The SEC's BALANCING Act:

Financial Penalties Against Corporations

By Harold K. Gordon

Newspaper headlines announcing a Securities and Exchange Commission ("SEC") action seeking a multimillion-dollar penalty against a corporation seem to have appeared monthly in recent years. For most of its 73-year history, however, the SEC policed the Federal Securities Laws primarily by seeking injunctions against future violations and disgorgement of ill-gotten profits, or by bringing administrative proceedings against registered securities firms and their personnel. Not until 1984 did Congress give the SEC the authority to seek civil money penalties, and at that time it could pursue penalties only for insider-trading violations. Congress gave the SEC significant additional enforcement tools in 1990, including the ability to impose administrative cease-and-desist orders, and to seek a court order preventing an individual from serving as a corporate officer or director and imposing financial penalties against individuals or corporations for any violation of the Federal Securities Laws. Following criticism from the defense bar and some of its own Commissioners that SEC financial penalties against corporations were inconsistent and frequently

served to unfairly punish innocent shareholders already victimized by the corporation's misconduct, in January 2006 the SEC issued a statement attempting to clarify the factors it will consider in determining when to seek a monetary penalty against a corporation. Though questions remain, those in the executive suite and the corporate defense bar welcomed the SEC's rare illumination of its decision-making process regarding corporate penalties.

THE SEC'S PENALTY AUTHORITY

With the passage of the Insider Trading Sanctions Act of 1984, the SEC obtained the ability to seek civil money penalties for insider trading. Based on the perception that the securities industry was not exercising sufficient vigilance in detecting and preventing insider trading, in 1988 Congress enacted the Insider Trading and Securities Fraud Enforcement Act ("ITSFEA"). Pursuant to ITSFEA, broker-dealers, investment advisors, and other securities firms must establish policies and procedures designed to detect and prevent insider trading by their employees. Congress also gave the SEC the authority under ITSFEA to request that a court impose substantial financial penalties not only on a person who engaged in insider trading, but on the firm that employed the insider trader and his supervisors if they knew or recklessly disregarded the fact that he was likely to engage in insider trading and failed to take sufficient steps to prevent it. ITSFEA also authorizes the SEC to seek penalties against the firm and supervisors if they intentionally or recklessly failed to establish sufficient policies and procedures required to prevent insider trading and that failure led to the employee's insider trading. Last June, the SEC obtained a $10 million penalty from Morgan Stanley & Company Inc. for an alleged failure to maintain and enforce sufficient written policies and procedures designed to prevent the misuse of material, nonpublic information by Morgan Stanley and its employees. In March 2007, Banc of America Securities LLC agreed to pay a $6 million penalty in settlement of alleged violations of the same securities-firm compliance requirement.

Efforts to provide the SEC with authority to pursue financial penalties outside the insider-trading context for any Federal Securities Law violation originated with a report issued in 1987 by the National Commission on Fraudulent Financial Reporting, known as the Treadway Commission. The Treadway Commission was a private-sector group sponsored by the accounting profession to identify ways to reduce the occurrence of fraudulent financial reporting by corporations. The Treadway Commission Report recommended that Congress enact legislation providing the SEC with the authority to seek civil money penalties for financial-reporting misconduct and other violations, along with bars against individuals serving as corporate officers and directors, and the authority to impose cease-and-desist orders, which are the administrative equivalent of a federal court injunction against further violations of the securities laws.

Congress adopted the Treadway Commission's recommended expansion of the SEC's enforcement arsenal in 1990 with the enactment of the Securities Enforcement Remedies and Penny Stock Reform Act ("Remedies Act"). The SEC's financial-penalty authority was added in Section 20(d)(1) of the Securities Act of 1933 and in Section 21(d)(3) of the Securities Exchange Act of 1934. Parallel penalty provisions were added to the Investment Company Act and the Investment Advisers Act. The SEC may seek a penalty whenever it believes that an individual or corporation has violated a Federal Securities Law statute or SEC rule, or a previously entered SEC cease-and-desist order, except for an insider-trading violation, which is covered by the separate ITSFEA penalty provisions. In federal court actions, the SEC has the burden of making a "proper showing" for the imposition of a financial penalty.

The amount of the financial penalty the SEC can request is governed by three tiers of potential penalties. The first tier authorizes the SEC to seek up to $5,000 in an action against an individual, up to $50,000 from a corporation, or the "gross amount of pecuniary gain" to a defendant as a result of the violation. The second tier increases the amounts of the penalties to $50,000 for an individual and $250,000 for a corporation (or the gross amount of pecuniary gain) if the violation involved "fraud, deceit, manipulation, or deliberate or reckless disregard of a regulatory requirement." The third tier raises the ceiling to $100,000 for an individual and $500,000 for a corporation (or the gross amount of pecuniary gain) if the violation involved the same conduct as the second tier and in addition directly or indirectly caused "substantial losses

With the passage of the Insider Trading Sanctions Act of 1984, the SEC obtained the ability to seek civil money penalties for insider trading.

or created a significant risk of substantial losses to other persons." Until passage of the Sarbanes-Oxley Act of 2002, penalties the SEC obtained were paid to the United States Treasury. Section 308 of the Sarbanes-Oxley Act, the so-called "Fair Funds provision," permits the SEC to request that penalties be added to any disgorgement fund established as part of an SEC enforcement action to return money to shareholders, investors, or other victims of the defendant's securities-law violations.

Despite the SEC's vital mission, not everyone favored giving the agency the authority to seek financial penalties outside the insider-trading context. Some believed that doing so was contrary to the SEC's function as a regulatory agency and the traditionally remedial and forward-looking nature of the remedies the SEC sought in its enforcement actions, whether returning funds to aggrieved investors, obtaining an injunction against future violations, or suspending supervisors or others at registered securities firms pursuant to an administrative order. Penalties constituted a punitive remedy, the argument went, and such quasi-criminal actions in egregious cases were historically referred by the SEC to criminal prosecutors. In fact, the American Bar Association ("ABA") opposed the broad penalty authority the Remedies Act would provide the SEC. In a letter from the ABA's Subcommittee on SEC Practice and Enforcement Matters to Senator Donald Riegle, Jr., chairman of the Senate Committee on Banking, Housing, and Urban Affairs, the ABA argued that the SEC should be granted authority for monetary penalties for specific violations, like insider trading, only where the SEC had shown that its existing remedies were inadequate. The ABA also contended that penalties should not be available for negligent violations or for "failure to supervise" violations, noting that SEC penalties would trigger jury-trial rights and double-jeopardy issues that could preclude or complicate criminal prosecutions and generally undermine the effectiveness of the SEC's enforcement program. Some practitioners warned that the SEC would inevitably seek penalties excessively, encouraging litigation over settlements and focusing the agency's enforcement program on punitive instead of remedial relief.

Congress and the SEC attempted to assure those who feared the results of expanded penalty authority that the SEC would exercise its new enforcement tool appropriately. The Senate Report accompanying the Remedies Act stated that it was not anticipated that the SEC would seek a monetary penalty in every case, especially in cases involving "isolated and unintentional conduct." S. Rep. No. 337, 101st Cong., 2d Sess. (1990). The legislative history indicates that Congress expected the SEC to be even more constrained in pursuing financial penalties against corporations. Fearing that such penalties would simply be passed through to shareholders, the Senate Report stated that penalties against corporations should be sought only when the shareholders benefited from the violation. Where the shareholders were the principal victims and would be harmed again by ultimately paying an SEC penalty, it was expected that the SEC would, where appropriate, seek penalties instead from the individual corporate

The Commission has historically been reluctant to impose civil penalties on public companies because of the negative impact such a penalty can have on shareholders who have already been victimized by the conduct being penalized.

officers or employees responsible for the corporation's misconduct. *Id.*

Richard Breeden, SEC chairman at the time the Remedies Act was enacted, confirmed in a letter to Senator Riegle that the SEC intended to seek penalties against corporations only when the violation resulted in an improper benefit to shareholders. In addition, in its memorandum in support of the Remedies Act, the SEC stated that the improper gain by a corporation and its shareholders that would be required to justify a penalty would not necessarily occur in a financial fraud case where the allegations concerned improper disclosure of financial performance:

> [I]n deciding whether and to what extent to assess a penalty against the issuer, the Commission may properly take into account its concern that civil penalties assessed against corporate issuers will ultimately be paid by shareholders who were themselves victimized by the violations. In a typical case of financial fraud in which an issuer overstates its earnings and revenues, for example, the only shareholders who reap a direct economic benefit are those who sell their shares at an inflated price before the fraud is exposed. By the time that an enforcement action is brought, a large percentage of the shareholders may consist of persons who purchased shares at a price that was artificially inflated as a result of the fraud. To assess a civil penalty in such a case against the issuer, as opposed to the individual officers who were responsible for the fraud, would appear to be inequitable.*[1]

The SEC provided similar reassurances more recently in its June 2003 court submission in support of the proposed settlement of its action against WorldCom, Inc. It stated:

> The Commission has historically been reluctant to impose civil penalties on public companies because of the negative impact such a penalty can have on shareholders who have already been victimized by the conduct being penalized. Due to this concern, the Commission has sought and obtained civil penalties against public companies in financial fraud cases on only a handful of occasions.[2]

THE SEC'S TRACK RECORD ON CORPORATE PENALTIES

In December 2005 remarks, SEC Division of Enforcement Director Linda Thomsen noted that since Xerox Corporation agreed in April 2002 to pay $10 million in penalties in a settled SEC financial-reporting and accounting action, the SEC had sought civil money penalties against only 25 public companies. A count of such actions on the SEC's web site from the Xerox action through December 2005 reveals no reason

* *Endnotes for this story appear on page 60.*

to dispute Thomsen's statement. What was nonetheless significant at the time of Thomsen's remark was the increasing size of SEC penalties, including penalties of $50 million against Vivendi Universal, $100 million against Bristol-Myers Squibb, $120 million against Royal Dutch Petroleum, $225 million against Computer Associates, $250 million against Qwest Communications, and $300 million against Time Warner Inc. Also troubling was that in a number of instances, the SEC appeared to contradict its assurances to Congress at the time the Remedies Act was passed that it would not seek financial penalties from a corporation where the shareholders were victims of the alleged securities-law violation and would only be victimized again by indirectly defraying the tab for any SEC penalties and by a further depressed stock price following news of an SEC enforcement action.

Those in the executive suite and the defense bar were not the only ones troubled by how the SEC had exercised its penalty authority. In a series of speeches to corporate trade groups and other organizations, SEC Commissioners Cynthia Glassman and Paul Atkins expressed their concern that shareholders were being unfairly penalized. In a December 2004 speech before the Annual Public Fund Boards Forum, Commissioner Glassman stated:

> Where a corporation's shareholders have benefited from the fraud, I believe that a monetary penalty against the company may be an appropriate punishment. However, in many recent financial fraud cases the victims of the corporate misconduct were the shareholders — typically in the form of a drastically reduced or even worthless stock value.[3]

Glassman emphasized the same concerns in a speech delivered in June 2005:

> If the shareholders have benefited from the fraud, then I would not normally oppose a penalty. But I cannot justify imposing penalties indirectly on shareholders whose investments have already lost value as a result of the fraud. Our use of so-called Fair Funds, provided by Sarbanes-Oxley, as a vehicle to return civil penalties to defrauded investors . . . leads to the anomalous result that we have shareholders paying corporate penalties that end up being returned to them through a Fair Fund[.] This gets a headline, but it makes no sense to me — it is form over substance.[4]

Commissioner Atkins expressed similar concerns on SEC penalties against corporations in February 2005 remarks in Atlanta before the National Association of Corporate Directors:

> Fundamentally, we also have to remember that the corporation may already have been punished through reputational and stock-price damage.
>
> Unless the corporation is a criminal enterprise, or the shareholders themselves have somehow benefited from the fraud to the detriment of other corporations or the marketplace as a whole, and the fine serves as a disgorgement of ill-gotten profits, fines against shareholders are often not appropriate. Corporations fined for disclosure-based transgressions use shareholder money to pay for behavior of which the shareholders were the victims. We have to ask ourselves: Who are the victims? Who really is paying the fines? By imposing such fines, are we not punishing the very people who might have already [been] punished through the marketplace when the stock price was clobbered?[5]

THE SEC'S STATEMENT ON FINANCIAL PENALTIES

Issued in January 2006, the SEC's Statement Concerning Financial Penalties ("Statement") represented a rare illumination of the SEC's enforcement program and its decision-making process concerning when the agency will invoke one of its enforcement tools. (The Statement is available at http://www.sec.gov/news/press/2006-4.htm.) The SEC based its new framework for determining the appropriateness of penalties against a corporation on the penalty statute and its legislative history. As SEC Chairman Christopher Cox noted in a press conference following release of the Statement, "[W]hat we did was go back to first principles. Specifically, to the law, to the authority that Congress gave to the SEC, and to the

continued on page 59

legislative history that describes the discretion the Commission has and the way that Congress intended that we utilize that discretion[.]" (An audio recording of the SEC's press conference is available at http://www.connectlive.com/events/secnews/.)

Hoping to achieve "clarity, consistency, and predictability" in the way in which the SEC's corporate-penalty authority is used, the SEC listed the considerations it will examine in determining when a corporate penalty is justified, noting that each of the factors was reflected in the statute and its legislative history. It stated that the appropriateness of a penalty against a corporation in a particular case would turn primarily on two factors: the presence or absence of a direct benefit to the corporation as a result of the violation, and the degree to which any shareholders harmed by the corporation's violation would benefit or suffer further harm from a penalty.

In addition to the two principal considerations, the SEC listed additional factors it will consider in determining whether a corporate penalty is justified, including the need for deterrence; the extent of injury to innocent parties; whether participation in the violation was widespread at the corporation; the degree of intent of the individuals involved; the degree of difficulty in detecting the particular violation at issue; the extent to which the corporation undertook remedial steps; and the corporation's cooperation with the SEC and, if applicable, other law enforcement agencies. The SEC did not indicate in the Statement that each of its secondary considerations will be applicable in each case. As courts have done with other multifactor tests applied to SEC requests for particular remedies or relief, which other factors beyond the two primary ones should be applied will depend on the specific facts and circumstances, as the SEC's penalty analysis requires.

In his press-conference remarks, SEC Chairman Cox said that the Statement's penalty guidelines will "inform . . . [the SEC's] future actions" regarding when it seeks corporate penalties. Acknowledging the concerns of Commissioners Glassman and Atkins, Cox said that it was "important not to compound the harm already caused to investors." Cox added that he

continued on page 60

continued from page 59

hoped the guidelines provided an objective way to appraise the SEC's use of its penalty authority. As he put it, the SEC's penalty decisions "ought not to be a matter of what the judge had for breakfast."

CONCLUSION

The SEC should be commended for heeding the concerns that had been expressed about its pursuit of financial penalties against corporations and explaining the factors that will guide its decisions regarding when corporate penalties are justified. Important questions remain, however. For example, the SEC's Statement on penalties is silent on the criteria the agency will consider in determining the amount of penalties it will seek after it has concluded that penalties are justified. Corporate counsel are left with the overly general standards that differentiate the three tiers of possible penalty amounts in the penalty statute.[6] Nor does the Statement shed light on what exactly will constitute an improper benefit to a corporation or its shareholders justifying a penalty and how such an improper benefit will be measured. The penalty statute refers to the "gross amount of pecuniary gain," suggesting that any improper benefit ought to be one that is readily quantifiable and had a material impact on a corporation's balance sheet or income statement.

It is too early to assess the impact of the Statement on the SEC's enforcement program and its decisions regarding when to seek financial penalties against a corporation. Given the concerns that motivated the Statement, one hopes that the test of time will reveal that the SEC has invoked its penalty authority in a manner consistent with its assurances and Congress's intent at the time the Remedies Act was enacted, avoiding penalties in the absence of improper corporate gain and when a penalty would only further injure a corporation's shareholders. ■

HAROLD K. GORDON
1.212.326.3740
hkgordon@jonesday.com

The SEC's Balancing Act — Endnotes

[1]Memorandum of the Securities and Exchange Commission in Support of the Securities Law Enforcement Remedies Act, at 4, Attachment A to the July 19, 1989 Statement of David S. Ruder before the Subcommittee on Telecommunications and Finance of the House Committee on Energy and Commerce.

[2] Submission of the Securities and Exchange Commission Addressing the Issues Identified in the Court's May 19, 2003 Order Concerning the Proposed Settlement of the Commission's Monetary Claims Against WorldCom, *SEC v. WorldCom*, *Inc*., No. 02-CV-4963 (JSR), *at* http://www.sec.gov/spotlight/worldcom/wcombrief060603.pdf (footnote omitted).

[3] Cynthia A. Glassman, Remarks at the 13th Annual Public Fund Boards Forum: The Challenges of Striking a Regulatory Balance (Dec. 6, 2004), *at* http://www.sec.gov/news/speech/spch120604cag.htm.

[4] Cynthia A. Glassman, SEC in Transition: What We've Done and What's Ahead (June 15, 2005), *at* http://www.sec.gov/news/speech/spch061505cag.htm.

[5] Paul S. Atkins, Remarks before the Atlanta Chapter of the National Association of Corporate Directors (Feb. 23, 2005), *at* http://www.sec.gov/news/speech/spch022305psa.htm.

[6] Though it does not answer this lack of guidance in the penalties Statement, Chairman Cox recently announced that the Commission was initiating a new program in which SEC Enforcement Staff will need to first obtain Commission approval and guidance on the range of appropriate monetary penalties in cases where the Staff believes corporate penalties are justified. Christopher Cox, Address to the Mutual Fund Directors Forum Seventh Annual Policy Conference (Apr. 13, 2007), *at* http://www.sec.gov/news/speech/2007/spch041207cc.htm. Cox added that where cases are then settled within the Commission-approved range, Commission approval of the settlement should proceed faster. *Id.* Cox noted that one goal of the new program was consistency and fairness or "horizontal equity" in the Commission's enforcement decisions around the country. *Id.* SEC Enforcement Staff members have traditionally had the authority to negotiate settlement agreements in principle with corporations and individuals subject to approval by the full Commission. Though the goals of faster settlement approvals and fairness and "horizontal equity" in Enforcement Staff and Commission decisions regarding penalties are laudable, the new Commission pre-review process concerning any penalties discussion the Enforcement Staff may subsequently have with company counsel should be implemented to give company counsel notice and a voice in what otherwise will be a one-sided conversation between the Enforcement Staff and the Commission. *See* Christian J. Mixter, *The Securities and Exchange Commission's New Course on Penalties*, 39 BNA Sec. Reg. & L. Rep. 17, 678 (Apr. 30, 2007).