EVALUATING THE MISSION: A CRITICAL REVIEW OF THE HISTORY AND EVOLUTION OF THE SEC ENFORCEMENT PROGRAM

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The United States Securities and Exchange Commission (the "SEC" or "Commission") is nearing its seventy-fifth anniversary, a milestone that will be marked by reflection on the past and contemplation of the future.[1] During this time of introspection, the Commission should take the opportunity to examine the manner in which it has reacted to the growth and changes in its regulatory authority and in the capital markets. One constant throughout its history has been the SEC's need to balance competing interests. The SEC's stated mission reflects this tension. Today, that mission is composed of three objectives: "to protect investors; maintain fair, orderly, and efficient markets; and facilitate capital formation."[2]

Historically, the SEC's mission has focused on investor protection. As the SEC and its regulatory powers have grown in response to the ever more complex and international financial services markets, the seemingly straightforward mission of investor protection has become more intricate and multidimensional, prompting questions such as, "Who are the investors that should be protected?" and "How should they be protected?" After all, investors range in sophistication, size, activity, goals, needs, and other attributes. They include traditional individual and institutional investors in the securities markets, traders, and foreign entities seeking to invest in the United States.[3] Choices that the SEC makes in its rulemaking and other activities can favor or disfavor one group of investors over another. A rule beneficial for one investor may be detrimental to another, depending on an investor's investment strategy or changing circumstances. Indeed, because investors ultimately pay for inefficiencies arising from regulatory mandates through direct or indirect costs, diminished returns, and reduced choice, the rules must be made with careful analysis and deliberation. Congress acknowledged this potential harm in 1996 when it revised the SEC's statutory mandate to expressly require the SEC "to consider or determine whether an action is necessary or appropriate in the public interest" and to "consider, in addition to the protection of investors, whether the action will promote efficiency, competition, and capital formation."[4]

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1. The SEC was created on July 2, 1934 during a period of heated debate over the country's economic turmoil. That day was literally heated: 93 degrees Fahrenheit, to be exact. The Federal Trade Commission met in an unairconditioned, temporary building in Washington, D.C., located on the present site of the Federal Reserve Building, to vote the SEC into existence pursuant to the Securities Exchange Act of 1934. Frank V. Fowlkes, *Agency Report/Congress Prods SEC To Get Firmer Grip on Nation's Securities Industry,* NATIONAL JOURNAL, Feb. 20, 1971, at 385.

2. U.S. SEC. & EXCH. COMM'N, 2006 PERFORMANCE AND ACCOUNTABILITY REPORT 5, *available* at http://www.sec.gov/about/secpar/secpar2006.pdf [hereinafter 2006 REPORT].

3. One group of foreign investors, sovereign wealth funds, has received much attention by the press in recent years. Sovereign wealth funds are estimated currently at $2.5 trillion and expected to grow to $10 to 15 trillion by 2015. Robert M. Kimmitt, *Public Footprints in Private Markets,* FOREIGN AFFAIRS, Jan./Feb. 2008, at 1-2, *available at* http://www.foreignaffairs.org /20080101faessay87109/robert-m-kimmitt/public-footprints-in-private-markets.html.

4. Securities Exchange Act of 1934 § 3(f), 15 U.S.C. § 78c(f) (2006).

This multidimensional aspect of investor protection applies not only to rulemaking, but also to enforcement matters. Each enforcement matter involves in some degree a balancing of competing interests, some at a pragmatic, case-specific level and others at a higher policy level. For example, in distributing money recovered in an enforcement action against a bankrupt company, the SEC conceivably could decline a distribution to all investors and instead choose a distribution that favors one class of investor over another, such as common stockholders over senior debtholders, which by virtue of their preferred position may have had greater recovery per dollar invested than did common stockholders, but still fell short of their desired recovery. In its overall enforcement program, the SEC's decisions about resource allocation, charges to be brought, and relief to be sought may enhance the protection of one group of investors at the potential cost of another. Advancing a novel legal theory may protect the group of investors in a particular case, but have unintended detrimental consequences to investors as a whole.[5]

The enforcement decisions of the SEC must be guided by the multidimensional nature of the SEC's mission of protecting investors; maintaining fair, orderly, and efficient markets; and facilitating capital formation. The difficult choices of balancing conflicting interests must be guided by the transcendent principles of predictability, fairness, and transparency, culminating in the rule of law. These principles are the defining characteristics of the U.S. markets.

In order to assess the SEC's application of these principles to its enforcement decisions, this Article investigates the shifting focus of the SEC's enforcement program from its inception to the present day. The Article explores the development and usage of the SEC's statutory enforcement powers in the context of due process and fairness. Finally, the Article calls for the Commission to appoint an independent advisory committee to conduct a detailed review and evaluation of the policies and procedures of the enforcement program in light of the changes in the SEC's statutory authority over the course of the last three decades.

THE ORGANIZATION OF THE SEC

The SEC is governed by five commissioners, all of whom are appointed by the President with the advice and consent of the Senate.[6] One of the commissioners is designated as chairman by an executive order of the President.[7]

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5. *See, e.g., Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc.*, - U.S. -, 128 S.Ct. 761 (2008).

6. Securities Exchange Act of 1934 § 4, 15 U.S.C. § 78d (2006).

7. *See* Reorganization Plan No. 10 of 1950, 15 Fed. Reg. 3175 (1950), *reprinted in* 5 U.S.C. 901 *et seq.* (2006), *and in* 64 Stat. 1265 (1950); *see also* 2006 REPORT, *supra* note 2, at 7. This power of the President to designate (or remove) the chairman by executive order does not apply to similar agencies. For example, the chairmen of the Board of Governors of the Federal Reserve and the Commodity Futures Trading Commission are separately nominated and

To ensure bipartisanship, Congress specified that only three of the five commissioners can belong to the same political party.[8]

The SEC is organized into four primary operating divisions and nineteen "offices," or special service units, each of which is headquartered in Washington, D.C. The SEC's staff, numbering approximately 3500, is located in Washington, D.C. and throughout its eleven regional offices.[9] The SEC's largest division—and the focus of this Article—is the Division of Enforcement, which has more than 1100 employees, and has grown by more than 40% in the past fifteen years.[10]

THE SEC'S AUTHORITY UNDER THE FEDERAL SECURITIES LAWS

Today, the SEC is charged with administering the Securities Act of 1933,[11] the Securities Exchange Act of 1934,[12] the Trust Indenture Act of 1939,[13] the Investment Company Act of 1940,[14] the Investment Advisers Act of 1940,[15]

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confirmed to their positions as chairmen, although they have separate terms as governor or commissioner, respectively. *See* 12 U.S.C. § 242 (2008) and 7 U.S.C. § 2(a)(2)(B) (2008).

8. Securities Exchange Act of 1934 § 4. The first five commissioners were Democrats Joseph P. Kennedy, James M. Landis and Ferdinand Pecora, and Republicans George C. Mathews and Robert E. Healy. The commissioners elected Joseph P. Kennedy to serve as the first chairman. *See* Fowlkes, *supra* note 1, at 385.

9. *See* U.S. SEC. & EXCH. COMM'N, 2007 PERFORMANCE AND ACCOUNTABILITY REPORT 2, *available at* http://www.sec.gov/about/secpar/secpar2007.pdf [hereinafter 2007 REPORT]. The SEC has grown tremendously since its inception. In 1942, the SEC had a staff of 1700 employees. In order to make room for wartime agencies, the SEC was forced to relocate to Philadelphia in 1942. By the time it returned to Washington in 1948, the staff had decreased to 1150. By 1955, there were only 666 employees. Fowlkes, *supra* note 1, at 383.

10. The Enforcement Division is currently the largest of the divisions and offices of the SEC, with more than 1100 personnel. *See* Christopher Cox, Chairman, Opening Remarks to the Practising Law Institute's SEC Speaks Series (Feb. 9, 2007), *available at* http://www.sec.gov/news/speech/2007/spch020907cc.htm. According to information provided by the SEC to Congress, the total number of employees in the Enforcement Division at the end of fiscal year 2008 is expected to be 1124—up from 781 in 1992.

11. Securities Act of 1933, 15 U.S.C. §§ 77a-77aa (2006).

12. Securities Exchange Act of 1934, 15 U.S.C. §§ 78a-78nn (2006); *see generally* Securities and Exchange Act of 1934, http://www.sec.gov/about/laws.shtml#secexact1934 (last visited May 8, 2008) (discussing some of the many powers granted by the 1934 Act, including regulating corporate reporting, proxy solicitations and tender offers).

13. Trust Indenture Act of 1939, 15 U.S.C. §§ 77aaa-77bbbb (2006) (focusing on debt securities such as bonds, debentures, and notes that are offered for public sale).

14. Investment Company Act of 1940, 15 U.S.C. §§ 80a-1 to a-64 (2006) (regulating the organization of companies, including mutual funds, that engage primarily in investing, reinvesting, and trading in securities, and whose own securities are offered to the investing public).

15. Investment Advisers Act of 1940, 15 U.S.C. §§ 80b-1 to b-21 (2006) (regulating investment advisors).

and certain provisions of the Sarbanes-Oxley Act,[16] some of which fall outside of the earlier securities laws.[17]

The Commission is vested with statutory authority to conduct any investigation it deems necessary to determine whether a person has violated federal securities laws and the rules and regulations promulgated thereunder.[18] As part of this investigative authority, the Commissioners—and any officer to whom the Commissioners' authority is delegated—have the power to "administer oaths and affirmations, subpena [sic] witnesses, compel their attendance, take evidence, and require the production of any books, papers, correspondence, memoranda, or other records which the Commission deems relevant or material to the inquiry."[19] The Commission has delegated these tasks to the Director of the Division of Enforcement, who undertakes them pursuant to formal orders that the Commission grants in individual matters.[20] If the Commission concludes that a securities law has been violated, the Commission may bring an action in federal court or in an administrative proceeding against the purported violators.

THE ESTABLISHMENT OF THE ENFORCEMENT DIVISION

Among its various other roles, the SEC acts to enforce the federal securities laws,[21] and it has built a strong reputation for professionalism and effectiveness in its enforcement program. At the time the Commission was established in 1934, the Commission's "Legal Division" was responsible for conducting investigations pertaining to federal securities law violations.[22] Within the first two years, the Commission assigned that duty to its regional offices.[23] For the next four decades, the regional offices were primarily responsible for conducting investigations and bringing enforcement actions while the

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16. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (2002) (codified in scattered sections of 11, 15, 18, 28 and 29 U.S.C.) (mandating a number of reforms to enhance corporate responsibility and financial disclosures and to combat corporate and accounting fraud). The Sarbanes-Oxley Act also created the Public Company Accounting Oversight Board to oversee the activities of the auditing profession..

17. On February 8, 2006, the repeal of the Public Utility Holding Company Act of 1935 took effect, relieving the SEC of what once arguably was its primary focus. The Act provided for the regulation of multi-state utilities by the SEC. Public Utility Holding Company Act of 1935, 15 U.S.C. § 79 (repealed 2006).

18. *See e.g.,* Securities Act §§ 8(e), 20(a); Securities Exchange Act § 21(a); Investment Company Act § 42(a); Investment Advisers Act § 209(a).

19. Securities Exchange Act § 21(b). Congress has granted similar authority in other provisions of the federal securities laws. *See* Investment Company Act § 42(b); Investment Advisers Act § 209(b).

20. 17 C.F.R. § 200.30-4(a)(1) (2008).

21. 2007 REPORT, *supra* note 9, at 2.

22. DANIEL M. HAWKE, A BRIEF HISTORY OF THE SEC'S ENFORCEMENT PROGRAM 1934-1981, at 2 (SEC Historical Society 2002), *available at* http://www.sechistorical.org/collection/oralHistories/roundtables/enforcement/enforcementHistory.pdf.

23. *Id.* A copy of the 1939 organization chart of the SEC is *available at* http://www.sechistorical.org/collection/papers/1930/1939_SEC_OrgChart.pdf.

Commission's Trading and Markets Division "played a largely supervisory and coordinating role supporting the regions and referring criminal cases to the Justice Department for prosecution."[24] By 1944, after only a decade of existence, the SEC had gathered information "concerning an aggregate of 44,399 persons against whom Federal or State action had been taken with regard to securities violations" and had obtained permanent injunctions against 1,057 firms and individuals.[25]

The second decade of the SEC's existence was marked by World War II and its aftermath. During the war, the SEC's headquarters moved temporarily to Philadelphia to make room for wartime operations in Washington, D.C.[26] When the SEC finally returned to Washington in 1948, it occupied temporary buildings that were erected during the war.[27] Despite the inconveniences caused by the war and post-war budget cuts, the SEC continued to bring a constant number of enforcement actions during this time.[28]

Beginning in the late 1950s and continuing through the 1960s, the enforcement program underwent a remarkable transformation, and the enforcement resources in the SEC's Washington, D.C. headquarters increased. With the added resources, the headquarters began to bring more actions for violations of the securities laws. During the *entire decade* of the 1950s, the home office brought a total of approximately fifty cases. Yet during the 1960s, that number escalated substantially — the home office brought approximately forty cases *per year*.[29]

The 1960s witnessed landmark decisions in the field of securities law in cases brought by the SEC, such as *SEC v. Texas Gulf Sulfur Co.*[30] and *SEC v. VTR, Inc.*[31] In *Texas Gulf Sulfur*, the Second Circuit adopted the SEC's application of Rule 10b-5 to insider trading cases by requiring insiders in possession of material, nonpublic information either to abstain from trading on such information or to disclose such information before trading.[32] In *VTR*, the SEC persuaded a federal district court to approve as a remedy for the securities law violation the appointment of independent directors and to order restitution.[33]

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24. *Id*. During the SEC's first decade, the Justice Department had a 95% conviction rate from the indictments that it brought based on referrals from the SEC. *Id.* at 13 (quoting TENTH ANNUAL REPORT OF THE SECURITIES AND EXCHANGE COMMISSION, at 3).

25. *Id.* at 13 (citing TENTH ANNUAL REPORT OF THE SECURITIES AND EXCHANGE COMMISSION, at 2-3).

26. *Id.* at 14.

27. *Id.*

28. *Id*.

29. *See* JOEL SELIGMAN, THE TRANSFORMATION OF WALL STREET: A HISTORY OF THE SECURITIES AND EXCHANGE COMMISSION AND MODERN CORPORATE FINANCE 360-61, 363 (3d ed. 2003). The impetus for the transformation was the enforcement staff's massive investigation into fraudulent practices by the American Stock Exchange. *See* HAWKE, *supra* note 22, at 2-3.

30. *See* SEC v. Tex. Gulf Sulfur Co., 401 F. 2d 833 (2d Cir. 1968), *cert. denied*, 394 U.S. 976 (1969).

31. *See* SEC v. VTR, Inc., 410 F. Supp. 1309 (D.D.C. 1975).

32. *See Tex. Gulf Sulfur*, 401 F. 2d at 848-52.

33. *See VTR, Inc.,* 410 F. Supp. 1309.

The *VTR* decision marked the beginning of a long series of civil cases obtaining ancillary relief in addition to an injunction against further misconduct.[34]

The growth in the number of actions being brought by the SEC sparked discussions, led by Chairman William J. Casey, about "concentrat[ing] resources by focusing all enforcement and investigative activity in one division."[35] In August 1972, the Commission reorganized the operating structure of its divisions by combining the enforcement programs of the divisions of Trading and Markets, Corporation Finance, and Investment Management into a newly created, stand-alone division.[36] The new "Division of Enforcement" would oversee all enforcement actions brought by the SEC.[37]

THE WELLS COMMISSION AND ITS RECOMMENDATIONS

On January 27, 1972, in a speech to the New York State Bar Association underscoring the importance of cooperation and collaboration between the Commission and the securities bar, Chairman Casey announced the creation of an advisory committee[38] to "review and evaluate the Commission's enforcement

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34. SELIGMAN, *supra* note 29, at 362.

35. U.S. SEC. & EXCH. COMM'N, THIRTY-EIGHTH ANNUAL REPORT OF THE SECURITIES AND EXCHANGE COMMISSION xxvii (1972), *available at* http://www.sec.gov/about/annual_report/1972.pdf. It has been suggested that this reorganization was initially resisted on the

> belief that enforcement responsibility should not be separated from the divisions of the Commission that deal with substantive regulation. The belief was that as the regulators developed new principles of regulation, if enforcement became too separate from such development, it might reflect the uncertainties of the rules and the appropriate nature of regulation.

Symposium, *Securities Law Enforcement Priorities*, 17 SETON HALL LEGIS. J. 7, 9 (1993) (statement by Leonard M. Leiman).

36. HAWKE, *supra* note 22, at 3. In 1971, there were 40 lawyers in the enforcement group of the Division of Trading and Markets. Fowlkes, *supra* note 1, at 380. The Commission, on November 14, 2007, restored the name of the "Division of Market Regulation" to the "Division of Trading and Markets." *See* Press Release, U.S. Sec. & Exch. Comm'n, SEC Renames Division of Market Regulation as Division of Trading and Markets (Nov. 14, 2007), *available at* http://www.sec.gov/news/press/2007/2007-229.htm. The Commission changed the name of the "Division of Corporate Regulation" to the "Division of Investment Management" in 1972. *See* Interview by Richard Rowe with Allan Mostoff (Oct. 30, 2002), *available at* http://www.sechistorical.org/collection/oralHistories/interviews/mostoff/mostoff100202Transcript.pdf.

37. HAWKE, *supra* note 22, at 3.

38. William J. Casey, Chairman, U.S. Sec. & Exch. Comm'n, Address to the New York Bar Association (Jan. 27, 1972), *available at* http://www.sec.gov/news/speech/1972/012772casey.pdf [hereinafter Casey Speech].

policies and practices and to make such recommendations as they deemed appropriate."[39] Chairman Casey called upon the private securities bar to contribute to improving the enforcement program by developing procedural safeguards to protect against abuses of the rights of prospective defendants.[40] Stressing the value of input from the private sector, Chairman Casey explained:

> [I] consider it essential for the Commission to redouble its efforts to keep in touch with the best thinking on investor protection at the private bar, in the accounting profession, and in the financial community generally. As one step – and I hope that it will prove a significant step – toward that end, I have created a special committee of three highly experienced practicing lawyers who will at my request examine the SEC's enforcement policy and practices, engage in frequent dialogue with the members of the Commission and with our staff, seek and sift the suggestions of the bar and make recommendations to the Commission for worthwhile improvements to our time-honored ways.[41]

Although the official name of the committee was the "Advisory Committee on Enforcement Policies and Practices," it is better known as the "Wells Committee" after its chairman, John A. Wells, a prominent lawyer and partner at the New York law firm of Royall, Koegel & Wells.[42] The Wells Committee also included former SEC chairmen Ralph H. Demmler and Manual F. Cohen, both of whom had taken an active interest in the workings of the enforcement program.[43] Howard G. Kristol, who served as special counsel to Chairman Casey, acted as a liaison to, and unofficial member of, the Wells Committee.[44]

The Wells Committee's stated mandate[45] was: first, "to advise on how the SEC's enforcement objectives and strategies may be made still more effective;"[46] second, to assess the due process implications of the enforcement practices;[47] third, to evaluate the enforcement policies and procedures;[48] fourth, "to make recommendations on the appropriate blend of regulation, publicity and formal enforcement action and on methods of furthering voluntary compliance;"[49] and

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39. U.S. SEC. & EXCH. COMM'N, REPORT OF THE ADVISORY COMMITTEE ON ENFORCEMENT POLICIES AND PRACTICES (June 1, 1972), *reprinted in* ARTHUR F. MATHEWS ET AL., ENFORCEMENT AND LITIGATION UNDER THE FEDERAL SECURITIES LAWS 1973, at 275 (Practicing Law Institute 1973) [hereinafter WELLS COMMITTEE ADVISORY REPORT]; Memorandum from John A. Wells et al., Chairman, SEC Advisory Committee on Enforcement Policy and Practices (Mar. 2, 1972), *available at* http://www.sechistorical.org/collection/papers/1970/1972_0302_ Casey.pdf [hereinafter Wells Memo].

40. Casey Speech, *supra* note 38, at 4-5.

41. *Id.*

42. *Id.* at 5-6. John Wells later formed a well-known law firm called Rogers & Wells.

43. *Id.*

44. Howard G. Kristol—Biography, *available at* http://www.duanemorris.com/attorneys/howardgkristol.html (last visited May 9, 2008).

45. Wells Memo, *supra* note 39.

46. *Id.* at 1.

47. *Id.*

48. *Id.*

49. *Id.* at 2.

fifth, "to make recommendations on criteria for the selection and disposition of enforcement actions and on the adequacy of . . . sanctions imposed in Commission proceedings."[50]

The Wells Committee was composed of three of the brightest minds of the securities bar, but the Committee did not conduct extensive, independent research and analysis. Instead, the Committee solicited comments from persons outside the Commission who were affected by the SEC's enforcement activities to "determine whether fairness could be more certainly assured, consistent with the need for effective enforcement."[51] The Wells Committee started its work in January 1972 and published a detailed report with forty-three recommendations for the Commission in June of the same year—an impressive achievement by any measure.[52] The report represented a candid and honest assessment of the enforcement program and reflected the substantial input the Committee received from the private bar.

The Wells Committee Recommendations

The most significant recommendations, from the perspective of a person defending against an SEC enforcement proceeding, are numbers 16, 17 and 20 of the report:[53]

> 16. Except where the nature of the case precludes, a prospective defendant or respondent should be notified of the substance of the staff's charges and probable recommendations in advance of the submission of the staff memorandum to the Commission recommending the commencement of an enforcement action and be accorded an opportunity to submit a written statement to the staff which would be forwarded to the Commission together with the staff memorandum.
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> 17. The procedures whereby a prospective defendant or respondent is permitted to present to the Commission his side of the case prior to authorization of an enforcement action should be reflected in a rule or published release.

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50. *Id.*
51. WELLS COMMITTEE ADVISORY REPORT, *supra* note 39, at 3.
52. *Id*. at ii-viii.
53. Harvey L. Pitt et al., *SEC Enforcement Process, Internationalization of the Securities Markets – Business Trends and Regulatory Policy*, C489 ALI-ABA 109, 238 (1989).

> 20. The Commission should adopt procedures permitting discussions of settlement between the staff and the prospective defendant or respondent prior to the authorization of a proceeding.[54]

These three recommendations became the impetus for what is now known as the "Wells Submission."

Providing prospective defendants with notice of potential charges and allowing them to respond, as reflected in Recommendations 16 and 17, was not a novel concept within the walls of the SEC. Even prior to the report of the Wells Committee, the SEC, under Chairman Hamer Budge, had afforded prospective defendants an opportunity to be heard by the Commission. A September 1, 1970, internal directive of the Commission[55] required the Enforcement staff to include within its memoranda recommending action by the Commission "any arguments or contentions as to either the facts or the law . . . which have [been] advanced by the prospective respondents and which countervail those made by the staff . . . ."[56] The purpose of the procedure was "to afford the Commission an opportunity to consider the position of the prospective defendant or respondent on any contested matters prior to authorization of a proceeding."[57]

The Wells Committee observed that "[a]s a practical matter, only experienced practitioners who are aware of the opportunity to present their client's side of the case have made use of [such] procedures."[58] The Committee felt that the process of providing notice to prospective defendants and allowing them to respond to the allegations before the Commission formally charged them was critical to protecting their rights and ensuring overall fairness.[59] The Committee recommended that the Commission codify the procedure through formal rulemaking.[60]

Unlike Recommendations 16 and 17, Recommendation 20 of the Wells Committee—to allow the staff to engage in preliminary settlement negotiations with a prospective defendant before the Commission authorized a proceeding[61]—was a significant departure from then-existing procedure. The 1970 internal directive required the staff to seek approval from the Commission to bring an action or proceeding prior to discussing its settlement.[62] Under the 1970 internal directive, the Enforcement staff could allow a defendant or respondent to present proposals and arguments prior to Commission authorization, so long as that

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54. WELLS COMMITTEE ADVISORY REPORT, *supra* note 39, at iv-v.

55. *See* Fowlkes, *supra* note 1 (describing the positions of the commissioners). It should be noted that this directive was supported by commissioners of both political parties.

56. This 1970 directive was made public solely as a result of pretrial discovery in *SEC v. National Student Marketing Corporation*. *See* SEC v. Nat'l Student Mktg. Corp., 68 F.R.D. 157, 166 appx. A (D.D.C. 1975) [hereinafter 1970 Internal Directive].

57. WELLS COMMITTEE ADVISORY REPORT, *supra* note 39, at 31.

58. *Id.* at 31-32.

59. *Id.*

60. *Id.* at 32.

61. WELLS COMMITTEE ADVISORY REPORT, *supra* note 39, at iv-v.

62. 1970 Internal Directive, *supra* note 56, at 165.

person initiated the discussions.[63] The staff, however, was precluded from negotiating settlement terms or disclosing to the defendant or respondent the "recommendation it intend[ed] to make to the Commission."[64] This process, which itself represented a departure from prior procedure for negotiating settlements, grew out of a concern by the Commission that "its discretionary authority regarding the institution of proceedings [would be] substantially impaired."[65] According to Commissioner A. Sydney Herlong, the 1970 internal directive was designed to prevent the staff from "bludgeoning" companies into consent settlements by using the threat of public proceedings that might never be approved.[66] Commissioner Herlong, who was one of two Democrats on the Commission, explained:

> The staff sometimes is overly zealous and they sometimes want quick settlements to clear up their files. Sometimes they would beat people over the head for a consent decree. We had reports from some people who weren't pleased with the treatment.[67]

Responding to comment letters, the Wells Committee recommended that the Commission withdraw this mandate and return to the prior procedure of allowing staff leeway to negotiate settlements with prospective defendants prior to having the authority to commence an action or proceeding.[68] The Wells Committee believed that "frank discussions between the staff and opposing counsel concerning the staff's conclusions and probable recommendation to the Commission would encourage settlements."[69] To address concerns with abuse, the Committee proposed that the Director of Enforcement or a regional administrator be responsible for supervising settlement negotiations and that the proposed defendant or respondent be shown the evidence that the staff has assembled in support of its case.[70] As the Wells Committee observed, "When the staff refuses to disclose its evidence or the theory of its case to the respondent's attorney before the hearing, the attorney, not knowing what his client faces, may be unable or reluctant to recommend a settlement."[71]

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63. *See id.* The staff was permitted to discuss the facts and nature of the alleged violations. *Id.*

64. *Id.*

65. WELLS COMMITTEE ADVISORY REPORT, *supra* note 39, at 35. Philip A. Loomis, then general counsel of the SEC, explained that the Commission abandoned the practice of considering settlements negotiated without prior Commission authorization because the Commissioners felt hindered by a pre-decided result. *See* Fowlkes, *supra* note 1, at 381. Commissioner Richard B. Smith "offered essentially the same reason, saying that he missed the opportunity to hear industry's side of a case and that it struck him as bad administrative procedure." *Id.*

66. Fowlkes, *supra* note 1, at 381.

67. *Id.*

68. WELLS COMMITTEE ADVISORY REPORT, *supra* note 39, at 35.

69. *Id.*

70. *Id.* at 35-36.

71. *Id.* at 37. Today, there are no specific guidelines concerning the amount and type of information that staff must share with a prospective defendant, so practices vary among the staff and across the regional offices.

The Wells Committee recommendation of a return to the pre-1970 procedure of allowing staff to negotiate settlements prior to Commission approval was met with favor by many members of the securities bar. In a May 23, 1972 letter to the Wells Committee concerning the proposed change, Arthur F. Mathews, a former SEC enforcement lawyer, wrote:

> [T]he changed enforcement policy has, although unintended, worked to the severe detriment of many defendants and prospective defendants who wish to achieve an acceptable consent settlement in lieu of litigation and who are not concerned that the Staff might "bludgeon" them. Rather, such persons usually are concerned with the continuing blasts of adverse publicity showering upon them, first by public institution of charges by the Commission, and later upon the conduct of a hearing or the announcement of the terms and conditions of a settlement subsequently negotiated. Such continuous publicity may be extremely unfair, particularly where serious allegations publicized upon institution of an action, are dropped subsequently by Staff and the Commission in accepting a consent settlement of the action.[72]

The notable aspect of this debate is that both sides were concerned with fairness and due process. Those in support of requiring Commission approval prior to settlement were concerned with the uneven negotiating position of the Commission's staff and the prospective defendant. Those in support of allowing informal settlement procedures prior to Commission approval believed that fairness would be advanced by limiting the time under which a prospective defendant could be exposed to adverse publicity. The ultimate conclusion of the Commission, however, emphasized the due process concerns of Commission oversight.

The Commission's Response to the Wells Recommendations

The recommendations of the Wells Committee were met with mixed responses within the agency. Although the private securities bar generally applauded the recommendations from the Wells Committee, the SEC staff disagreed with many of them, and the commissioners were reluctant to adopt formal rules.[73] With respect to Recommendations 16 and 17, the Commission "agree[d] that the objective [was] sound," but "concluded that it would *not* be in the public interest to adopt formal rules for that purpose."[74] The Commission apparently felt hamstrung by the mandatory-sounding nature of the phrase "except

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72. Letter from Arthur F. Mathews of Wilmer, Cutler & Pickering, to the Advisory Committee on Enforcement Policies and Practices 30 (May 23, 1972). Stanley Sporkin, then an associate director, agreed, stating that "it saved everybody a lot of bother and was welcomed by many of the people we regulate because it gave them a means of settling quickly." Fowlkes, *supra* note 1, at 381.

73. *See* Pitt et al., *supra* note 53, at 63.

74. Procedures Relating to the Commencement of Enforcement Proceedings and Termination of Staff Investigation, Securities Act Release No. 5310, [1972-1973 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 79,010, at 82, 183-86 (Sept. 22, 1972) (emphasis added) [hereinafter SEC Release No. 5310].

where the nature of the case precludes." The Commission believed that the formal adoption of the proposals "could seriously limit the scope and timeliness" of enforcement actions and inject issues "irrelevant to the merits."[75] As a result, the Commission indicated that, where "practical and appropriate," it would allow, on an informal basis, prospective defendants to provide written submissions before a charging decision was reached by the Commission.[76]

Although it did not immediately embrace Recommendations 16 and 17, the Commission eventually adopted the substance of these recommendations in procedural rules in November 1972, formulating today's Wells submission process. The process as adopted provided a proposed defendant or respondent with the opportunity to respond to charges.[77] The Commission notified the public of the opportunity for prospective defendants or respondents to "submit a written statement to the Commission setting forth their interests and positions in regard to the subject matter of the investigation."[78] SEC procedural rules directed the staff, in its discretion, to advise prospective defendants or respondents "of the general nature of its investigation, including the indicated violations as they pertain to them, and the amount of time that may be available for preparing and submitting a statement prior to the presentation of a staff recommendation to the Commission for the commencement of an administrative or injunctive proceeding."[79] The Commission, however, explained that a prospective defendant's opportunity to submit a response was not absolute, and the Commission expressly reserved the right to take any action while awaiting a submission by a proposed defendant or respondent.[80]

The Commission rejected Recommendation 20 of the Wells Committee, which would have permitted settlement discussions prior to authorization from the Commission to commence an action or proceeding.[81] Apparently, the Commission continued to harbor concerns that its discretionary authority regarding the institution of proceedings would be substantially impaired.[82] Irving Pollack, then director of the Division of Enforcement, explained the reason for rejecting the recommendation as two-fold: first, it would be difficult for the Commission to reject a settlement already reached between staff and a prospective defendant; second, there was concern that settlement discussions prior to Commission approval would give the staff the leverage to threaten prospective defendants into submission.[83] Therefore, the procedure described in the 1970 internal directive of requiring the staff to seek Commission approval to bring an action prior to negotiating settlement of it remained in effect.

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75. *Id.* at 2.

76. Stephen A. Glasser, *SEC Adopts Rules Changes in Areas of Enforcement*, N.Y.L.J., Sept. 29, 1972.

77. *See* 37 Fed. Reg. 23,829 (Nov. 9, 1972) (codified at 17 C.F.R. § 202.5(c)).

78. 17 C.F.R. § 202.5(c) (2006).

79. *Id.*

80. *See* SEC Release No. 5310, *supra* note 74, at 2.

81. WELLS COMMITTEE ADVISORY REPORT, *supra* note 39, at 34.

82. *Id.* at 35.

83. Glasser, *supra* note 76.

In 1979, the Commission, under Chairman Harold Williams,[84] formally adopted in the SEC procedural rules the requirement that the enforcement staff must have Commission authorization before engaging in settlement discussions.[85] The Commission reasoned that its involvement in settlement discussions was critical to ensuring a fair process and to protecting the rights of defendants.[86]

Although the Commission did not adopt all of the forty-three specific recommendations, the most obvious legacy of the Wells Committee was the adoption of the "Wells Process," a process whereby prospective defendants or respondents are afforded an opportunity to submit a writing—essentially a brief—to the Commission and its staff after the staff's investigation is completed, but before the staff has made a recommendation to the Commission. Under this procedure, a prospective defendant or respondent enjoys due process—a hallmark of our Anglo-American judicial system.

THE EVOLUTION OF THE ENFORCEMENT PROGRAM AND ITS PHILOSOPHY

Prior to 1990, the SEC's statutory purpose for enforcing the securities laws was to provide remedial relief for aggrieved investors and to deter future violations.[87] The enforcement program began by serving primarily a remedial purpose, through the Commission's injunctive powers and the disgorgement remedies that the Commission fashioned.[88] In the decades following the Wells Committee, the Commission's enforcement actions began to shift from remedial to punitive in nature. This shift of emphasis arose from the new powers that Congress gave the SEC, such as the authority to impose officer and director bars, penalties against individuals and registered entities, and censures in administrative actions.

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84. Harold M. Williams—Biography, http://skadden.com/index.cfm?contentID=45 &bioID=848 (last visited May 8, 2008). During his tenure, Chairman Williams increased the Office of the General Counsel from approximately a dozen attorneys to more than forty attorneys as an alternative source of advice to the Commission on issues such as enforcement matters.

85. *See* 17 C.F.R. § 202.5(f) (2006).

86. John M. Fedders, Dir., Div. of Enforcement, U.S. Sec. & Exch. Comm'n, Remarks to the 1981 SEC Accounting Conference Foundation for Accounting Education: New York State Society of Certified Public Accountants 3-6 (Nov. 16, 1981).

87. *See, e.g.,* Memorandum from John S.R. Shad, Chairman, U.S. Sec. & Exch. Comm'n, to Rep. Timothy E. Wirth, Chairman, Subcomm. Telecomms., Consumer Prot., & Fin. of the H. Energy and Commerce Comm. 350 (Feb. 22, 1984) [hereinafter Memorandum to Chairman Wirth].

88. *See, e.g., SEC v. Manor Nursing Ctrs., Inc.,* 458 F.2d 1082, 1104 (2d Cir. 1972) ("The deterrent effect of an SEC enforcement action would be greatly undermined if securities law violators were not required to disgorge illegal profits."); *SEC v. Commonwealth Chem. Sec., Inc.,* 574 F.2d 90, 102 (2d Cir. 1978) ("[T]he primary purpose of disgorgement is not to compensate investors. . . .[I]t is a method of forcing a defendant to give up the amount by which he was unjustly enriched.").

In 1984, the SEC staff, in response to a congressional request, prepared a review of the adequacy of enforcement sanctions and remedies.[89] The resulting report stated that "[t]he federal securities laws are presently viewed by the courts as remedial rather than punitive" and that the SEC's non-monetary remedies were "effective in most cases" in providing that remedial relief.[90] The staff reported that, aside from the area of insider trading, which Congress was addressing at the time,[91] "the Commission has been unable to identify a serious need for additional remedies to deter a specific type of conduct."[92]

The report asserted that "the advantages of seeking additional civil penalties appear to be marginal" and "must be balanced against a number of potentially serious disadvantages."[93] Chief among those identified disadvantages was the concern that giving the SEC the authority to seek or impose civil monetary penalties for violations of the federal securities laws would "change the character of the enforcement program from remedial to punitive, [and] might lead the judiciary to be less receptive to the SEC's injunctive actions."[94] Traditionally, the Commission relied on the Department of Justice to exercise these remedies through its criminal authority.[95]

By the late 1980s, these philosophical views substantially changed. In a memorandum in support of the Securities Enforcement Act of 1989, the Commission stated that "variable-penalty provisions are appropriate to *penalize and deter the broad range of conduct* for which these penalties will be assessed."[96] The Commission conceded that moving to remedies that were more punitive in nature could result in one of two things: increased difficulty in obtaining settlements as a result of defendants' unwillingness to settle cases involving large civil penalties, thereby potentially harming aggrieved investors, or a greater likelihood of settlement by defendants hoping to avoid much larger civil monetary penalties after litigation.[97] The Commission's asserted need in 1990 to penalize a broad range of conduct was a significant departure from its representation to Congress only six years earlier that its existing remedies were effective.[98]

In 1990, former Director of Enforcement Gary Lynch, who had recently left the SEC, testified before the Senate Subcommittee on Securities. Although he

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89. *See* Memorandum to Chairman Wirth, *supra* note 87 (transmitting "Results of the Review of the Adequacy of Enforcement Remedies and Sanctions").

90. *Id.*

91. Congress was considering proposed legislation that eventually became the Insider Trading Sanctions Act of 1984. *See* Insider Trading Sanctions Act of 1984, Pub. L. No. 98-376, § 1, 98 Stat. 1264 (codified as amended in scattered sections of 15 U.S.C.).

92. Memorandum to Chairman Wirth, *supra* note 87, at 350.

93. *Id.*

94. *Id.*

95. *Id.*

96. U.S. Sec. & Exch. Comm'n, Memorandum of the Securities and Exchange Commission in Support of the Securities Law Enforcement Remedies Act of 1989, *reprinted in* H.R. No. 975, 101st Cong., at 7 (emphasis added) [hereinafter SEC Memorandum in Support of Remedies Act].

97. Memorandum to Chairman Wirth, *supra* note 87, at 350-51.

98. *Id.* at 350.

testified in favor of providing additional penalty powers to the Commission, he cautioned:

> I think it is important for the Commission to maintain its historical focus on achieving remedial relief, rather than taking punitive action in every case, and that the Commission should still continue to judge the effectiveness of the Commission's enforcement program based on what it actually accomplishes, as opposed to what the dollar amount is that is ordered in a particular case.[99]

Congress provided the SEC with enhanced enforcement remedies, including expanded remedial powers and new penalty authority. These powers were included in the Insider Trading Sanctions Act of 1984,[100] the Insider Trading and Securities Fraud Enforcement Act of 1988,[101] and the Securities and Enforcement Remedies and Penny Stock Reform Act of 1990.[102]

As a result of these laws, the SEC gained three significant new sets of powers: (1) the ability to seek civil monetary penalties against persons and entities that may have violated federal securities laws; (2) the authority to bar directors and officers of public companies from serving in those capacities if they violated federal antifraud provisions; and (3) the authority to issue administrative cease-and-desist orders, temporary restraining orders, and orders for disgorgement of ill-gotten profits to violators of federal securities laws. These significant powers and laws enabling them are discussed in more detail below.

The Insider Trading Sanctions Act of 1984

In connection with its enhanced enforcement efforts with respect to insider trading,[103] the SEC submitted proposed legislation to Congress on September 27, 1982, that would authorize the SEC to seek (and a United States District Court to impose) civil monetary penalties of up to three times the profit realized or loss avoided in insider trading cases.[104] At the time of the proposal, the SEC's primary weapons "against insider trading [were] injunction[s] requiring a defendant to comply with the law in the future, and ancillary equitable relief in

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99. *The Securities Enforcement Remedies Act of 1989: Hearing Before the Sec. Subcomm. of the S. Banking, Hous., & Urban Affairs Comm.* (Feb. 1, 1990) (statement of Gary G. Lynch, Fmr. Dir., Div. of Enforcement, U.S. Sec. & Exch. Comm'n).

100. Insider Trading Sanctions Act of 1984, Pub. L. No. 98-376, § 1, 98 Stat. 1264 (codified as amended in scattered sections of 15 U.S.C.).

101. Insider Trading and Securities Fraud Enforcement Act of 1988, Pub. L. No. 100-704, § 1, 102 Stat. 4677 (codified as amended in scattered sections of 15 U.S.C.).

102. Securities Enforcement Remedies and Penny Stock Reform Act of 1990, Pub. L. No. 101-429, 104 Stat. 931 (1990).

103. U.S. Sec. & Exch. Comm'n, Memorandum of the Securities and Exchange Commission in Support of the Insider Trading Sanctions Act of 1982, *reprinted in* H.R. REP. No. 98-355, 98th Cong., at 18 (1984), *and in* 1984 U.S.C.C.A.N. 2274, 2293 [hereinafter SEC Memorandum in Support of Insider Trading Sanction Act].

104. Letter from John Shad, Chairman, U.S. Sec. & Exch. Comm'n, to Hon. Thomas P. O'Neill, Jr., with accompanying memorandum (Sept. 27, 1982), *reprinted in* H.R. REP. No. 98-355, 98th Cong., at 18 (1984), *and in* 1984 U.S.C.C.A.N. 2274, 2292.

the form of disgorgement of illegal profits."[105] Previously, the power to seek "penalties" in the form of prison sentences, criminal fines and restitution resided solely in the Department of Justice ("DOJ") and state authorities.

As a result of the growing number of insider trading cases, the Commission believed that its existing tools of injunctions and disgorgement were inadequate to deter persons from trading on material, nonpublic information. Injunctions, the Commission explained, merely order a defendant prospectively to comply with existing law, and do "not penalize the defendant for the illegal conduct for which the injunction was imposed."[106] The Commission viewed the remedy of disgorgement as likewise inadequate because it merely "strips the defendant of the fruits of his unlawful trading and returns him to the position he was in before he broke the law."[107] Apparently discounting the possible criminal sanctions and the reputational harm associated with injunctive and ancillary relief, the Commission explained to Congress, "[A]n insider who is caught improperly profiting from the use of material information is placed in no worse a position than the honest man who refuses to act."[108]

In response, Congress passed the Insider Trading Sanctions Act of 1984 ("ITSA"), which was signed into law on August 10, 1984. ITSA authorized treble damages in insider trading cases[109] and increased the maximum criminal fine for Exchange Act violations to $100,000.[110] ITSA was the first significant legislation that provided the SEC with the authority to penalize, and it was premised on the Commission's limited belief that penalties in the form of monetary sanctions were necessary to deter the specific securities law violation of insider trading.[111] At that time, the Commission believed that existing remedies were effective against other securities law violations.

Insider Trading and Securities Fraud Enforcement Act of 1988

After the passage of ITSA, Congress continued to evaluate whether the legislation was sufficient to deter insider trading.[112] In the mid-1980s, insider-trading scandals dominated the financial news and involved such high-profile

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105. SEC Memorandum in Support of Insider Trading Sanction Act, *supra* note 103, at 24.

106. *Id.*

107. *Id.*

108. *Id.* (quoting HARVEY J. GOLDSCHMID, REPORT FOR THE U.S. ADMINISTRATIVE CONFERENCE: AN EVALUATION OF THE PRESIDENT AND POTENTIAL USE OF CIVIL MONEY PENALTIES AS A SANCTION BY THE FEDERAL ADMINISTRATIVE AGENCIES 36 (1972)).

109. *See* Insider Trading Sanctions Act of 1984, Pub. L. No. 98-376, § 2, 98 Stat. 1264 (codified as amended in scattered sections of 15 U.S.C.).

110. *See id.* § 3. Previously, the maximum criminal fine for Exchange Act violations was $10,000. *Id.*

111. *See* Memorandum to Chairman Wirth, *supra* note 87 (transmitting "Results of the Review of the Adequacy of Enforcement Remedies and Sanctions").

112 . *See* Thomas J. Woo, *Legislation and Legitimation: Congress and Insider Trading in the 1980s* (The Berkeley Electronic Press, Working Paper No. 941, 2006), *available at* http://law.bepress.com/cgi/viewcontent.cgi?article=4566&context=expresso.

Wall Street traders as Ivan Boesky, Michael Milken, and Dennis Levine.[113] Insider trading became the focus of Congressional hearings in June and July 1986 and continued to be the focus of hearings for the next several years.[114]

In 1988, members of the House Committee on Energy and Commerce introduced additional legislation "[a]fter learning of an increasing number of serious insider trading cases."[115] The new legislation, the Insider Trading and Securities Fraud Enforcement Act of 1988 ("ITSFEA"), was prompted by an "unstated premise that broker-dealers in particular, and others in general, were not doing enough to detect and deter insider trading."[116]

Congress passed ITSFEA and President Reagan signed it into law in November 1988. The new law extended the SEC's authority to impose penalties on persons who control a person who trades on material nonpublic information in violation of the law,[117] and it required broker-dealers and investment advisers to "establish, maintain, and enforce written policies and procedures reasonably designed . . . to prevent the misuse . . . of material, nonpublic information."[118] ITSFEA extended the DOJ's criminal authority by: (1) increasing maximum criminal fines for Exchange Act violations to $1,000,000 for individuals and $2,500,000 for non-natural persons;[119] (2) increasing the maximum duration of imprisonment to ten years;[120] and (3) authorizing the payment of a reward to those "persons who provide information leading to the imposition of [a] penalty."[121] ITSFEA also vested private plaintiffs with authority to assist in the deterrence effort by creating an express private right of action against insiders who trade on material nonpublic information.[122]

The Securities Enforcement Remedies and Penny Stock Reform Act of 1990

In October 1987, prior to the passage of the ITSFEA, the National Commission on Fraudulent Financial Reporting—dubbed the "Treadway Commission" after its chairman, former SEC Commissioner James C. Treadway,

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113. *Id.* at 7.

114. *Id.*

115. Stuart J. Kaswell, *An Insider's View of the Insider Trading and Securities Fraud Enforcement Act of 1988*, 45 BUS. LAW. 145 (1989); *see also* H.R. REP. No. 100-910, 100th Cong., at 7 (1988), *reprinted in* 1988 U.S.C.C.A.N. 6043, 6044 ("The Insider Trading and Securities Fraud Enforcement Act of 1988 represents the response of [the House Committee on Energy and Commerce] to a series of revelations over the last two years concerning serious episodes of abusive and illegal practices on Wall Street.").

116. Kaswell, *supra* note 115, at 156.

117. Insider Trading and Securities Fraud Enforcement Act of 1988, Pub. L. No. 100-704, § 3, 102 Stat. 4677 (codified as amended in scattered sections of 15 U.S.C.). The penalty authorized for such control persons could not exceed the greater of three times the profit realized or loss avoided or $1,000,000. *Id.*

118. *Id.*

119. *Id.* § 4.

120. Id.

121. *Id.* § 3.

122. *Id.* § 5.

Jr.—published a comprehensive report that identified causes of financial reporting fraud and issued recommendations for their reduction.[123] The Treadway Commission Report recommended the creation of additional SEC enforcement remedies, namely the imposition of fines outside the limited context of insider trading cases, cease-and-desist orders and corporate officer and director bars or suspensions.[124] The stated purpose of these proposals was to afford the Commission "[t]he ability to tailor enforcement actions more precisely to particular facts[,] [thereby] enabl[ing] the SEC to maximize its enforcement effectiveness."[125] In response to the Treadway Commission Report, the chairman directed the staff to develop legislative recommendations in response to the conclusions of the Treadway Commission.[126]

Although the House Committee on Energy and Commerce anticipated taking up the SEC's legislative proposals in response to the Treadway Commission at the same time the House Committee considered ITSFEA,[127] the SEC was unable to complete its proposals in time for inclusion in that legislation.[128] To prompt the SEC to submit additional legislative proposals, Congress added section 3(c) to ITSFEA, which directed the Commission to submit to Congress "any recommendations the Commission considers appropriate with respect to the extension of the Commission's authority to seek civil penalties or impose administrative fines."[129]

After ITSFEA was passed, but before it was signed into law, the Commission submitted to Congress its first recommended legislative response to the recommendations of the Treadway Commission.[130] The Commission initially asked for the authority to seek civil penalties in all administrative proceedings, including in proceedings against issuers under explicit, limited circumstances.

In a memorandum to Congress, the Commission, under Chairman David Ruder, set forth the factors that should be considered in determining whether to seek a civil penalty against an issuer in an administrative proceeding.[131] First, the SEC underscored that the proposed law would not "dictate" that the Commission must seek or impose a civil penalty against an issuer.[132] Instead, as the Commission explained, the Commission could proceed against culpable individuals and exercise discretion in *not* seeking an issuer penalty.[133] Second, the Commission stressed that it "may properly take into account its concern that civil penalties assessed against corporate issuers will ultimately be paid by

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123. *See* NAT'L COMM'N ON FRAUDULENT FIN. REPORTING, REPORT OF THE NATIONAL COMMISSION ON FRAUDULENT FINANCIAL REPORTING (1987), *available at* http://www.coso.org/Publications/NCFFR.pdf.

124. *See id.* at 64-67.

125. *Id*. at 64.

126. Kaswell, *supra* note 115, at 171.

127. *Id.*

128. *Id.*

129. Insider Trading and Securities Fraud Enforcement Act § 3.

130. *See* H.R. REP. No. 101-616, 101th Cong., at 15 (1990), *reprinted in* 1990 U.S.C.C.A.N. 1379.

131. SEC Memorandum in Support of Insider Trading Sanction Act, *supra* note 103, at 4.

132. *Id.*

133. *Id.*

shareholders who were themselves victimized by the violations."[134] The Commission explained that penalties should be assessed against issuers only in the rare situation where the issuer received a "direct economic benefit" from the fraud:

> In a typical case of financial fraud in which a[n] issuer overstates it[s] 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.*[135]

The Commission further elaborated in a footnote on the limited instances where shareholders of a company might have received a direct economic benefit from fraud:

> The lack of a direct economic benefit to shareholders differentiates financial fraud from other types of violations for which public companies may be fined under other statutes. For example, if a corporation violates environmental standards relating to emissions control, it generally realizes a cost saving that is ultimately realized by shareholders.[136]

Third, the Commission stated that a civil penalty should be imposed on an issuer "only where the violation resulted in an improper benefit to shareholders," but that, even under those circumstances, the passage of time and resulting shareholder turnover may weigh against imposing a penalty.[137]

Central to the Commission's analysis of the propriety of seeking a penalty against an individual or an issuer was whether the penalty would serve a "public interest."[138] To that point, the Commission outlined several additional factors it would consider to determine if the penalty was in the public interest:

- whether the act or omission for which such penalty is assessed involved fraud, deceit, manipulation, or deliberate or reckless disregard of a regulatory requirement;
- the harm to other persons resulting either directly or indirectly from such act or omission;

134. *Id.*
135. *Id.* (emphasis added).
136. *Id.* at 4 n.5
137. *Id.* at 5.
138. *Id.* at 9.

- the extent to which any person was unjustly enriched, *taking into account any restitution made to persons injured by such behavior*;[139]
- whether such person previously has been found by the Commission, other appropriate regulatory agency, or self-regulatory organization to have violated the federal securities laws, state securities laws, or the rules of a self-regulatory organization, or has been enjoined by a court of competent jurisdiction from violations of such laws or rules;
- the need to deter such person and other persons from committing such acts or omissions; and
- such other matters as justice may require.[140]

In its February 1, 1990, "modified proposal" to Congress, the Commission removed its request for the authority to seek civil monetary penalties against issuers in administrative proceedings.[141] The Commission also removed its prior request for authority to impose officer and director bars in administrative proceedings.[142] The modified proposal added provisions that expressly authorized the SEC to issue cease-and-desist orders and to order disgorgement in administrative proceedings, and allowed federal courts to bar persons from serving as directors or officers.[143] The Commission's "modified proposal" eventually became law through the "the Securities Enforcement Remedies and Penny Stock Reform Act of 1990," commonly referred to as "The Remedies Act."

As enacted, the Remedies Act significantly expanded the permissible enforcement remedies the Commission may seek in civil proceedings or impose in administrative proceedings.[144] The Remedies Act formulated a three-tiered penalty framework, which sets forth the amount of a fine based on the number

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139. *Id.* (emphasis added); *compare* Press Release, U.S. Sec. & Exch. Comm'n, Statement of the Securities and Exchange Commission Concerning Financial Penalties (Jan. 4, 2006) (omitting this clause), *available at* http://www.sec.gov/news/press/2006-4.htm.

140. SEC Memorandum in Support of Insider Trading Sanction Act, *supra* note 103, at 9.

141. *See The Securities Law Enforcement Act of 1990: Hearings on S. 647 Before the S. Subcomm. on Sec.,* 101st Cong. 31 (1990) (statement by Richard C. Breeden, Chairman, U.S. Sec. & Exch. Comm'n).

142. *Id.*

143. *Id.*

144. For a general discussion of each class of remedies created by the Remedies Act, *see* Richard A. Spehr & Michelle J. Annunziata, *The Remedies Act Turns Fifteen: What is its Relevance Today?*, 1 N.Y.U J.L. & Bus. 587, 589-95 (2005).

and nature of violations.[145] At each tier, the fine may not exceed the higher of the gross pecuniary gain or the maximum statutory amount.[146] This variable penalty framework was not in the original draft of the Remedies Act but was later included to reflect the Commission's belief that variable penalties would aid in tailoring the size of the penalty to fit the circumstances of individual cases.[147]

The Remedies Act further gave the SEC the power to seek (and an administrative law judge to impose) civil penalties through administrative proceedings against specified persons and entities directly regulated by the Commission, such as broker-dealers and investment advisors, when a penalty would be in the "public interest."[148] The Remedies Act also gave the SEC the power to seek civil monetary penalties against issuers, but only in federal court proceedings. Although Congress understood that imposing civil monetary penalties on issuers would harm shareholders,[149] Congress expected that the SEC would exercise discretion and seek civil monetary penalties against issuers *only* when a violation resulted in improper benefits to shareholders.[150]

Congress took comfort in the fact that federal judges would operate as an independent check to the Commission's decision to seek an issuer penalty and the amount sought to be recovered. The concern among members of Congress and internally at the SEC was that if the same remedies were available to the SEC under both judicial and administrative proceedings, then the SEC might be perceived to have an incentive to conduct more enforcement actions through its

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145. *See* The Securities Law Enforcement Remedies Act of 1990, S. REP. No. 101-337, 101st Cong. (1990). Originally, there were three tiers of maximum penalty amounts separated according to the gravity and extent of harm caused by the violation, and each penalty is per violation. For SEC administrative proceedings, the first tier penalty was $5,000 for natural citizens and $50,000 for any other person. The second tier maximum penalty was $50,000 for natural persons and $250,000 for any other person and applies to violations involving fraud, deceit, manipulation or deliberate or reckless disregard of a regulatory requirement. The third-tier penalty for natural persons was $100,000 and $500,000 for any other person and applies to violations that either resulted in substantial losses to other persons or created the risk of such losses. These amounts have been increased by subsequent regulation. *See* 17 C.F.R. 201.1001, *et seq.* (citing the Debt Collection Improvement Act of 1996).

146. *See id.*

147. *See* SEC Memorandum in Support of Insider Trading Sanction Act, *supra* note 103, at 49; *see also* S. REP. No. 101-337, 101st Cong. (1990)

148. *See* Securities Enforcement Remedies and Penny Stock Reform Act of 1990, Pub. L. No. 101-429, § 202, 104 Stat. 931 (1990) (for certain Exchange Act violations); *id.* § 301 (for certain Investment Company Act violations); *id.* § 402 (for certain Advisers Act violations).

149. *See The Securities Law Enforcement Remedies Act of 1990: Hearings on S. 647 Before the S. Subcomm. on Sec.,* 101st Cong. 85 (1990) (statement by Sen. John Heinz) ("Doesn't the imposition of a fine against a publicly held company penalize the shareholder?").

150. *See* S. REP No. 101-337, 101st Cong. 16-17 (1990). Echoing the Commission's intent, the Senate Committee on Banking, Housing, and Urban Affairs stated that it

> intends that a penalty be sought when the violation results in an improper benefit to shareholders. In cases in which shareholders are the principal victims of the violations, the Committee expects that the SEC, when appropriate, will seek penalties from the individual offenders acting for a corporate issuer. Moreover, in deciding whether and to what extent to assess a penalty against the issuer, the court may properly take into account whether civil penalties assessed against corporate issue[r]s will ultimately be paid by shareholders who were themselves victimized by the violations.

own administrative proceedings, rather than before a federal district court judge. The final legislation did not include penalty authority in administrative proceedings precisely because there would be no oversight by Article III judges as there would be in civil proceedings. In practice, however, public companies seldom choose to litigate with the SEC, and *settled* injunctive actions rarely receive any detailed judicial scrutiny. To guarantee the safeguards that normally accompany a judicial determination of a penalty, commissioners must exercise sufficient, policy-level scrutiny, such as the "public interest" analysis described above, in evaluating a penalty recommendation.[151]

After the Remedies Act was signed into law in 1990 and before the SEC's April 2002 Xerox case,[152] the Commission brought only four issuer-penalty cases, totaling less than $5 million.[153] The Xerox case, in which the company paid a $10 million penalty, is viewed by many as the beginning of the "corporate penalty era" at the Commission. Between the Xerox case and the date this Article was written, the Commission has imposed penalties against approximately sixty issuers, totaling billions of dollars.

THE CORPORATE SCANDALS AT THE BEGINNING OF THE 21ST CENTURY

In the first years of this century, the investing public was scarred by major corporate scandals leading to the demise of several large companies such as Enron Corp.[154] and WorldCom Inc.[155] that were viewed previously as paragons of industry. Congress reacted to the new spate of corporate scandals in the same

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151. In January 2006, the Commission issued a statement outlining the parameters under which it would consider seeking penalties against issuers. *See infra,* text accompanying notes 178-181.

152. Xerox Corp., Litigation Release No. 17465, 77 SEC Docket 971, 2002 WL 535379 (Apr. 11, 2002).

153. There were large penalties against registered entities during this period. *See, e.g.,* Press Release, Department of Justice and SEC Enter $290 Million Settlement with Solomon Brothers in Treasury Securities Case, *available at* http://www.usdoj.gov/atr/public/press_releases/1992/211182.htm. These penalties are not discussed in this Article because they were levied against registered entities for defrauding their customers or the market, as opposed to defrauding their shareholders.

154. At the time that it declared bankruptcy in 2001, Enron was the seventh largest company on the Fortune 500 list by revenues. *See* Matt Moore, *Bankrupt Enron No. 5 in Fortune 500 List,* HOUSTON CHRONICLE, Apr. 4, 2002, *available at* http://www.chron.com/disp/story.mpl/special/enron/1327642.html.

155. Until the financial problems of WorldCom became acute in spring 2002, the bills under consideration in the Senate and House were not given much chance of passage. *See* Peter J. Wallison, *Sarbanes-Oxley as an Inside-the-Beltway Phenomenon,* AMERICAN ENTER, I NST. FOR PUB. POLICY RESEARCH, June 2004, at 2, *available at* http://www.aei.org/publications/pubID.20582/pub_detail.asp. The collapse of WorldCom, relatively close to the 2002 congressional election, which both political parties acknowledged as a rematch of the very close presidential election of 2000, led to the eventual enactment of the Sarbanes-Oxley Act, with only three votes against it in the entire Congress. Some in Washington dubbed the Sarbanes-Oxley Act the "Bernie Ebbers Memorial Act" after the then-CEO of WorldCom.

way that it did in response to the insider trading scandals of the 1980s—it provided the SEC with significant authority to enforce new and existing laws.[156] The Sarbanes-Oxley Act of 2002 imposed significant, additional requirements on corporations and their officers and directors.[157] The Sarbanes-Oxley Act greatly expanded the Commission's enforcement powers and the criminal penalties for violating the federal securities laws.[158]

Section 1105 of the Sarbanes-Oxley Act permits the SEC to obtain officer and director bars in administrative proceedings, and section 305(a) amended 15 U.S.C. § 78u(d)(2) and 15 U.S.C. § 77t(e) by lowering the standard for obtaining a bar from "substantially unfit" to "unfit." Prior to the adoption of the Sarbanes-Oxley Act, an officer and director bar was available only in civil injunctive actions after a showing that the officer or director was "substantially unfit" to serve in the position.[159]

Section 308(a) of the Sarbanes-Oxley Act contained a novel "Fair Funds" provision that allows the Commission to disperse the penalties obtained from wrongdoers to compensate harmed shareholders.[160] Section 308 had no counterpart in the Senate bill, because it was added during the conference process.[161] Accordingly, the Senate Banking Committee report does not discuss this provision.

Prior to Section 308(a), the Commission was permitted to remit amounts obtained in actions as *disgorgement* to injured investors, but was required to remit any *penalties* it received to the U.S. Treasury. Section 308(a) provided flexibility to the Commission to distribute both disgorgement and penalties through a Fair Fund, but the penalties cannot be dispersed absent disgorgement of ill-gotten gains.[162] Congress, joined by the Justice Department, wanted to avoid having penalties become a substitute for disgorgement. Disgorgement is the forfeiture of the ill-gotten gains received by the defendant; it is not inherently a mechanism to recompense aggrieved investors. By making disgorgement a prerequisite for

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156. In the intervening years following the Remedies Act, Congress did not adjust the SEC's enforcement authority to any great extent. The principal exception was the Private Securities Litigation Reform Act of 1995 § 104, Pub. L. No. 104-67, 109 Stat. 737 (1995) (codified at 15 U.S.C. 78t(e)). The PSLRA amended the securities laws to allow the SEC to bring actions against secondary violators that aid and abet securities law violations. Congress wisely declined to extend that right to private parties, out of concern over abusive securities litigation.

157. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (codified in scattered sections of 11, 15, 18, 28, and 29 U.S.C.).

158. The changes relevant to this Article are discussed below. The Sarbanes-Oxley Act included other provisions that are not discussed here.

159. Sarbanes-Oxley Act § 1105, 15 U.S.C. 7246 (2006).

160. *Id.* § 308(a).

161. *See* Press Release, Baker Proposes New Federal Investor Restitution Fund (July 17, 2002), *available at* http://web.archive.org/web/20031108035021/www.baker.house.gov/News/fair_fund.htm [hereinafter Baker I].

162. *See* Sarbanes-Oxley Act § 308(a). Within the first six months of having the authority, the Commission sought federal court approval of Fair Fund distributions on at least 12 occasions. Stephen Cutler, Dir. of Enforcement, U.S. Sec. & Exch. Comm'n, Testimony Concerning Returning Funds to Defrauded Investors Before the H. Subcomm. on Capital Mkts., Ins., & Gov't Sponsored Enters., Comm. on Fin. Servs. 10 (Feb. 26, 2003) *available at* http://www.sec.gov/news/testimony/022603tssmc.htm [hereinafter Cutler Testimony].

adding penalties to the Fair Fund, Congress focused on depriving the defendant of its ill-gotten gains, not necessarily punishing wrongdoers.[163] Congress also may have been concerned with a possible windfall to investors if the defendant did not receive any ill-gotten gain from the wrongdoing.

Congress also required the SEC to study ways to improve the Fair Funds process. Section 308(c) of Sarbanes-Oxley instructed the SEC to review and analyze enforcement actions over the course of the five years prior to enactment "to identify areas where such proceedings may be utilized to efficiently, effectively, and fairly provide restitution for injured investors . . . including methods to improve the collection rates for civil penalties and disgorgements."[164] Section 308(c) instructed the SEC to provide a report to Congress within 180 days of the enactment of the Act that included "a discussion of regulatory or legislative actions" that the SEC recommended or "that may be necessary to address concerns identified in the study."[165]

In response to Section 308(c), the Commission submitted a report to Congress on January 23, 2003.[166] In its report, the Commission described the limitations of the requirement in Section 308(a) for the SEC to obtain disgorgement before adding the penalty amount to the Fair Fund:

> Currently, the Fair Fund provision permits the Commission to add penalty money to distribution funds in limited circumstances. If a defendant is ordered only to pay a penalty, then that defendant's penalty amount cannot be added to the disgorgement fund. Moreover, if no defendants in a case are ordered to pay disgorgement, then no penalties may be distributed to injured investors. Some issuer financial fraud and reporting cases do not result in any disgorgement orders because no defendant received a tangible profit causally connected to the fraud.[167]

To alleviate these restrictions, the Commission recommended that Congress amend Section 308 to permit the penalties to be added to the Fair Funds even when no disgorgement is obtained. The Commission's report stated:

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163. *See* Press Release, Baker Statement to Open House-Senate Conference on Corporate Reform (July 19, 2002), *available at* http://web.archive.org/web/20030906035258/www.baker.house.gov/News/conf_corprfm.htm.

> How is it possible for anyone to sit idly by while watching a corporate official move into his $20 million mansion, with hundreds of millions of dollars in retirement benefits, having generated this lifestyle by manipulating the books and defrauding shareholders? With the adoption of the FAIR plan, we will make this much less likely to occur and offer the hope to investors for a small reduction in their loss.

Id.; see also Baker I, *supra* note 161.

164. Sarbanes-Oxley Act § 308(c).

165. *Id.*

166. *See* U.S. SEC. & EXCH. COMM'N, REPORT PURSUANT TO SECTION 308(C) OF THE SARBANES OXLEY ACT OF 2002, *available at* http://www.sec.gov/news/studies/sox308creport.pdf.

167. *Id.* at 34.

> By amending the Fair Fund provision to allow defendants' penalties to be distributed to investors irrespective of whether the defendant has been ordered to disgorge money, Congress could allow more monies to be returned to harmed investors.[168]

In response to the Commission's request, Chairman Richard Baker of the Subcommittee on Capital Markets, Insurance, and Government-Sponsored Enterprises of the House Financial Services Committee introduced legislation in 2003 and 2006 to permit any penalty monies obtaining by the Commission to be added to a Fair Fund for the benefit of victims of the securities law violation.[169] Neither bill passed Congress.[170]

Proponents of corporate penalties argue that the Fair Funds provision of the Section 308 of the Sarbanes-Oxley Act alleviates the earlier concerns raised by the Commission in 1989 and Congress in 1990 about harm to shareholders, because any penalties collected are distributed to shareholders. This argument is premised on flawed, circular reasoning. When the Commission obtains penalties from a corporation, there is always one group of shareholders that must pay. The Commission is taking from one group of shareholders to recompense another.[171] Whatever its characterization, ultimately the costs of making this circular distribution are borne by shareholders.

There is no doubt that Section 308 was rooted in good intentions of attempting to help defrauded shareholders. Unfortunately, it has injected an element of uncertainty because penalties are inherently subjective, while disgorgement is rooted in the notion of illicit gain, which generally is quantifiable. In many instances, the SEC has avoided—some argue circumvented—the requirements of Section 308 by assessing a "nominal" disgorgement amount of $1 in order to obtain the "hook" to justify seeking a large corporate penalty to put

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168. *Id.; see also* Cutler Testimony, *supra* note 162.

> [I]t would be beneficial if the Commission could distribute penalties collected from these defendants (as well as from defendants who are paying disgorgement) to harmed investors in that case . . . . We recommend making technical amendments to the Fair Fund provision to permit the Commission to use penalty moneys for distribution funds in these additional circumstances.

Id.

169. *See* Fair Fund Improvement Act, H.R. 5956, 109th Cong. (2006); Securities Fraud Deterrence and Investor Restitution Act of 2004, H.R. 2179, 108th Cong. (2004); Dissenting Views to Accompany H.R. 2179, H.R. REP. No. 108-475 (Apr. 27, 2004); *see also* Press Release, Baker, Oxley Introduce Bill To Strengthen SEC Powers Against Securities Fraud, Return Funds To Defrauded Investors (May 21, 2003), *available at* http://web.archive.org/web/20030602192406/www.baker.house.gov/News/fair_bill.htm.

170. The bills did not advance in Congress because of the general unwillingness to re-open the Sarbanes-Oxley Act of 2002.

171. The Fair Fund distribution thus creates a circular situation: the Commission penalizes a corporation to put the money into a fund to reimburse the shareholders who were themselves just indirectly penalized.

into a Fair Fund for distribution.[172] As a result, the Fair Fund provision, which was designed to *protect* shareholders, has been used as a justification for obtaining large corporate penalties, which may *harm* shareholders. Therein lies the paradox: Fair Funds used to compensate injured shareholders are often funded largely through corporate penalties, which are paid by the corporation's current shareholders and result in additional adverse consequences for the company through depletion of its assets.

AN ERA OF INCREASING PENALTIES AGAINST SHAREHOLDERS

The size of the penalties imposed by the Commission has increased markedly in recent years.[173] For example, in 2002, the SEC obtained its first $10 million penalty against a public corporation in its settlement with Xerox Corporation.[174] Since then, the Commission has levied many civil penalties in that amount or larger. In 2003, the Commission obtained twenty penalties in that range or greater, while in 2004, it obtained forty such penalties.[175] The total amount of issuer penalties in 2003 and 2004 was greater than the total amount of *all* penalties imposed by the SEC for the prior fifteen years combined. From 2003

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172. *See, e.g.,* Bruce Carton, *When a Dollar (of Disgorgement) Is Worth Millions,* SEC. CLASS ACTION SERV., (Institutional S'holder Servs.), Dec. 3, 2004, *available at* http://scas.issproxy.com/Newsletter/issscasDecember2004.html#POVEditorial (discussing recent settlements such as Symbol Technologies ($1 disgorgement; $37,000,000 civil penalty), i2 Technologies ($1 disgorgement; $10,000,000 civil penalty), Royal Dutch Petroleum ($1 disgorgement; $120,000,000 civil penalty), Bristol-Myers Squibb Co. ($1 disgorgement; $150,000,000 civil penalty), and Qwest ($1 disgorgement; $250,000,000 civil penalty)). Disgorgement is a remedy that, if available, is supposed to be exhausted before the SEC seeks a penalty. Therefore, only in the rarest of circumstances should the SEC seek a penalty that accomplishes the goal of stripping away an ill-gotten benefit. Unfortunately, that has not been the case in many SEC penalty actions. Many of those actions have blurred the distinction between "benefit" and "restitution."

173. Not only have civil monetary penalties increased, the number of officer and director bars has also increased drastically over the last several years as has the involvement of criminal authorities, such as the Department of Justice, in securities law violations. In 2004, 170 director and officer bars were entered—more than three times as many as entered in 2001—and the DOJ brought criminal proceedings against 302 entities and individuals in SEC related matters. U.S. CHAMBER OF COMMERCE, REPORT ON THE CURRENT ENFORCEMENT PROGRAM OF THE SECURITIES AND EXCHANGE COMMISSION 25 (2006), *available at* http://www.uschamber.com/NR/rdonlyres/eodmudjqljq2lvttjhn56rn4uubva3yoyzeijj2sh4ugkxlo6xyrpu3cqismvuckpgea3o4gpn4utyo7uzs7ueqydmc/0603SECEnforcementStudy.pdf.

174. Xerox Corp., Litigation Release No. 17465, 77 SEC Docket 971, 2002 WL 535379 (Apr. 11, 2002); *see* U.S. SEC. & EXCH. COMM'N, 2004 ANNUAL PERFORMANCE PLAN AND 2002 ANNUAL PERFORMANCE REPORT (2003), *available at* http://www.sec.gov/about/gpra2004_2002.pdf.

175. *See* U.S. SEC. & EXCH. COMM'N, 2004 ANNUAL PERFORMANCE REPORT (2005), *available at* http://www.sec.gov/about/secpar/secpar04.pdf; U.S. SEC. & EXCH. COMM'N, ANNUAL REPORT 2003 (2004), *available at* http://www.sec.gov/pdf/annrep03/ar03full.pdf.

through 2007, approximately $13.8 billion in disgorgement and civil penalties were ordered to be paid to the SEC, courts, or other appointed trustees.[176]

An essential consideration in deciding the appropriateness of any corporate penalty is determining who has profited from the illegal conduct. Sometimes, shareholders have benefited, as in cases of price fixing or bribery of foreign officials; without the bribe, the corporation would not have received a benefit. Regulated entities, such as broker-dealers or registered investment advisors, might increase profits or revenues, which in turn benefit shareholders, by failing to comply with regulatory requirements.[177] In the rare instances where disgorgement may be difficult to calculate, corporate penalties may be appropriate to reverse the ill-gotten benefit.

On the other hand, there are situations where the shareholders did not benefit from the securities law violation. In a typical financial fraud case, management misrepresented the corporation's financial performance to the owners of the corporation. In the typical case, the shareholders have suffered from management's deception and received no ill-gotten gain. When the fraud becomes public, often the market reacts by depressing the value of the stock. In addition, an investigation and ensuing litigation distracts management from the business, drains corporate resources, and harms the corporation's reputation. A penalty would add further to shareholder injury.

In the majority of SEC corporate penalty cases, the corporation has also been sued for the same transgressions in civil class action suits seeking restitution for allegedly harmed shareholders. Settlement proceeds from such private actions should be recognized by the Commission as an offset when determining whether to penalize a corporation in a financial fraud case. Indeed, by statute, the Commission must consider such restitution in its own administrative proceedings when a penalty is under consideration.

Another essential consideration in seeking and imposing a penalty is the effectiveness of the sanction. There is an inherent conflict of interest between management and shareholders of a corporation. If senior managers are faced with the threat of enforcement actions against them or their former colleagues, the senior managers might be motivated by their self-interest to settle the action against the corporation for a large corporate penalty. The penalty obtained in settlement with the corporation may satisfy the SEC's desire to garner public awareness (and thus enhance the "deterrent" effect), causing the SEC to forgo seeking large penalties against individual managers. This willingness to forgo seeking penalties against individuals increases when the evidence against the individuals is relatively weak (indicating a greater risk of losing at trial), or when the individuals have negligible assets or name recognition (diminished publicity and deterrence value).

Other potential conflicts of interest exist between management and shareholders that may interfere with the effectiveness of the sanction. New senior managers, who may have started after the departure of former employees tainted by the fraud, may feel compelled to settle the matter to minimize negative

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176. 2007 REPORT, *supra* note 9, at 26.
177. Penalty figures in this Article do not include regulated entities.

publicity from their being associated with the fraud. In addition, corporate boards, while exercising business judgment, may approve a settlement to avoid the costs and other negative effects of prolonged litigation with the SEC.

As both a philosophical and practical matter, the effectiveness of a corporate penalty as a means for deterrence is questionable. Corporations do not act; individuals do. Senior managers who commit fraud undoubtedly do so with the knowledge that their actions, if exposed, will cause reputational and economic harm to their corporation, such as a depressed stock price, loss of customers and business partners, shareholder litigation, and legal and investigative costs. Often, what motivates the wrongdoer to commit the fraud is the potential personal pecuniary gain of increased stock price, personal advancement within the corporation, or masking the negative effects of strategic or tactical management decisions on the performance of the company. If wrongdoers have little concern for their company and shareholders when they commit the fraud, it is doubtful that the behavior of potential wrongdoers will be altered by the threat of a corporate penalty on the company and shareholders that they are seeking to victimize. Are would-be fraudsters more likely to be deterred by headlines trumpeting a multimillion dollar corporate fine, or by hearing that a senior executive was fired, lost his savings, became barred from serving as an officer or a director, suffered irreparable harm to his reputation, and perhaps faces incarceration?

Each of these considerations continues to be important when the Commission evaluates whether to seek a penalty against a corporation. In providing the SEC with the power to seek penalties against corporations, Congress recognized the need for the SEC to have the authority in limited and rare circumstances, and it trusted the SEC with the discretion to use that authority in accordance with the SEC's mission of protecting investors. In order to provide some transparency to the process, the Commission has issued guidance to the public concerning what factors the Commission considers and what prospective defendants may do to avoid a penalty or reduce the amount.

THE 2006 STATEMENT OF THE SECURITIES AND EXCHANGE COMMISSION CONCERNING FINANCIAL PENALTIES

Under a new chairman, the Commission on January 4, 2006, released a statement concerning the factors that the SEC would evaluate in assessing a monetary penalty.[178] In formulating the penalty statement, the Commission returned to first principles: it discussed the 1989 and 1990 Commission and Congressional statements regarding penalties and attempted to set up a hierarchy of balancing considerations to guide future deliberations. It stated unequivocally

178. Press Release, U.S. Sec. & Exch. Comm'n, Statement of the Securities and Exchange Commission Concerning Financial Penalties (Jan. 4, 2006), *available at* http://www.sec.gov/news/press/2006-4.htm [hereinafter 2006 Penalty Statement].

that penalties against corporations can harm shareholders, a point that previously had been in dispute within the Commission.

The Commission explained that the two most significant factors are: (1) the presence or absence of a direct benefit to the corporation as a result of the violation, and (2) the degree to which the penalty will recompense or further harm shareholders.[179] The first key factor focused on unjust enrichment to the corporation, and thus to the shareholders. Any improper benefit would have to be balanced against the losses incurred by the shareholders as a result of the fraud.

The second key factor balances the possibility that the penalty will "recompense" investors with the injury that the penalty would do to them. In this factor, the Commission, unfortunately, was rather imprecise with its terms. In every case, current stockholders pay for the penalty. The purpose of this language was to cover the cases in which other classes of investors may have been harmed for the benefit of the stockholders—for example, fraudulently enhanced financial statements may have resulted in lower coupon interest rates or yields to bondholders, to the benefit of the corporation and its common stockholders.

The Commission also announced secondary factors for consideration. Those factors are: (1) "The need to deter the particular type of offense;" (2) "The extent of the injury to innocent parties;" (3) "Whether complicity in the violation is widespread throughout the corporation;" (4) "The level of intent on the part of the perpetrators;" (5) "The degree of difficulty in detecting the particular type of offense;" (6) "Presence or lack of remedial steps by the corporation;" and (7) "Extent of cooperation with Commission and other law enforcement."[180]

The penalty statement has served as a reminder of the fact that corporate penalties harm shareholders. Nevertheless, it has had some unintended consequences. In particular, the last factor—the extent of cooperation with the Commission and law enforcement—has been used along with other Commission guidance as a means to *credit* prospective defendants, particularly corporations, for waiving their attorney-client privilege and work-product protections.[181]

The SEC's explicit willingness to credit cooperation, even if it involves the waiver of the attorney-client privilege and work-product protection, predates the 2006 Statement on Penalties and the Sarbanes-Oxley Act. On October 23, 2001, the Commission released an investigative report pursuant to section 21(a) of the Exchange Act, addressing the relationship of cooperation and agency

179. *Id.*

180. *Id.*

181. The New York Stock Exchange lists waiver of the attorney-client privilege as a factor in evaluating whether a Member has exhibited "extraordinary cooperation." *See* New York Stock Exchange, Information Memorandum No. 05-65 to All Members, Member Organizations and Chief Operating Officers 5 (Sept. 14, 2005). Members of the New York Stock Exchange are required as a condition for listing to cooperate and produce documents upon request by the Exchange, but that required cooperation does not include a mandatory requirement to produce attorney-client privileged information. FINRA (formerly NASD) Rule 8210 requires members and persons associated with members to produce non-privileged documents and provide testimony upon request by FINRA. *See* FINRA Rule 8210, *available at* http://finra.complinet.com. As a general matter, the SEC does not impose any similar mandatory requirements to cooperate in its investigations.

enforcement decisions.[182] That report, called the "Seaboard Report" based on the name of the defendant at issue, marked the first time that the Commission announced the factors that it would evaluate in measuring cooperation and assessing whether to bring an enforcement action.

The Commission intended this report to encourage companies to cooperate with the SEC in investigations. In that respect, the report was a major improvement in the transparency of the SEC in its enforcement investigations. Lacking a public manual of policies and procedures, the SEC in effect encouraged an informal body of knowledge to develop among long-time SEC enforcement practitioners as to what was expected of potential defendants in dealing with the Commission.[183] The Seaboard report was a long-overdue attempt to open up the process.

Among other issues, the Seaboard Report discussed disclosures to staff of confidential information protected by the attorney-client privilege or work-product doctrine. In a footnote, the Seaboard Report stated:

> The Commission recognizes that these privileges, protections and exemptions serve important social interests. In this regard, the Commission does not view a company's waiver of a privilege as an end in itself, but only as a means (where necessary) to provide relevant and sometimes critical information to the Commission staff.[184]

Waiver is not itself listed as one of the Seaboard criteria for determining whether, and how much, to credit self-policing, self-reporting, remediation, and cooperation. Nonetheless, the Enforcement Division and the Commission in the ensuing years often have misinterpreted the Seaboard Report as a basis for rewarding companies for waiving privilege. As a practical matter, rewarding companies for cooperating by waiving privilege has the same effect as punishing

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182. Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934 and Commission Statement on the Relationship of Cooperation to Agency Enforcement Decisions, Exchange Act Release No. 44,969 (Oct. 23, 2001), *available at* http://www.sec.gov/litigation/investreport/34-44969.htm#P54_10935.

183. The Wells Committee had the same concern with inexperienced practitioners being unaware of a prospective defendant's ability to provide written submissions that raised factual and legal defenses. *See supra*, text accompanying note 58.

184. *Id.* at n.3.

them for not waiving privilege—both effectively strip the attorney-client privilege, which is a fundamental component of our legal system.[185]

Another problem with a permissive approach to waiver is that waiver becomes mandatory in practice. Faced with concerns over their fiduciary duties and the expense and risk of litigation to the corporation, a corporation's board of directors may feel compelled to take full advantage of any cooperation credit available to it by waiving the attorney-client privilege and work-product protection. Indeed, shareholders likely would be unable to establish that the board of directors breached its fiduciary duty by waiving the corporation's privilege in exchange for cooperation credit if the corporation faced the threat of a large penalty.[186]

The idea of crediting the waiving of the attorney-client privilege or work-product protection originated with the Department of Justice. Two years prior to the Seaboard Report, the DOJ published the first memorandum—of what would ultimately be several memoranda—illuminating on the meaning of cooperation

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185. *See, e.g.,* The Thompson Memorandum's Effect on the Right to Counsel in Corporate Investigations: Hearing Before the S. Comm. on the Judiciary (2006) (statement of Edwin Meese III, former Att'y Gen. of the United States and Chairman, Ctr. for Legal and Judicial Studies, Heritage Foundation), *available at* http://judiciary.senate.gov/testimony.cfm?id=2054&wit_id=5741.

> [E]xperience has shown that the [Thompson] Memorandum has resulted in the dilution of essential rights encompassed by the attorney-client relationship. . . .[T]he Thompson Memorandum itself pressures companies to fulfill its nine factors, including by waiving their attorney-client privilege and cutting off their employees' attorney fees. Even if no prosecutor ever mentions either factor to a company, the fact that the Thompson Memorandum requires federal prosecutors to take all nine of its factors into consideration when deciding whether to indict a business organization necessarily places great pressure on the company to take these two steps.

Id. For a discussion of the Thompson Memorandum and other Justice Department memoranda regarding waiver of attorney-client privilege and work-product protection, *see infra* note 187.

186. Just as with any individual, corporations must not obstruct government investigations and must comply with duly issued subpoenas and court orders. Individuals and corporations, however, owe no duty to abandon all potential defenses and privileges in the face of government investigations. In fact, under state law, the directors of a corporation owe fiduciary duties to their shareholders. *See, e.g., Smith v. Van Gorkom*, 488 A.2d 858 (Del. 1985) (discussing the duties of directors). Under most state laws, including Delaware General Corporate Law, the board of directors of a corporation owes to its *shareholders* a duty of care and loyalty. *See id.* In some instances, cooperating with the SEC or another regulator may be contrary to the fiduciary duties of the directors because cooperation may lead to the corporation's being susceptible to meritless governmental actions and frivolous shareholder litigation. In those circumstances, it may be appropriate for the board of directors, in fully evaluating the situation and exercising business judgment, to decline to waive their attorney-client privilege with respect to a government investigation.

and the general principles that the Department of Justice follows when investigating business organizations.[187] These DOJ memoranda stated explicitly that a corporation's willingness to waive the attorney-client privilege and work-product protection should be considered in determining whether a corporation has cooperated adequately with the government. Given the number of parallel investigations by the DOJ and SEC, the policies of one agency affect the conduct of the other's investigations and limit the possible range of choices available to a defendant.[188]

The practices of the SEC and DOJ to credit cooperation for waiving the attorney-client privilege or work-product protection have met with significant criticism. On February 5, 2007, the American Bar Association ("ABA") submitted to the SEC a proposed "Revised Commission Statement on the Relationship of Cooperation to Agency Enforcement Decisions," which seeks to

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187. The first memorandum was sent by Deputy Attorney General Eric Holder to all Department Component Heads and U.S. Attorneys on June 16, 1999 (the "Holder Memorandum"). The Holder Memorandum focused on the prosecution of corporate criminal activity and included a document called "Federal Prosecution of Corporations," which outlined factors and considerations to be taken into account when charging corporations. Memorandum from Eric Holder, Deputy Att'y Gen., to Heads of Department Components and United States Attorneys (June 16, 1999) (on file with the Department of Justice). The second memorandum, which was a response to the substantial controversy that arose over the Holder Memorandum, was sent by Deputy Attorney General Larry Thompson in January 2003 and included much of the same text from the Holder memo, with some changes to reflect findings of the Corporate Fraud Task Force. Memorandum from Larry D. Thompson, Deputy Att'y Gen., to Heads of Department Components and United States Attorneys (Jan. 20, 2003), *available at* http://www.usdoj.gov/dag/cftf/corporate_guidelines.htm. Mounting criticism regarding lack of policies and procedures in this regard led acting Deputy Attorney General Robert McCallum in 2005 to amend the U.S. Attorney's manual to require that U.S. Attorneys establish a written waiver review process for their respective districts. See Memorandum from Robert D. McCallum, Jr., Acting Deputy Att'y Gen., to Heads of Department Components and United States Attorneys (Oct. 21, 2005), *available at* http://www.usdoj.gov/usao/eousa/foia_reading_room/usam/title9/crm00163.htm. Finally, the Justice Department, under the direction of Deputy Attorney General Paul J. McNulty, released a memorandum that attempted to draw distinctions on categories of privileged material. *See* Memorandum from Paul J. McNulty, Deputy Attorney General, to Heads of Department Components and United States Attorneys (Dec. 12, 2006), *available at* http://www.usdoj.gov/dag/speeches/2006/mcnulty_memo.pdf. The McNulty memorandum still gives entities credit for turning over attorney-client privileged material and attorney work product.

188. The implications extend to individuals as well. DOJ allows prosecutors to consider a company's willingness to punish employees who assert their constitutional rights and whether the company entered into joint-defense or information-sharing agreements with employees. This policy could cause an employee to face the difficult choice of losing his job or cooperating in an internal investigation without counsel and without constitutional protections. *See, e.g., Proposed Amendment of Commentary on Section 8c2.5 of the Federal Sentencing Guidelines Regarding Waiver of Attorney-Client Privilege and Work Product Doctrine Before the United States Sentencing Commission* (2006) (statement of Kent Wicker, Nat'l Ass'n of Criminal Def. Lawyers).

> This compelled waiver of the attorney-client privilege forced my client to give up the protection at the heart of our criminal justice system: The privilege under the Fifth Amendment against self-incrimination. It is not enough to say he could have just given up his job and retained his Fifth Amendment rights. This is a real person, with a real family to support.

Id.

have the SEC revise the Seaboard Report with respect to the waiver of the attorney-client privilege and work-product protection.[189] The proposal amends the section of the Seaboard Report describing the factors by which cooperation may be measured to read: "provided, however, that a company shall not be required to take any of the foregoing actions to the extent that it would result in a waiver of the attorney-client privilege or work product doctrine."[190] The proposal also seeks to remove the ambiguous footnote 3 of the Seaboard Report that describes waiver as "a means (where necessary) to provide relevant and sometimes critical information to the Commission staff." The proposal adds a new paragraph and related footnote describing the importance of attorney-client privilege and work-product protection and the adverse consequences when staff seeks the waiver.[191] The new paragraph states in part:

> Commission staff shall not take any action or assert any position that directly or indirectly demands, requests or encourages a company or its attorneys to waive its attorney-client privilege or the protections of the work product doctrine. Also, in assessing a company's cooperation, Commission staff shall not draw any inference from the company's preservation of its attorney-client privilege and the protections of the work product doctrine. At the same time, the voluntary decision by a company to waive the attorney-client privilege and/or the work product doctrine shall not be considered when assessing whether the company provided effective cooperation. The Commission may consider, however, in assessing whether a company has provided effective cooperation, the degree to which the company has provided factual information to the Commission staff in a manner, to be worked out by the company and the Commission staff, that preserves the protections of the attorney-client privilege and work product doctrine to the extent possible.[192]

Similar criticisms by other groups have been, and continue to be, levied against using the Seaboard Report to encourage waiver of the attorney-client privilege or work-product protection.[193]

As the SEC and other Federal agencies press to have the attorney-client privilege waived as they undertake investigations, the entire privilege is gradually weakened. As knowledge of its weakening spreads, corporate employees may

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189. Letter from Karen J. Mathis, President, American Bar Ass'n, to Christopher Cox, Chairman, U.S. Sec. & Exch. Comm'n (Feb. 5, 2007), *available at* http://www.abanet.org/poladv/letters/attyclient/2007feb05_privwaivsec_1.pdf.

190. *Id.* at 2.

191. *Id.* at 2-3.

192. *Id.* at 3. The proposal recognizes that there are limited, specific exceptions where the staff, after obtaining advance approval from the Director of Enforcement or his/her designee, may seek privileged or work-product materials. Those exceptions arise when the company asserts the advice of counsel defense or the SEC staff establishes the elements for the crime/fraud exception. *Id.*

193. *See, e.g.,* McLucas, Shapiro & Song, *The Decline of the Attorney-Client Privilege in the Corporate Setting,* 96 J. CRIM. L. & CRIMINOLOGY 621 (2006); Posting of Thomas O. Gorman, The Rolling Stones Test: SEC And DOJ Cooperation Standards, SEC Actions Blog, http://www. Secactions.com/?p=190 (May 22, 2007, 01:07 EST) ("Conversely no cooperation credit should be given for what the government says it does not usually need—privileged material and waivers.").

become less candid and forthcoming, corporate internal investigations will be less trustworthy, and shareholders and government investigators will be frustrated in their efforts to prevent misdeeds. Given those outcomes, revisiting Seaboard and the SEC's approach to the attorney-client privilege and work-product protection is long overdue.

A CALL FOR A NEW ADVISORY COMMITTEE

The SEC Enforcement Division is viewed with pride by Commissioners, staff, alumni, and many outsiders. The Division has a long history of stellar achievements and dedicated attorneys, accountants, and other staff. Thirty-six years after its creation, the Division is larger, stronger, and more visible than any member of the Wells Committee could have imagined. Thus, it makes sense that the Commission should consider whether it is time to convene a Wells-like committee to "bring to date" the best thinking on enforcement practices.

The new advisory committee's mission would be to conduct an independent review of the Commission's enforcement program from multiple, diverse perspectives, and to recommend to the Commission, if warranted, any needed changes. We propose that the new advisory committee adopt the same mandate as that of the Wells Committee in 1972. The tasks assigned to the Wells Committee are as important today as they were in 1972. If the same mandate is adopted, the new advisory committee would be charged with virtually the same tasks as the original Wells Committee, only slightly adapted to developments in the last three decades:

> (1) reviewing and evaluating the Commission's enforcement policies and practices in light of its statutory responsibilities and mission to protect investors; to maintain fair, orderly, and efficient markets; and to facilitate capital formation;
> (2) advising how the SEC's enforcement objectives and strategies may be made more effective;
> (3) examining the Commission's enforcement practices and procedures from the point of view of due process,[194] respect for the prospective defendants' attorney-client privilege and work-

194. The Committee should consider the Commission's current procedure regarding authorization of cases implicating potential corporate penalties, under which the Commission authorizes the staff to negotiate a settlement, before the staff engages in any settlement discussions with the prospective defendant. At issue is whether the Commission, at the time of authorization of negotiations, should also authorize the staff to litigate if the settlement negotiations prove unfruitful, or whether the staff should return to the Commission to seek litigation authorization. The issues hearken back to those that animated the debate around the original Wells Committee Recommendation 20, namely whether authorizing staff to litigate before commencing settlement negotiations skews the negotiations through the implicit threat to litigate if no settlement is reached. *See supra* notes 61-72 and accompanying text.

product protection,[195] the relationship of enforcement action to notice of legal requirements, the attribution of responsibility for violations, and the protection of reputation and rights of privacy of those with whom the Commission interacts;[196]
(4) making recommendations on the appropriate blend of regulation, publicity, and formal enforcement action and on methods of furthering voluntary compliance with securities laws;
(5) making recommendations on criteria for the selection and disposition of enforcement actions, in particular, providing timely notice to parties of the closing of an investigation; and
(6) advising on the appropriate uses of penalties against corporations in light of the SEC's mission of protecting investors.

Among the many issues that would fall under this broad mandate would be the implementation of mechanisms to provide more efficacy, predictability and transparency to the enforcement program. The overall philosophy and management of the enforcement program should be examined to determine how best it can fulfill the SEC's mission, in light of resources and statutory authority.

Predictability and transparency provide for a fair process that respects the rights of all parties involved and ensures adherence to the rule of law.[197] Of course, the Commission's discretion should not be eliminated in favor of rote application of a mathematical formula for calculating penalties. Discretion plays an important role in forgoing certain theories of liability or not bringing an action at all. For example, a company and its shareholders may have been punished enough through other avenues or the securities law violation may have been merely an honest mistake. Indeed, the Wells Committee's Recommendation 14 discussed this type of discretion:

> The Commission should give due consideration in cases which appear to involve honest mistake or good faith efforts at compliance to exercising its

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195. Included in this task would be the need to re-evaluate the 2006 Statement Regarding Penalties and the 2001 Seaboard Report, particularly with respect to the expectation of waiver of attorney-client privilege and work-product protection as a determinant of cooperation.

196. Beyond the scope of this Article is the ancillary issue of disclosure by issuers of the various stages of an SEC investigation. Although in large part a facts-and-circumstances determination as to materiality, guidance would be helpful to issuers and practitioners.

197. With the increasing emphasis on a more punitive enforcement approach, are sufficient safeguards in place to protect the rights of prospective individual defendants? At the time of the Wells Committee, the SEC lacked the power to seek punitive damages against individuals, so the potential costs to the individual defendant were not as pronounced as they are today. Individual defendants are faced with high costs of defending an SEC action and severe consequences if they lose. These consequences at times can be tantamount to criminal sanctions, including large monetary payments and loss of livelihood. Often, the only option is a pro-se defense. Will a Commission one day decide that it should establish a system to provide representation to individual defendants who cannot afford to hire private counsel?

> discretion against bringing a formal enforcement proceeding notwithstanding the appearance of a violation.[198]

The ability of the Enforcement Division to recommend to the Commission that no action be taken in a particular matter should be encouraged and institutionalized. This will require, among other things, a re-evaluation of the incentives for bringing actions and obtaining large penalties (such as through promotions, awards, and public recognition). Statistics, such as the number of cases brought and the penalties recovered, should play only a minimal role in assessing individual performance. Instead, an evaluation system should focus on rewarding high quality efforts and professionalism regardless of the outcome of particular actions. A decision to forgo bringing an enforcement action should not be treated automatically as a loss, but it should be evaluated qualitatively alongside other enforcement decisions.

In some instances, exercising discretion may not be appropriate. There should not be institutional encouragement for using discretion to formulate theories of liability that overstep the boundaries of existing law. Law making is reserved for legislative process in Congress and the SEC rulemaking process under the strict requirements of the Administrative Procedure Act; it is not a function of the Enforcement Division.

Another aspect that could be considered by the advisory committee is the implementation of a written and uniform "full-disclosure" policy for enforcement matters.[199] In criminal procedure, this is often referred to as an "open jacket" policy. Operating under such a policy, the enforcement staff would show defense counsel the evidence it has against the prospective defendant, which is the essence of due process. Some practicing lawyers have criticized the SEC Enforcement Division for failing to explain to defendants the allegations of wrongdoing and failing to share critical incriminating—and most importantly, exculpatory—evidence that the SEC has gathered.[200] Because no such policy is in place today, arguments in Wells Submissions often are based on defense counsel's best guess as to the conduct that enforcement staff has identified as violating federal securities laws. The sharing of information would promote the goal of fact-finding, which is paramount to due process and to the administration of justice.

With the advent of additional remedies in the SEC's arsenal in the decades after the Wells Committee and a shift in approach towards a more punitive focus, the idea of a full-disclosure policy is even more important than it was when the Wells Committee made its recommendations. The SEC staff should inform fully individuals and companies about the allegations and the evidence at the time of a Wells call or, at the very latest, before entering into settlement discussions. Corporate boards, in particular, must be sufficiently informed so that they can

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198. WELLS COMMITTEE ADVISORY REPORT, *supra* note 39, at iv.

199. The Wells Committee proposed the institutionalization of a similar policy. *See supra* note 71 and accompanying text. Currently, there is not a uniform practice among the various units in the Enforcement Division.

200. *See, e.g.,* Kevin J. Harnishch & Natasha Colton, *When the SEC Comes Knocking,* 15 A.B.A. SEC. BUS. L. 1 (2005), *available at* http:/www.abanet.org/buslaw/blt/2005-09-10/colton.shtml.

apprise their shareholders and exercise good business judgment in determining whether to settle a matter with the SEC.

Another aspect of the enforcement program that the new advisory committee should consider is the process for closing investigations. In a report to Congress by the General Accountability Office ("GAO"), the GAO harshly criticized the Enforcement Division for not closing investigations promptly and observed that the Division had a "potentially large backlog of investigations that are not likely to result in enforcement actions and for which closing packages have not been completed."[201] As a result, the GAO concluded that "the subjects of many aged and inactive investigations may continue to suffer adverse consequences until closing actions are completed."[202]

Enforcement Division officials told the GAO that their attorneys may believe that pursuing potential securities violations is a higher priority than closing investigations.[203] Officials also cited a scarcity of time, administrative support, and incentives to comply with established procedures for closing investigations.[204] Although the GAO recognized that resolving the potentially large backlog of investigations would impose resource challenges for Enforcement Division,[205] the GAO recommended that the SEC chairman direct the Enforcement Division to "consider developing expedited procedures for closing investigations."[206]

When the Commission or its staff determines than an investigation should be closed or action is not warranted, the agency promptly should send a closing letter.[207] Closing letters should be sent not only to those who have made a Wells Submission, but also to any significant non-party that has provided documents, information, or testimony to the SEC. Similarly, if the enforcement staff views a person only as a witness or source of information in an investigation, staff should make that clear to the person.

In its proposed mandate to examine enforcement practices and procedures from the point of view of due process, the new advisory committee should consider ways to improve the cherished Wells process. One way in which the Wells process should be bolstered is through a mechanism to allow a proposed defendant to appear before the Commission to oppose a proposed enforcement

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201. U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-07-830, SEC: ADDITIONAL ACTIONS NEEDED TO ENSURE PLANNED IMPROVEMENTS ADDRESS LIMITATIONS IN ENFORCEMENT DIVISION OPERATIONS 22 (2007), *available at* http://www.gao.gov/new.items/d07830.pdf. For example, according to the GAO Report, one SEC regional office reported that as of March 2007 about 35% of its open investigations were "more than 2 years old, had not resulted in an enforcement action, and were no longer being actively pursued." *Id.* at 21. In response, the Enforcement Division has undertaken to review the backlog and streamline the closing process. *Id.* at 46.

202. *Id.*

203. *Id.*

204. *Id.*

205. *Id.*

206. *Id.* at 7.

207. The Wells Committee in Recommendation 8 proposed that the "Commission adopt in the usual case the practice of notifying an investigatee against whom no further action is contemplated that the staff has concluded its investigation . . . ." and will not recommend an enforcement action. WELLS COMMITTEE ADVISORY REPORT, *supra* note 39, at 20.

proceeding. Although it would likely be both unnecessary and unmanageable to allow such an "oral Wells submission" in every situation, it may be beneficial to both the Commission and proposed defendants for the Commission to have a discretionary avenue to hear from proposed defendants prior to taking action. Matters that might be appropriate for this procedure would include complex factual cases, such as those necessitating expert witnesses, disputes concerning the level of cooperation, or cases in which character assessment and credibility is particularly important.[208]

A review of the enforcement process would not be complete without a review of the costs to parties responding to an investigation. Responding to an SEC investigation is costly, particularly in the age of e-mails and electronic data. The SEC must ensure that its investigations and enforcement actions do not impose unnecessary costs. Overly broad subpoenas or document or interview requests add to a responding entity's costs, and not every responding entity becomes a defendant. Innocent parties pay the price of overly broad requests. Notices to preserve—and subsequent requests to produce—electronic data, including e-mails, voicemails, and server back-up tapes are particularly burdensome and costly to a company. While it is undoubtedly critical for the SEC to have certain electronic data to conduct an investigation and litigate a matter, preservation notices and requests for production are often generic and extend well beyond the boundaries of the existing investigation. It is difficult to justify imposing unnecessary costs on a company, particularly when the investigation may last many years and result in no action taken.

The new advisory committee should recommend ways to minimize costs through the formulation of detailed procedures to address preservation notices and production requests for electronic data. In recommending the procedures, the advisory committee should take into account the burden and expense of preserving certain kinds of records, such as electronic voicemail, and producing data stored in long-term media such as back-up tapes. Preservation notices should be reasonably related to the matters under investigation, and prospective preservation of information should be invoked only if misconduct is suspected or ongoing.[209] The use of generic preservation notices, covering data that the company might not otherwise preserve in the normal course of its operations, should be prohibited.

Production requests should be narrowly tailored and should first seek information that is readily accessible. Requests should not demand the production of data stored on back-up tapes unless unavailable through other sources. As a measure to guard against overbroad requests, the advisory committee should consider ways to incorporate in enforcement procedures pre-approval of document requests by a senior member of the Enforcement Division.

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208. For example, at both the Federal Trade Commission and the Federal Communications Commission, in-person presentations to commissioners and staff of evidence and advocacy positions in advance of potential enforcement actions are routine.

209. Subjects of investigation already have other legal obligations to preserve documents. *See, e.g.,* 18 U.S.C. § 1512 (2006).

The advisory committee also should explore the establishment of an ombudsman to review and evaluate complaints about the enforcement process and behavior of the Enforcement staff. An ombudsman would provide an avenue for persons to convey their grievances to the Commission without fear of reprisal. People should be able to make these complaints anonymously through a hotline.[210]

The new advisory committee should examine the usage, effects, amount, and appropriateness of issuer penalties in financial fraud cases. The committee should consider whether these issuer penalties are consistent with the SEC's mission of investor protection; maintaining fair, orderly, and efficient markets; and facilitating capital formation. For example, do penalties protect investors? Do they harm or benefit shareholders? Is the circularity of Fair Fund penalty distributions consistent with ensuring fair, orderly, and efficient capital markets? Is capital formation impeded by the threat of large, unpredictable issuer penalties?

The advisory committee also should evaluate the moral hazards associated with issuer penalties. One moral hazard is the possibility that managers of companies might agree to a large corporate penalty in order to avoid or soften actions against culpable individuals.[211] Are individuals deterred from wrongdoing if they expect that shareholders will pay the penalties for the misconduct?

The SEC also faces it own moral hazards when contemplating the assessment of issuer penalties. Does the prospect of large issuer penalties and the inevitable press coverage cause the SEC to misallocate resources to build these cases to the detriment of other types of enforcement actions?

The Commission's 2006 penalty statement was a significant first step in setting forth a principled foundation for examination of many of these concerns.[212] In applying the penalty statement, the Commission has encountered areas not addressed by the statement, such as the determination of the amount of penalty and the appropriateness of imposing penalties on new shareholders.[213] Taking the Commission's experience into consideration, the new advisory

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210. The SEC's Office of Compliance Inspections and Examinations already has such a hotline. *See* U.S. Sec. & Exch. Comm'n, Office of Compliance Inspections & Examinations, Examination Hotline, http://www.sec.gov/about/offices/ocie/ocie_hotline.shtml (last visited May 9, 2008).

211. *See generally* Donald C. Langevoort, *On Leaving Corporate Executives "Naked, Homeless and Without Wheels": Corporate Fraud, Equitable Remedies, and the Debate over Entity versus Individual Liability*, 42 WAKE FOREST L. REV. 627 (2007). As Professor Langevoort explains:

> The corporate sanction avoids the need to attribute fault to any particular individual under circumstances where there is likely mutual finger pointing about who is to blame. For all these reasons, company sanctions are the path of least resistance; the SEC can claim its victory and move its resources to new matters that deserve attention. There is probably a publicity-related reason as well: sanctions against companies can be large enough to grab headlines, which is less likely to occur with respect to individual sanctions, even in the aggregate.

Id. at 654.

212. *See* 2006 Penalty Statement, *supra* note 178.

213. Many of these same concerns were raised by the Commission during the legislative debate over the Remedies Act of 1990. *See, e.g.,* SEC Memorandum in Support of Remedies Act, *supra* note 96.

committee should re-examine these issues with the input of economists, legal scholars, and practitioners.

These and any additional recommendations from the advisory committee that ultimately are approved by the Commission should be set forth in a publicly available Enforcement Manual. In 2007, the minority members of the Senate Finance Committee recommended that the SEC create such a manual, which would be similar to the U.S. Attorney Manual, "to address situations or issues likely to recur."[214] The public accessibility of the manual would ensure transparency and uniform application. The manual itself, and any later changes to it, should be reviewed and approved by the Commission. Deviations from the manual, while necessary in some instances, should be discouraged. The manual will serve as the governing guidelines for the Enforcement staff at headquarters and in the regional offices. An Enforcement Manual that reflects the recommendations of an advisory committee, as adopted by the Commission, could serve as a useful framework for the Commission's enforcement program in the years to come.

CONCLUSION

The SEC's enforcement program serves a critical function in ensuring proper compliance with the U.S. securities laws. Throughout its history, the SEC has protected investors and the general public from a wide array of fraudulent conduct. Given the importance of enforcement to the SEC's mission, a critical review of the enforcement program—similar to that done by the Wells Committee in 1972—is long overdue. This article is intended to start a list of items for consideration, but does not purport to identify all the areas that should be evaluated by a new Wells-like advisory committee. The members of the advisory committee undoubtedly will draw from their own experiences and expertise to develop a full agenda. The Commission should be receptive to considering any new ideas for improving the enforcement program and furthering the SEC's mission. We are confident that the result will be an enforcement program that is more transparent, better embodies principles of due process, and more effectively combats violations of the federal securities laws.

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214. *See* Staff of S. Fin. Comm., 110th Cong., Report on the Firing of an SEC Attorney and the Investigation of Pequot Capital Management 7 (Comm. Print 2007), *available at* http://finance.senate.gov/sitepages/leg/LEG%202007/Leg%20110%20080307%20SEC.pdf.