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SEC ENFORCEMENT

Back to the Future: Chairman Schapiro Ends Pilot Program for Corporate Penalties, Eliminates Commission Pre-authorization, Allows Staff to Negotiate

BY MARK K. SCHONFELD

On February 6, 2009, in her first speech as Chairman of the Securities and Exchange Commission, Mary Schapiro announced the end of a two-year pilot program in which the staff of the Enforcement Division was required to seek authorization from the Commission before negotiating a penalty settlement with a public company that had engaged in accounting fraud.[1] The termination of the pilot program means a return to the practice that had existed previously under which the staff negotiated settlements with companies and then recommended a negotiated settlement to the Commission for final approval. By announcing this change in her second week on the job, Chairman Schapiro is sending a clear signal that she intends to make good on her promise to reinvigorate the Commission's enforcement program. More important, the termination of the pilot program will have significant consequences for companies involved in investigations of their accounting practices.

[1] Mary L. Schapiro, Chairman, U.S. Sec. and Exch. Comm'n, Address at Practising Law Institute Program: SEC Speaks in 2009 (Feb. 6, 2009).

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The Origins of Corporate Penalties – The Remedies Act

In order to understand the significance of Chairman Schapiro's recent announcement, it is necessary to review the history of the SEC's use of penalties against public companies.

Until 1990, the SEC had no authority to obtain penalties against public companies for violations of the federal securities laws. In 1990, Congress enacted the Securities Enforcement Remedies and Penny Stock Reform Act (the ''Remedies Act'').[2] Among other things, the Remedies Act gave the SEC the authority generally to seek civil monetary penalties in enforcement actions. The use of the penalty power against public companies was a particular point of debate in the legislative process. Opponents argued that obtaining penalties from public companies merely penalized the current shareholders of the company who were either (1) holders of the stock before and after disclosure of the fraud, and thus had already been harmed by the fraud, or (2) purchasers of the stock since disclosure of the fraud and

[2] Securities Enforcement Remedies and Penny Stock Reform Act of 1990, Pub. L. 101-429, 104 Stat. 931.

thus hadn't benefited in any way from the fraud, but were harmed by the penalty.

Proponents of the use of penalties against public companies argued that penalties were an essential means of deterring corporate fraud and that shareholders who had purchased since disclosure of the fraud were buying into the company with knowledge of the fraud and obtaining the stock at a discount incorporating the future likelihood of a penalty.

The Report of the Senate Committee on Banking, Housing and Urban Affairs expressed the dichotomy with respect to penalties. The Report expressed the view of the Committee that penalties should be applied to corporations and that penalties play an important role in deterrence and in encouraging corporate compliance programs to prevent future violations. However, the Report also noted that, ''because the costs of such penalties may be passed on to shareholders, the Committee 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 issuers will ultimately be paid by shareholders who were themselves victimized by the violations. The court also may consider the extent to which the passage of time has resulted in shareholder turnover.''[3]

One unfortunate weakness in the original penalty provision was the limitation on what the SEC could do with the penalties it collected. The SEC could only put penalties in the U.S. Treasury. The SEC could not use the penalties to compensate shareholders harmed by the fraud. Thus, the class of purchasers who held stock before and after disclosure of the fraud received no benefit from the penalties.

As a result, following passage of the Remedies Act, the SEC used its penalty authority against public companies sparingly. Indeed, it was not until 2002, that the SEC obtained a substantial penalty against a public company for accounting fraud. In that year, the SEC settled a long-running investigation of Xerox by obtaining a $10 million penalty, then the largest penalty the SEC had ever obtained from a public company for accounting fraud.[4]

The SEC's Statement on Cooperation Another significant step in the evolution of the SEC's policy on penalties came in 2001, with the SEC's Report of Investigation and Statement on the Relationship of Cooperation to Agency Enforcement Decisions, which came to be known as the ''Seaboard Report,'' so named for the company subject to the investigation.[5]

The report laid out the factors the SEC would consider in making charging and settlement decisions against public companies that had engaged in financial fraud. In summary, the factors are:

1. Self-policing prior to the discovery of the misconduct, including establishing effective compliance procedures and an appropriate tone at the top;
2. When misconduct is discovered, conducting a through independent internal investigation and self-reporting the results to the government and the public;
3. Remediation, including dismissing or disciplining wrongdoers, improving internal controls and compensating those adversely affected; and
4. Cooperation with law enforcement authorities, including providing the SEC staff with all information relevant to the underlying violations.

The Seaboard Report was written in the context of a case in which, in view of the relatively limited violation and the company's extraordinary cooperation, the SEC decided not to file any charges against the company and to make that decision public. Thus, the Seaboard Report signaled the possibility for a company, under the right circumstances, to avoid charges altogether.

On the other hand, the Report also presaged the opposite possibility – that a company that, in the SEC's view, has committed a serious violation of the securities laws, and that fails to cooperate or even obstructs or hinders an investigation, could face a demand for substantial penalties.

At about the same time came the infamous accounting frauds of Enron, Worldcom, Adelphia and others. With that came the expectation, much like today, that the SEC needed to be more aggressive in seeking sanctions against public companies engaged in fraud.

Sarbanes-Oxley The next step came in 2002, with the passage of the Sarbanes-Oxley Act. Among its many provisions, one was particularly relevant to this issue: Section 308, the ''Fair Funds'' provision.[6] Section 308 provided that if the SEC collected disgorgement and penalties, the SEC could put the penalty, along with the disgorgement into a fair fund for distribution to victims. As a consequence, penalties sought from the company would not need to go solely to the U.S. Treasury. More important, the argument that penalties merely harm current shareholders was diminished – penalties could be redistributed to compensate harmed shareholders.

Not surprisingly, penalties began to rise in both amount and frequency. According to data recently cited by Commissioner Luis Aguilar, penalties in 2003 reached a total of $800 million.[7] In the case of WorldCom, the federal court approved a settlement with a penalty to be satisfied post-bankruptcy by the company's payment of $500 million in cash and stock valued at $250 million.[8]

At the same time, due to other waves of scandal involving investment banks, mutual funds and other

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[3] S. Rep. No. 101-337, at 17 (1990).

[4] Press Release, U.S. Sec. and Exch. Comm'n, Xerox Settles SEC Enforcement Action Charging Company with Fraud (Apr. 11, 2002).

[5] 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, 76 SEC Docket 220 (Oct. 23, 2001).

[6] Sarbanes-Oxley Act of 2002, Pub. L. 107-204, § 308, 116 Stat. 745.

[7] Luis A. Aguilar, Commissioner, U.S. Sec. and Exch. Comm'n, Empowering the Markets Watchdog to Effect Real Results, Address Before the North American Securities Administrators Association's Winter Enforcement Conference (Jan. 10, 2009).

[8] Press Release, U.S. Sec. and Exch. Comm'n, The Honorable Jed Rakoff Approves Settlement of SEC's Claim for a Civil Penalty Against Worldcom (July 7, 2003).

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''Wall Street'' firms, penalties increased particularly against SEC registered financial services firms. The nine-figure settlement became routine. The investment banks paid a total of $1.6 billion to resolve cases arising out of analyst research. Subsequently, mutual fund companies and hedge funds paid in excess of $2 billion in disgorgement and penalties to settle cases arising from mutual fund market timing, late trading and shelf space arrangements. In most cases, the money is being distributed through fair funds.

The SEC's Statement on Corporate Penalties As the penalties escalated, so too did the debate among commentators, practitioners and the Commissioners over the merits of such high penalties. In addition to the sheer size of penalties, the securities bar commented on the inability to reconcile the outcome of a settlement to the particular facts of a case, as well as an inability to discern the weight the staff gave to the issuer's cooperation in the investigation. In a speech delivered in 2004, Stephen Cutler, then the Director of the Division of Enforcement, delivered a speech in which he laid out the factors the staff took into account in determining an appropriate penalty, including (a) core factors: the severity of the violation, the degree of harm to shareholders, and the extent of the company's cooperation, and (b) other factors: recidivism, benefit derived from the violation, and the defendant's financial resources.[9]

Nevertheless, the debate over corporate penalties continued. In a speech delivered in 2005, then Commissioner Paul Atkins explained the objection to assessing large penalties against public companies: ''Large corporate penalties . . . generally make good headlines, but do they make economic sense in cases of financial fraud, where management basically has lied to shareholders? Shareholders, who have already lost money as a result of a financial fraud when their stock's value declined in the marketplace, are again penalized when the corporation is slapped with a penalty. Our goal is to return this money to defrauded shareholders. But would it not make more sense to leave it with the shareholders in the first place and go after individual wrongdoers instead? Supporters of large corporate penalties justify them as necessary for deterrence. But whom are we deterring? Corporations don't act, people do. Wouldn't stiff penalties against individuals have a larger deterrent effect?''[10]

In 2006, the SEC issued a Statement Concerning Financial Penalties (the ''Penalty Statement'').[11] The Penalty Statement represented an attempt by a divided Commission to reach consensus on a set of principles under which the Commission would determine whether and to what extent to impose civil penalties against a public company. The Penalty Statement reviewed the legislative history of the Remedies Act and the competing concerns of deterrence on the one hand and avoiding further harm to shareholders on the other hand. The Commission reiterated its view that ''corporate penalties are an essential part of an aggressive and comprehensive program to enforce the federal securities laws.'' The Penalty Statement then set forth nine criteria the Commission would consider in determining whether, and to what extent, to seek penalties from a public company. The first two factors were the ''principal'' considerations: (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 the injured shareholders. The remaining seven criteria were deemed ''additional'' factors: (3) the need to deter the particular type of offense, (4) the extent of injury to innocent parties, (5) whether complicity in the violation is widespread through the corporation, (6) the level of intent on the part of the perpetrators, (7) the degree of difficulty in detecting the particular type of offense, (8) the presence or lack of remedial steps by the corporation, and (9) the extent of cooperation with the Commission and other law enforcement.

Unfortunately, the Penalty Statement did little to resolve the debate among the Commissioners on the issue of corporate penalties.

The Pilot Program In 2007, then Chairman Cox announced in a speech a ''pilot program'' for cases against a public company in which the staff recommends seeking a monetary penalty.[12] In such cases, before the staff could negotiate a settlement with the issuer, the staff must first obtain the authorization of the Commission to negotiate within a proposed range of penalties. This was a departure from the practice the SEC had followed up to that point, and which the staff continued to follow with respect to all other cases, namely that the staff would first negotiate all aspects of a settlement and then recommend the settlement to the Commission for final approval. Chairman Cox explained the merits of the pilot program as threefold. First, the negotiating position of the staff would be strengthened by knowing that the Commission had already approved the penalty. Second, cases that were settled within the range approved by the Commission would be eligible for expedited final approval by the Commission through its seriatim procedure. Third, Commission pre-authorization would help to bring national consistency and predictability to the use and determination of penalties.

The pilot program became the subject of criticism for adding delay to the settlement process and reducing the penalties assessed against companies. In a speech delivered in January 2009, Commissioner Luis Aguilar cited data on the total penalties assessed against public companies in each year (excluding cases under the antibribery provisions of the Foreign Corrupt Practices Act): $637 million in 2006, $310 million in 2007, and $96 million in 2008 – as compared to $800 million in 2003.[13] Commissioner Aguilar called for the immediate termination of the pilot program and announced his intention to ask Chairman Schapiro to make termination of the pilot program her first official act.

At her confirmation hearing before the Senate Committee on Banking, Housing and Urban Affairs, Senator Jack Reed (D-RI) asked Chairman Schapiro about her

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[9] Stephen M. Cutler, Director, Div. of Enforcement, U.S. Sec. and Exch. Comm'n, Address at 24th Annual Ray Garrett Jr. Corporate & Securities Law Institute (Apr. 29, 2004).

[10] Paul S. Atkins, Commissioner, U.S. Sec. and Exch. Comm'n, Remarks Before the SIA Industry Leadership Luncheon (June 8, 2005).

[11] Press Release, U.S. Sec. and Exch. Comm'n, Statement of the Securities and Exchange Commission Concerning Financial Penalties (Jan. 4, 2006).

[12] Christopher Cox, Chairman, U.S. Sec. and Exch. Comm'n, Address to the Mutual Fund Directors Forum Seventh Annual Policy Conference (Apr. 13, 2007).

[13] Aguilar, *supra* note 7.

views on the pilot program. Chairman Schapiro responded that as to the pilot and other aspects of the enforcement process, she intended to ''take the handcuffs off the Enforcement Division.''[14]

True to her word, in her first speech Chairman Schapiro announced the termination of the pilot program. In her speech, Chairman Schapiro stated that the pilot program introduced significant delays into the process of bringing a corporate penalty case, discouraged staff from arguing for a penalty and sometimes resulted in reductions in the size of penalties imposed. Chairman Schapiro further stated that the end of the program is designed ''to expedite the Commission's enforcement efforts and ensure that justice is swiftly served.''[15]

Implications of Termination of the Pilot Program In general, Chairman Schapiro's first speech clearly signals an intent to make good on her promise to reinvigorate SEC enforcement. As a result, subjects of SEC investigations are likely to start to experience greater pressure from the SEC staff to respond more quickly to requests for documents and testimony.

More specifically, the termination of the pilot program on corporate penalties will have several significant consequences for public companies under investigation. First, to the extent the elimination of the program expedites the process of resolving investigations, companies will benefit from an ability to bring closure to an investigation more promptly. In many cases, the extended overhang of an investigation and the impact on the company's franchise can be more costly to a public company than the ultimate settlement.

Second, it is likely that penalties will go up, both in size and frequency. In the current environment, there is substantial pressure on the SEC to demonstrate that it will be aggressive against securities fraud. At the same time, however, the SEC and its staff will need to weigh sanctions against the precarious financial condition in which many public companies currently find themselves and the substantial shareholder value that has already been lost due to the broader economic turmoil.

Third, the change in procedure also means that penalties could become more variable depending on the particular office and staff of the SEC that conduct the investigation. This will undermine the goals of consistency and predictability promoted by the prior Commission. In place of the pilot program, the SEC may wish to consider some more concrete form of guidelines that give public companies and their shareholders some greater degree of predictability as to their exposure depending on the underlying conduct and various mitigating and aggravating factors.

Fourth, the change will heighten the importance of the factors identified in the Seaboard Report—factors other than the specific alleged misconduct, which go into the SEC's determination of an appropriate penalty. For example, beyond the egregiousness of the alleged fraud, the company's pre-existing compliance procedures and internal controls, cooperation in the investigation and remediation of deficiencies will be important factors in the outcome of any settlement. More to the point, it will be the staff's perception of the company's response that will be relevant. As a result, it will be important that a company responding to an SEC investigation demonstrate early to the SEC staff that it had reasonable compliance procedures in place and that it is responding appropriately to the investigation.

Finally, the termination of the pilot program will not resolve the underlying debate over corporate penalties. Both sides will continue to argue over the costs and benefits of corporate penalties as an appropriate remedy and an effective deterrent for accounting fraud committed by senior management. For now, the debate will be subsumed beneath larger issues concerning the SEC's response to the current financial crisis and its role in the future financial regulatory structure. The real challenge will be to see how the SEC resolves the debate over appropriate penalties in particular cases over an extended period of time. Past experience indicates that the approach will be heavily dependent on the prevailing winds in Washington and Wall Street.

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[14] *Nomination Hearing Before the S. Comm. on Banking, Housing, and Urban Affairs*, 111th Cong. (2009) (statement of the Hon. Mary Schapiro, Chairman-Designate, U.S. Securities and Exchange Commission), *available at* http://banking.senate.gov/public/index.cfm?Fuseaction=Hearings.Detail&HearingID=ab9dda7a-3a2f-41f9-bb69-5b0c7c4e10fb.

[15] Schapiro, *supra* note 1.

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