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The SEC's Willingness To Spare Cooperators

Law360, New York (January 10, 2011) -- A recent U.S. Securities and Exchange Commission enforcement development potentially signals an increased willingness by the SEC to incentivize public companies to self-report violations, cooperate with SEC enforcement staff and remediate. On Dec. 20, 2010, the SEC announced that it had entered into a nonprosecution agreement with Carter's Inc., a public company that manufactures children's clothing. This is the first nonprosecution agreement that the SEC has announced since starting its cooperation initiative in January 2010.

In January 2010, the SEC announced with considerable fanfare that it was authorizing its staff to use various tools to encourage individuals and companies to report violations and provide assistance to the agency. The Enforcement Division laid out the new tools in a revised version of the division's enforcement manual in a new section entitled "Fostering Cooperation." The new cooperation tools, not previously available in SEC enforcement matters, included nonprosecution agreements, which the enforcement manual described as:

"A nonprosecution agreement is a written agreement between the commission and a potential cooperating individual or company, entered in limited and appropriate circumstances, that provides that the commission will not pursue an enforcement action against the individual or company if the individual or company agrees to, among other things: 1) cooperate truthfully and fully in the commission's investigation and related enforcement actions; and 2) comply, under certain circumstances, with express undertakings."

Simultaneously with the announcement of the nonprosecution agreement with Carter's, the SEC announced that it had filed a complaint against Joseph Elles, the former executive vice president of sales at Carter's. In its complaint, the SEC alleges that between 2004 and 2009, Elles fraudulently manipulated the amount of discounts that Carter's granted to the Kohl's Corporation, its largest wholesale customer, in order to induce that customer to purchase greater quantities of Carter's clothing for resale.

According to the SEC, Elles then concealed his conduct by persuading Kohl's to defer subtracting the discounts from payments until later periods and creating and signing false documents misrepresenting the timing and amount of those discounts to Carter's accounting personnel. The SEC alleged that Elles caused Carter to overstate its quarterly net income by between 5 percent and 19.1 percent. The SEC also alleged Elles had received almost $5 million in stock profits from the sale of stock during the period in which Carter's overstated its profits as a result of Elles's misconduct.

In the press release announcing the nonprosecution agreement, the SEC provided the following explanation for why the SEC had entered into the agreement:

"The nonprosecution agreement reflects the relatively isolated nature of the unlawful conduct, Carter's prompt and complete self-reporting of the misconduct to the SEC, its exemplary and extensive cooperation in the investigation, including undertaking a thorough and comprehensive internal investigation, and Carter's extensive and substantial remedial actions."

In 2001, the SEC set forth in its Seaboard Report criteria that it considers in determining whether, and how much, to credit self-policing, self-reporting, remediation and cooperation from "the extraordinary step of taking no enforcement action" to bringing reduced charges, seeking lighter sanctions, or including mitigating language in documents the SEC uses to announce and resolve enforcement actions.

Although the SEC has never applied the Seaboard criteria pursuant to a strict formula, it is noteworthy that several of the criteria set forth in the Seaboard Report arguably might have militated in favor of an enforcement action against Carter's:

- The nature of the misconduct involved. Elles's alleged misconduct was egregious; he allegedly acted with scienter, arranged for Kohl's to provide false representation letters, knowingly provided false representation letters to Carter's accounting personnel, and sold Carter's stock when he knew that Carter's financial statements were materially misleading.
- Where in the organization the misconduct occurred. Although the alleged misconduct was isolated to Elles and did not appear symptomatic of how Carter's engaged in business, as an executive vice president, Elles held a senior position at Carter's.
- How long the misconduct lasted. Elles's alleged misconduct lasted for at least 18 quarters.
- The amount of harm the misconduct inflicted upon investors and other corporate constituencies. The complaint alleges that Carter's reported quarterly net income was overstated by as much as 19 percent in one quarter and that the price of Carter's stock fell almost 24 percent when Carter's announced that it was delaying the issuance of its third quarter financial results.
- Whether the company is the same company in which the misconduct occurred, or whether it changed through a merger or bankruptcy reorganization. Carter's has not merged or gone through bankruptcy. Indeed, the current CEO of Carter's was chief financial officer of Carter's during a portion of the misconduct at issue.

In light of the arguable failure of Carter's to satisfy these criteria, the decision of the SEC, nevertheless, to enter into a nonprosecution agreement with Carter's might signal an increased willingness on the part of the SEC to reward a company that demonstrates exemplary self-reporting, cooperation and remediation.

The decision of the commission not to pursue such an action is particularly interesting since Carter's self-reporting does not appear to have been prompted by the SEC's January 2010 cooperation initiative in that 1) Carter's self-reported before the SEC announced the initiative and 2) it appears likely that Carter's recently issued financial statements were materially misstated as a result of Carter's alleged misconduct and the federal securities laws therefore required Carter's to disclose the misstatement in SEC filings, in any event.

Moreover, the factors that the commission identified as having driven its decision not to bring an enforcement action against Carter's are factors that were largely under the control of Carter's once Carter's identified a potential impropriety.

Accordingly, although a single nonprosecution agreement does not give the enforcement community a lot of guidance, this development underscores the need for a company learning of potential violations of the federal securities laws to consider seriously prompt self-reporting, extensive cooperation with the SEC and thorough internal investigation in managing its enforcement risk.

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