factual information given, the timeliness of the provisions of information and the usefulness of the information."), quoted favorably by Commissioner Kathleen L. Casey in her Remarks Before the First Annual Southeast Securities Enforcement Conference (Mar. 27, 2008), http://www.sec.gov/news/speech/2008/spch032708klc.htm.

[11] See Enforcement Manual at Section 2.6.2, which provides:

> The Division's policy is to notify individuals and entities at the earliest opportunity when the staff has determined not to recommend an enforcement action against them to the Commission. This notification takes the form of a termination letter. The staff may send termination letters to individuals or entities before the investigation is closed and before a determination has been made as to every potential defendant or respondent. Termination letters should be sent regardless of whether the investigation was pursuant to a formal order.

another investigating organization to describe the company's cooperation. Except for the requirement that the company's request be in writing (a requirement that does not typically appear in criminal non-prosecution agreements), this is no different from the circumstance where the Commission determines not to charge someone but does not enter into an Agreement. The fact that no other government or self-regulatory investigator is bound by an SEC non-prosecution agreement is not surprising, but it does limit the agreement's scope.

5. Restrictions on Public Statements. Carter's Inc. is prohibited by the Agreement from directly or indirectly denying the factual basis "of any aspect of this Agreement" in any public statement, other than in legal proceedings to which the SEC is not a party. The company agrees not to permit present or future attorneys, employees, agents or other persons authorized to speak for it to make such a denial. The Agreement says this prohibition does not apply to statements by individuals in government or self regulatory proceedings against them, "unless such individual is speaking on behalf of the Respondent." It is not clear what the latter provision means or how this prohibition will unfold in practice.

The general prohibition on employees denying the facts alleged by the SEC arguably provides leverage to the SEC by allowing it to claim that Carter's Inc. breached the Agreement if company employees testify in a way helpful to the defense of Mr. Elles. It will be important for the SEC and for companies entering into non-prosecution agreements to take care in dealing with corporate employees who are potential defense witnesses to avoid an argument that they are pressuring employees to favor the government's view. The provision is reminiscent of a similar provision in the 2005 deferred prosecution agreement entered into by the United States Attorney's Office for the Southern District of New York and KPMG ("DPA") that was upheld by U.S. District Court Judge Lewis Kaplan in 2005.[12]

Judge Kaplan's decision arose in related proceedings, in which defendant Jeffrey Eischeid filed a Motion to Dismiss his Indictment. In his Memorandum of Law in Support of the Motion to Dismiss, Eischeid argued that the DPA violated his rights under Fifth and Six Amendments by depriving him of the ability to defend himself. Eischeid argued that two potential witnesses who were employed by KPMG could provide supportive testimony for him, but their testimony would violate the DPA and lead to the loss of their jobs. Judge Lewis Kaplan ruled on this Motion to Dismiss and found Eischeid's argument unpersuasive, noting "The DPA does not purport to control the actions of individuals. . . . The government expressly disavows any intention of using this provision to pressure individuals, directly or through the agency of KPMG, to testify in any particular way or to limit access by the defense to potential witnesses."[13] Judge Kaplan also rejected the concern that employees might be hesitant to testify for fear of retaliation by KPMG, noting that this was "speculative" and that further, "any attempt by KPMG to interfere with or retaliate for testimony or voluntary cooperation with the defense by KPMG employees could result in prosecution of any responsible individual and perhaps even the firm."[14] Arguably the same expectations and protections would apply here.

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[12] Letter to Robert S. Bennett from David N. Kelly (Aug. 26, 2005), available at http://lib.law.virginia.edu/Garrett/prosecution_agreements/pdf/kpmg.pdf.

[13] Memorandum & Opinion as to Jeffrey Eischeid at 4-5, United States v. Stein, 05 Crim. 0888 (LAK) (S.D.N.Y. Apr. 4, 2006).

[14] Id. at 5.

Most companies would prefer to cooperate voluntarily and for the SEC to conclude that no enforcement action at all is required over entering into a non-prosecution agreement with the SEC. A non-prosecution agreement like the one Carter's Inc. signed is clearly better than an enforcement action, however, creating fewer collateral consequences because no injunction, administrative order or express finding of a violation is involved. One thing is certain: we will be seeing more public SEC cooperation agreements as the new initiatives continue to unfold.

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This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its contents. If you have any questions about the contents of this memorandum, please call your regular Fried Frank contact or the attorneys listed below:

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