Report on the Current Enforcement Program of the Securities and Exchange Commission

U.S. Chamber of Commerce

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INDEX

EXECUTIVE SUMMARY .................................................................................................................................................. 2

INTRODUCTION ................................................................................................................................................................ 4

RECOMMENDATIONS .......................................................................................................................................................... 7

I. BACKGROUND: THE CURRENT SEC ENFORCEMENT PROGRAM ............................................................................ 9

II. A VIEW OF THE SEC’S CURRENT ENFORCEMENT PROGRAM .................................................................................. 16
   A. Observations on the Enforcement Process and the Focus of the Program ............................................................. 16
      1. General Enforcement Focus and Process ............................................................................................................... 16
      2. Increased Enforcement Actions in Cases of Legal or Factual Uncertainty ......................................................... 17
      3. Increasingly Punitive Nature of the SEC’s Enforcement Program ........................................................................ 24
   B. Observations on Specific Current Enforcement Policies .......................................................................................... 26
      1. Imposition of Penalties on Public Companies ...................................................................................................... 26
      2. Imposition of Fines for “Lack of Cooperation” .................................................................................................... 30
      3. Pressure to Waive Privilege During Investigations ............................................................................................ 35
      4. Marginalizing of Reliance on Experts and Subordinates ...................................................................................... 37

CONCLUSION ........................................................................................................................................................................ 40
The Securities and Exchange Commission (the SEC or Commission) has primary responsibility for maintaining the health and competitiveness of our capital markets. It has been and is regarded as a strong steward, promulgating well-considered regulation and carrying out fair enforcement. As a result, the U.S. capital markets have attracted trillions of dollars of investment from both domestic and foreign sources, and all aspects of our economy have benefited.

Over the last few years, as a result of a tremendous crisis in confidence in U.S. corporations, the Commission’s policies and procedures have become subject to external pressures that threaten to have, or in fact have had, a negative effect on the fundamental fairness of certain aspects of the enforcement program. Concern has been expressed from many quarters about increased lack of clarity in standards of conduct and a move toward an overly punitive approach to enforcement. Such developments could be detrimental to the Commission, to the interests of the investors it is to serve, and to the capital markets that it is mandated to enhance.

The U.S. Chamber of Commerce (the Chamber), which represents the interests of more than 3 million businesses and organizations of every size, sector, and region, strongly believes that the U.S. capital markets are the lifeblood of our economy—and that sound regulation and enforcement are needed to help our markets remain healthy and competitive. Many of the Chamber’s members have expressed the same concerns referenced above. In order to move away from argument by anecdote, the Chamber asked David Andrews, retired senior vice president for government affairs, general counsel, and secretary for PepsiCo Inc., to review the current SEC enforcement program and make recommendations for improvements. To support his review, Mr. Andrews engaged Bruce Hiler, chair of the Securities and Financial Institutions Regulation Department at Cadwalader, Wickersham & Taft and a former associate director of the SEC’s Division of Enforcement. In addition to extensive legal research, this report is informed by interviews with over 35 securities practitioners, academics, and general counsels and corporate secretaries from public companies, including former SEC commissioners and staff members. It is intended to be a thoughtful and responsible examination of the issues presented in this critical area.

On pages 7–9, the report makes recommendations concerning both the investigative process and certain policies pursued by the Commission in assessing whether to bring an enforcement action and what the appropriate sanctions should be. It is recommended that the Commission appoint an Advisory Committee to study its enforcement processes and that the Commission review the reasons for a wave of recent litigation losses. In those recent losses, administrative law judges and courts have been critical of the SEC’s legal and factual analysis or positions. The report greatly applauds the Commission’s recent efforts to clarify its standards for seeking fines against public companies for securities law violations caused by individual employees, and suggests further clarification as it gains experience in applying those standards. In addition, it rec-
ommends that the SEC make clear that waiver of attorney-client privilege is not required in order to be viewed as cooperative in its investigations, and calls upon the SEC to stop entirely the practice of imposing fines on corporations for perceived lack of cooperation. The report also calls for the commissioners to be involved in determinations concerning the appropriateness of criminal referrals and criminal investigations of securities law violations, and to make clear that good-faith reliance on the involvement of attorneys and accountants in corporate transactions and disclosure decisions will be viewed as relevant to the Commission’s enforcement decisions, in accord with federal court decisions.

It should be emphasized that a critical examination of enforcement policies and procedures does not imply—and should not be construed as implying—any support for businesses or individuals that engage in improper conduct. It is critical for the health and welfare of our capital markets that the SEC have a strong and vigorous program of enforcement that punishes and removes bad actors from the stage. However, it also has to be acknowledged that enforcement that burdens good, responsible companies will have extremely negative effects on our markets. This report is simply intended to help the SEC to avoid that outcome.
The SEC has become a premier federal agency, charged with administering the various statutes through which the U.S. securities markets are regulated. The Commission has wide-ranging powers to investigate and sanction violations of the statutes it administers. Those powers periodically have been enhanced by congressional action, often in response to events in the securities markets that Congress viewed as calling for strengthening and expanding the Commission’s ability to deter those who would endanger the integrity of those markets through their misconduct.

Beginning in 2001, revelations at certain major U.S. public companies led to additional congressional action to strengthen both the SEC’s enforcement powers and its authority to oversee and regulate corporate disclosure, internal controls, and other corporate activities. The public generally has applauded the Commission’s aggressive use of its enforcement powers to attempt to remedy the issues that have come to light and to punish those responsible. Over the past several years, however, corporate officials, securities practitioners, academics, and even present and former members of the SEC increasingly have expressed concern over certain aspects of the SEC’s current enforcement program. These concerns have ranged from matters relating to the investigative processes, such as the use of industry-wide sweeps and pressure on corporations to waive attorney-client privilege during investigations, to policy issues, such as the appropriateness of imposing fines on corporations for violations caused by corporate employees or for perceived lack of cooperation. The membership of the Chamber generally has echoed many of those same concerns.

In early 2005, the Chamber engaged David Andrews, retired senior vice president for government affairs, general counsel, and secretary, PepsiCo Inc., to develop this report. He engaged Bruce Hiler of Cadwalader, Wickersham & Taft as counsel for the project. They conducted interviews of over 35 securities practitioners, general counsels, and corporate secretaries from public companies in a variety of businesses, as well as academics who teach in the securities law area. Some of those interviewed were formerly SEC staff members or commissioners. They also reviewed numerous academic and financial press articles and various studies or reports relating to the current operation and focus of the SEC’s enforcement program. They reviewed litigated SEC enforcement actions and criminal matters over the last four years and statistics and reports on SEC enforcement actions, both settled and litigated. Interviews were conducted as informal dialogues and no formal survey method or questionnaire was utilized.

The purpose of this report is to provide a viewpoint on the SEC’s enforcement program from those who come in contact with and see the effects of that program on corporate America from outside the government.

The purpose of this report is to provide a basis to begin a dialogue with the Commission concerning the issues discussed and the recommendations that are offered. In light of the recent changes in both the SEC’s enforcement and regulatory authority and the views and recommendations expressed in this report, we believe the Commission should undertake a review of its enforcement practices and policies and should consider modifications where appropriate.
In the past, the Commission has recognized the need periodically to review and reevaluate its enforcement program. In 1972, the SEC itself convened an Advisory Committee on Enforcement Policies and Practices (the Wells Committee) to conduct a study of its enforcement processes and policies. In June 1972, the Wells Committee submitted its report to the Commission and made numerous recommendations. They ranged from recommending that the Commission defer enforcement action when violations resulted from honest mistakes or where there were good-faith efforts at compliance, to recommending that the Commission designate an official to audit the investigative practices and techniques of enforcement personnel on a continuing basis for “fairness, promptness, and efficiency.”

Although it may be tempting for some to dismiss the concerns raised in this report as simply the subjective views of individuals involved on the defense side of the enforcement process, there are at least two important objective factors supporting careful consideration of those concerns.

First, as noted above, the Commission itself has recognized the legitimacy and need to consider seriously the views of those whom its regulation and enforcement activities affect. The Wells Committee Report recognized in 1972 some of the same issues that continue to be of concern to those interviewed for this report. More recently, the Commission itself has recognized the significance of some of the policy issues raised in the report. This latter point will be referenced in the body of the report where applicable, but a recent prominent example is the Commission’s public enunciation of certain standards for determining whether to impose fines on public companies and the appropriate amount of any such fine. The very announcement of those standards, as well as other statements by various commissioners discussed throughout the report, indicate that certain of the issues raised by interviewees in fact are recognized by the commissioners as worthy of careful consideration.

Second, evidence from objective, independent third parties indicates that a number of the issues raised by those interviewed should be of concern to a responsible regulator. That evidence consists of recent criticisms by federal courts or administrative law judges of litigation positions taken by the Commission in a number of actions in just the last two years. In a number of cases decided in 2004 and 2005, the Commission’s theories were rejected or its decisions were overturned for one or more of the following reasons: (1) the Commission used an inappropriately low threshold for scienter; (2) the Commission asserted that the applicable legal principle or the inappropriateness of the conduct was clear or obvious when in fact it was not; (3) there was a complete or significant failure to present evidence or analysis on various issues.

in the case. These cases, discussed in Part II.A.2 of the report, provide an objective and compelling reason that the Commission should carefully consider the views expressed by interviewees. Those views are summarized below.

The report is in two main parts. Part I presents a discussion of the background for the report and the development of the SEC’s current enforcement program. Part II is divided into two portions. Part II.A presents a discussion of issues identified concerning the general focus of the SEC’s current enforcement program, and issues relating to the conduct of its investigative process. Generally, concerns expressed in this area went to the overall fairness of the Commission’s fact-finding investigations, the desire for more uniformity in results and sanctions, and the desire for more transparency and objectivity in the standards being applied in both judging conduct and imposing sanctions. Interviewees generally expressed the view that the Commission is increasingly advancing legal principles or interpretations of those principles in settlements and litigated actions that would lower the threshold for key elements of liability like scienter and materiality. The Commission is viewed as moving the standards of acceptable conduct and of corporate responsibility toward an almost strict liability standard, or one that tends to presume bad faith where a violation has occurred. This issue is discussed specifically in Part II.A.2 and evidenced through the reaction of federal courts to a number of Commission-litigated actions over the last two years.

Part II.B of the report presents a discussion of issues relating to a number of apparent policies being pursued or applied currently by the SEC through its enforcement program. The most prominent issues raised by interviewees in this area were (1) the imposition of penalties on public companies; (2) the imposition of fines for lack of cooperation with Commission investigations; (3) the pressure being brought to bear on corporations to waive attorney-client privilege and work product protection during investigations; and (4) the marginalizing of reliance on attorneys and accountants. Generally, interviewees expressed concern over the size of penalties being required from public companies in SEC settlements and the justification and lack of a uniform or transparent rationale for them. There also was general concern over the amount of pressure that has developed for corporations to waive attorney-client privilege and to terminate employees during SEC and parallel Department of Justice (DOJ) investigations. Concern was expressed over the effects of that pressure on other corporate interests, including a corporation’s position in private litigation. Finally, there was concern that the Commission is pursuing some actions without giving adequate deference to the fact that legal, accounting, or other experts reviewed or advised on particular transactions or disclosure which the Commission later questions.
**RECOMMENDATIONS**

1. The Commission should appoint an Advisory Committee to study its enforcement processes and policies, as was done by the Wells Committee. The study should include a review of all aspects of the conduct of investigations to ensure fairness and efficiency. Similar to one of the recommendations of the Wells Committee, it is recommended that the Commission also consider developing a mechanism for periodic review of its enforcement techniques, policies, and procedures and their effects on corporate and shareholder interests.

2. The Commission also should review the reasons for recent litigation setbacks, and should consider whether the Commission is attempting to shift the standards for civil liability on issues like materiality and scienter to an inappropriately low level, through its litigation and settlement positions.

3. The Commission should endeavor to avoid interpretation or expansion of regulations through enforcement actions and should seek to clarify its views on standards of conduct and legal standards before initiating enforcement actions for violation of those standards.

4. The Commission should consider the use in appropriate cases of formal reprimands, as suggested by the Wells Committee in 1972, and of Memoranda of Understanding, as utilized by banking regulators, to remedy situations short of enforcement actions. In addition, the wider use of Reports of Investigation under Exchange Act Section 21(a) can help provide meaningful guidance on difficult disclosure and accounting issues and on the Commission’s emerging views on appropriate standards of conduct.

5. The Commission should work to ensure that the line between civil actions and appropriate criminal prosecutions is not blurred, and that criminal referrals for securities violations are reserved for clearly egregious cases. The Commissioners should be actively involved and have a significant role in the decision-making process before the DOJ pursues an investigation or initiates a prosecution of possible federal securities law violations, and in referrals to criminal prosecutors.

6. We greatly applaud the Commission’s efforts to clarify its standards for seeking fines against public companies for securities law violations caused by individual employees. The Commission should continue to clarify this policy as it gains experience in applying its recently announced standards, and consider utilizing them only in cases where (1) the possibility of a reasonable fine will encourage entities to direct resources at compliance; or (2) consistent with the legislative history of the fining provisions, a tangible, improper benefit to current shareholders from the misconduct outweighs the inevitable harm to current shareholders and other stakeholders that results from such a fine.

7. The Commission should make clear that a waiver of attorney-client privilege or work product protection is not required in order to be viewed as cooperating with a Commission investigation, and to obtain more lenient treatment.
8. Although corporations should endeavor promptly to determine when employees have engaged in improper conduct, in considering cooperation and remedial efforts by corporations involved in investigations, the Commission should be cognizant of the difficulties corporations face in fairly coming to a determination about that conduct. The Commission should ensure that corporations are not pressured to reach unsupported or hasty conclusions on employee conduct during ongoing investigations.

9. In judging the cooperation of corporations, the Commission should carefully consider burdens associated with complying with demands which were made during an investigation for document production, especially where electronic documents are involved or where investigations require extensive searches for hard-copy documents from older or off-site files.

10. The Commission should not impose fines on corporations for lack of cooperation in its investigations. The Commission has adequate tools through its traditional use of subpoena enforcement actions, the threat of such actions, and its rules relating to maintenance and production of books and records by regulated entities to ensure that corporations are not dilatory in dealing with the Commission.

11. To the extent the Commission believes it is authorized to impose penalties for lack of cooperation, it should enunciate clear and consistent standards and establish a disciplined process for review of alleged uncooperative conduct, at the Commission level.

12. The Commission should make clear that it does not disfavor and will not deem uncooperative corporations that either indemnify or advance legal expenses for their employees in connection with SEC investigations or litigation.

13. The Commission should make it clear that good-faith reliance on the involvement of attorneys and accountants with transactions and disclosure issues will be viewed as relevant to enforcement decisions.

14. The Commission should continue to take steps to eliminate overlap between securities enforcement efforts of state Attorneys General, self-regulatory organizations, the Public Company Accounting Oversight Board, and its own enforcement efforts.

15. The Commission should encourage its operating divisions and offices and the self-regulatory organizations to conduct an open dialogue with corporations and regulated entities, and provide guidance on regulatory and disclosure issues.
I. BACKGROUND: THE CURRENT SEC ENFORCEMENT PROGRAM

Through most of its 71-year history, the SEC has enjoyed a respected status as a dynamic and fair administrative agency, effectively regulating the U.S. securities markets and enforcing the federal securities laws. Beginning with the establishment of a separate Division of Enforcement in 1972, the SEC’s enforcement program began a transformation from a necessary adjunct to the agency’s regulatory functions, with a focus on remedial enforcement actions seeking equitable remedies, to a program focused largely on pursuing more punitive actions by what has become a powerful federal prosecutor. As the U.S. securities markets and industry grew in size and complexity, Congress, often at the request of the Commission, steadily augmented the Commission’s enforcement powers. With the help of the Insider Trading Sanctions Act of 1984, the Insider Trading and Securities Fraud Enforcement Act of 1988, and the Securities Enforcement Remedies and Penny Stock Reform Act of 1990, the SEC entered the nineties equipped with broad remedial and punitive enforcement authority. This included authority to issue administrative cease-and-desist orders, temporary restraining orders, and orders for disgorgement.

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5 The background section of the Insider Trading and Securities Fraud Enforcement Act of 1988 House Report states that “the Commission also voted recently to seek a statutory expansion of its authority to impose fines in cases of securities law violations that do not involve insider trading.” H.R. Rep. No. 100-910, at 16 (Sept. 14, 1988), reprinted in 1988 U.S.C.C.A.N. 6043, 6053. After a discussion of the Ivan F. Boesky and Drexel Burnham Lambert, Inc., scandals, the report noted the Commission’s lack of resources, and testimony of SEC Chairman David S. Ruder, and United States Attorney for the Southern District of New York Rudolph Giuliani, that “their respective offices have been unable to pursue all potential insider trading investigations solely due to a lack of needed resources.” Id. at 6051.


As a result of these Acts, the Commission also was authorized to ask federal district courts to bar an individual from acting as an officer or director of a public company for antifraud violations and to impose civil money penalties against anyone who violates any provision of the federal securities laws. 12

More recently, the Sarbanes-Oxley Act (SOX), signed into law on July 20, 200213 in the wake of a number of corporate scandals, has altered the fabric of the federal securities laws, possibly more so than any other single or combined group of Acts since 1934. Testifying before Congress about SOX, then SEC Chairman William Donaldson called it “sweeping” and “far reaching,” noting that it “affects every reporting company, both domestic and foreign, as well as their officers and directors.”14 From an enforcement perspective, SOX dramatically increased criminal penalties for violating the federal securities laws15 and gave the SEC additional enforcement powers.16 Both SOX and the flurry of new rules and regulations mandated by it increased the exposure of corporations and their officers and directors to enforcement actions under broad, general, and sometimes ambiguous provisions. 17

12 Exchange Act § 21(d)(2), (3), 15 U.S.C. § 78u(d)(2), (3); Securities Act § 20(d), (e), 15 U.S.C. § 77t(d), (e); Advisers Act § 209(e), 15 U.S.C. § 80b-9(e); Investment Company Act of 1940 § 42(e), 15 U.S.C. § 80a-41(e). The Commission also was given authority to impose fines in administrative proceedings against regulated entities, such as broker-dealers and investment advisors. Advisers Act § 203(i), 15 U.S.C. § 80b-5(i); Investment Company Act § 9(d), 15 U.S.C. § 80a-9(d). In 1984, The Insider Trading Sanctions Act, supra n.6, had authorized the Commission to seek civil penalties of up to three times the profit or loss avoided in insider trading cases, in federal court. The statute was expanded in 1988 to allow penalties against control persons in insider trading cases. See Insider Trading and Securities Fraud Enforcement Act, supra n.7.


14 See William H. Donaldson, Testimony Concerning Implementation of the Sarbanes-Oxley Act of 2002 Before the Senate Committee on Banking, Housing and Urban Affairs (Sept. 9, 2003), at 3, available at http://www.sec.gov/news/testimony/090903tswhd.htm (Donaldson Sarbanes-Oxley Testimony); see also Joseph Nocera, For All Its Cost, Sarbanes Law Is Working, N.Y. Times, Dec. 3, 2005, at C1 (quoting the Chairman of PriceWaterhouse Coopers as saying that SOX was “the most significant change to the securities laws since they were put into effect. . .”).

15 SOX contains a number of provisions that establish or significantly increase criminal penalties. Section 807, for instance, creates a new federal offense of “securities fraud” that carries a maximum prison sentence of 25 years, while Section 993 increased the maximum sentence for mail and wire fraud from 5 to 20 years, in each case. See Sarbanes-Oxley Act, supra n.13, at §§ 807, 1107, 18 U.S.C. §§ 1348, 1513. Though the Commission itself does not have criminal enforcement authority, it cooperates closely with criminal authorities. See, e.g., Cutler Michigan Law Speech, supra n.4, at 7–9 (describing SEC cooperation with DOJ); Roberta S. Karmel, Creating Law at the Securities and Exchange Commission: The Lawyer as Prosecutor, 61-WTR Law & Contemp. Probs. 33, 43 (1998) (discussing SEC’s formal criminal reference process).

16 See, e.g., Sarbanes-Oxley Act, supra n.13, at § 305, 15 U.S.C. § 78u(d)(2) (lowering threshold for officer or director bar orders); id. at § 1103, 15 U.S.C. § 78u-3(c)(1) (authorizing SEC to seek temporary freeze of extraordinary payments by issuers during investigations); see generally Levine & Hawke, supra n.4.

For example, under SOX Section 1103, the SEC can freeze the “extraordinary payments” to corporate officials during an SEC investigation, though the operative term is undefined and already has been the subject of differing judicial views. Another provision, SOX Section 304, provides that where an issuer is required to prepare a restatement “as a result of misconduct,” the CEO and CFO must reimburse the issuer for any bonus or incentive-based compensation and any profits from the sale of securities during the 12-month period following the first public filing of the financial report that ultimately was restated. However, Section 304 does not contain any guidance on what types of “misconduct” will trigger the provision and does not provide for a clear nexus between that misconduct and the officials who must forfeit their bonuses or profits. Under these and other new and undefined standards, corporate managers are exposed to additional potential liability in SEC enforcement proceedings in which, as discussed above, the Commission has increased powers to impose more punitive remedies. Interviewees expressed a fear that, ultimately, corporations and their executives are left without clear guidance on numerous new responsibilities and standards, with their potential liability in SEC or criminal enforcement actions largely left to the discretion of the Commission or the DOJ in interpreting and enforcing these provisions. SOX also authorized increased funding for the SEC, more than doubling the Agency’s budget in merely four years from

18 Sarbanes-Oxley Act, supra n.13, at § 1103, 15 U.S.C. § 78u-3(c). Compare SEC v. Gemstar TV Guide Int'l, Inc., 367 F.3d 1087, 1092–95 (9th Cir. 2004) (noting that a determination of what was an “extraordinary” payment required a comparison to an ordinary or usual payment and reversing because such a finding had not been made on the record), cert. denied sub nom., 126 S. Ct. 416 (2005) with SEC v. Gemstar-TV Guide Int'l, Inc., 401 F.3d 1031, 1045–47 (9th Cir. 2005) (en banc decision) (holding that “extraordinary” payment means a payment that typically would not have been made by the company in its customary course of business), cert. denied sub nom., 126 S. Ct. 416 (2005).

19 Sarbanes-Oxley Act, supra n.13, at § 304, 15 U.S.C. § 7243. Recently, a district court held that no implied private right of action exists under Section 304. Neer v. Pelino, 389 F. Supp. 2d 648 (E.D. Pa. 2005). However, it remains to be seen what positions other courts will take.

20 For example, SOX Sections 302 and 906 both provide that the CEO and the CFO of a reporting company must submit certifications for periodic reports filed with the SEC. Section 906 requires certification that each report “fully complies” with applicable reporting requirements and that the “information” in the report “fairly presents, in all material respects, the financial condition and results of operations of the company.” Sarbanes-Oxley Act, supra n.13, at § 906, 18 U.S.C. § 1350. Section 302 and the SEC rules promulgated thereunder similarly require, among other things, that the CEO and the CFO certify that to their “knowledge” the company’s “financial” disclosures “fairly present” in all material respects the company’s financial condition and results of operations. Sarbanes-Oxley Act, supra n.13, at § 302, 15 U.S.C. § 7241. Certifications that are made “knowing” that a report does not comply with the requirements set forth in section 906 are punishable by a criminal penalty of up to $1,000,000 and 10 years’ imprisonment. Sarbanes-Oxley Act, supra n.13, at § 906(c)(1), 18 U.S.C. § 1350(c)(1). “Willfully” certifying while “knowing” of a failure to comply under section 906 increases the possible fine to $5,000,000, and the possible prison term to 20 years. Id. at § 906(c)(2), 18 U.S.C. § 1350(c)(2). The operative standards under Sections 302 and 906, such as when will a report be deemed to “fairly present” a company’s financial condition and what is meant by “knowledge” under Section 302, are nowhere specified. Although the SEC has indicated that its rules under Section 302 are not intended to change “the current obligations of corporate officers,” see Certification of Disclosure in Companies’ Quarterly and Annual Reports, SEC Rel. Nos. 33-8124, 34-46427 (Aug. 28, 2002), 67 Fed. Reg. 57,276, 57,279 (Sept. 9, 2002), it is not clear that “knowledge” means actual knowledge, or whether in enforcing the provision, the term could be interpreted to cover “reckless” certifications or those who the Commission believes in hindsight that a officer “must have” been aware that the financial condition was not “fairly” represented, whatever that means. Moreover, the SEC has stated that “fairly present” is a higher standard than “in accordance with [GAAP].” Id.; see, e.g., Lorne, supra n.17 (discussing additional exposure); John C. Coffee, Jr., Gatekeeper Failure and Reform: The Challenge of Fashioning Relevant Reforms, 84 B.U. L. Rev. 301, 343–44 (2004) (discussing increased liability after SOX); David S. Ruder, The Securities and Exchange Commission’s Pre- and Post-Enron Responses to Corporate Financial Fraud: An Analysis and Evaluation, 80 Notre Dame L. Rev. 1103, 1143, 1148–49 (2005).

21 For example, recently, in Howard v. SEC, the DC Court of Appeals held that the SEC applied an inappropriately low scienter standard, and rejected the Commission’s assertion that the legal principle at issue was “obvious.” 376 F.3d 1136, 1147 (D.C. Cir. 2004). In another recent case, SEC v. Siebel Systems, Inc., 384 F. Supp. 2d 694 (S.D.N.Y. 2005), the SEC advocated an interpretation of the concept of materiality which was rejected by the District Court, which specifically noted that the regulation in question “was never intended to be utilized in the manner attempted by the SEC under the [circumstances presented].” See additional cases discussed infra at nn.69–71; see also United States v. Cassese, 428 F.3d 92 (2d Cir. 2005) (holding that the DOJ advanced an inappropriately low standard of what constitutes a “willful” violation of the securities laws);
$412 million in 2001 to $888 million in 2005.22 According to the Government Accountability Office (GAO), the SEC’s “enforcement program, including its regional offices, increased its staffing by approximately 29% between 2003 and 2004,” and the SEC overall hired more than 1,000 new employees as a result of increased funding authorized by SOX.23 With the aid of these new employees, the SEC’s enforcement staff pursued approximately 950 investigations in 2004, resulting in more than $3 billion in penalties and disgorgement, a record amount ordered in enforcement actions.24 This compares to 485 investigations, and penalties and disgorgement of $522 million, in 2001.25 In the last two years, the Commission has continued to pursue an unprecedented number of investigations and enforcement actions.26

Thus, as the SEC enters its eighth decade, its Enforcement Division finds itself armed not only with formidable enforcement powers and remedies, but also with unprecedented staffing and resources. Some of the increased enforcement powers, and certainly the dramatic increase in staffing and funding, resulted from the public and congressional reaction to the corporate defalcations that came to light after 2001. The U.S. financial markets periodically have experienced notable scandals.27 But the failures of Enron and WorldCom and subsequent allegations of excesses and financial fraud at other large U.S. corporations28 came on the heels of the deflation of the stock market bubble of the late 1990s, which erased trillions of dollars of market value and shareholder wealth.29 The deflation of this market bubble was unique in that it came at a time when more American households had participated in the stock market than at any previous time in U.S. history.30

Abbe David Lowell & Kathryn C. Arnold, Corporate Crime After 2000: A New Enforcement Challenge or Déjà Vu?, 40 Am. Crim. L. Rev. 219, 229-33 (2003) (discussing erosion of the standard for “intent” in criminal cases). This is not a new phenomenon, as is evidenced by the two Checkosky cases in the District of Columbia Circuit. The case involved Commission Rule 102(e), then rule 2(e), which, among other things, described when licensed accountants would be deemed unfit to practice before the Commission due to having engaged in “improper professional conduct,” but provided no clear guidance on the general standard enunciated. In a case in which two CPAs challenged the standard, the U.S. Court of Appeals for the District of Columbia initially remanded the case to the Commission “for a more adequate explanation of its interpretation of Rule 2(e)(1)(ii).” Checkosky v. SEC, 23 F.3d 452, 454, 468, 471 (D.C. Cir. 1994) (Checkosky I). Four years later the case was once again before the Court of Appeals, which held that the SEC’s continued failure to articulate a discernable standard warranted dismissal. Checkosky v. SEC, 139 F.3d 221, 227 (D.C. Cir. 1998) (Checkosky II). The Commission finally amended the rule in 1998.

24 Id. at 33.
Thus, the public and political outcry in reaction to conduct at certain corporations that came to light shortly thereafter took on an unprecedented grassroots and politicized tone. In this highly charged environment, the SEC, accustomed to being praised for its vigilance and effectiveness, suddenly found itself the target of critics from the media, Congress, and even other regulators and government agencies.

These factors have provided fertile ground to encourage, and even demand, the SEC to continue to expand its enforcement powers, to press expansive theories of liability, and to seek increasingly punitive sanctions in its enforcement actions. It is evident that the Commission has felt the need to respond to the perception that decisive action is required to stem perceived corporate malfeasance, and to demonstrate the Commission’s effectiveness as the primary guardian of the U.S. financial markets.

Against this backdrop, the SEC’s enforcement program has taken on an increasingly punitive tone. Current enforcement policy seems focused on securing large fines against both corporations and individuals and on seeking officer and director bars in most cases where a violation of the Exchange Act antifraud provision, Section 10(b), is alleged. It is evident that a


31 See, e.g., Lowell & Arnold, supra n.21, at 219-20 (discussing this phenomenon); Wasserman, supra n.17, at 5; N. Richard Janis, Taking the Stand: Deputizing Company Counsel as Agents of the Federal Government: How Our Adversary System of Justice is Being Destroyed, Wash. Law. (Mar. 2005), available at www.dcbar.org/or_lawyers/washington_lawyer/march_2005/stand.cfm (discussing response to public and political pressures); Aaron Bernstein, et al., Bracing for a Backlash, Bus. Week (Feb. 4, 2002), at 34.


33 See, e.g., Wasserman, supra n.17 (discussing post-Enron environment and government reaction); see also Levine & Hawke, supra n.4; Cutler Michigan Law Speech, supra n.4, at 2 (crediting the record setting number of enforcement actions to the "unusual pressure to deliver results"); Janis, supra n.31, at 1.

34 During a recent SEC Historical Society panel, former SEC General Counsel Ralph Ferrara noted that the Commission “was intended to be forward-looking, remedial and prophylactic in its enforcement program,” that it was never intended to be a punitive agency. Mr. Ferrara added that in his view the biggest mistake Congress ever made was to allow the SEC to levy civil penalties. Enforcement Remedies with Ralph Ferrara, Theodore Levine, William McLucas, Mary Schapiro and Linda Thomsen (Oct. 20, 2005), at 6, available at http://www.sechistorical.org/museum/programs/transcripts/Transcript_2005_1020_EnforceRem.pdf; Wasserman, supra n.17, at 3–7; see also Levine & Hawke, supra n.4, at 17 (discussing historical remedial actions); Stephen M. Cutler, Speech by SEC Staff: 24th Annual Ray Garrett Jr. Corporate & Securities Law Institute (Apr. 29, 2004), at 7, available at http://www.sec.gov/news/speech/spch042904smc.htm (Cutler Ray Garrett Speech) (discussing the Commission’s use of penalties generally, and describing the “regular imposition of large civil penalties” as a “relatively recent phenomenon”).

35 Under Exchange Act § 21(d)(2), 15 U.S.C. § 78u(d)(2), the SEC may seek an order in Federal District Court to prohibit an individual who has violated Exchange Act Section 10(b) or the rules thereunder (the “antifraud provisions”) from serving as an officer or director of a public company permanently, or for a specified period of time. A finding of fraud under Exchange Act Section 10(b) may be based on “recklessness.” See, e.g., Sundstrand Corp. v. Sun Chem. Corp., 553 F.2d 1033, 1039–40 (7th Cir.) (holding “recklessness” sufficient under Enforcement Act Section 10(b) and Rule 10b-5), cert. denied, 434 U.S. 875 (1977).
major focus of the current SEC enforcement program is to exact punishment for the avowed purpose of deterring violations by others.

For example, in fiscal 2002, the SEC obtained its first $10 million penalty against a public corporation in its settlement with Xerox Corporation. In 2003, it obtained 20 penalties of that amount or more, and in 2004 it imposed 40 such penalties on corporations. Writing in 2004, then Commissioner Harvey Goldschmid noted that the total amount of penalties imposed by the SEC in each of the years 2003 and 2004 ($2 billion in each year) was higher than the total amount of penalties imposed for the prior 15 years combined. Though acknowledging that “the numbers are off the page,” Commissioner Goldschmid maintained in separate comments that “[e]ffective deterrence requires a strong, credible threat [of enforcement],” and that “[p]enalties must sting if they are to be effective.” Similarly, the Commission’s use of orders barring individuals from serving as officers or directors of a public company in fraud actions has increased greatly over the last several years. In 2004 alone, 170 such orders were entered.

The post-Enron and WorldCom environment also has encouraged criminal authorities to become increasingly active in cases involving securities law issues and even to prospect for high-profile cases, spurred on by public and political calls for increased prosecutions. In 2004, the DOJ brought criminal proceedings against 302 entities and individuals in SEC-related matters, while the SEC and DOJ are collaborating to an unprecedented level on securities investigations.

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38 Goldschmid, supra n.2, 80 Notre Dame L. Rev. at 829.
40 See Allen, supra n.39; see also Goldschmid, supra n.2, 80 Notre Dame L. Rev. at 829 (in fiscal year 2003, the number of such bars had reached 170, and the number for 2004 is likely similar); Cutler Ray Garrett Speech, supra n.34, at 2.
41 See, e.g., Cutler Michigan Law Speech, supra n.4, at 8 (“Now, rather than cajoling criminal authorities into taking securities cases, we’re fending off competing phone calls from prosecutors vying to take the lead . . .”); Second Year Report to the President—Corporate Fraud Task Force (July 20, 2004), at 1.2, available at http://www.usdoj.gov/dag/cfft/2nd_yr_fraud_report.pdf (“President George W. Bush created the Corporate Fraud Task Force by Executive Order 13271 on July 9, 2002. Since its creation, the Task Force has coordinated and overseen all corporate fraud matters under investigation by the Department of Justice and enhanced inter-agency coordination of regulatory and criminal investigations”); Janis, supra n.31. Several commentators have noted “the political and career benefits that flow to prosecutors who focus on white-collar fraud and the resulting competition among prosecutors for high-profile securities cases.” John H. Hemann & William Kimbell, More Charges under Age-old Securities Laws; Increase in Prosecutions Results from Change Not in Laws, But in DOJ’s Priorities and Resources, Nat’l L.J., July 18, 2005, at P13.
42 Financial Audit, supra n.23, at 33.
Additionally, state attorneys general have become increasingly active in cases normally left to the federal government, the attorney general of New York’s actions involving the activities of mutual funds and Wall Street investment banks being the most prominent example of this recent trend. 44

These conditions for something of a perfect prosecutorial storm came together at a time when the SEC and the DOJ, buttressed by the Federal Organizational Sentencing Guidelines, 45 were aggressively pushing corporations to cooperate with government investigations in return for credit in resulting prosecutions. 46 The pronouncements on cooperation by the DOJ and the SEC, which began as methodologies to avoid prosecution or harsh sanctions, have turned into a prescription for corporate self-indictment and for the government to justify even harsher penalties for those deemed not to have fulfilled this expanded obligation to “cooperate.” 47 The reaction of corporations to these cross-currents and multiple prosecutorial and public pressures generally has been to waive attorney-client privilege and work product protections during government investigations, and to discipline, terminate, or force the resignations of employees even suspected of wrongdoing prior to completion of government investigations. Corporations generally seek to move quickly toward settlements with the government to be able to move on with the conduct of business and to remove the cloud of public suspicion and uncertainty resulting from a government investigation, which is damaging to the company’s stock price and its employee morale and work environment. 48

Clearly, it is both reasonable and to be expected that after the failures and defalcations that came to light in the last several years, government regulators and prosecutors would reevaluate their enforcement efforts and methods. Many of the recent regulatory reforms and pressures on corporations to improve oversight of management and financial reporting have enhanced corporate governance and the reliability of corporate reporting. But the threat of harsh, punitive sanctions for violations based on complex and unclear legal and accounting principles, and the over criminalization of securities law violations, can stifle creativity and legitimate risk-taking and create a liability-imbued and uncertain environment in which to do business. 49


46 See discussion infra Part II.B.2.

47 See Janis, supra n.31; Phyllis Diamond, SEC Demand for “Cooperation” Seen Raising Due Process Concerns, 36 Sec. Reg. & Law Rep. (BNA) 1070 (June 14, 2004); see, e.g., John C. Richter, acting assistant attorney general, Criminal Division, Remarks to the Association of Certified Fraud Examiners (July 11, 2005), at 3 (noting that “you have to get all the way on board and do your best to help the Government”).

48 For instance, the threat of a criminal prosecution against AIG and Marsh & McLennan essentially forced the boards of those companies to remove their CEOs. See Irwin M. Stelzer, The Spitzer Effect: A State Attorney Flaps His Wings and There’s a Tempest at the Fed, The Daily Standard (Apr 18, 2005) (“The Spitzerization of companies goes like this: First, public accusation; then, threat of criminal charges and corporate ruin unless the accused waive their right to confidential access to counsel, and the board fires its CEO; and, in the end, a cash settlement in lieu of a trial that would determine the truth of his charges. Even this defender of Sarbanes-Oxley and corporate reform worries whether the happiest of ends justifies these means”).

49 See, e.g., Steve Odland, Corporate Governance Task Force Chairman Speech to the FBI Corporate Fraud Training Conference on “Ethics, Corporations and Fraud,” (“We could cripple our competitiveness if the threat of criminal sanctions became so pervasive that corporations simply stopped taking risks”) (Aug. 25, 2005), available at www.businessroundtable.org/newsroom/index.aspx (Odland FBI Speech); Wasserman, supra n.17.
II. A VIEW OF THE SEC’S CURRENT ENFORCEMENT PROGRAM

A. Observations on the Enforcement Process and the Focus of the Program

1. General Enforcement Focus and Process

The SEC historically has maintained a vigorous and effective enforcement program. The agency generally has received praise for both its attempts at balanced regulatory policy and the tough but fair enforcement of the statutes and rules it administers. This historical view of the Commission’s enforcement program generally was shared by those interviewed for this report. Interviewees also generally agreed with current efforts at tough enforcement where there is clearly illegal conduct and the subjects of the action are on notice of a well-defined standard of conduct. On the other hand, concern was expressed over multiple regulators or government authorities pursuing investigations or actions for the same conduct or transactions. Some interviewees also expressed concern that insider trading was an area warranting additional investigative attention.

A number of interviewees expressed concern with the current practice of so-called industry sweeps. These sweeps are broad requests for documents and information sent to corporations across an industry where the enforcement staff has found or believes that one or more corporations in the same industry have engaged in a particular improper accounting or disclosure practice. Concern was expressed over the breadth of those requests and the time and expense of complying with them where there is no indication that the corporations to which the requests are sent have engaged in conduct similar to that found at other industry participants. Because such sweeps, in essence, require confirmation by the responding corporations that they have not engaged in similar conduct, those corporations must conduct extensive reviews, seeking to prove the negative on a wide range of transactions covering a lengthy period of time. Not only is this difficult, time-consuming, and expensive, but concern was expressed over the potential exposure of the corporation and those who responded on its behalf if it is later discovered that the review failed to uncover some impropriety.

Interviewees also generally expressed the view that over the last several years the Commission’s investigative process has become more adversarial and less objective in reaching the goal it was designed to achieve: to find the facts and determine whether a violation has occurred. Obviously, there recently have been a number of cases in which corporations have announced that they have uncovered apparent violations, but even in those situations, the degree of wrongdoing and the culpability of individuals is still often an open issue for full, objective investigation. The tone and method of questioning witnesses during testimony reportedly has become in some cases adversarial, accusatorial, or apparently presumptive of liability. It is, of course, difficult for those on either side of a matter that goes through the investigative process or reaches the formal action stage to be entirely objective. Nevertheless, where an agency is charged with setting sound regulatory policy to govern a system as unique, complex, and fundamentally important to the U.S. economy as the national securities markets, that agency must, it would seem, maintain the highest level of objectivity and informed decision-making possible.

50 See Levine & Hawke, supra n.4.
51 And see Lowell & Arnold, supra n.21, at 235-40 (discussing problems and issues with parallel government proceedings).
52 See, e.g., Wallison & Smith, supra n.1, at 14-15.
in pursuing enforcement actions. There have been situations where, even absent the types of circumstances requiring the Commission to forgo its usual processes and seek quick relief to freeze assets or enjoin ongoing conduct, the opportunity for a Wells submission has not been provided.

Some of these same issues were the subject of the recommendations of the Wells Committee in 1972. A number of the recommendations of the Wells Committee either were adopted or have been followed in practice over the years. A number of them, however, have not been adopted either formally or informally. Although the Commission’s enforcement program and the markets it regulates have changed dramatically since 1972, many of the Wells Committee recommendations are worthy of reconsideration, and were echoed by interviewees for this report.

2. Increased Enforcement Actions in Cases of Legal or Factual Uncertainty

There was a sense among many interviewees (a view shared by a number of commentators), that the current pro-enforcement atmosphere and criticisms of the Commission’s enforcement program from some quarters have encouraged the Commission to advance aggressive theories through enforcement actions, where the relevant issues are far from clear. There was a sense that there often is little patience among the Enforcement Staff for factual or legal distinctions or argumentation and that there is a lack of appropriate consideration by the Commission of the difficulties with which executives are faced in interpreting complex disclosure, accounting, and legal issues and in uncovering fraud. As one commentator put it,

53 See, e.g., Edward H. Fleischman, Toward Neutral Principles: The SEC’s Discharge of its Tri-Functional Administrative Responsibilities, 42 Cath. U. L. Rev. 251 (1993) (discussing, for example, the tension between the Commission’s rule-making and its adjudicative powers); see also Paul S. Atkins, Speech by SEC Commissioner: Remarks before the American Institute of Certified Public Accountants (Dec. 5, 2005), at 3, available at http://www.sec.gov/news/speech/spch120505psa.htm (Atkins AICPA Speech) (noting the heavy toll of investigations and that even a “light” sanction in an SEC enforcement action can have. There is no doubt that most corporations are well represented in SEC investigations, but ultimately the positions and tack taken by defense counsel are governed by the wishes of the corporation and its Board of Directors, who may be responding to the types of pressures discussed above, or those recognized by former SEC Chairman Donaldson, infra n.77 and accompanying text. When the threat of possible criminal action is added to the mix, the pressure simply to resolve the matter is intensified.

54 The so-called “Wells” process has been utilized since 1972, based on a recommendation of the Wells Committee. When the Enforcement staff anticipates making a recommendation to the Commission to authorize an enforcement action, the staff generally will allow persons who may be subject of the recommendation to submit arguments against authorization of the proposed action. See Wells Committee Report, supra n.1, at 2.

55 See, e.g., SEC v. Zahareas, 374 F.3d 624, 629 (8th Cir. 2004) (where the court criticized the SEC’s investigative procedure and noted with disapproval that the SEC “failed to allow [a defendant] to make a ‘Wells Submission’”); see also SEC v. Merchant Capital, LLC, 400 F. Supp. 2d 1336, 1373 (N.D. Ga. 2005). In Merchant Capital, the court made note of the fact that the defendant had no expectation that an action was being prepared against it, as it “was not given an opportunity by the SEC to make a Wells submission. . . . Nor was Merchant Capital given an opportunity to formally respond to any of the Commission’s charges before this action was filed.” Id. at 1364 (citation omitted).

56 A number of additional concerns expressed by interviewees for this report that had been raised as issues by the Wells Committee in 1972 include the lack of formal notice that the investigation has ended; the need for additional training and conduct manuals for staff of the Division of Enforcement; and the need for some additional, consistent, and objective review of enforcement recommendations to ensure consistency, factual support, and compliance with applicable legal principles. All of these items were the subject of recommendations by the Wells Committee Report, including that “the Commission should designate an official . . . [to] be responsible directly to the Commission, whose function would be, on a post-audit basis, to determine whether the Commission’s policy of fairness, promptness and efficiency in investigative procedure is being observed.” Wells Committee Report, supra n.1, at 2. The Wells Committee Report also recommended that the Commission give “continued attention to the conduct of investigations.” Id. at 1.

57 See, e.g., Wasserman, supra n.17, at 2, 19; Lowell & Arnold, supra n.21. See also, Baker, supra n.17, 89 Cornell L. Rev. at 313, 337-39 and 349-53 (discussing expansive character of federal criminal law and the recent stigmatizing of public companies, generally).
“[f]ueled by media coverage, the public presumption has been one of bad faith, with conduct frequently being judged with the benefit of hindsight in the worst possible light.” 58 The concern, uniformly shared by interviewees, was that the Commission’s enforcement decision-making process, to some extent, has been affected by the current wave of public sentiment that is highly suspicious of corporate motivations and conduct. The view is that in the anti-corporate, pro-enforcement atmosphere that developed since 2001, the Commission has been encouraged to pursue some enforcement actions with insufficient legal and factual bases, viewing conduct in hindsight in the “worst possible light.”

There also was a sense that there presently is an enforcement primacy at the Commission that may be affecting the decisions and the regulatory judgments of other SEC divisions and the self-regulatory organizations (SROs) to an unprecedented degree. Those divisions and the SROs at times appear reluctant to offer advice or guidance for fear of confining the parameters of possible enforcement theories. 59 Many interviewees reported that outside auditors also have become extremely cautious about giving guidance or about completing audits during SEC investigations out of apparent fear of increasingly aggressive SEC and DOJ prosecutions and shareholder actions. Interviewees expressed the view that where punitive enforcement now seems a primary goal of the SEC and the sanctions being sought are increasingly onerous, clear guidance should be offered on what are complex and often general disclosure and accounting principles, susceptible to being shaped through enforcement actions into new standards of what is acceptable or expected conduct by corporations and their directors and employees. 60

58 Wasserman, supra n.17, at 2.

59 See, e.g., Rachel McTague, Securities Lawyers Find Difficulties in Obtaining Guidance from SEC, SROs, Sec. L. Daily (BNA) (Aug. 11, 2005) (reporting that lawyers at a meeting of the Market Regulation Subcommittee of the Business Law Section’s Federal Regulation of Securities Committee expressed “strong concerns” over the difficulty in obtaining guidance from SROs as a result of recent enforcement actions against the NYSE and NASD, and that even the Commission’s own operating divisions may fear being second-guessed by the SEC’s examination and enforcement staffs).

For example, although the Commission staff’s guidance on materiality in Staff Accounting Bulletin (SAB) 99 and on revenue recognition in SAB 101 provide some helpful guidance, they include ambiguous, undefined language that appears designed to broaden enforcement options without giving clear guidance on what is expected to avoid enforcement action. Consider, for example, the reference in SAB 99 to the staff’s view that even “immaterial” or “inconsequential” misstatements can involve fraud. SEC Staff Acct. Bull. No. 99, 64 Fed. Reg. 45,150, 45155 n.44 (Aug. 19, 1999). See Harvey L. Pitt, et al., The SEC’s New Materiality Pronouncement: Materiality by Hindsight?, Insights (Oct. 1999), at 32.

Recent participants in the SEC’s General Counsel’s Forum gave SAB 101 as an example of the Commission allowing the staff to issue interpretations in a complex and controversial area, which, though issued at the staff level, have the effect of law without the dialogue and interchange of ideas inherent in the notice and comment process normally used for regulatory actions. SEC Hosts General Counsel Roundtable, 2005-222 SEC Today (Nov. 18, 2005), at 2; see also Atkins AICPA Speech, supra n.53 (same).

A number of interviewees referenced the comment process engaged in by the Corporation Finance Division during last year’s proxy season as an example of where clear guidance was not given in an area that could readily result in enforcement actions: disclosure of executive perquisites such as the use of aircraft, resulting in inconsistent treatment among issuers.

60 One noted law professor recently expressed concern that a lack of clarity from an apparent shift to a principles-based system of financial disclosure invariably exposes “American issuers and their gatekeepers to a substantially heightened threat of liability.” Coffee, supra n.20, 84 B.U. L. Rev. at 343. As an example, Professor Coffee cites the problem proposed by SOX Sections 302 and 906 in requiring certification that a filed report “fairly presents” the issuer’s financial condition and operations as not limited by any references to GAAP and seemingly requiring “full and fair disclosure in the form of a holistic picture of the company that reveals all material financial weaknesses, even if their disclosure were not required by [GAAP].” Id.; see also Paul Grant, FASB Chairman Says U.S. Is Still Some Way From Accepting Principles-Based Standards, Accountancy Age (Nov. 3, 2005), available at http://www.accountancyage.com/accountancyage/news/2145443/readycorvergence (quoting FASB Chairman Rubert Herz saying, “Principles-based accounting is hard when you don’t have principles-based enforcement or principles-based litigation around the system”); see also Rachel McTague, SEC Should Improve Communications, Former General Counsel Becker Suggests, Sec. L. Daily (BNA) (Nov. 18, 2005) (David M. Becker stating that the SEC does not communicate its expectations “with adequate precision”); General Counsel Roundtable hosted by Chairman Cox (Nov. 17, 2005), available at http://www.connectlive.com/events/secroundtable1105. And see, e.g., cases cited infra nn.69–71.
Indeed, in a recent address before the American Institute of Certified Public Accountants (AICPA) National Conference, SEC Commissioner Atkins discussed the need for clarity in accounting standards, stating that enforcement actions should not be based upon “informal guidance” or “reasonable differences of opinion about the application of GAAP.” Recently, both SEC Chairman Cox and the acting chief accountant of the Commission have lamented the complexity and lack of clarity in accounting principles. This view generally was shared by interviewees, and it extended beyond accounting principles to general legal and disclosure standards. The Commission is seen as increasingly attempting to impose shifting standards of conduct and liability through enforcement proceedings. This reportedly has caused a sense of uncertainty to envelop the business community, along with a fear that the Commission will impose a standard of liability that has not been clearly enunciated.

As a result, there is a desire for more transparency in enforcement standards, and for forward-looking interpretative guidance and rule-making where there is uncertainty as to currently acceptable standards of conduct. There also is a sense that the Commission should be even more careful in pursuing aggressive theories because of the increasingly serious effects of enforcement investigations and actions on their subjects, even where the Commission may consider a sanction to be relatively minor. There was a sense among interviewees that the aggressiveness of both the sanctions sought and the theories advanced by the Commission will lead courts to scrutinize more closely the SEC’s factual and legal bases for its enforcement actions.

Indeed, federal judges as well as administrative law judges (ALJs) recently have rejected the legal theories and factual conclusions or assumptions advanced in a number of SEC actions.65 In some instances, judges have felt that

61 See Atkins AICPA Speech, supra n.53, at 5.
63 See, e.g., Atkins AICPA Speech, supra n.53, at 3 (recognizing heavy toll of enforcement investigations on those involved); SEC Hosts General Counsel Roundtable, supra n.59, at 2 (reporting comments of former SEC General Counsel, James Doty, that “the SEC has yet to see that subjecting an individual to a cease-and-desist order can be career-ending”).
64 Members of the Supreme Court recently signaled their concern with the need for clarity on standards of conduct in the Arthur Andersen case, in which the Supreme Court overturned the accounting firm’s conviction of obstruction of justice that had been based on its application of a document retention and destruction policy in the face of a possible SEC investigation. During oral argument, Justice O’Connor asked Deputy Solicitor General Michael Dreeben, about the statute at issue: “If this thing is so confusing, how’s the business person supposed to know what they can do? How’s the lawyer supposed to know?” Transcript of Oral Argument in Arthur Andersen LLP v. United States, No. 04-368 (Apr. 27, 2005), at 46, available at http://www.supremecourtus.gov/oral_arguments/argument_transcripts/04-368.pdf. Meanwhile, Justice Anthony M. Kennedy observed that the government’s “sweeping position . . . would cause problems for every major corporation or small business in the country. I just don’t understand it.” Id. at 30.
the facts justified an award of attorneys’ fees to the aggrieved respondent under the Equal Access to Justice Act (EAJA).66

Of course, the fact that the Commission does not win every case it brings does not necessarily mean that it generally is over-reaching or is filing ill-considered actions. Yet, given the current reality of the effect on individuals and corporations of defending or being sanctioned in even settled SEC actions, it is reasonable that the Commission should closely evaluate the number of recent losses in litigated enforcement actions, the various reasons for those losses, and the criticisms of both factual assertions and legal theories that are contained in the decisions. This is especially of concern now that the investigative process has been imbued with intense pressure to cooperate, and thus for corporations to offer little in the way of resistance or defense of conduct, especially in defense of corporate employees.67 One Commission staff member said recently, “[w]henver the Commission loses a case, it makes us think.”68 The number of recent adverse decisions and the particular criticisms leveled against the Commission in those cases should be of particular interest to the SEC. Such cases cannot be explained simply as isolated occurrences or on the basis that an agency should push the envelope to make sure its efforts are effective.

In a number of cases decided in just the last two years, the Commission’s actions were rejected or overturned for one or more of the following reasons: (1) the Commission used an inappropriately low threshold for scienter;69 (2) the Commission asserted that the applicable legal principle or the impropriety of the conduct was clear or obvious


67 This concern is addressed in greater detail in Part II.B.2 & 3 of this Report.

68 Phyllis Diamond, More Reg FD Cases in Pipeline, Beller Says at Lawyers’ Gathering, Sec. L. Daily (BNA) (Nov. 11, 2005)

69 Rockies Fund, 428 F.3d 1088. In Rockies Fund, the Commission had affirmed an ALJ’s findings of violations of Sections 10(b) and 13(a) of the Securities Exchange Act, and the imposition of a $500,000 fine on one individual, a $160,000 fine on each of two other individuals, and a cease-and-desist order and permanent or temporary bars against all of the individual respondents. Id. at 1092. The Court of Appeals affirmed the findings of misleading disclosures in certain filings but rejected the SEC’s finding of violations for certain stock trades, stating that “the record conflicts with the SEC’s scienter findings under any standard of intent” with respect to that charge. Id. at 1095.

Similarly, in Howard, 376 F.3d at 1138, the Court characterized the Commission’s opinion as “confused and confusing.” It criticized the Commission’s interpretation and application of the appropriate scienter standard, saying “it wound up applying a ‘should have known’ negligence standard that we have rejected.” Id.; cf. id. at 1150-53 (Henderson, J., concurring) (opining that the SEC applied a recklessness standard but that the SEC’s finding in that respect was not supported by substantial evidence). See also In re MarketXT, Inc., SEC Rel. No. ID-304, 2005 WL 3500281, at *23 (Dec. 22, 2005) (finding that the SEC advanced an inappropriately low standard for scienter, and that it failed to prove its case under even the lower standard; noting that using the lower standard in a trading case such as the one at issue “could result in prosecution and sanctions for legitimate conduct that results from mere inadvertence or of [sic, from] the ‘trading for trading’s sake’ that might lead to the next technological breakthrough in electronic trading”)

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when in fact it was not; 70 and/or (3) there was a complete or significant failure to present evidence or analysis on various issues in the case. 71

70 In WHX, 362 F.3d 854, the District of Columbia Court of Appeals, in 2004, criticized the SEC for misapplying the standard governing when it should issue cease-and-desist orders in SEC administrative proceedings. The Court of Appeals held that the Commission failed to explain how “any reasonable application of [the factors applied by the Commission] could support the imposition of a cease-and-desist order.” Id. at 860. The Court disagreed with the Commission’s simple characterizations of the violation as “serious” and “clear.” Id. The Court of Appeals held that the imposition of a cease-and-desist order was “arbitrary and capricious” when it was based on a “single, isolated violation” of the SEC's All Holders Rule by a party that was without authoritative guidance from the SEC as to whether a condition it included in the offer would violate the rule, and where that party “immediately withdrew [its] offering condition once the SEC made its official position clear. . . .” Id at 861. The Court concluded that the factors stressed in the SEC’s decision—violation and remainder in the market—were insufficient to prove risk of future violation because those factors are present in nearly every case. Id

In In re MarketXT, 2005 WL 3500281, an ALJ dismissed all charges against the chief technology officer of an entity that owned and operated MarketXT as an electronic trading network (ECN, i.e., electronic communications network), based on allegations that they had manipulated the market for certain exchange traded funds (ETFs) through a trading program they created. The case is a prime example of how a corporation can make a decision to settle a case that, if litigated, would have resulted in dismissal. It also demonstrates the extreme care required before conclusions are drawn about complex, unfamiliar factual situations without considering the full context of the conduct and without crediting an alternative, more complex analysis of the facts. The SEC alleged that the chief technology officer devised an electronic trading program that resulted in wash sales (trades involving no change in beneficial ownership) and matched orders (entry of near-simultaneous buy and sell orders at substantially the same price for substantially the same amount of a security). It was alleged that the program was designed to generate trade activity in order to receive trade rebates from NASDAQ (rebates received by market makers for reaching a specified volume of trades). MarketXT settled the matter with the SEC. In re MarketXT, Inc., SEC Rel. No. 34-51864, 2005 WL 1421101 (June 17, 2005). The technology officer went to hearing, and the ALJ found that the SEC “misinterpreted the context of the automated trading program at issue,” demonstrated “confusion” about the manner of execution of the trades, and “misinterpret[ed] the reality faced by [respondent] during the three days of running the program”, that were the subject of the allegations. 2005 WL 3500281, at **25-26. The ALJ was highly critical of the SEC’s expert, finding that he could not read computer code, did not compute thousands of trades that were excluded from the SEC’s exhibits, and did not know how many trades on the three days in question fell outside of the parameters he used for wash sales. The SEC’s expert computed the trades in seconds, when in fact the program at issue could execute in milliseconds. The ALJ noted that the SEC “ignor[ed] the fact that NASDAQ found nothing improper in the trades. . . .” Id. at *26. The ALJ found that the trades were not wash sales or matched orders, but rather were pairings of buys and sells at the market price, and that the trading program at issue in fact swept the entire market twice to find the execution (market) price for each side of each pairing. Thus, the ALJ found, “the few pairings among the thousands of trades were inadvertent.” Id. He continued: “This unintended, inadvertent, and unforeseeable result was due to a perfect storm wherein the speed of technological innovation and its effect on the marketplace went beyond what any of the participants intended.” Id. at *27. The ALJ found that the SEC failed to prove a primary violation by MarketXT, though that entity earlier had settled an SEC action to the same charges. Id. at **27-28.

In September 2005, the Federal District Court for the Southern District of New York rejected an SEC case that also involved factual nuances and how a controversial regulation should be applied to them. In Siebel Systems, the Court rejected what it viewed as an extension of Regulation FD (which requires issuers to make public disclosure of certain nonpublic information) beyond its original bounds. The judge admonished the Commission that “Regulation FD was never intended to be utilized in the manner attempted by the SEC under these circumstances.” 384 F. Supp. 2d at 704. Speaking implicitly to the difficulty that corporations face in interpreting broad, ill-defined standards like materiality, the Court observed that the SEC’s approach “places an unreasonable burden on a company’s management and spokespersons to become linguistic experts, or otherwise live in fear of violating Regulation FD should the words they use later be interpreted by the SEC as connoting even the slightest variance from the company’s public statements.” Id.

In Howard, the Court took issue with the Commission’s argument that the legal standard in question was “common sense.” Characterizing the Commission’s opinion as “confused and confusing,” 376 F.3d at 1138, the Court disagreed with the Commission’s position that the laws applicable to Rule 10b-9 offerings are clear, citing to authority that the law in that area “‘[h]a[ve] never been clear, and ha[ve] been based on a partly unwritten body of interpretation, . . .’” Id. at 1148 (quoting Robert B. Robbins, Structuring Best Efforts Offerings and Closings Under Rule 10b-9, SH067 ALI-ABA 297, 299 (2003)).

Most recently, in Rockies Fund, discussing the charges relating to stock trades, the Court found that the Commission “reads far too much into Calandrella’s testimony and explains far too little about the supposed trading pattern.” 428 F.3d at 1094. “With no explanation, it announces that
Many interviewees, in accord with numerous commentators, expressed the view that the Commission, as well as criminal prosecutors, recently have shifted and shaped malleable standards such as “materiality,” “scienter,” and “willfulness” to comport with their own subjective judgments of what is or is not significant for disclosure purposes, and have been influenced by the public view that almost all corporate conduct and motivations of corporate officials are suspect. Certainly in the post-Enron political and pro-prosecutorial environment of the last few years, the temptation has been great to move to what one commentator has called a “zero-tolerance” policy and stricter standards of liability. It is incumbent on regulators and prosecutors alike strongly to resist lowering the standards for liability for fraud and blurring the line between civil and criminal responsibility in the name of raising standards of corporate conduct. The Commission has in the past been aware of the dangers of “regulation through enforcement” and of changing standards of conduct by way of enforcement actions. In a speech on September 14, 2003, then SEC Chairman Donaldson specifically recognized the

See also In re IFG Network Sec., Inc., SEC Rel. No. ID-273, 2005 WL 328278 (Feb. 10, 2005) (the judge rejected the Commission’s claim that the defendants should have told their clients that they received higher commissions for selling a particular class of shares, because of a lack of rules or precedents supporting such a duty at the time of the proceeding, finding no violation).

For example, in Howard, the District of Columbia Circuit vacated an SEC administrative order finding that the respondent aided and abetted certain antifraud and other fraud violations of the securities laws in connection with private placement offerings, and criticized the Commission for its lack of evidence and for its attempts to conflate recklessness with heightened negligence. The Court found that the factual record contained no evidence of obvious danger signs or red flags that should have alerted Howard to violation of Exchange Act Rule 10b-5. 376 F.3d at 1149. The Court found that the Commission “disregarded evidence tending to show that Howard did not act recklessly . . . .” Id. at 1138.

In Monetta Fin. Servs., Inc. v. SEC, 390 F.3d 952, 956-57 (7th Cir. 2004), on appeal from an ALJ decision, the SEC had dismissed all but one of the charges against the president of an investment adviser for failing to disclose stock allocations that he made on behalf of the adviser to certain directors of fund clients. The 7th Circuit vacated the SEC’s order as to the firm president, holding that although the investment adviser indeed should have made the disclosure in question, the SEC “has not provided any evidence suggesting that [the firm’s president] was, in fact, aware that disclosure . . . was required,” and that even a recklessness standard was not satisfied.

Also in 2004, the Eighth Circuit, in Zahareas, reversed and remanded a lower court’s finding that appellant was not entitled to attorney’s fees based on an inadequately supported enforcement action. The Court of Appeals criticized the Commission at one point for lapses in the investigative process: “The SEC’s failure to appropriately and adequately investigate [defendant] according to its own rules and guidelines, led the SEC to bring an action based on an ungrounded and unsubstantiated legal theory, and without sufficient factual support.” 374 F.3d at 629.

In SEC v. Guenthner, 395 F. Supp. 2d 835, 847 (D. Neb. 2005) (the Court granted the summary judgment motion of both defendants, stating that there had been “a complete and utter failure of proof by the Commission”).

Finally, in Rockies Fund, the Court concluded that the “monetary sanctions imposed by the SEC amount to the harshest available-third-tier sanctions,” despite the fact that “the SEC’s analysis [in arriving at the sanctions] was not just superficial; it was nonexistent.” 428 F.3d at 1099. The Court vacated the sanctions and remanded the matter for further proceedings. See also Merchant Capital, 400 F. Supp. 2d at 1373-74 (ruling on the merit for defendants on all counts, because the interests at issue were not securities, and commenting that if it had ruled in favor of the Commission, the Court would have denied injunctive relief, disgorgement and civil penalties).

Under Exchange Act § 32(a), 15 U.S.C. § 78ff(a), persons who “willfully” violate certain provisions of the act are subject to criminal sanctions. In addition, certain persons who “willfully” violate the federal securities laws can be subject to SEC administrative sanctions. See, e.g., 15 U.S.C. § 78o(b)(4), (6) (applicable to registered broker-dealers or their associated persons).

See, e.g., Wasserman, supra n.17, at 5 (“Corporations and their managers, directors and agents face the heightened expectations of a wide cast of critical constituencies, each of which is setting the bar higher with shifting and not always consistent standards and objectives”); Baker, supra n.17, 89 Cornell L. Rev. at 316, 341–53. See also cases cited infra n.111.


See SEC Major Issues Conference (Jan. 13–15, 1977), supra n.1, at 3, available at http://www.sechistorical.org/collection/papers/1970/1977_0101_SEC_MIC_Final_Rpt.pdf (“Policy is better understood, and more likely to be well-received, if it does not come as a surprise to those who must comply. . . . If, as a result of the greater use of prospective policy guidelines, it might not be possible to pursue some enforcement activities, that is a small price to pay for the guidance and certainty offered by prospective
dangers that can flow from the current pressure on the Commission to bring cases quickly or to cater to public sentiment resulting from the atmosphere created by recent corporate scandals. Chairman Donaldson cautioned:

Enforcement of the laws can, in some circumstances, become a vehicle for changing the rules. That is, when faced with the risks and costs of litigating an enforcement action, some parties may agree in settlement to change or restrict their future conduct in significant and far-reaching ways. Thus, an enforcement proceeding can realign an industry standard in much the same way as a new rule, at times, making the line between rulemaking and enforcement unclear . . . Nor will [competing prosecutors] continuously butting- heads and scrambling to file a case first lead to the best results. If it appears that each of us cares more about getting there first than getting it right, the public will question the fairness and integrity of our processes— and that’s something none of us can afford.

In a recent speech, SEC Commissioner Cynthia Glassman stated that she favors continuing “to push for more focus on encouraging good outcomes proactively rather than looking for violations after the fact,” noting that “[b]y setting clear standards, we can make it easier for regulated entities to comply with our rules and easier for our examination staff to inspect for compliance.” Such efforts are greatly needed now, especially to provide clarity in areas involving disclosure standards, materiality, the interpretation and application of generally accepted accounting principles (GAAP), and the diligence required of corporate officials faced with complex transactions and issues on which they necessarily look to others for assurances of propriety and compliance with legal and accounting principles.

These concerns also extended to criminal securities cases. Although, as mentioned earlier, interviewees supported efforts to deal with serious, clear violations of the federal securities laws, there is great concern that criminal authorities have become overly aggressive in prosecuting securities cases. As noted in Part II.A, it is clear that criminal authorities, both federal and state, have dramatically increased their efforts in pursuing securities cases. Indeed, the competition for such cases became so intense that it led former SEC Chairman Donaldson specifically to address “the supposed clash” between federal and state authorities in a speech in 2003, in which he cautioned, as quoted above, that “scrambling to file a case

guidelines . . . the Commission should be reluctant to move away from rulemaking and its notice-and-comment process”); Interview of then SEC Enforcement Director Richard Walker, SEC is Stretched to Limit, Nat’l L.J., May 18, 1998, at A12 (“You have to give sufficient guidance so that people know how to act responsibly within the industry and know how to do their jobs”). SEC Commissioner Edward Fleischman, for instance, more than 10 years ago, noted the concern that the “expansive force of individual SEC policy positions that are taken in the heat of abusive market contexts, undoubtedly for the benefit of investors, are then gradually extended to a different market issue, and then another, without analysis of how far from the original context the underlying reasoning has been stretched.” Fleischman, supra n.53, at 258. This concern over the tendency to expand policy decisions beyond their original design is a valid one, and translates equally well to a concern over how difficult it is for the Commission to separate out what legitimately should be reviewed and treated as a policy issue to be resolved through interpretative guidance and rule-making, and whether or when those policy issues should be advanced in an enforcement action. See, e.g., Wallison & Smith, supra n.1, at 4 (discussing “policy-making through enforcement proceedings”).

76 Donaldson NASAA Speech, supra n.44, at 5.
77 Id. (emphasis in original).
78 Cynthia A. Glassman, Speech by SEC Commissioner: SEC in Transition: What We’ve Done and What’s Ahead (June 15, 2005), at 2, available at http://www.sec.gov/news/speech/spch061505cag.htm (Glassman Speech); see also Atkins AICPA Speech, supra n.53, at 3 (stating that “we should not foster a regulatory environment that relies on informal guidance as a basis for enforcement actions”).
79 This latter issue is discussed in Part II.B.4 of this report.
first” will not lead to the best results. It is worth quoting again his caution against creating a public perception that prosecutors care “more about getting there first than getting it right.”

Our interviews suggest that this is indeed an emerging perception in the corporate community. There is evidence of this in the number of dismissed or failed criminal prosecutions actually brought to trial.

The mere threat of criminal prosecution greatly affects the decision-making process of corporations and their officers and directors in dealing with government investigations and the employees who may be involved in them. The increase in criminal sanctions for securities law violations and the potential destructive effect of an indictment on a business, as evidenced by the case of Arthur Andersen, can lead to pleas and settlements for both individuals and corporate entities, who simply are unwilling to face the risks of a long prison sentence or of an indictment that will destroy the corporation.

There is a sense that prosecutors may be taking advantage of the anti-corporate atmosphere that developed post 2001 in pursuing some cases and theories. Professor John Baker has written about the phenomenon that “[a]nyone who is convinced that another person or class of persons, is guilty of crime tends to becomes impatient with legal niceties.” Professor Baker also notes that “[c]orporations and their executives are easily demonized.” He discusses the phenomenon that “[s]igmatizing [p]roduces [p]leas.” Because of all of the above issues, it is even more important for criminal authorities to be cautious in their approach to prosecution of complex securities disclosure and accounting matters. It is important that the Commission consider carefully those matters that it refers to criminal authorities or that those authorities take up on their own initiative.

3. Increasingly Punitive Nature of the SEC’s Enforcement Program

Although until the mid-1980s the Commission’s enforcement tools consisted mainly of injunctive actions seeking equitable relief and administrative proceedings against regulated entities, it used those tools to fashion creative remedies. As noted above, the SEC’s enforcement arsenal has increased steadily over the last two decades, including the addition of the authority to seek monetary penalties for any violation of the securities laws and to seek to bar individuals from serving as officers and directors of public companies.
On a number of occasions over the last decade, the Commission and its staff have indicated that they saw a need to ratchet up the severity of enforcement sanctions. In the wake of the corporate defalcations and public reaction of the last few years, it is understandable that the Commission would evaluate the effectiveness of its sanctions and penalties. Although current enforcement actions and settlements frequently contain relief designed to require remedial efforts, a major and pervasive focus of the SEC’s current enforcement program seems to be squarely on exacting punishment. In a March 18, 2005, speech to a group of corporate directors, the director of enforcement noted that the total penalty amounts being obtained may be “startling . . . to veteran SEC-watchers,” but asserted that the SEC’s current enforcement approach is “about where it needs to be.” Similarly, in a speech in April 2004, the SEC enforcement director explained that “[i]n 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.”

The use of officer and director bars in SEC actions also has increased in recent years. Though such sanctions are clearly punitive, Congress recently significantly lessened the standard for imposition of these bars. Section 305 of SOX modified the existing specific authority for the SEC to seek officer and director bars in federal court actions, changing the applicable standard from one of “substantial unfitness” to merely general “unfitness.” Since 2001, the SEC has been seeking officer and directors bar orders more routinely in enforcement actions. In 2001, the agency obtained 51 such bars. In 2004, there were more than three times as many, most of which were imposed in settled actions.

Although interviewees generally recognized that tough sanctions have a place in the Commission’s enforcement program and can have a deterrent effect, concern was expressed that the Commission carefully balance the effects of a generally punitive approach to enforcement on corporations, their shareholders, and employees to ensure that the goal of deterrence does not overwhelm other policy considerations. These considerations include the need to encourage self-reporting of misconduct; the need to encourage employees to raise issues at an early stage without fear that they may be making the

88 Cutler Michigan Law Speech, supra n.4, at 8 (discussing steps toward “ratcheting up” penalties); Cutler DC Bar Speech, supra n.4, at 6 (“The penalties the Commission is routinely obtaining these days, against both entities and individuals, were simply unheard of ten years ago”); Stephen M. Cutler, Speech by SEC Staff: The Themes of Sarbanes-Oxley as Reflected in the Commission’s Enforcement Program (Sept. 20, 2004), at 8, available at http://www.sec.gov/news/speech/spch092004smc.htm (Cutler Sarbanes-Oxley Speech) (“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”).


90 Id. at 6; see also SEC v. Deloitte & Touche LLP, SEC Litig. Rel. No. 19202, 2005 WL 956885 (Apr. 26, 2005).

91 Cutler Ray Garrett Speech, supra n.34, at 2. Commissioner Glassman recently stated that “in several cases, [she has] pushed for higher penalties and other sanctions on individuals.” Glassman Speech, supra n.78 at 2.


93 Allen, supra n.39; see also Goldschmid, supra n.2, 80 Notre Dame L. Rev. at 829 (in fiscal year 2003, the number of such bars had reached 170, and the number for 2004 is likely similar); Cutler DC Bar Speech, supra n.4, at 6 (noting 170 O&D bars in fiscal year 2004 as compared to 38 in fiscal year 2000). See, e.g., Wasserman, supra n.17, at 7 (“Today, any suggestion of a 10b-5 violation means at a minimum that officer bars may be required. . . .”).
wrong decision because of possible punitive sanctions; the need to maintain employee trust; and the need to avoid stifling legitimate risk-taking and creativity in corporate transactions and business decisions.94

There is concern that a general punitive approach to enforcement, which increases the stakes for corporations that litigate, may force some entities to settle cases where important accounting and legal issues are far from clear. Increasing the stakes in litigation at the same time that standards for liability are shifted can create an atmosphere that stifles competitive creativity. In cases involving accounting and disclosure issues, often the line between improper conduct and mistakes, and between misfeasance and a failure to appreciate the complexities or the legal ramifications of difficult, complex situations, can easily be blurred, resulting in allegations of fraud to justify large penalties and career-ending sanctions.95 The concerns raised by interviewees seemed to go to a fundamental issue of whether a general punitive approach is appropriate in a civil context, where the standards for liability are often quite low.96 Interviewees generally believed that a general punitive approach eventually will result in increased litigation, increased scrutiny of the Commission’s theories by courts, and a more adversarial relationship between the Commission and those it regulates.

**B. Observations on Specific Current Enforcement Policies**

1. **Imposition of Penalties on Public Companies**

   Over the last several years, the Commission increasingly has sought large penalties against public companies for violations of the federal securities laws. The policy justification for this has been that the violations allegedly have been so pervasive or egregious that the companies themselves must be punished in order to deter similar conduct at other companies.97

   Interviewees generally questioned the validity and appropriateness of this policy because such penalties in current actions were thought unfairly to punish the corporation, its shareholders, and other stakeholders for the acts of usually a few individuals. Some interviewees also questioned the policy because it is unclear that the actions of other corporations will be deterred by the high penalties in current cases, and because corporate management and boards traditionally have responded appropriately to guidance and direction from the Commission and to public and investor criticisms.

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94 See Janis, supra n.31, at 3; Odland speech, supra n.49, at 5 (“We must exercise caution not to strive so hard to rid ourselves of rogue corporations and officers that we ignore the possibility of collateral damage to our corporations, jobs, our investments and economic prospects”); SEC Hosts General Counsel Roundtable, supra n.59 (Doty comments); Atkins AICPA Speech, supra n.53, at 3 (“Even if a sanction is ‘light’, the mere existence of an enforcement action is significant. We must acknowledge the heavy personal toll [even] an enforcement investigation takes on the subjects of the action. . . ”).

95 See, e.g., supra n.66; Baker, supra n.17, 89 Cornell L. Rev. at 313, 342–44 (discussing how “the manner in which government prosecutions of so-called ‘white-collar crime’ creates stigma and presumptions of guilt. . . ”).

96 The standard of proof in SEC enforcement actions generally is “a preponderance of the evidence,” Steadman v. SEC, 450 U.S. 91, 104 (1981), and the Commission can bring actions against any person who was “a cause” of another person’s violation. Supra n.9.

97 See, e.g., Cutler Ray Garrett Speech, supra n.34 (discussing SEC use of penalties and deterrence effort); Kip Betz, Thomsen Says SEC Presence is Key to Deterring Wrongdoing, 37 Sec. Reg. & L. Rep. 1880 (BNA) (Nov. 14, 2005) (“It is our hope that the enforcement actions that we bring do serve the fundamental purpose that they’re supposed to, which is to deter others and change behavior going forward”).
In the decade after the passage of the Securities Enforcement Remedies and Penny Stock Reform Act of 1990, which gave the SEC authority to seek civil fines against any person for any securities law violation,98 the Commission used its new authority only twice to levy significant penalties on corporations. In the first such case, Sony Corporation paid a $1 million civil penalty as part of a negotiated settlement.99 In the second case, America Online agreed to a $3.5 million civil penalty.100

Then, in April 2002, the Commission announced a settlement with Xerox for a $10 million civil penalty against the entity.101 The Commission noted that the settlement contained “the largest fine ever obtained by the SEC against a public company in a financial fraud case.”102 Little more than a year later, however, WorldCom, then in bankruptcy, agreed to pay a penalty in an SEC action totaling $750 million in cash and stock after it emerged from bankruptcy.103 The SEC thereafter has continued the trend of eight- and nine-figure penalties against corporations.104

A review of the legislative history of the Act that gave the Commission its broad authority to impose penalties shows that Congress envisioned a cautious use of the Commission’s power to seek penalties against corporations. In the Senate Report on the Securities Enforcement Remedies and Penny Stock Reform Act of 1990,105 the Senate Committee stated, “The Committee anticipates that the SEC will not seek or impose a civil money penalty in every case.”106 As to the use of penalties against corporate entities, the Committee stated that, “because the costs of such penalties may be passed on to the shareholders, the Committee intends that a penalty be sought when the violation results in an improper benefit to shareholders.”107 Despite this congressional direction, the most common factor shared by the recent

98  Supra n.12.
101 Xerox, 2002 WL 535379.
106 Id. at 9
cases in which the SEC imposed civil penalties on corporations is the Commission's reliance on the perceived deterrence effect of large penalties. 108

Even where the penalties may be directed back to investors who were harmed, under the Fair Funds provisions of SOX, 109 this transfers wealth from present and, indeed, future shareholders to others, who may no longer be shareholders at the time of the transfer. 110 Moreover, the process of administering that distribution is costly and time-consuming. Although the Commission usually appoints a third party to administer the process, it is still cumbersome and consumes valuable Commission time and resources. 111 Indeed, even where the Fair Funds provisions are utilized, private litigants will continue to pursue actions to collect additional amounts. Interviewees also noted that larger penalties imposed in SEC actions can affect the dynamics of private litigation.

In addition, the imposition of large penalties on corporations has not been shown to be an effective deterrent to conduct that necessarily is carried out by corporate employees. Since corporations can act only through individuals, ultimately the theory of deterring corporate conduct by fining the corporate entity depends on the effect of the fine on individual employees at all levels. It is difficult to test empirically the premise that executives or employees will be deterred from violating the federal securities laws because they see, by virtue of the Commission's actions against WorldCom or others, that their company also runs the risk of suffering severe monetary penalties. Any individuals who understand that they are violating the federal securities laws at the time of the violation are likely also to understand that if they are discovered, they will be terminated from their corporate position. By the time action is taken against the corporation, those involved in the wrongdoing may have little concern about the ramifications of a penalty on the entity. Moreover, since those who were responsible for the misconduct likely have been or will be terminated by the company by the time of an enforcement action, the fine will be imposed on an entity in which innocent or new managers are taking steps to remedy any problems and prevent recurrence. It is not doubted that large penalties and punitive sanctions may have a deterrent effect on certain individual defendants. However, the use deterrent effect of large penalties against public companies based on deterrence is not supported by the relevant Senate Report, and indeed, corporations are well positioned, eventually, to pass the effect of those penalties on to customers or others.

In a June 2005 speech, SEC Commissioner Cynthia Glassman noted that “there has been disagreement among us on the appropriateness of imposing corporate penalties, which, at the end of the day, are paid by the shareholders.” 112

108 See supra n.102 and releases cited in n.104.

109 Sarbanes-Oxley Act of 2002, supra n.13, § 308, 15 U.S.C. § 7246(a). Under the Fair Funds provision, where the Commission otherwise has ordered disgorgement, but only where that has occurred, the Commission can request that the Court add any penalty to the disgorgement fund for the benefit of “victims” of the alleged violations. In cases where apparently no disgorgement would otherwise be ordered, the Commission has begun the practice of ordering disgorgement of one dollar, so that the Fair Funds provision can be utilized in effect to disgorge the penalty to investors. See GAO Report to Congressional Requestors, SEC and CFTC Penalties—Continued Progress made in Collection Efforts but Greater SEC Management Attention Needed (Aug. 2005), at 28, available at http://www.gao.gov/new.items/d05670.pdf (SEC/CFTC Penalties).

110 Though penalties in SEC cases may be distributed to investors who have been harmed by a fraud at a public company, it is doubtful whether taking that penalty, in effect, from the present shareholders and transferring it to those who held or sold shares at the time of the revelation of the problems is in the public interest, when a corporation and all its present, innocent investors are further harmed.

111 See, e.g., SEC/CFTC Penalties, supra n.109, at 10 (critiquing SEC Fair Funds collection and distribution efforts, indicating that “although the SEC has increased the number of staff devoted to collection efforts, the agency has neither developed a method to ensure that adequate and consistent supervision is provided to them, nor has it formally assessed whether its additional resources are being used effectively” and noting that only “a small amount” of over $4.8 billion marked for return to investors has been distributed).

112 Glassman Speech, supra n.78, at 2.
More recently the Commission, through the efforts of Chairman Cox, announced guidelines that it intends to utilize in the future in determining whether and to what extent to seek to impose monetary penalties on corporations. \(^{113}\) Chairman Cox indicated that the Commission “is in unanimous agreement that corporate penalties are an essential part of a comprehensive program of enforcement of our securities laws.”\(^ {114}\) He noted that a “key question” for the Commission in determining whether and what penalty to impose is whether the issuer’s conduct “resulted in benefit or harm to the shareholders.”\(^ {115}\) This is a welcome effort at setting a clearer standard in a difficult area, and would seem to comport with the Senate Committee Report on the SEC penalty provisions, which, as noted above, indicated that it was intended that penalties be sought against corporations “when the violation results in improper benefit to shareholders.”\(^ {116}\) The Senate Committee also clearly intended that consideration be given to “whether civil penalties assessed against corporate issuers will ultimately be paid by shareholders who were themselves victimized by the violations . . . [and] the extent to which the passage of time has resulted in shareholder turnover.”\(^ {117}\)

In considering the issue of potential harm to shareholders from corporate penalties, it seems that it is the current shareholders who must be considered when determining whether it is appropriate to exact a monetary penalty from their corporation. Any shareholders who continued to hold until announcement of a financial problem presumably will have lost any value that accrued due to misconduct at the corporation, and those who benefited from an inflated value generally are those who already sold their stock and will not be affected by a penalty against the company. Logically, it appears that the Senate Committee was referring to entities in which it is clear that present shareholders benefited or even designed the misconduct to benefit themselves, such as in a closely held corporation.\(^ {118}\)


\(^{114}\) Cox Corporate Penalties Speech, supra n.113, at 2.

\(^{115}\) Id.

\(^{116}\) S. Rep. No. 101-337, supra n.105, at 13. In its Statement Concerning Penalties, the SEC notes other factors which the Commission says the Senate Report “suggests” may be relevant to corporate penalties. Statement Concerning Penalties, supra n.113, at 2. However, the factors cited are not specifically cited in the Senate Report as applicable to entities with public shareholders, and largely are discussed in the portion of the Committee Report dealing with penalties that are authorized against regulated entities, such as broker-dealers and investment advisers, in SEC administrative proceedings. S. Rep. No. 101-337, supra n.105, at 10-13. Although penalties can encourage compliance efforts by regulated and unregulated entities alike, the amount and frequency of penalties imposed recently against public companies seem beyond what Congress envisioned and may be having adverse consequences on shareholders or others to whom the final impact eventually may be passed. Some persons interviewed after the Commission released its Statement Concerning Penalties expressed concern that the standards set out in the Commission’s Statement will become a rigid formula, justifying large penalties in most cases, based on the reference to factors like the level of intent of the individual participants and the difficulty of detecting the violation, both of which may be beyond the purview of the corporate entity. These interviewees hoped that the Commission would continue to clarify its policy on corporate penalties at it gains experience in applying the recently enunciated standard.


\(^{118}\) In one of the cases the Commission announced simultaneously with its announcement of the penalty guidelines, it fined McAfee, Inc., $50 million in connection with an alleged financial disclosure fraud. In doing so, the SEC enforcement director noted that in considering this penalty, the SEC considered that “McAfee benefited from the conduct, especially through acquisitions made with its inflated stock,” and that the conduct was “pervasive and occurred over a significant time period.” Linda Chatman Thomsen, Speech by SEC Staff: Statement regarding McAfee, Inc., and Applix, Inc. (Jan. 4, 2006), at 2, available at http://www.sec.gov/news/speech/spch010406lct.htm. She also noted that McAfee was financially strong and that the penalty monies can be distributed effectively to shareholders injured by the fraud. Id. Most of these factors do not address
Interviewees who addressed the issue of corporate deterrence generally expressed the view that the vast majority of regulated entities and public companies are managed and directed by ethical and honest individuals, who respond quickly and appropriately to indications of misconduct, even absent the prospect of seeing their corporation fined in an SEC action. For example, in a recent survey of New York Stock Exchange CEOs, the NYSE found that although 42% of the CEOs indicated that “overregulation could have the greatest impact on the bottom line,” and 78% said “boards do not operate more efficiently” post-SOX, most agreed that boards are better informed and more engaged as a result of SOX and NYSE governance regulations, and as one CEO commented, “Anything that’s going to regain investor confidence in Corporate America is worth it.” This sentiment is a result not of increased SEC penalties, but rather of the simple recognition that for any corporation to prosper, it needs the confidence of shareholders, creditors, and other corporate constituencies, as well as the public at large, i.e., the marketplace. Indeed, it would appear that the marketplace in fact provides a swift, effective deterrent for corporate misconduct, in addition to that provided by the possibility of a government enforcement action.

2. Imposition of Fines for “Lack of Cooperation”

Many interviewees expressed concern over an apparent enforcement policy of imposing fines on corporate entities for failure to cooperate in SEC investigations. In the past, the SEC at times has offered benefits to corporations that cooperated with its investigations through voluntary disclosures or other means. Nevertheless, prior to the issuance of the Report of Investigation and Commission Statement on the Relationship of Cooperation to Agency Enforcement Decisions in October 2001, commonly referred to as the “Seaboard” 21(a) Report, the Commission had not issued formal guidance on the benefits of cooperation. The Seaboard Report initially was both promoted and perceived as an indication that the

improper benefit to shareholders. The fact that McAfee was able to use an inflated stock value to make presumably valuable acquisitions may in some sense continue to benefit present shareholders, but to impose a large penalty in such circumstances would still seem only to punish current public shareholders who no doubt were unaware of the alleged fraud and did not directly benefit.

119 Phyllis Diamond, Thomsen Defends Corporate Penalties, Expects to See More Hedge Fund Cases, Sec. L. Daily (BNA) (Nov. 9, 2005) (reporting comments of former SEC Enforcement Director Gary Lynch at the PLI 37th Annual Institute on Securities Regulation); Odland FBI Speech, supra n.49, at 2–3; Cutler DC Bar Speech, supra n.4, at 1–2 (noting that financial services firms responded when he challenged them to do comprehensive reviews of business operations for conflict of interest issues); Wasserman, supra n.17 (suggesting “prudential measures” and supervision and cooperative guidance as effective method to guard against corporate misconduct and encourage good governance).

120 NYSE CEO Agenda 2006 (Aug. 2005), Overview at 2, available at http://www.nyse.com/pdfs/CEOSurveySpecial0805.pdf (quoting Richard Harrington, president and CEO of The Thomson Corp.); see also Odland FBI Speech, supra n.49, at 2 (asserting that “[t]he overwhelming majority of business leaders are highly principled and ethical. All these responsible business leaders were embarrassed by the scandals perpetrated by a few bad corporate executives—could not and must not—let the misdeeds of a few unscrupulous corporate executives jeopardize the public trust in our economic system. That trust is the basis of our free market system”).

121 See, e.g., In re Westwood One, Inc., SEC Rel. Nos. 33-7941, 34-33489, 1994 WL 19140, at *1 n.1 (Jan. 19, 1994) (“In determining to accept Westwood’s Offer, the Commission considered certain remedial acts undertaken by the company”); In re Ciro, Inc., SEC Rel. No. 34-34767, 1994 WL 548994, at *6 (Sept. 30, 1004) (“In determining to accept Ciro’s Offer of Settlement, the Commission considered the remedial acts undertaken by Ciro and cooperation afforded the Commission’s staff”); In re Collins Indus., Inc., SEC Rel. Nos. 33-7107, 34-34934, 1994 WL 601329, at *1 (Nov. 3, 1994) (“In determining to accept the Offers of Settlement, the Commission considered the cooperation provided during the course of the investigation. After the [auditors] . . . brought the allegations to the attention of Company management, Collins, through counsel, conducted internal investigations. Collins then provided the Commission with the results of the investigations and access to the professionals who conducted them”).

Commission would use certain types of cooperative conduct to justify more lenient treatment in enforcement actions.\(^{123}\) Indeed, in the matter out of which the Seaboard Report arose, the Commission did not bring any enforcement action against the corporate entity.

Although many of the factors listed in the Seaboard Report simply are factors that the Commission traditionally has considered in determining the type of sanction to seek, several of the factors involve matters not legally required when responding to an SEC subpoena, and clearly involve extraordinary cooperation. Chief among such factors was the expressed desire of the Commission to have access both to the results of any internal corporate review of possible misconduct and to additional information to allow the SEC’s staff to judge the quality of any such review.\(^{124}\) This information, of course, normally would be subject to attorney-client privilege and work product protection. Other factors listed would require a company to make judgments about whether information should be disclosed to the staff which was not directly requested, and to make “all reasonable efforts” to secure employee cooperation.\(^{125}\)

At the time the Seaboard Report was first issued, corporations were thought to have received a road map of extraordinary steps that could be taken to receive the benefits of cooperation, and presumably could assume that not taking steps outlined in the Seaboard Report would leave them in the same position in which they would have been pre-Seaboard. However, the general view among interviewees is that the factors that were supposedly optional to garner favor are becoming the requirements for a company under investigation to avoid an extraordinary fine by the SEC or indictment by criminal authorities. Responsible entities normally cooperate with SEC investigations and want to determine whether their employees have engaged in misconduct, but there is a fear that certain of the concepts enunciated in the Seaboard Report are being turned into onerous requirements that are set subjectively by those involved in the investigation and can result in incentives that endanger other important public policies and corporate interests.

Shortly after issuing the Seaboard Report, the Commission made clear through its enforcement actions and penalty assessments that what appeared to be a carrot of leniency under Seaboard would in fact be a stick for companies that did not comply with the Commission’s view of cooperation.\(^{126}\) In April 2002, just six months after the Seaboard Report, the Commission announced a settlement with Xerox Corporation on securities fraud charges in which the company agreed to an extraordinary penalty of $10 million, which the Commission characterized in its press release as “in part, a sanction for the company’s lack of full cooperation in the investigation.”\(^{127}\) The Commission, however, did not elaborate what it considered as demonstrating a lack of “full cooperation.” In September 2002, the Commission settled a case against Dynegy in which the company agreed to a civil penalty of $3 million and noted in the Commission’s press release that the penalty “reflect[ed] the Commission’s dissatisfaction with Dynegy’s lack of full cooperation in the early stages of the Commission’s investigation.”\(^{128}\) It was at this point that the Seaboard cooperation factors seem to have turned from what clearly were


\(^{124}\) See Seaboard 21(a) Report, supra n.122, at item 10.

\(^{125}\) Id. at item 11.


\(^{127}\) SEC Press Rel. No. 2002-52, supra n.102.

thought to be factors designed to mitigate sanctions into requirements for avoiding large penalties. The Dynegy press release stated, “Just as the Commission is prepared to reward companies that cooperate fully and completely with agency investigations, the Commission will also penalize those who do not.”

Finally, in March 2004, the SEC required a $10 million penalty in a settlement against a corporation for failing timely to produce documents under an SEC rule requiring registered broker-dealers to furnish requested documents “promptly.” Although premised on this rule violation, the action “sprang entirely from the firm’s uncooperative conduct during the staff’s investigation.” Although the Commission used its rule requiring registered broker dealers to furnish the Commission “promptly” with certain required books and records as the rule basis for this fine, the Commission does not have statutory authority to impose fines simply for lack of cooperation.

This apparent policy of imposing fines for lack of cooperation was of great concern to interviewees. Concern was expressed that there is a lack of workable objective standards to be applied by the staff involved in conducting the day-to-day investigation, who are given great discretion and authority to judge an entity’s “cooperation.” Workable standards may never be obtainable, and the judgments of individual staff members are necessarily subjective and may vary from person to person and from office to office. Moreover, some interviewees were concerned that corporations may be subject to an unknowable and moving standard set by the most recent case wherein a particular corporation cooperated. If the Commission intends to punish corporations for lack of cooperation, the standards should be clear and consistent, and there should be a disciplined process for review of the cooperation by the Commission throughout the investigation. There is concern that the Commission is failing to consider the specific factual and legal situations relevant to a particular case. What one corporation may decide to do in light of its circumstances may differ considerably from what another, facing different factual and legal issues, decides to do. This is especially so when considering the effects of cooperating with the government on a corporation’s position in private litigation.

Concern also was expressed by interviewees over the issue of whether indemnification of employees for the legal costs associated with an SEC investigation or litigation will be deemed uncooperative. In 2004, Lucent Technologies, Inc. settled a financial disclosure case with the Commission, agreeing to a $25 million penalty. In addition to the underlying allegations, the SEC press release listed certain factors that contributed to the Commission’s imposition of the large fine, including:

129 Id.
131 See, e.g., Cutler Ray Garrett Speech, supra n.34, at 2.
132 17 C.F.R. § 240.17a-4(j).
133 See, e.g., Cutler DC Bar Speech, supra n.4, at 6 (indicating that the Enforcement staff had been directed “to keep an ongoing log recording parties’ cooperation, or lack thereof, throughout each investigation”).
(1) “After reaching an agreement in principle with the staff to settle the case, and without being required to do so by state law or its corporate charter, Lucent expanded the scope of employees that could be indemnified against the consequences of this SEC enforcement action”; and (2) “Lucent also failed over a period of time to provide timely and full disclosure to the staff on a key issue concerning indemnification of employees.”

There has been some confusion over what exactly occurred in the Lucent matter as it concerns employee indemnification. The Commission has a policy of accepting only settlements with individual employees in which the employees agree not to be indemnified for penalties or disgorgement by their employers. But the Commission should make clear, if that is the case, that no portion of the penalty in the Lucent matter was imposed for the corporation agreeing to indemnify employees by paying their legal fees during the investigation or subsequent litigation with the Commission. If in fact a reason for the penalty was that type of indemnification, the Commission should reevaluate whether it is appropriate to impose penalties for providing for the legal representation of corporate employees. Such a policy could have severe effects on the relationship between corporations and their employees.

Concern also was expressed by interviewees that, due to the pressure to cooperate and the uncertainty of what that entails in a particular case, corporations feel enormous pressure to terminate those who might be responsible for possible wrongdoing during the pendency of an investigation. The Seaboard Report lists as cooperation considerations whether persons responsible for any “misconduct” are still with the company, as well as whether the company identified “possible violative conduct and evidence with sufficient precision to facilitate prompt enforcement actions against those who violated the law.” Corporations should attempt to uncover improper conduct, correct it, and discipline or terminate responsible employees without prompting by the SEC. But if the Commission judges cooperation by how quickly employees under suspicion are terminated, it can create skewed incentives for corporations and an atmosphere that can have severe adverse effects on the relationship between corporations and their employees and, ultimately, on company operations. It also can put employees at an unfair disadvantage in defending themselves by simply leaving them to fend for themselves in unclear situations, or can lead to unfair results.

136 Id.
137 See, e.g., Diamond, supra n.47, at 2 (“Some companies may not view their indemnification obligations as cut-and-dried [and] may prefer to risk being sued by someone refused indemnification than to be deemed non-cooperative by regulatory bodies”); see also Janis, supra n.31.
138 The Commission has rewarded companies that, among other “cooperative” actions, fired top executives. See Anita Raghavan & Deborah Ball, Ahold Settles Charges in SEC Investigation With No Fine—Move Caps Investigation Into Accounting Practices of Supermarket Operator, Wall St. J., Oct. 14, 2004, at A6 (quoting associate director of the Division of Enforcement’s characterization of Ahold’s cooperation as “extraordinary,” where the company conducted a review “without prompting from [the SEC]” and then reported the discovered accounting problems to the staff, waived privilege, “fired top officers and made witnesses available”).
139 See Seaboard 21(a) Report, supra n.122.
140 See, e.g., Kip Betz, Ex-Merrill Brokers Awarded Millions on Defamation Charges, Sec. L. Daily (BNA) (Jan. 10, 2006) (reporting arbitration award of more than $14 million to four stockbrokers fired in connection with a mutual fund trading scandal, for claims that included defamation and breach of contract).
141 There is a concern that the pressure on corporations to cooperate under an indefinite standard, which calls for swift action against employees in conformity with the government’s view of the employees’ conduct, can create unjust results. This is evident in a Justice Department action in 2001. After obtaining a guilty plea and $885 million in settlement to criminal and civil claims from TAP Pharmaceuticals, Inc., 11 TAP employees went to trial with the defense that the practices in question were common in the industry and not illegal. Of the 11 who went to trial, two were acquitted by direction of the court, the government dismissed the case as to one, and the remaining eight were acquitted by a jury on all counts.
The view was expressed that in pressing corporations to cooperate with its investigations, the Commission should consider carefully both the rights of corporations and of individuals to defend themselves against charges, and, as a practical matter, the difficulties and time required for corporations to reach reliable conclusions as to employee conduct. The threat of increased sanctions unless a corporation conforms to an indefinable view of “cooperation” can detract from a corporation’s opportunity to develop valid defenses to a potential enforcement action, and discourages vigorous debate on complex legal and factual issues. There is concern that companies that choose initially to challenge the staff’s view of matters under investigation while gathering facts, and later decide to “cooperate,” risk the imposition of more severe sanctions simply for their initial stance.

There also is a view that recent demands with regard to document production may be out of sync with the realities faced by large corporations with many employees and far-flung operations, especially when faced with the complexities of retrieving electronic communications. It may be difficult to obtain all of the information requested by the staff quickly, and may be extremely costly to do so at any pace. Concern was expressed that the cost and resources required to restore emails or collect and search for documents and review them for relevance and privilege quickly enough to meet Commission demands for those documents can be prohibitive for some companies, or can be used to assert that a corporation is not cooperating fully. Broad investigations can strain resources and divert employee attention from the demands of business, at even the largest of corporations.

See discussion in Janis, supra n.31, at 5–9 (“One is left with the clear impression that the Department of Justice’s protestations about a company funding counsel for its employees has much less to do with concern about misuse of shareholders’ assets than it does with the department’s concern that employees who have capable defense counsel will be more difficult to coerce into pleading guilty and ‘cooperating,’ and may actually put the government to the test of a trial of often dubious theories of criminal liability that the company itself cannot risk testing. (Indeed, in rare moments of candor, a number of federal prosecutors have conceded as much to me.”)).

On December 19, 2005, the SEC announced that a Federal District Court had dismissed all claims with prejudice against four former officials of TenFold Corporation, based on the Commission’s motion to voluntarily dismiss the claims. SEC v. Tenfold Corp., SEC Litig. Rel. No. 19504, 2005 WL 3488693 (Dec. 20, 2005). The Commission did not elaborate on this decision, but the corporation previously had consented to a permanent injunction against fraud and other violations, SEC v. Tenfold Corp., SEC Litig. Rel. No. 17852, 2002 WL 31627066 (Nov. 20, 2002). The SEC’s motion to dismiss the action against the remaining defendants covered all individuals who had been included in the initial action. See Janis, supra n.31, at 8.

142 See Donaldson NASAA Speech, supra n.44, at 5 (The then SEC chairman noted, “Enforcement of the laws can, in some circumstances, become a vehicle for changing the rules. That is, when faced with the risks and costs of litigating an enforcement action, some parties may agree in settlement to change or restrict their future conduct in significant and far-reaching ways. Thus, an enforcement proceeding can realign an industry standard in much the same way as a new rule, at times . . .”). Pressure to cooperate to avoid stricter sanctions, as opposed to earn a more lenient remedy, calls for even more caution in considering enforcement settlements.

143 See, e.g., supra n.70 and text accompanying; WHX, 362 F.3d 854. In the WHX case, the Court of Appeals reversed the entry of an SEC cease-and-desist order, among other things, questioning the Commission’s characterization of violation as “serious” or “willful,” simply because the company persisted in the position even after the staff expressed its view that a particular condition included in a tender offer violated the Commission’s All Holders Rule. Id. at 860. The Court said, “[f]inding a violation ‘serious’ and ‘willful’ simply because of a failure to comply immediately with the staff’s interpretation effectively punishes parties who make Wells Submissions that are ultimately unsuccessful. To do so, is arbitrary and capricious. . . .” Id. at 860–61.


145 See discussion of these difficulties in Wallison & Smith, supra n.1, at 15.
3. Pressure to Waive Privilege During Investigations

Interviewees generally expressed the view that, as a result of the recent policies advanced by the DOJ and the Commission, corporations have felt intense pressure to waive attorney-client privilege and work product protection during SEC investigations. Corporate managers and their counsel fear that without a waiver, the corporation will not receive adequate credit for cooperation, or worse, will be perceived as hiding significant information from the Commission during an investigation. Interviewees expressed the view that the recent pressure to waive privilege is having adverse effects on a corporation’s need for legal advice, its relationships with its employees, and its position in private litigation.

Beginning in 1999, the Department of Justice formalized the credit a corporation could receive for waiving attorney-client privilege and/or work product protection in the context of decisions whether to prosecute. That year, the DOJ issued a memorandum entitled “Principles of Federal Prosecution of Business Organizations,” (the so-called “Holder Memo”), which it amended and reissued in 2003 (the so-called “Thompson Memo”). These memoranda identified several factors to be considered by a prosecutor in determining whether to prosecute a corporation and in negotiating plea agreements. The factors include “the corporation’s timely and voluntary disclosure of wrongdoing and its willingness to cooperate in the investigation of its agents, including, if necessary, the waiver of the corporate attorney-client and work product privileges.”

In the same vein, in 2001, the SEC issued the Seaboard Report (discussed supra), addressing the relationship of corporate cooperation to Commission enforcement decisions. In The Seaboard Report, the Commission identified four critical areas of conduct it evaluates in considering whether to “credit” cooperation in determining enforcement sanctions: self-policing; self-reporting; remediation; and cooperation. With regard to waiver, the Commission stated in a footnote, “In some cases, the desire to provide information to the Commission staff may cause companies to consider choosing not to assert the attorney-client privilege, the work product protection and other privileges, protections and exemptions with respect to the Commission.” Despite the statement in that footnote that “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,” interviewees reported that corporations increasingly feel that they may suffer adverse consequences if they do not waive privilege.


147 Thompson Memo, supra n.146.

148 Seaboard 21(a) Report, supra n.122, at n.3.

149 Id. at 2.

150 Id. Similar language was included in the November 1, 2004, amendments to the Federal Sentencing Guidelines, in the amended commentary to Section 8C2.5, which states, “Waiver of attorney-client privilege and of work product protections is not a prerequisite to a reduction in culpability score under subdivisions (1) and (2) of subsection (g) unless such waiver is necessary in order to provide timely and thorough disclosure of all pertinent information known to the organization.” Amendments to Federal Sentencing Guidelines § 8C2.5 (Nov. 1, 2004), at cmt. 12, available at http://www.ussc.gov/ 2004guid/8c2_5.htm.
Members of the SEC Enforcement staff repeatedly have stated that a waiver of privilege is not required for a corporation to obtain credit for cooperating, and that failure to waive will not be held against parties. 151 No matter what is being said publicly, corporations feel pressure to waive privilege in SEC and parallel criminal investigations. Concern was expressed that the benefits of the attorney-client privilege are being eroded due to this pressure. For example, in an April 2005 survey by the Association of Corporate Counsel, of 719 respondents, 30% of inside counsel respondents and 40% of outside counsel respondents said they experienced an erosion of the attorney-client privilege that was “significantly more burdensome than prosecutors and others in government oversight positions have suggested exists.” 152

This pressure to waive privilege is felt with regard not only to the results of an ongoing internal investigation, but also with regard to past attorney-client communications. One result of the pressure to waive privilege on such matters is possibly to increase reluctance on the part of corporate employees to seek advice from company counsel. Such reluctance may in fact lead to a greater incidence of violations. Employees who may be less likely to inquire into the propriety of an act because of the (correctly) perceived non-confidential nature of the inquiry may choose instead to proceed with conduct that otherwise would have been curtailed through prospective advice by company counsel. 153 The ABA Presidential Task Force on Attorney-Client Privilege expressed the same concerns in its recent report and recommendations. 154

Finally, waivers pursuant to attempts to cooperate with the staff usually give rise to waivers in private litigation, which often accompany SEC investigations. Although some courts have reasoned that providing the SEC or Department of Justice with otherwise privileged information will not necessarily create a waiver as to private litigants, 155 most courts considering the issue have held that a waiver before a government agency constitutes a waiver as to other private parties. 156 Interviewees generally expressed concern over the adverse effects that the pressure to waive has on the course and settlement of private litigation.


152 Executive Summary—Association of Corporate Counsel Survey: Is the Attorney-Client Privilege Under Attack? (Apr. 6, 2005), available at http://www.acca.com/surveys/attyclient.pdf (ACC Survey); See also Report of the ABA Presidential Task Force on the Attorney-Client Privilege (Aug. 9, 2005), available at http://www.abanet.org/buslaw/attorneyclient/materials/hod/report.pdf, infra n. 154 (ABA Attorney-Client Privilege Report) (discussing pressures to waive the privilege and affects on corporate interests); Diamond, supra n.47, at 6 (comments of an attorney at the Association of Corporate Counsel, “[W]e find that the government is using waiver of the privilege as the price of entry to the justice system”). See also Panelists Discuss SEC’s Enforcement Program, 2005-231 SEC Today (Dec. 2, 2005), at 2 (report that if company asserts privilege with respect to notes of interviews in an internal investigation, the independence of the investigation may be questioned.); and see Janis, supra n.31.

153 See Upjohn v. United States, 449 U.S. 383, 392-93, 396-97 (1981) (noting that limiting privilege to a corporation’s control group would impair the ability of corporate counsel to ensure a corporation’s voluntary compliance with the law); see also ACC Survey, supra n.152, at 2 (94% of respondents believed that the existence of the privilege enhanced the likelihood that employees would come forward to discuss sensitive or difficult issues regarding company compliance with the law).

154 ABA Attorney-Client Privilege Report, supra n. 152. The ABA adopted the Task Force recommendations, opposing “the routine practice by government officials of seeking to obtain a waiver of the attorney-client privilege or work product doctrine through the granting or denial of any benefit or advantage.” ABA Task Force on Attorney-Client Privilege Recommendation 111, available at http://www.abanet.org/buslaw/attorneyclient/materials/hod/recommendation_adopted.pdf

155 See, e.g., In re Steinhardt Partners, 9 F.3d 230, 236 (2d Cir. 1993) (confidentiality agreement with government preserves work product protection); In re Leslie Fay Cos. Sec. Litig., 161 F.R.D. 274, 284 (S.D.N.Y 1995) (same).

156 See, e.g., In re Columbia/HCA Healthcare Corp. Billing Practices Litig., 293 F.3d 289 (6th Cir. 2002); United States v. Mass. Inst. of Tech., 129 F.3d 681 (1st Cir. 1997); Genentech Inc. v. United States Int’l Trade Comm’n, 122 F.3d 1409 (Fed. Cir. 1997); Westinghouse Elec. Corp. v. Republic of the Philippines, 951 F.2d 1414 (3d Cir. 1991); In re Martin Marietta Corp., 856 F.2d 619 (4th Cir. 1988), cert. denied sub nom., 490 U.S. 1011 (1989);
4. Marginalizing of Reliance on Experts and Subordinates

Some interviewees expressed a view that recent Commission enforcement actions have marginalized the notion that senior corporate officials can, and indeed must, rely on the ethical functioning and the advice of other members of corporate management, employees, advisors, and experts for resolution of difficult accounting and legal issues. Concern was expressed that in making some enforcement decisions, especially where there is an alleged omission or failure to recognize “red flags” of potential irregularities, the standard being used to evaluate conduct has become almost presumptive of bad faith, and fails adequately to recognize the extent to which management must rely on subordinates and experts in the process of negotiating, vetting, and reviewing corporate transactions.

In the process of making business decisions, officers and directors often must consider complex accounting, disclosure, and legal issues. In determining whether a particular transaction should be pursued, a prime focus of management is on business analysis. Certainly, officers and directors must and do consider accounting and disclosure issues in this decision-making process. To function efficiently and, indeed, to ensure compliance with applicable legal and accounting requirements, management and directors necessarily must consult with and rely on appropriate experts. If the Commission, after the fact, believes that a particular accounting or disclosure judgment was inaccurate, it will always be the case that an additional question could have been asked, or additional steps taken, that might have led to the answer which the Commission feels was the correct one. And, of course, in cases in which the Commission believes the incorrect decision was made, there are often factual disputes as to whether a particular corporate official had information that would have caused a person to ask additional questions or continue to pursue a different answer to a legal or accounting issue.

However, there is a view that the Commission, through its enforcement positions, is signaling that it expects corporate officials to have a level of suspicion and expertise such that they are required to recognize legal and accounting issues that are far from clear. There is a view that the Commission expects corporate officials to continue to pursue any disclosure and accounting issues that arise during a transaction personally, despite the involvement of counsel, accountants, and other experts, until the issues are resolved in a fashion in which the Commission thought they should have been.

Expansion of principles governing what is expected from corporate officers and directors in reviewing and approving the financial reporting and other disclosures by their corporations is a natural result of recent scandals. Certain standards actually enacted into law or put into place through Commission rule-making efforts may add significantly to corporate governance and improve the processes through which corporate transactions are evaluated and reported. However, there is concern that the SEC is taking enforcement actions designed to raise those standards based on the Commission’s view,

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*Permian Corp. v. United States*, 665 F.2d 1214 (D.C. Cir. 1981). The ABA’s Task Force on the Attorney-Client Privilege has explained the general refusal of the courts to accept the doctrine of selective waiver for disclosures made to the government as the result of their misunderstanding that the “disclosures are sufficiently voluntary for purposes of evidentiary law to effect a waiver.” *ABA Attorney-Client Privilege Report, supra* n.154, at 19. The Task Force went on to state that “[t]he case law was developed well before government agencies adopted the current practice of using cooperation credits to obtain ‘voluntary’ disclosures, and the law does not take into account that the legal authority wielded by government agencies makes their requests coercive as a practical matter.” *Id.*

157 See, e.g., *In re Phillips*, SEC Rel. No. ID-55, 1994 WL 485042 (Aug. 26, 1994), in which the ALJ rejected the Commission’s assertion that the CEO of a subsidiary was liable for the parent company’s inaccurate reporting when he failed to take additional actions concerning possible irregularities. The ALJ stated that management is entitled to rely on the representations of financial staff, *id.* at *3*, and cited approvingly to state law cases providing that “[i]n fulfilling their duty to inform themselves, officers and directors are entitled to rely on the advice of financial and legal advisors.” *Id.* at *6 n.12.
after the fact, of what corporate officers or directors “should have” done or “should have” recognized, and that the view being imposed greatly diminishes the ability of managers to function without fear of being second-guessed when they rely in good faith on the involvement of competent subordinates, counsel, or other experts. 158

As to reliance on counsel specifically, the courts generally have held that advice of counsel is not a defense in SEC actions. 159 But they also have recognized the appropriateness of management relying on counsel’s involvement in a particular transaction as relevant to a manager’s liability for incorrect decisions, or even if subordinates have committed fraud. Recently, in Howard, 160 the D.C. Circuit criticized the Commission for failing to recognize that “reliance on the advice of counsel need not be a formal defense” in order to be “a relevant consideration in evaluating a defendant’s scienter.” 161 In Howard, the Court noted that the Commission argued that review of the transaction at issue by outside counsel was irrelevant because: (1) Howard never claimed the formal reliance on counsel defense, and (2) he would not qualify for the defense because he had not fully disclosed all relevant facts to counsel. The latter issue is present in many cases where a manager raises the involvement of counsel in defense of an alleged failure to question a legal or accounting decision, not because the manager purposefully has withheld facts from counsel, but rather because managers whom the Commission includes in its enforcement actions are often involved in a high-level review of a transaction or in an oversight function, and are

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158 For example, in Howard, 376 F.3d 1136, the D.C. Circuit found that the Commission in its opinion in the underlying administrative proceeding “disregarded evidence tending to show that Howard did not act recklessly” and that it applied “a ‘should have known’ negligence standard that we have rejected”. Id. at 1138; see also supra n.70. This is not a new phenomenon, and the Commission signaled its direction in this regard as early as 1997. In the Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934 Concerning the Conduct of Certain Former Officers and Directors of W.R. Grace & Co., SEC Rel. No. 34-39157, 1997 WL 597984 (Sept. 30, 1997), the Commission criticized four directors, including two outside directors, of W.R. Grace & Co., for failing to take steps to “ensure” adequate disclosure of certain retirement benefits granted to one officer and of a related-party transaction, and for failing specifically to question counsel’s decision on disclosure. Id. at **2–3. One commissioner took the unusual step of dissenting from the Commission’s statement “to the extent it suggests that officers and directors must ‘ensure’ the accuracy and completeness of company disclosures.” Id. at **3–4. If an SEC Commissioner involved in discussing the statement as it was formulated is not certain what standard the Commission applied, how much more confusing are such statements to those outside the Commission who must conform their conduct to those standards? Indeed, the dissenting commissioner, Steven Wallman, stated that to conclude on the facts presented that the named officers and directors failed to fulfill their obligations under the federal securities laws is to “impose strict liability” for disclosure failures. Id. at *5. This issue is of special concern due to the availability to the Commission, since 1988, of a statutorily created cause of action that allows the Commission to sue any person “that is, was, or would be a cause of the violation, due to an act or omission the persons knew or should have known would contribute to such violation. . . . ” See supra n.9. Thus, a person can be responsible for disclosure and other major deceptions by negligently failing to recognize something that the Commission later can argue should have caused additional questions to be raised or, eventually, a different result to be reached.

Recently, the Commission applied this principle in a settled case where the Commission stated that those who “caused” the violation through their failure to act were given false information by others. In re Barge, SEC Rel. No. 34-51400, 2005 WL 645212 (Mar. 21, 2005). Respondents were “corporate-level finance and accounting executives at the company who were responsible for, among other things, reviewing and approving the accounting treatment recommended by the company’s business units.” Id. at *2 The Commission stated that the respondents approved the company’s accounting based on “the form of the transactions and oral and written representations, some of which were false and omitted material facts, by other company employees.” Id. They also consulted with and received the approval of the company’s outside auditors. Id. at *7 n.3. Nevertheless, the Commission felt that they “failed to pursue facts and circumstances that evidenced the true economic substance of the transactions.” Id at *2. The Commission lists a number of factors which it finds the respondents knew and failed to recognize as indicating possible improper accounting, but at the core, this appears to be a case where the ability of senior officials to rely on their subordinates, and even on the outside auditors, was called into question in a way that appears to further erode that principle.

159 Bevis Longstreth, Reliance on Advice of Counsel as a Defense to Securities Law Violations, 37 Bus. Law. 1185 (Apr. 1982).
160 Supra nn.21 and 72–74.
161 376 F.3d at 1147.
not directly involved in all or many aspects of developing or negotiating the transaction. Thus, they do not know all the facts and do not formally seek “advice of counsel.” Rather, they take comfort in the fact that counsel is involved and that responsible subordinates who presumably do know all the facts are consulting with counsel. In Howard, the Court rejected the Commission’s two arguments, above, that review by outside counsel was irrelevant, stating, “The SEC opinion relied on neither rationale . . . and it would have been error for it to do so.”

The Howard Court specifically recognized the relevance of counsel’s approval of a particular investor’s purchase as giving comfort that the purchase appropriately could be counted toward the requirements of a so-called all-or-none offering, when in the SEC’s view it should not have been counted. The D.C. Circuit criticized the SEC’s contrary approach:

The SEC’s response, found in its brief but not its opinion, is that the evidence does not bear on Howard’s conduct because Matcovsky, not Howard, served as the liaison to [outside counsel]. That cannot be correct. Suppose a company president communicates directly with competent outside counsel; makes full disclosure; is advised—incorrectly—that the proposed transaction is entirely lawful; tells junior officers in the company of the legal advice; and instructs them to consummate the transaction. Under the SEC’s theory, the president could avoid charges of fraudulent conduct by using the attorney’s advice to prove his lack of scienter while those working under him could not. That is illogical and makes no sense whatsoever. If the SEC were right, all corporate employees . . . would have to consult outside counsel directly in order to receive the same legal advice. . . .

Corporate officials and the entities they serve should be vigilant to misconduct and must make informed, good-faith decisions. Likewise, counsel and other experts must give their best advice to guide their clients to the correct answers. But there is concern that the involvement of counsel or other experts in corporate decision-making is being marginalized through positions taken in enforcement matters, such as that advanced by the Commission in the Howard case.

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162 Id.
163 Id. at 1148.
164 See, e.g., Wasserman, supra n.17, at 11–15 (discussing this issue in detail). See SEC v. Merchant Capital, LLC, 2005 U.S. Dist. LEXIS 28798 (D. Ga. Nov. 10, 2005) (holding that limited partnership interests were not securities and stating that even if they were, the court would not grant any of the requested relief, finding the defendants acted in good faith and received various legal opinions). Anecdotal information suggests that the SEC’s Enforcement staff has raised the rationale rejected by the D.C. Circuit in Howard when faced with claims during an investigation that a corporate official should not be liable for failing to question the judgment of counsel or another expert. Reference to the involvement of counsel is objected to as irrelevant unless a formal defense of advice of counsel is claimed, and attorney-client privilege is waived as to the advice. As explained above, senior managers cannot qualify for the strict application of such a “defense” because they often do not directly interact with counsel, request a formal opinion, or know all the facts of which counsel should be informed before the defense would be triggered. The advice of counsel may be marginalized even further if attorneys, viewed as “gatekeepers,” can more easily be turned into potential defendants or respondents the more involved they become in corporate transactions. Lawyers and accountants are expected to exercise their best judgment in giving advice on corporate transactions and to be appropriately informed in giving that advice. Yet, as the Commission’s general counsel recognized in a speech in 2004, in judging attorney conduct in connection with advising on corporate transactions or disclosure, the SEC should not second-guess attorney judgments or “permit 20/20 hindsight to be the Commission standard.” Giovanni P. Prezioso, Speech by SEC Staff: Remarks before the Spring Meeting of the Association of General Counsel (Apr. 28, 2005), at 2, available at http://www.sec.gov/news/speech/spch042805gpp.htm (“In matters involving close or difficult judgment calls, I do not believe that the Commission has—or should—second guess those calls, even when the lawyer is close to the center of the decision-making process. The securities laws often are too complex—and involve too many questions on which reasonable lawyers legitimately can disagree—to permit 20/20 hindsight to be the Commission standard”). Despite this appropriate sentiment, there is a concern that recent SEC initiatives as to so-called “gatekeepers” have sent a confusing signal to those who must operate under the principles applied in those often settled enforcement actions. One case referenced by some interviewees was In re Google, Inc., SEC Rel. Nos. 33-8523, 2005 WL 82435 (Jan. 13, 2005). In the Google matter, the company’s general counsel consented to “causing” the issuer’s violation of the securities law provisions that would require registration of certain
The SEC has been recognized as a preeminent regulatory agency. It has seen its enforcement powers continuously augmented, and today it has the ability to impose harsh, punitive sanctions, as well as to fashion remedial and equitable remedies. Recently, the Commission has used this authority aggressively to respond to revelations about conduct in the securities markets and at some corporations which shook investor confidence and rightly focused corporate America on governance and compliance issues. Our interviews suggest that concern now is growing among corporate officials, counsel, and others about certain of the enforcement policies and practices that have evolved as the SEC and criminal authorities worked to remedy and punish that conduct.

The concerns expressed throughout this report come from persons who have wide-ranging experiences in dealing with the SEC and securities law and enforcement issues. Many of them were staff members at the SEC or held positions with the DOJ, and several are former SEC commissioners. Their views are shared by numerous commentators, and recently, the Courts have questioned the legal theories or factual bases for a number of SEC enforcement cases. The Commission has always prided itself on being a responsible, responsive, and fair regulator. Its reputation as such allows it to regulate often through an open and constructive dialogue with those whom its rules and actions affect. It is hoped that as a result of this survey, the Commission once again will undertake a comprehensive study of its enforcement processes and policies, to ensure that the rights and interests of all those constituencies that work within the framework of regulation the Commission administers are adequately considered and protected during the enforcement process. The Chamber of Commerce would welcome the opportunity to participate in a dialogue with the Commission concerning the issues covered by this report, and others that may affect the SEC’s enforcement program.
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