

## **SEC's First Free Pass Under Cooperation Program ... But Don't Expect a Trend**

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The U.S. Securities and Exchange Commission (SEC) announced on March 19, 2012, that it was giving the proverbial "free pass" to an alleged securities law violator who cooperated in an SEC investigation. The cooperator assisted the agency in bringing enforcement actions last year against AXA Rosenberg Group, a California-based institutional money manager and investment adviser, and the firm's co-founder for violations of the antifraud provisions of the federal securities laws. The charges stemmed from the failure at AXA Rosenberg to disclose a computer coding error in its quantitative, or "quant," investment model used to manage client investment portfolios.

The recent announcement touts the SEC's decision to reward a former senior executive at AXA Rosenberg for his cooperation in the investigation by not taking any enforcement action against him. The free pass from charges comes despite the senior executive's confessed participation in the misconduct. This marks the first time that the SEC has publicly acknowledged that it was giving full cooperation credit to an individual (that is, not filing charges) under the agency's "Framework for Evaluating Cooperation by Individuals," announced back in January 2010.

While it is tempting to view this recent announcement as the beginning of a trend for individuals hoping to avoid SEC charges by cooperating with the agency's investigations, defense counsel should carefully consider the circumstances of this particular AXA Rosenberg cooperator when counseling clients on the likelihood of obtaining the same free pass. As discussed below, this is certainly the case for clients who wish to remain employed in the securities industry.

### **Cooperation Framework**

In January 2010, SEC enforcement chief Robert Khuzami announced a new SEC cooperation program which he called a "game-changer" for the enforcement division. The program set forth, for the first time, a formal framework for how the agency would evaluate and credit individuals who cooperate with SEC investigations. The cooperation framework for individuals was intended to complement the agency's existing cooperation framework for companies set forth in the 2001 "Seaboard Report." With respect to individuals, the SEC identified four factors that it would take into consideration when determining cooperation credit:

- the assistance provided by the individual;
- the importance of the underlying matter in which the individual cooperated;
- the societal interest in ensuring the individual is held accountable for his or her misconduct;
- and

- the appropriateness of cooperation credit based upon the risk profile of the cooperating individual.

(The agency's policies for determining whether to reward individual cooperators can be found in the SEC's Enforcement Division Manual, which is publicly available on the SEC's website at [www.sec.gov](http://www.sec.gov).)

The SEC's enforcement chief also announced in January 2010 that the agency was planning to use several new cooperation "tools" to reward cooperators, including the use of formal cooperation agreements, deferred prosecution agreements and non-prosecution agreements. This also marked a new chapter in SEC enforcement policy as the civil law enforcement agency sought to empower itself with the same cooperation tools used by the U.S. Department of Justice and other criminal law enforcement agencies. Previously, the SEC offered little incentive for individuals to cooperate because anyone admitting to participating in misconduct would almost certainly face SEC charges. This, obviously, provided little motivation for individuals to self-report their misconduct and cooperate with the SEC.

### **'Matter of AXA Rosenberg'**

The SEC's March 19 announcement that the former AXA Rosenberg senior executive would not face any enforcement action as a reward for his cooperation marks the agency's first public announcement that it was giving a free pass from charges to an individual cooperator.

In the underlying enforcement actions, the SEC alleged that AXA Rosenberg and its co-founder intentionally concealed a material error in the firm's computer code for the quantitative investment model used to manage client investment portfolios. (In the Matter of AXA Rosenberg Group, Release No. 2011-37 (Feb. 3, 2011) and In the Matter of Barr M. Rosenberg, Release No. 2011-189 (Sept. 22, 2011)).

The computer error affected more than 600 client portfolios and caused \$217 million in client losses. As part of the settlements in the administrative proceedings, AXA Rosenberg agreed to return \$217 million to harmed clients plus pay a \$25 million civil penalty, and the co-founder agreed to pay a \$2.5 million civil penalty and consented to a lifetime bar from working in the securities industry.

One of the AXA Rosenberg entities had developed the computer code for a quantitative investment model and another affiliated entity, the institutional money manager, used the model to manage client investment portfolios. The SEC alleged that in June 2009, an employee discovered an error in the firm's computer code that effectively eliminated one of the key components in the risk management analysis. The error led to underperformance of client portfolios due to a failure to properly account for certain industry, country and stock fundamental risks.

According to the SEC, the senior executive who cooperated played some role in the events surrounding the concealment of the coding error. However, the SEC alleged that the firm's co-

founder instructed the senior executive who cooperated and others to conceal the coding error from the firm's CEO. The firm also failed to disclose the error to its clients and misrepresented to them that the portfolios' underperformance was due to market volatility and other factors, when it was really due to the error in the model's risk control measures.

Eventually, the cooperating senior executive informed the firm's CEO of the problem and the CEO authorized an internal investigation into the matter. The firm subsequently disclosed the computer error to the SEC staff after the agency informed the firm that it was planning a regulatory examination. According to the SEC, the cooperating AXA Rosenberg senior executive "was the first to offer his cooperation and voluntarily requested to be considered" for credit under the agency's new cooperation program for individuals. In return for his substantial cooperation for providing detailed information, the agency decided that it would not charge him for his role in the misconduct.

### **The Four Factors**

In the public release announcing the cooperation credit for the former AXA Rosenberg senior executive, the SEC discussed the four factors relevant to determining cooperation credit for individuals.

First, the SEC considered the "assistance provided" by the cooperator. The SEC concluded that the senior executive's substantial assistance enabled the agency to conduct an efficient and effective investigation of a complex matter, and that his cooperation proved valuable because of its timeliness and quality. The SEC noted that he was forthcoming and provided truthful, complete and reliable information. Moreover, his position in the company and first-hand knowledge of the facts allowed him to provide detailed, credible information that was crucial to the investigation. The SEC also noted that the senior executive provided substantial assistance "without conditions."

Second, the SEC considered the "importance of the underlying matter." The investigation involved the concealment of a material error within quantitative investment models and the compliance policies and procedures for these models, a priority area for the enforcement division. The enforcement actions were the first arising from errors in a quantitative investment model, and the SEC was able to return to clients all of their \$217 million in losses as a result of the settlement with the AXA Rosenberg entities.

Third, the SEC considered the "interest in holding the senior executive accountable." While the senior executive played a limited role in the events surrounding the concealment of the coding error, he advocated from the beginning that AXA Rosenberg's CEO be informed of the error. Moreover, his cooperation maximized the SEC's law enforcement interests by facilitating the quick and successful resolution of its enforcement actions.

Fourth, the SEC considered the senior executive's "profile." The SEC stressed that the cooperator was not currently an "associated person" of any regulated securities entity, a

fiduciary for other individuals or entities regarding financial matters, or an officer or director of a public company. He did not have any disciplinary or regulatory history in the industry.

Moreover, and indeed most importantly, the cooperator resigned from his position at AXA Rosenberg and retired from working in the investment advisory industry. In its release announcing the cooperation credit, the SEC emphasized that the cooperating senior executive was "no longer in a position to commit future violations of the federal securities laws."

### **The Real Story**

It is tempting to view the SEC's recent announcement as heralding in a new era in SEC enforcement practice where individuals may avoid charges in exchange for their confessions and offers to assist the agency in building cases against others. Defense counsel should take note, however, that the real story here is that the former senior executive who cooperated agreed to retire from the securities industry. It is hard to believe that, all other things being equal, the SEC would have offered the same free pass to someone who was still working as a securities industry professional.

Certainly, there are those inside and outside the SEC who believe that the agency's most important contribution to policing the securities markets is its congressional authority to permanently bar individuals who engage in misconduct from ever again working in the securities industry. Internally, the SEC has little appetite for giving a free pass to current securities industry professionals even when they self-report and offer to cooperate. Nor does the agency wish to deal with the public criticism that would likely accompany the use of its prosecutorial discretion to give a free pass to current industry professionals.

So, unless clients are prepared to make a credible showing that their personal circumstances are such that they will no longer be working in the securities industry—in effect, agreeing to a self-imposed permanent industry bar—defense counsel should not expect the SEC to offer the same free pass from charges that the AXA Rosenberg cooperator received for his cooperation. At a minimum, counsel should expect to discuss some form of a settled enforcement action and a less-than-permanent association bar, or "time-out," from working in the securities industry.

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