THE REMEDIES ACT TURNS FIFTEEN

WHAT IS ITS RELEVANCE TODAY?

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As the Securities Enforcement Remedies and Penny Stock Reform Act (the "Remedies Act" or "Act")[1] approaches its fifteenth anniversary in November of this year, there are significant questions as to the extent to which it remains relevant. Certainly, its provisions governing injunctions, cease and desist orders, and directors and officers bars remain important enforcement tools. However, the core of the Act—its civil penalty regime—appears to have significantly less relevance today. Indeed, far from providing the Securities and Exchange Commission ""with a powerful deterrent penalty structure, the SEC seems to barely pay heed to the penalty provisions of the Act, instead exacting huge settlements against alleged corporate wrongdoers that apparently bear little or no relationship to what the SEC could reasonably obtain under the Act. Ironically, then, rather than providing the SEC with a powerful enforcement weapon as originally envisioned, the penalty provisions of the Act appear to have been largely ignored by the SEC, and today constitute a rarely applied brake on the SEC's enforcement program, rather than an expansion of it.

This article discusses the background and provisions of the Remedies Act, the Sarbanes-Oxley amendments to it, and recent relevant case law construing the Act. The article then discusses the SEC's "current approach to penalties," as enunciated by its director of enforcement, Stephen Cutler, in April 2004. Finally, in light of the enormous recent settlements obtained by the SEC pursuant to the Director's "current approach"—settlements that seem to bear little or no relationship to the penalty provisions of the Remedies Act—the article

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1. Securities Enforcement Remedies and Penny Stock Reform Act of 1990, Pub. L. No. 101-429, 014 Stat. 931 (1990).

concludes that the penalty provisions of the Act may not carry the importance originally envisioned.

I.
BACKGROUND AND PROVISIONS OF THE REMEDIES ACT.

Prior to the enactment of the Remedies Act, the SEC was empowered to obtain financial penalties only in very limited circumstances—primarily for insider trading violations.[2] For other securities law violations, the SEC's enforcement power was generally limited to enjoining future violations, or seeking a court's exercise of its equitable powers to obtain disgorgement or restitution.[3]

In response to the perception by Congress and the SEC that the Commission's enforcement tools were inadequate, the Remedies Act greatly expanded available sanctions, signifi-

2. The passage of the Insider Trading Sanctions Act of 1984 ("ITSA") gave the SEC the authority to seek civil monetary penalties for insider trading violations. *See* H.R. REP. NO. 98-355 (1983). The maximum penalty allowed was three times the profit gained or loss avoided as a result of the unlawful purchase, sale, or communication. *Id.*; *See also* 15 U.S.C. § 78u-1(a)(2) (2005). Congress expanded the scope of the SEC's power to seek monetary penalties in 1988 by passing the Insider Trading and Securities Fraud Enforcement Act ("ITSFA"), which authorized the imposition of civil penalties on "controlling persons" who failed to take appropriate measures to prevent their employees from engaging in insider trading. *See* 15 U.S.C. § 78u-1(a)(3) (2005); Gary G. Lynch & James D. Liss, *The Securities Enforcement Remedies and Penny Stock Reform Act of 1990*, 755 PLI/CORP 337, 341 (describing the scope of the ITSFA). Despite this increase in the SEC's power, the ITSA and the ITSFEA were directed only at insider trading violations. Philip R. Lochner, Jr., *The SEC's New Powers Under The Securities Enforcement Remedies and Penny Stock Reform Act of 1990*, 718 PLI/CORP 107, 110 (1990).

3. Lochner, *supra* note 2, at 110-11 (noting that prior to the enactment of the Remedies Act, injunctions, disgorgement or restitution were the only enforcement tools available to the SEC for securities law violations other than insider trading). *See also* Ralph C. Ferrara, et al., *Hardball! The SEC's New Arsenal of Enforcement Weapons*, 47 BUS. LAW. 33, 35-6 (1991) (discussing the SEC's view that injunctions and disgorgement were inadequate enforcement remedies because injunctions were "ineffective with respect to certain offenders and particularly onerous for others" and disgorgement "merely required the wrongdoer to return the benefits of the illegal conduct and, thus, did not have a sufficient deterrent effect").

cantly increasing the deterrent effect of the SEC's enforcement program.[4]

Broadly speaking, there were four new classes of remedies provided to the SEC pursuant to the Act: (1) cease and desist authority; (2) civil monetary penalties; (3) disgorgement of ill-gotten gains; and (4) officer and director bars.[5] Each is discussed below.

Cease and Desist Authority

By enacting the Remedies Act, Congress gave the SEC the authority to issue both permanent and temporary cease-and-desist orders, which significantly expanded the SEC's administrative jurisdiction.[6] A permanent cease-and-desist order directs the respondent to refrain from committing future violations of the securities laws, and can also direct the respondent to make disgorgement or to take affirmative steps to ensure compliance with the order.[7] By contrast, a temporary cease-

4. *See* H.R. REP. NO. 101-616, at 17 (1990) [*hereinafter* "House Report"] ("[b]ecause many of the charges in the most prominent securities fraud cases of the 1980's have involved violations other than insider trading, the Commission believes that it needs the additional authority contained in [the Remedies Act] to attack the full range of fraudulent activity in the securities markets"). *See also* S. REP. NO. 101-337, at 1 (1990) [*hereinafter* "Senate Report"] (noting that the Remedies Act "is designed to strengthen the enforcement powers of the [SEC] and provide the agency with a broader range of remedies to protect investors and maintain the integrity of the nation's securities markets").

5. The statutory authorization for these new enforcement remedies is found in the Remedies Act amendments to the following: The Securities Act of 1933, 15 U.S.C. §§ 77a-77aa (2000) ("Securities Act"); The Securities Exchange Act of 1934, 15 U.S.C. §§ 78a-78nn (2000) ("Exchange Act"); The Investment Company Act of 1940, 15 U.S.C. §§ 80a-1—80a-64 (2000) ("Investment Company Act"); and The Investment Advisers Act of 1940, 15 U.S.C. §§ 80b-1—80b-21 (2000) ("Investment Advisers Act") (collectively "the securities laws").

6. See 15 U.S.C. § 77h-1 (2000); 15 U.S.C. § 78u-3 (2000); 15 U.S.C. § 80a-9(f) (2000); 15 U.S.C. § 80b-3(k) (2000); MARC. I. STEINBERG & RALPH C. FERRARA, SECURITIES PRACTICE: FEDERAL AND STATE ENFORCEMENT § 6.13 (2d ed. 2002).

7. House Report, *supra* note 4, at 24; Senate Report, *supra* note 4, at 19; STEINBERG and FERRARA, *supra* note 6, at § 6.14. The following are additional features of a permanent cease-and-desist proceeding: (1) the SEC must give the respondent notice and opportunity for a hearing before it can issue a permanent cease-and-desist order; (2) a hearing before an administrative judge must begin no earlier than 30 days and no later than 60 days after

and-desist order can be issued against certain classes of respondents (brokers, dealers, investment advisers, investment companies, municipal securities dealers, government securities brokers and transfer agents) who are engaging in or who are about to engage in a violation that is likely to result in a significant dissipation or conversion of assets, significant harm to investors, or that is otherwise likely to result in substantial harm to the public interest before a permanent cease-and-desist proceeding could be completed.[8] Prior to the enactment of the Remedies Act, the SEC had to move in federal court for emergency injunctive relief, such as a temporary restraining order, in order to direct a person to refrain from engaging in further illegal conduct.[9] By virtue of the Remedies Act, a federal injunction proceeding—and the significant burdens that accompany it—is no longer required. These cease and desist orders are now issued administratively after a hearing.[10]

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issuance of the order instituting proceedings (unless time periods are waived by mutual agreement); (3) respondents can appeal decision of administrative law judge to full SEC, and then to circuit court of appeals. *See* Senate Report, *supra* note 4, at 19, *See also* William R. McLucas, *Cease and Desist Authority Under the Securities Enforcement Remedies and Penny Stock Reform Act of 1990*, 793 PLI/CORP 169, 172 (1992).

8. House Report, *supra* note 4, at 25; Senate Report, *supra* note 4, at 19-12; STEINBERG and FERRARA, *supra* note 6, at § 6.16. The following are additional features of temporary cease-and-desist proceedings: (1) temporary orders take effect upon service; (2) the SEC should give prior notice to respondent for due process reasons, however if notice is impracticable or contrary to public interest, the SEC can serve the temporary order without notice; (3) respondent can seek judicial review of the SEC's issuance of a temporary cease-and-desist order either immediately or within 10 days of service of the order; (4) respondent can petition the SEC anytime after service of the order to have the order set aside, limited or suspended; (5) the SEC can modify or vacate a temporary order; (6) if the SEC, after conducting a hearing determines that a permanent order is not warranted, the temporary order becomes immediately ineffective; (7) if the SEC issues a permanent cease-and-desist order, the respondent may appeal the determination to the appropriate federal court of appeals. Senate Report, *supra* note 4, at 20. *See also* McLucas, *supra* note 7, at 172.

9. House Report, *supra* note 4, at 23.

10. According to the Senate Report, the filing of a civil injunctive action in federal court often resulted in protracted litigation or negotiation, whereas the cease-and-desist authority granted by the Remedies Act would allow the SEC to resolve cases more quickly. Senate Report, *supra* note 4, at 18. In addition, the Senate Report notes that emergency relief, such as preliminary injunctions, temporary restraining orders, asset freezes and appointment of receivers often imposed collateral consequences on defend-

Civil Monetary Authority

The SEC has the authority to seek, and district courts have jurisdiction to impose, civil monetary penalties for violations of the securities laws, the rules and regulations promulgated under the securities laws, as well as cease-and-desist orders.[11] Part of the impetus behind Congress's grant of civil penalty authority was the notion that disgorgement was an insufficient remedy because it merely put the wrongdoer in the same posi-

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ants. *Id.* The grant of cease-and-desist authority was designed to allow the SEC to respond to violate conduct quickly and appropriately. *Id.* at 2.

11. 15 U.S.C. § 77t(d) (2000); 15 U.S.C. § 78u(d)(3) (2000); 15 U.S.C. § 80a-41(e) (2000); 15 U.S.C. § 80b-9(e) (2000). Insider trading violations, which are subject to penalties under Section 21A of the Exchange Act, are exempted from the penalty provisions of the Remedies Act. *See, e.g.*, 15 U.S.C. § 77t(d)(1).

The Remedies Act also authorizes the SEC itself to impose monetary penalties in administrative proceedings against broker-dealers, investment advisers, municipal securities dealers, government securities dealers, transfer agents and their associated persons. *See* 15 U.S.C. § 78u-2 (2000); 15 U.S.C. § 80b-3(i) (2000). The SEC can impose a monetary penalty in an administrative proceeding if doing so would be in the public interest and if the respondent has willfully: (1) violated any provision of the securities law or the rules and regulations promulgated thereunder; (2) aided, abetted, counseled, commanded, induced or procured such a violation by any other person; or (3) made or caused to be made a false or misleading statement with respect to any material fact in any required SEC filing (this includes the omission of a material fact that should have been included in an SEC filing). *See, e.g.*, 15 U.S.C. § 80b-3(i) (2000).

To determine whether a penalty is in the public interest, the Remedies Act sets forth factors the SEC should consider: (1) whether the act or omission involved fraud, deceit, manipulation, or deliberate or reckless disregard of a regulatory requirement; (2) the harm to other persons resulting either directly or indirectly from the act or omission; (3) the extent to which any person was unjustly enriched, taking into account any restitution made to persons injured by the behavior; (4) whether the respondent previously had been found by the Commission, other appropriate regulatory agency, or a 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, or has been convicted of a misdemeanor or felony violation described in § 15(b)(4)(B) of the Securities Exchange Act or § 203(e)(2) of the Advisers Act; (5) the need to deter the respondent and other persons from committing the acts or omissions; and (6) such other matters as justice may require. *See* 15 U.S.C. § 80b-3(i) (2000).

tion it was in before committing the violation.[12] District courts are now charged with determining the amount of the penalty "in light of the facts and circumstances" surrounding each case.[13] While the district court has discretion with respect to the amount of the penalty, or whether to impose a penalty at all, Congress adopted a three-tier framework[14] which

12. House Report, *supra* note 4, at 17; Senate Report, *supra* note 4, at 6; *see also* Arthur B. Laby & W. Hardy Callcott, *Patterns of SEC Enforcement Under the 1990 Remedies Act: Civil Money Penalties*, 58 ALB. L. REV. 5, 13-14 (1994).

13. *See, e.g.*, 15 U.S.C. § 77t(d)(2)(A) (noting that the district court shall determine the amount of the penalty based on the facts and circumstances of the case and setting out the three-tier penalty structure). *See also* House Report, *supra* note 4, at 22, (noting that the district court would have the "discretion to determine whether a penalty would be imposed and the amount of such penalty").

14. The three-tiered system functions as follows:

(A) FIRST-tier—The amount of the penalty shall be determined by the court in light of the facts and circumstances. For each violation, the amount of the penalty shall not exceed the greater of (i) $5,000 for a natural person or $50,000 for any other person, or (ii) the gross amount of pecuniary gain to such defendant as a result of the violation.

(B) SECOND-tier—Notwithstanding subparagraph (A), the amount of penalty for each such violation shall not exceed the greater of (i) $50,000 for a natural person or $250,000 for any other person, or (ii) the gross amount of pecuniary gain to such defendant as a result of the violation, if the violation described in paragraph (1) involved fraud, deceit, manipulation, or deliberate or reckless disregard of a regulatory requirement.

(C) THIRD-tier—Notwithstanding subparagraphs (A) and (B), the amount of penalty for each such violation shall not exceed the greater of (i) $100,000 for a natural person or $500,000 for any other person, or (ii) the gross amount of pecuniary gain to such defendant as a result of the violation, if—

(I) the violation described in paragraph (1) involved fraud, deceit, manipulation, or deliberate or reckless disregard of a regulatory requirement; and

(II) such violation directly or indirectly resulted in substantial losses or created a significant risk of substantial losses to other persons.

15 U.S.C. § 77t(d)(2) (2000); 15 U.S.C. § 78u(d)(3) (2000); 15 U.S.C. § 80a-41(e)(2) (2000); 15 U.S.C. § 80b-9(e)(2) (2000). The penalties described above are periodically adjusted for inflation. 17 C.F.R. § 201.1002 (2001). Thus, for securities law violations occurring after February 2, 2001, first-tier penalties have been increased to $6,000 for a natural person or $60,000 for any other person; second-tier penalties have been increased to $60,000 for a natural person or $300,000 for any other person; and third-tier penalties have been increased to $120,000 for a natural person or $600,000 for any other person. Adjustments to Civil Monetary Penalty Amounts, Exchange Act Release Nos. 33-7946, 34-43897, IA-1921, IC-24846 (Feb. 2, 2001).

establishes a maximum penalty per violation.[15]

Disgorgement

The Remedies Act also authorizes the SEC to order the disgorgement of ill-gotten gains in administrative proceedings in which the SEC has authority to impose monetary penalties.[16] Prior to the enactment of the Remedies Act, the SEC had no express authority to order disgorgement in administrative proceedings.[17] Rather, if the SEC determined that disgorgement was an appropriate remedy, it was required to file an injunctive action in district court.[18] The SEC can also consider whether a respondent has made restitution in assessing whether it will impose administrative monetary penalties—a fact that may prompt voluntary disgorgement.[19] To the extent it does not, however, the SEC's express disgorgement powers

15. Although the Remedies Act provides for a maximum penalty "per violation," it is unclear what constitutes a violation, as the term "violation" is not defined in the Remedies Act. *See* Ferrara et al., *supra* note 3, at 44 (noting that neither the Remedies Act nor the legislative history addresses "whether a course of conduct prohibited by the securities statutes shall constitute a single violation or whether each illegal act or transaction [in furtherance of that course of conduct] will constitute a separate violation"). There is no discussion of this issue in the legislative history. Thus, the way in which the SEC characterizes a claim may alter the number of violations for which a penalty may be sought, and by extension, drastically increase the amount of the penalty. *See id.* at 45. Note, however, that the case law discussed *infra* seems to define a violation narrowly, as only the act or omission, and not predicate acts. *See infra,* note 49 and accompanying text.

16. 15 U.S.C. § 78u-2(e) (2000); 15 U.S.C. § 80a-9(e) (2000); 15 U.S.C. § 80b-3(j) (2000) ("In any proceeding in which the Commission may impose a penalty under this section, the Commission may enter an order requiring accounting and disgorgement, including reasonable interest. The Commission is authorized to adopt rules, regulations, and orders concerning payments to investors, rates of interest, periods of accrual, and such other matters as it deems appropriate to implement this subsection.")

17. STEINBERG and FERRARA, *supra* note 6, at § 6.12. Although the SEC did not have the express authority to order disgorgement, the SEC had, on certain occasions, effectively obtained disgorgement by "conditioning the imposition of a sanction upon the respondent's compliance with an undertaking to disgorge profits or make restitution to injured customers". *Id.* (citing House Report, *supra* note 4).

18. *Id.*

19. *Id. See also* House Report, *supra* note 4, at 23.

provide that securities law violators in administrative proceedings will not be able to retain their ill-gotten gains.[20]

Officer and Director Bars

The Remedies Act also gives federal courts the authority to bar or suspend individuals from serving as officers or directors of any company that has reporting obligations to the SEC.[21] Specifically, federal courts can bar an individual from serving as an officer or director of a reporting company if that individual has violated § 17(a)(1) of the Securities Act, § 10(b) of the Exchange Act, or the rules and regulations promulgated thereunder.[22] Under the Act, that individual, by his or her conduct, must also demonstrate "substantial unfitness" to serve as an officer or director.[23] Congress intended this as a severe remedy: individuals who demonstrate "blatant disregard for the requirements of the Federal securities laws should not be placed in a position of trust with a publicly held corporation."[24]

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20. *Id. See also* House Report, *supra* note 4, at 17. The House Report further noted that the purpose of disgorgement in administrative actions was to "forc[e] a defendant to give up the amount by which he was unjustly enriched" as opposed to damages in private actions, which are designed to compensate the victims of the violation. *Id.* at 24 (quoting SEC v. Blavin, 760 F.2d 706 (6th Cir. 1985).

21. 15 U.S.C. § 77t(e) (2000); 15 U.S.C. § 78u(d)(2) (2000); House Report, *supra* note 4, at 29; Senate Report, *supra* note 4, at 5.

22. 15 U.S.C. § 77t(e) (2000); 15 U.S.C. § 78u(d)(2) (2000); House Report, *supra* note 4; Senate Report, *supra* note 4, at 5.

23. Securities Enforcement Remedies and Penny Stock Reform Act, P.L. 101-429 104 Stat. 935-36 (1990). The passage of the Sarbanes-Oxley Act of 2002 ("Sarbanes-Oxley") lowered the standard for imposing an officer and director bar from "substantial unfitness" to "unfitness." Sarbanes-Oxley also conferred the authority to impose officer and director bars on the SEC in addition to the federal courts. *See* Sarbanes-Oxley Act of 2002 § 305(a)(1-2).

24. Senate Report, *supra* note 4, at 19. Because corporate governance issues are traditionally governed by state law, former SEC Chairman Richard Breeden noted in his testimony before Congress that the purpose of the Remedies Act was not to establish minimum qualifications for officers and directors. *See Hearings before the Subcomm. on Securities of the Committee on Banking, Housing and Urban Affairs, United States Senate, concerning S. 647, The Securities Law Enforcement Remedies Act of 1989*, S. Hrg. No. 101-935, 101st Cong., 2d Sess. at 63 (1990) (Statement of Richard C. Breeden) ("Breeden Testimony") (The purpose of the corporate bar provisions is not to establish federal standards governing the qualifications of corporate officers or directors. Rather, the purpose of this provision is to protect public investors from per-

II.
BRIEF LEGISLATIVE HISTORY OF THE REMEDIES ACT'S CIVIL PENALTY PROVISIONS

Importantly, there are several pieces of the legislative history of the Remedies Act that provide further guidance on the interpretation of the civil penalty provisions.

Although both the Senate and House Reports on the Remedies Act demonstrate legislative support for the civil penalties provisions, the reports also state that Congress did not intend that the SEC should seek civil penalties in every case. The civil penalty provisions were designed to punish and deter certain types of conduct for which disgorgement and injunctive relief proved to be ineffective remedies.[25] Therefore, Congress stated that penalties might not be appropriate where deterrence was not an issue, such as in cases of isolated or unintentional misconduct, or when the defendant was subject to concurrent criminal prosecution.[26]

Additionally, Congress stated that the imposition of a civil penalty on a registered investment company rarely would be

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sons who have already demonstrated a propensity to abuse a position of corporate trust. Where a person's conduct is such that the disclosure provisions of the federal securities laws, even when supplemented by the coercive power of a federal court injunction, are insufficient to protect investors from further loss, the availability of such a provision is necessary.").

25. Senate Report, *supra* note 4, at 7. Congress noted that civil monetary penalties would be necessary to punish and deter those who receive enormous economic benefits from intentionally or deliberately violating securities laws (such as those who engage in penny stock fraud, market manipulation and fraudulent financial reporting) because disgorgement did not impose "any meaningful economic cost on the law violator" as it only entailed the return of illegally obtained profits. *Id.* Congress also indicated that with respect to repeat offenders, civil penalties (as opposed to an injunction) would better deter recidivism "by increasing the costs associated with repeated securities law violations." *Id.*

26. Senate Report, *supra* note 4, at 11 ("when failure to comply with SEC requirements involves isolated and unintentional conduct, the implementation of new procedures or a similar remedial measure [as opposed to a monetary penalty] may be the most appropriate resolution of the case" because monetary penalties are designed to punish intentional or repeat conduct); House Report, *supra* note 4, at 21 (noting same and adding that where defendant is also subject to criminal prosecution, the imposition of a civil penalty in the SEC action may be unnecessary to achieve deterrence). *See also* Laby & Callcott, *supra* note 12, at 14 (discussing situations in which monetary penalties would be inappropriate).

appropriate because the penalty would only be passed on to shareholders.[27] Consequently, Congress intended that penalties authorized under the Investment Company Act would be imposed on the individuals associated with the company as opposed to the company itself.[28]

Similarly, and far more relevant in terms of recent SEC settlements, the Senate Report states that it would be inappropriate to penalize issuers in situations where the shareholders would have to bear the cost of the penalty.[29] For example, in the case of fraudulent financial reporting, the shareholders are often the victims of the issuer's misconduct, and as such, Congress noted that any monetary penalty imposed on the issuer would doubly punish the shareholders.[30] As a result, Congress intended that in such situations the responsible individuals associated with issuers should be penalized, but not the issuer itself, except in extraordinary cases.[31] Monetary penalties, for example, might be imposed on the issuer itself, but only when the securities law violation resulted in an improper benefit to shareholders of the corporation.[32]

III.
THE SARBANES-OXLEY AMENDMENTS TO THE REMEDIES ACT

It has been observed that in the decade or so following the enactment of the Remedies Act, the SEC did not often

27. Senate Report, *supra* note 4, at 15 ("The Committee also expects that the SEC will not ordinarily seek penalties against registered investment companies. Generally an investment company is a managed portfolio of liquid assets, with all expenses being passed on to shareholders . . . penalties based on violations of the Investment Company Act . . . [should] be assessed against the responsible individuals").

28. *Id.*

29. *Id.* ("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 . . . 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 issuers will ultimately be paid by shareholders who were themselves victimized by the violations").

30. *Id. See also* Laby & Callcott, *supra* note 12, at 15 (citing fraudulent financial fraud as example of a violation that victimizes shareholders).

31. Senate Report, *supra* note 4, at 15.

32. *Id.*

seek or obtain penalties against public companies.[33] As William McLucas, former head of SEC enforcement, has stated: "the policy was certainly influenced by the federal courts' 'unwillingness to impose significant penalties in . . . litigated matters' . . . The SEC may also have been reluctant to seek or impose penalties on public companies because, in theory, of the negative impact such a penalty would have on shareholders who had already been defrauded by the company's wrongdoers."[34]

With the passage of the Sarbanes-Oxley Act of 2002, any reluctance by the Commission to aggressively pursue large awards and settlements against alleged corporate wrongdoers came to an end.[35]

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33. Russell G. Ryan, *Civil Penalties in SEC Enforcement Cases: A Rising Tide*, 17 No. 6 INSIT. 17, 18 (2003) (noting that the Commission, despite its authority to seek civil penalties against public companies, did not often do so in the decade following the enactment of the Remedies Act).

34. William McLucas, John C. Nagel & Julie J. Song, *An Overview of SEC Enforcement, Remedial and Settlement Powers Before and After the Sarbanes-Oxley Act*, 1396 PLI/CORP 1111, 1116-7 (2003). *See also* Ryan, *supra* note 33, at 18 (attributing the SEC's reluctance to impose civil penalties on public companies to Congress' warning that such penalties "may be passed on to shareholders who either were victimized by the underlying violation or became shareholders long after any benefit accrued to the company and was reflected in its stock price"); Senate Report, *supra* note 4, at 15 (recommending that penalties be imposed against the company itself only "when the violation results in an improper benefit to shareholders").

35. In the months following the passage of Sarbanes-Oxley, the Director of the SEC's Division of Enforcement, Stephen M. Cutler, remarked on several occasions that the SEC should and would actively pursue large civil penalties against public corporations, and that the SEC's apparent reluctance to do so was disappearing with increased discovery of corporate fraud. *See* Stephen M. Cutler, *Remarks at the Glasser LegalWorks 20th Annual Federal Securities Institute* (Feb. 15, 2002), *available at* www.sec.gov/news/speech/spch538.htm (stating that the SEC would be "more willing than ever" to seek monetary penalties against public companies who use delay tactics in SEC investigations, and noting that the SEC would be justified in seeking penalties, even if the cost was passed on to shareholders because the costs of management recalcitrance are imposed by "wrongheaded management, not by the SEC"); Stephen M. Cutler, *Remarks at the University of Michigan Law School* (Nov. 1, 2002), *available at at* www.sec.gov/news/speech/spch604.htm (positing that the SEC's failure to seek large monetary penalties facilitates corporate fraud because it creates the perception that the risk of being sanctioned is relatively low; and noting that the SEC should take steps toward "ratcheting up financial fraud penalties and reversing the Commission's historical practice [of not pursuing large monetary penalties in financial fraud cases]"). In-

Like the Remedies Act, Sarbanes-Oxley added an array of new administrative and judicial remedies to the SEC's enforcement arsenal. With respect to the Remedies Act, there are three important updates provided by Sarbanes-Oxley: bonus forfeiture; the administrative director and officer ("D&O") bar, including a reduction in the standard for obtaining such a bar; and the Fair Funds Provision. Each will be discussed below.

Bonus Forfeiture

If an issuer's misconduct results in material non-compliance with SEC financial reporting requirements, such that a financial report must later be restated, the CEO and CFO of that company may be required to reimburse the company for certain bonuses and other compensation.[36] Specifically, the CEO and CFO will have to repay to the company:

> (1) any bonus or other incentive-based or equity-based compensation received by that person from the issuer during the 12-month period following the first public issuance or filing with the Commission (whichever comes first) of the financial document embodying such financial reporting requirement; and (2) any profits realized from the sale of securities during that 12-month period.[37]

Where necessary or appropriate, the SEC may exempt individuals from this requirement.[38]

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deed, in April 2004, Mr. Cutler noted that the goal of pursuing and imposing large monetary penalties on public companies had been accomplished. *See* Stephen M. Cutler, *Remarks at the 24th Annual Ray Garrett Jr. Corporate & Securities Law Institute* (April 29, 2004) *available at* www.sec.gov/news/speech/spch042904smc.htm ("In only a decade, we've gone from a regime in which monetary penalties were imposed only rarely to one in which large penalties seem to be part of virtually all significant settlements.").

36. *See generally* Sarbanes-Oxley Act of 2002 § 304 ,15 U.S.C. § 7242 (2002). *See also* Colleen P. Mahoney, et al., *Developments in SEC Enforcement*, 1456 PLI/CORP 1149, 1171-72 (2004); Michael R. McAlevey, *Understanding the Sarbanes-Oxley Act of 2002: What Every Corporate & Securities Lawyer Needs to Know Now*, 1345 PLI/CORP 213, 218 (2002).

37. Sarbanes-Oxley Act of 2002 § 304(a)(1), (a)(2). *See also* Mahoney et al., *supra* note 36, at 1171-1172; McAlevey, *supra* note 36, at 218.

38. Sarbanes-Oxley Act of 2002 § 304(b). *See also* Mahoney et al., *supra* note 36, at 1171-1172; McAlevey, *supra* note 36, at 218.

D&O Bars

As noted above, the Remedies Act provides that the SEC can seek, and district courts can impose, director and officer bars, prohibiting an individual from serving as an officer or director of a public company, where that individual is found to have violated the antifraud provisions of the securities laws, and if that person's conduct demonstrates "substantial unfitness" to serve as an officer or director of a public company.[39] The enactment of Sarbanes-Oxley, however, lowered the standard governing the imposition of officer and director bars from "substantial unfitness" to "unfitness," making it easier for the SEC to obtain such a bar.[40] In addition, the SEC can now seek director and officer bars in administrative proceedings, where previously it had to obtain an order from a federal court to obtain such a bar.[41]

Fair Funds

Sarbanes-Oxley provides that where the SEC obtains disgorgement or a civil penalty in a judicial or administrative proceeding or in settlement, the SEC can direct that the amount of the civil penalty be added to and become part of the disgorgement fund for the benefit of the victims of the violation.[42] The Fair Funds provision of Sarbanes-Oxley reflects Congressional intent that the civil penalty and disgorgement provisions of the Remedies Act serve not only to punish viola-

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39. *See supra* notes 36-7 and accompanying text. *See also* 15 U.S.C. § 78u(d)(2)(2005); 15 U.S.C. § 77t(e)(2005).

40. *See* Sarbanes-Oxley Act of 2002 §305(a) (amending 15 U.S.C. § 78u(d)(2) and 15 U.S.C. § 77t(e) by striking "substantial unfitness" and inserting "unfitness"). *See also* Mahoney et al., *supra* note 36, at 1182-1183 (noting that the reduced standard may result in the SEC's seeking director and officer bars more frequently, particularly in the areas of accounting and financial reporting); Stephen M. Cutler, *Remarks at the Glasser LegalWorks 20th Annual Federal Securities Institute* (Feb. 15, 2002), *available at* www.sec.gov/news/speech/spch538.htm (noting at a time when the standard was still "substantial unfitness" that the SEC was reluctant to seek officer and director bars because the Commission is "compelled to seek in court only what it realistically can expect to obtain." Because "substantial unfitness" was a difficult standard to satisfy, the SEC did not take advantage of director and officer bars as a remedy).

41. Mahoney et al., *supra* note 36, at 1182; McAlevey, *supra* note 36, at 218.

42. Sarbanes-Oxley Act of 2002 § 308(a).

tors, but also to compensate the investors who were the victims of the violations.[43]

As with the Remedies Act, the legislative history of Sarbanes-Oxley makes clear that these new provisions, and many others beyond the scope of this article, were intended to punish and thereby deter corporate wrongdoers.

For example, both the bonus forfeiture and D&O bar provisions demonstrate that one of the prime legislatives purposes of Sarbanes-Oxley was to deter corporate wrongdoing by creating more personal accountability among senior management.[44] To that end, Sarbanes-Oxley requires public company CEOs and CFOs to certify that the financial statements issued by their companies are accurate.[45] The failure to do so can subject these officers to civil or criminal penalties, bonus forfeiture, a D&O bar, or any combination of those penalties.[46]

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43. *See* Stephen M. Cutler, *Remarks Before the District of Columbia Bar Association* (Feb. 11, 2004), *available at* www.sec.gov/news/speech/spch021104smc.htm ("Congress's enactment of the Fair Funds provision of the Sarbanes-Oxley Act, which enables us to return penalty monies to harmed investors rather than to the U.S. Treasury, suggests that Congress intended that the Commission use its penalty authority to maximize investor recompense. Believe me when I tell you, we intend to do so.").

44. Stephen M. Cutler, *The Themes of Sarbanes-Oxley as Reflected in the Commission's Enforcement Program* (Sept. 20, 2004), *available at* www.sec.gov/news/speech/spch092004smc.htm (discussing the "three themes" of Sarbanes-Oxley as being: (1) accountability of gatekeepers such as auditors, corporate counsel, research analysts and boards of directors; (2) integrity of the investigative process; and (3) personal accountability and deterrence among senior management).

45. *See* Sarbanes-Oxley Act of 2002 § 302 (requiring CEOs and CFOs to certify that they have reviewed the company's SEC filings and that statements contained in the filings are accurate).

46. Stephen M. Cutler, *The Themes of Sarbanes-Oxley as Reflected in the Commission's Enforcement Program* (Sept. 20, 2004), *available at* www.sec.gov/news/speech/spch092004smc.htm ("Consistent with Sarbanes-Oxley's focus on accountability and deterrence, we have, in the past two years, held accountable the most senior executives at some of America's most fabled companies for their roles in their companies' fraudulent schemes. The list of officers we have sued is too long to detail, but includes: 16 members of Enron's former senior management team, including Kenneth Lay, Jeffrey Skilling and Andrew Fastow; Scott Sullivan, the former CFO of WorldCom, and other WorldCom executives; Linda Wachner, the former CEO, and William Finkelstein, the former CFO, of Warnaco; and Richard Scrushy, the ex-CEO and Chairman of HealthSouth Corporation, as well as 11 other HealthSouth executives. We've also brought enforcement actions against senior executives

As discussed above, Sarbanes-Oxley "strengthened the Commission's hand" in deterring corporate misconduct from the top down by lowering the standard the Commission must satisfy in order to obtain a D&O bar from "substantial unfitness" to "unfitness".[47] Thus, Sarbanes-Oxley makes clear that senior executives of public companies cannot turn a blind eye to the day-to-day activities of the company because these executives ultimately will be held accountable for the accuracy of the corporate information disseminated to the public.[48]

IV.
RECENT RELEVANT CASE LAW.

The case law construing the Remedies Act is very sparse. While there are a number of cases that reference the Act, there are a minimal number of decisions substantively analyzing its provisions. There are, however, four decisions that merit discussion here. All four come from the Southern District of New York. Two were decided by Judge Constance Baker Motley.

SEC v. Moran

In *SEC v. Moran*, the SEC alleged, and the Court found, that defendants, an investment advisory firm and its principals, committed six violations of the Investment Advisors Act and the Exchange Act by, among other things, misusing customer funds, as well as violating certain disclosure rules.[49]

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of Gateway, Adelphia, Xerox, Waste Management, Vivendi, Rite Aid, HomeStore and Gemstar, for their roles in their companies' accounting frauds").

47. *Id.* (noting that the lowering of the standard from "substantial unfitness" to "unfitness" substantially has increased the number of D&O bars sought by the Commission: "[w]hile [lowering the standard] may seem picayune, the numbers demonstrate how significant this change has been for us: in the fiscal year ended September 30, 2001, we sought only 51 officer and director bars against corporate wrongdoers. In the last two years, we have sought approximately 300").

48. *See id.*

49. *See generally* SEC v. Moran, 944 F.Supp. 286 (S.D.N.Y. 1996). The penalty provisions of the Exchange Act and the Investment Advisers Act are nearly identical. Both the Exchange Act and the Investment Advisers Act permit the Commission to seek monetary penalties in civil court, and impose monetary penalties in administrative proceedings for violations of the respective Acts. In each Act, the three-tiered penalty structure governs the

The Court began its Remedies Act discussion by summarizing the well-known goals of the Act:

> By enacting the Penalty Act, Congress sought to achieve the dual goals of punishment of the individual violator and deterrence of future violations. Indeed, the House Report on the Penalty Act made clear its intention stating:
>
> > The Committee believes that the money penalties proposed in this legislation are needed to provide financial disincentives to securities law violations other than insider trading . . . Absent a criminal prosecution or a private suit for damages . . . even the defendant who makes a deliberate decision to violate the law and causes a significant harm to the markets does not risk any monetary sanction more severe than an order of disgorgement. Disgorgement merely requires the return of wrongfully obtained profits; it does not result in any actual economic penalty or act as a financial disincentive to engage in securities fraud. A violator who avoids detection is able to keep the profits resulting from illicit activities. Currently, even a violator who is required merely to give back his gains with interest, leaving him no worse off financially than if he had not violated the law. The Committee therefore concluded that authority to seek or impose substantial money penalties, in addition to the disgorgement of profits is necessary for the deterrence of securities law violations that otherwise may provide great financial returns to the violator.
>
> Both the Exchange Act and the Advisers Act provide that any civil penalty is to be determined by the Court "in light of the facts and circumstances" of the particular case.[50]

The Court then concluded that a penalty was warranted, but reduced the penalty requested by the Commission, explaining that, "[i]n making this determination the court con-

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imposition of penalties for violations. *See* Senate Report, *supra* note 4 (noting that the penalty provisions of the two Acts mirror one another).

50. *Moran*, 944 F.Supp at 296.

siders the personal suffering which [defendant] has experienced, the substantial loss of business incurred by [defendant's] firms, the other measures imposed by the court, and the nature of Moran Sr.'s violations."[51]

The basis for the Court's reduction seems to be its consideration of the appropriate award in the framework of previous decisions:

> Both sides have offered substantial authority in the form of prior cases, to support their views of the appropriate civil penalty herein. Considering the discretionary nature of the civil penalty framework, prior decisions and consent decrees are of little comparative value for any individual matter. Each case, of course, has its own particular facts and circumstances which determine the appropriate penalty to be imposed. The court, however, recognizes the usefulness of utilizing these cases to put the current matter in a clearer perspective.[52]

Based on its review of the case law, the Court substantially reduced the total possible Tier-Two award from $1.8 million to $100,000 for all parties.[53] "The Court wrote that "this amount of penalty, while taking into account the specific circumstances of [defendants], is necessary for the protection of investors, the market, and to deter future violations [there]."[54]

SEC v. Coates

SEC v. Coates was a 10b-5 action in which the SEC alleged, among other things, that the defendant company and its controlling shareholders misrepresented the results of certain emissions testing on an automobile engine that they designed.[55] The Court found that defendants committed a total of four violations of the federal securities laws.[56]

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51. *Id.*

52. *Id.*

53. The Court applied a Second-Tier penalty as there was no allegation of continuing harm to investors. *Id.* at 296.

54. *Id.* at 298.

55. SEC v. Coates, 137 F. Supp. 2d 413 (S.D.N.Y. 2001).

56. *Id.* The Court's conclusion that defendants' four misrepresentations constituted a total of four violations of the securities laws may shed some light on the definition of violation for purposes of the civil penalty provi-

Having concluded that there were four violations for which penalties were warranted, Judge Motley then analyzed whether, as the SEC claimed, a finding of a Third-Tier violation was warranted. The Court rejected this request and found instead only a Second-Tier violation. The Court focused on the limited number of investors, defendant's cooperation, and the fact that the controlling shareholder—Coates—was jailed for a short time.[57]

Interestingly, however, rather than applying the maximum Second-Tier penalty of $50,000 per violation, the Court issued a penalty of $10,000 per violation, for a total penalty of $40,000. Other than to generally note that it considered the "context of all the facts," Judge Motley did not discuss how the $40,000 total penalty was reached.[58]

SEC v. Kane

In *SEC v. Kane*, the SEC alleged, and Judge Motley found, based on a consent decree, that defendant broker "misappropriated" approximately $595,000 of customer funds, among other misdeeds:[59]

> The SEC now seeks an order requiring Kane to pay a "substantial civil penalty" pursuant to Section20(d)(2)(C) of the Securities Act, 15 U.S.C. §77t(d)(2)(C) and Section 21(d)(3)(B)(iii). Congress promulgated these sections pursuant to the Securities Enforcement Remedies and Penny Stock Reform Act of 1990 (the "Penalty Act"). "By enacting the Penalty Act, Congress sought to achieve the dual goals of punishment of the individual violator and deterrence of future violations." Where a securities law violation has been established, the court is au-

sions of the Remedies Act. Although, as noted above, the term "violation" is not defined in the Act or discussed in the legislative history of the Act, the *Coates* case seems to indicate that a course of conduct that results in a violation of a provision of the securities laws constitutes one violation, not a series of violations, of that provision. *See Id.* at 428-30. *See also* Ferrara et al., *supra* note 3, at 45 (noting that the Commission's historical practice in seeking injunctive relief in the district courts was to treat a course of conduct as a single violation).

57. *Id.* at 428.

58. *Id.* at 431.

59. *Kane*, 2003 WL 174293 at *2 (S.D.N.Y. 2003).

> thorized to impose civil monetary penalties, with the amount of any penalty to be "determined by the court in light of the facts and circumstances" of the particular case.
>
> Section 20(d)(2) of the Securities Act and Section 21(d)(3) of the Exchange Act provide for three tiers of maximum penalties for specified degrees of culpability. The third tier allows for a penalty *for each violation of the Act* of up to $100,000 for a natural person or the gross amount of pecuniary gain to defendant as a result of the violation if the violation (1)involved "fraud, deceit, manipulation, or deliberate or reckless disregard of a regulatory requirement" and (2)such violation directly or indirectly "resulted in. . . or created a significant risk of substantial losses" to other persons.[60]

After reviewing the governing Remedies Act provisions, Judge Motley applied a Third-Tier penalty:

> The case before the court also satisfies the second prong, thus qualifying the defendant for a third-tier penalty. Kane misappropriating approximately $595,000 of his clients' money from 1989 to 1996. Notwithstanding his disgorgement of pecuniary gain, it is evident that Kane's actions "created a significant *risk* of substantial losses to other persons." 15 U.S.C. §§77t(d)(2)(C), 78u(d)(3)(B)(iii) (emphasis added). That the defendant may not have ultimately realized a net gain (inasmuch as he disgorged all profits form his illegal activities) is irrelevant to consideration of whether he created a significant "risk" of loss on others".[61]

The Court then set out the factors to be considered in determining the penalty level:

> The court may consider a number of factors in determining the appropriate amount for a civil penalty, including (1) the egregiousness of the defendant's conduct; (2) the degree of the defendant's scienter; (3) whether the conduct created substantial losses or the

60. *Id.* at *2.
61. *Id.* at *3.

> risk of substantial losses to other persons; (4) whether the conduct was isolated or recurrent; and (5) whether the penalty should be reduced in light of the defendant's demonstrated current and future financial condition.[62]

Ultimately, the Court issued a Third-Tier penalty in the amount of $200,000.[63] However, it is not clear how the Court reached that result. Presumably, the Court found only two Third-Tier violations of $100,000 each. However, the Court noted that in fact there were multiple violations of the Exchange Act that were undisputed.[64] In the end, it appears that the Court, after applying all of the above factors, simply settled on a penalty it found as fair.

SEC v. Lybrand

In the final case, the SEC charged that defendant, a broker, aided and abetted a stock manipulation scheme. The sole issue before the Court was to determine whether, and to what extent, the SEC was entitled to a penalty under the Remedies Act.[65]

After reviewing the Act and legislative history, the court summarized the relevant factors:

> General factors that courts look to in imposing those penalties include (1) the egregiousness of the violations at issue; (2) defendants' scienter; (3) the repeated nature of the violations, (4) defendants' failure to admit to their wrongdoing; (5) whether defendants' conduct created substantial losses or the risk of substantial losses to other persons; (6) defendants' lack of cooperation and honesty with authorities, if any; and (7) whether the penalty that would otherwise be appropriate should be reduced due to

62. *Id.* at *4. These factors do not directly emanate from the legislative history of the Remedies Act, however, they are generally the types of factors that district courts consider in their assessment of the "facts and circumstances" surrounding the violation.

63. *Id.* at *5.

64. *Id.* at *3.

65. SEC v. Lybrand, 281 F. Supp. 2d 726 (S.D.N.Y. 2003).

> defendants' demonstrated current and future financial condition.[66]

The court then found a Third-Tier violation and imposed a total penalty of $1.1million on all defendants:

> These egregious actions were fraudulent and involved deceit and market manipulation that resulted in millions of dollars in losses to unwitting investors, and could not have occurred but for defendants' active involvement and knowledge. Far from being an isolated event, the actions of these men involved a multitude of improper securities transactions that occurred over several months—they violated the securities laws repeatedly and with regularity.[67]

Note, however, that it is again not at all clear how the Court reached this number as there were numerous Exchange Act violations alleged, which, had a Third-Tier penalty been applied, would have yielded a much higher award. Thus, apparently the Court, consistent with other decisions in this area, simply settled on a number it felt was fair, rather than precisely analyzing the number of violations and multiplying them by the appropriate penalty.

V.
THE COMMISSION'S CURRENT APPROACH TO PENALTIES

In his most recent reported speech on the Commission's penalty jurisdiction in April 2004, Stephen Cutler, the SEC Chief of Enforcement, described the Remedies Act as "the most significant expansion of the Commission's penalty authority."[68] As he went on to say:

> With the Remedies Act, Congress addressed misconduct outside the insider trading arena and for the first time, granted the SEC the power to seek penalties for any violation of any major securities statutes. Citing "the disturbing levels of financial fraud, stock manipulation and other illegal activity in the U.S.

66. *Id.* at 730.
67. *Id.* at 731.
68. *See* Stephen M. Cutler, *Remarks at the 24th Annual Ray Garrett Jr. Corporate & Securities Law Institute* (April 29, 2004), *available at* http://www.sec.gov/news/speech/spch042904smc.htm .

> markets," Congress intended that the new civil penalties would "deter unlawful conduct by increasing the financial consequences of securities law violations.[69]

Far from focusing on the statutory language of the Act, however, Cutler made no mention of the Remedies Act in respect of how the Commission determines the appropriate penalty:

> I think we start from the presumption that any serious violation of the federal securities laws should be penalized with a monetary sanction. Indeed, Congress's willingness to extend the Commission's penalty authority to reach all categories of violations suggests lawmakers agreed that no violation should be inherently exempt from a penalty. We recognized, however, that in particular cases, there may be factors present which justify departing from this penalty presumption. Unfortunately, the number and variety of facts that may be relevant in the broad range of cases we pursue precludes our developing—or my spelling out for you—a precise, formulaic approach to arrive at a penalty amount. Indeed, if you tried to do so, you would no doubt quickly conclude that the combinations of facts and factors are nearly infinite. Nevertheless, as the staff examines the equities in each case, there are certain core factors, which are always relevant to our analysis. Supplementing these core considerations are a number of other factors which, if relevant in a particular case, may also influence our penalty recommendation.[70]

The Staff thus concentrates, not on the Three-Tier penalty regime of the Act, but instead on three "core factors," as Cutler describes them: the type of violation, the harm to investors, and cooperation with the SEC.[71]

With respect to the type of violation at issue, a key consideration is whether the violation involved fraud.[72] The Staff may be less likely to impose a penalty where the violation did

69. *Id.*
70. *Id.*
71. *Id.*
72. *Id.*

not involve fraud.[73] In his speech, however, Cutler cautioned against considering the presence or absence of fraud to be the "bright line" for determining whether the Commission will impose a penalty, noting that "[t]he Commission has frequently imposed penalties for violations of the non-fraud provisions of the securities laws . . . although [the fraud element] is always relevant, this factor may be swamped by the presence or absence of the other core factors."[74]

Next, the Staff considers the degree of harm resulting from the violations.[75] As logic would dictate, more significant penalties will generally result from more significant harm.[76] Where the violator is a public company, the Staff will assess the significance of the harm by looking at the losses to investors caused by the company's misconduct, as reflected in the company's change in market capitalization.[77]

Finally, the Staff considers the extent of a violator's cooperation with the Commission, as measured by the standards set forth in the Commission's 21(a) Report.[78] According to Cutler, this factor "will often prove decisive in [the Staff's] analy-

73. *Id.*

74. *Id.*

75. *Id.*

76. *Id.*

77. *Id.* Cutler went on to note that where the violator is a regulated entity, "the enforcement staff is likely to assess harm from a slightly different perspective. Because of the unique, gatekeeper role these entities play in the operation of our markets, instead of simply weighing investor losses, we may also assess the harm that their misconduct caused to public confidence and trust in the markets. Examples of violators that scored high in this regard include the Wall Street firms that were part of the global research analyst settlement and the investment advisory firms that recently have reached agreements with the Commission or its staff to settle actions involving late trading and/or market timing. In this category are Massachusetts Financial Services and Putnam, which have consented to orders to pay penalties of $125million and $70million, respectively".

78. On October 23, 2001, the SEC issued a Report of Investigations Pursuant to § 21(a) of the Securities Exchange Act of 1934 and Commission Statement on the Relationship of Cooperation to Agency Enforcement Decisions ("Seaboard Report"). *See* SEC Release No. 44969 (Oct. 23, 1991). The Seaboard Report's purpose was to set forth "a framework for evaluating a company's cooperation in determining whether and how to charge violations of the federal securities laws." The Seaboard Report indicates that the SEC will consider certain factors in deciding whether to "credit" a company for its cooperation in assessing whether to charge that company with a violation of the securities laws. The Seaboard Report's framework is comprised of

sis."[79] If the violator or its counsel is "recalcitrant" or otherwise uncooperative during an investigation, the Staff is "very likely to seek a penalty in settlement."[80] Examples of recalcitrant or uncooperative behavior include misleading the Staff, or failing unreasonably to comply with the Commissions' processes.[81]

The Staff, according to Cutler, also considers certain "supplemental factors" in determining how great a penalty it will seek.[82] These factors include: (i) whether the wrongdoer is a recidivist; (ii) whether the wrongdoer is a sophisticated party who violated a clear legal standard; and (iii) whether the wrongdoer was enriched by its wrongdoing.[83] If any of these factors are present, the Staff will likely seek a larger penalty.[84] Finally, because it is important to the Staff that the wrongdoer "feel some sting" from the penalty imposed, the Staff may take into account the net worth of an individual in recommending a penalty.[85]

VI.
THE REMEDIES ACT AND THE SEC'S CURRENT APPROACH TO PENALTIES

Since the enactment of Sarbanes-Oxley in 2002, there has been an ever growing list of enormous SEC settlements with both corporate and individual alleged wrongdoers. . Noteworthy company settlements include: Worldcom ($750 million settlement); Qwest Communications ($250 million settlement); Bristol-Meyers Squibb Company ($150 million settlement); Bank of America ($125 million settlement); and Royal Dutch

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four broad measures: (1) self-policing; (2) self-reporting; (3) remediation; and (4) cooperation

79. Stephen M. Cutler, *Remarks at the 24th Annual Ray Garrett Jr. Corporate & Securities Law Institute* (April 29, 2004), *available at* http://www.sec.gov/news/speech/spch042904smc.htm.

80. *Id.* Cutler added that the penalty is "likely to be particularly substantial if the violator's underlying conduct has also resulted in significant investor harm".

81. *Id.*

82. *Id.*

83. *Id.*

84. *Id.* The Staff also considers the duration of the misconduct the seniority of the employees involved in the misconduct in determining an appropriate penalty.

85. *Id.*

Shell ($120 million settlement). The individual settlements have also been extraordinary: David W. Delainey of Enron ($3.74 million settlement); Paul A. Allaire of Xerox ($1 million settlement); Jean-Marie Messier of Vivendi ($1 million settlement); John Giesecke, Jr. of Homestore, Inc. ($360,000 settlement); and Peter C. Boylan of Gemstar-TV Guide International, Inc. ($300,000 settlement).

It is difficult to analyze how these settlements square with the Remedies Act. While it is undoubtedly correct that the Remedies Act itself—along with Sarbanes-Oxley—opened the door to much larger settlements, both through monetary and non-monetary penalty provisions, it is almost certainly correct to say that these settlements, and many others like them, exceed by many multiples what the tiered-penalty provisions of the Remedies Act would permit.[86]

There are undoubtedly many reasons for this outcome. First, the increased threat of criminal prosecution in the event the SEC action is not settled leads to relatively speedy and high payments to the SEC. Second, the D&O bar may be avoided or limited by a higher payout to the SEC. Third, many companies simply want to put the SEC investigation behind them at virtually any cost that would enable them to continue to do business without the cloud of an investigation. Finally, the fair funds provisions of Sarbanes-Oxley, discussed above, have arguably made it easier for the SEC to proceed against companies for large awards, as the awards can be justified in terms of making the shareholders whole.[87]

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86. In his most recent speech, Stephen Cutler stated that the sanctions sought and obtained by the SEC have "always been governed by principles of fundamental fairness" and that accusations that the SEC's penalty regime is overzealous "just don't stand up." *See* Stephen M. Cutler, *Remarks before the Directors' Education Institute at Duke University: Staying the Course* (March 18, 2005), *available at* http://www.sec.gov/news/speech/spch031805smc.htm. Cutler also noted that the corporate misdeeds with which the SEC has been faced "have merited nothing less than a tough response." *Id.* Nowhere does Cutler indicate that the Remedies Act—which gave the SEC its monetary penalty authority—factors into "principles of fundamental fairness" or the determination of what constitutes a "tough response". *See id.*

87. As noted above, Stephen Cutler has stated that the SEC should use its penalty authority to "maximize investor recompense." *See* Stephen M. Cutler, *Remarks Before the District of Columbia Bar Association* (Feb. 11, 2004), *available at* http://www.sec.gov/news/speech/spch021104smc.htm (noting that "the large-scale frauds that have been revealed recently warrant meaningful

All of these rationales, alone and in combination, have surely driven such enormous settlements. As the SEC itself has recognized, however, if the pattern of extraordinarily large settlements continues, these settlements may lose their deterrent effect, as the failure of the SEC to distinguish between relative levels of culpability will surely cause some defendants to litigate.[88] To that end, and in order to simultaneously maximize the SEC's twin goals of deterrence and fairness,[89] this article suggests that an increased focus, by both the SEC and corporate defendants, on a true application of the penalty provisions of the Remedies Act to the violations that can reasonably be proven, might allow for the differentiation among companies that the SEC seeks.[90]

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sanctions . . . we've taken other steps, such as dictating that penalties cannot not be paid by insurers or written off as tax deductions, to heighten their effects . . . Congress's enactment of the Fair Funds provision of the Sarbanes-Oxley Act, which enables us to return penalty monies to harmed investors rather than to the U.S. Treasury, suggests that Congress intended that the Commission use its penalty authority to maximize investor recompense.").

88. *See* Stephen M. Cutler, *Remarks at the 24th Annual Ray Garrett Jr. Corporate & Securities Law Institute* (April 29, 2004), *available at* http://www.sec.gov/news/speech/spch042904smc.htm (noting that "if penalties were to become uniformly high, they could, ironically, become less powerful as a deterrent").

89. *See* Stephen M. Cutler, *Remarks before the Directors' Education Institute at Duke University: Staying the Course* (March 18, 2005) *available at* http://www.sec.gov/news/speech/spch031805smc.htm (noting that civil penalties "speak loudly in a language that every defendant and respondent can understand . . . they help achieve deterrence"). *See also id.* (noting that "principles of fundamental fairness" govern the SEC's enforcement program in addition to toughness).

90. *See* Stephen M. Cutler, *Remarks at the 24th Annual Ray Garrett Jr. Corporate & Securities Law Institute* (April 29, 2004), *available at* http://www.sec.gov/news/speech/spch042904smc.htm (noting that monetary penalties must be able to distinguish "the bad from the worse" if they are to remain an important investor protection tool"). *See also* Stephen M. Cutler, *Remarks before the Directors' Education Institute at Duke University: Staying the Course* (March 18, 2005), *available at* http://www.sec.gov/news/speech/spch031805smc.htm (where Cutler expresses the view that the SEC's penalties "have been tied to specific wrongdoing by specific parties and tailored and proportionate to the unlawful conduct alleged").