

# What More Can Be Done to Deter Violations of the Federal Securities Laws?

David M. Becker<sup>\*</sup>

A significant purpose of the U.S. Securities and Exchange Commission's enforcement program is to prevent violations of the federal securities laws. Under the best of circumstances, this is an effort that never ends and that meets with varying success. The conventional wisdom is that the SEC has been especially unsuccessful in its efforts at deterrence of late. Most of the criticism has focused on the severity of sanctions the SEC obtains in its settlements with wrongdoers.<sup>1</sup> As with all law enforcement authorities, settlements account for the vast majority of dispositions of SEC cases that end with sanctions.<sup>2</sup>

This paper takes the position that much of the focus on severity is misplaced, not because severity is unimportant but because there is much more that is equally, if not more, important. As with all violations of law, severity does not necessarily guarantee efficacy. This paper calls upon the SEC and the academic community to think about SEC deterrence more comprehensively, including considerations of how securities laws violations arise, what types of penalties are most likely to be effective with what types of offenders or violations, and how—besides simply raising sanctions—the SEC might enhance the deterrent value of its enforcement program.

This Article suggests that there is probably little to be gained from increasing sanctions and that the SEC probably would be better served by focusing its efforts on increasing the likelihood that certain violations are punished and by redoubling its efforts to move more quickly.

A word of caution: This is neither a research paper nor a work of systematic study. Rather, it is a compilation of observations gleaned from thirty-five years of practicing law. I hope the observations are useful, but

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<sup>\*</sup> The author is a partner at Cleary Gottlieb Steen & Hamilton LLP and member of the Bars of Washington, D.C. and New York. The author served as General Counsel and Senior Policy Director of the U.S. Securities and Exchange Commission from 2009 to 2011 and as General Counsel from 2000 to 2002. The author thanks Matthew Wingerter, Michael Hurst, and Jennifer Klein for their help on this Article. The opinions expressed in this Article are the author's alone.

1. See Barbara Black, *Should the SEC Be a Collection Agency for Defrauded Investors?*, 63 BUS. LAW. 317, 330–31 (2008) (discussing the large penalties imposed by the SEC and describing corporations' critical reactions); James J. Park, *Rules, Principles, and the Competition to Enforce the Securities Laws*, 100 CALIF. L. REV. 115, 153–54 (2012) (describing the SEC's reaction to criticism of the larger penalties it had been imposing).

2. See MAX GULKER ET AL., NERA ECON. CONSULTING, SEC SETTLEMENT TRENDS: 2H11 UPDATE 26 n.5 (2012) (“[T]he overwhelming majority of [SEC] cases are resolved via settlement.”).

this Article relies principally on the eyes, ears, and perspective of but a single person.

### I. General Considerations About Deterrence and the Federal Securities Laws

Criminology literature indicates that the success of a deterrent strategy turns on four factors: (a) the severity of sanctions, (b) the degree of certainty that sanctions will be imposed, (c) “celerity,” which means the amount of time that lapses between the unlawful conduct and when sanctions are imposed, and (d) the extent to which there are extralegal consequences from the unlawful conduct.<sup>3</sup>

General deterrence is an exercise in communication. That is, for a sanctions regime to deter, the potential wrongdoer must be able to apprehend what conduct might give rise to a particular level of pain, in the form of a sanction.<sup>4</sup> To the extent persons considering wrongdoing calculate (consciously or otherwise, rationally or otherwise) whether to do so, effective deterrence affects those calculations.<sup>5</sup> Those who appraise the utility of an illegal course of action will weigh what they perceive could be gained against what they perceive could be lost.<sup>6</sup> And in valuing what is to be lost, they will discount the maximum available sanction by the likelihood that it will be imposed and by some sense of how far in the future it will be imposed.<sup>7</sup> Further, in weighing any extralegal sanctions, they will do so with some notion as to how family, friends, prospective employers, and prospective customers will react to reports of those persons’ wrongdoing.<sup>8</sup> Presumably, potential bad actors will have some perception as to these matters; law enforcement aims to affect these perceptions in a way that counsels against wrongdoing.<sup>9</sup>

In thinking about deterrence under the federal securities laws, it is useful to consider the variety of people who are to be deterred and the types of violations they are to be deterred from. It is harder to deter some people

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3. See Raymond Paternoster, *How Much Do We Really Know About Criminal Deterrence?*, 100 J. CRIM. L. & CRIMINOLOGY 765, 781, 783 (2010) (laying out the first three factors and discussing extralegal factors such as social censure that arise from being arrested, which contribute to deterrence).

4. See *id.* at 785–86 (explaining that deterrence is increased by the increased perception of higher or more frequent sanctions).

5. See *id.* at 783 (discussing how the probability of sanctions impacts the theoretical model for calculating the potential costs and benefits of committing a crime).

6. *Id.*

7. See *id.* at 784 (presenting a theoretical model for calculating the costs and benefits of a crime and explaining that certainty, severity, and celerity are all related to the costs of a crime, which are discounted by the probability that the costs will be enforced).

8. See *id.* at 781 (discussing extralegal factors such as social censure that arise from being arrested, which contribute to deterrence).

9. See *id.* at 766 (“Law enforcement exists both to apprehend wrongdoers and to convince would-be wrongdoers that there is a risk of apprehension and punishment if they commit a crime.”).

than others. Those who do not calculate the costs and benefits of misbehavior—whether consciously or not—are less amenable to being deterred than those who do. Some people have little to lose by anything that the SEC can do to them. Without authority to pursue criminal cases, the SEC cannot put anyone in jail. A fine does little damage to someone without the means to pay it. And the loss of a license does little to someone willing to act without one.

The benefit side of the calculus matters too. It has long seemed to me that securities violations increase in times of rapid economic change, where there is much money to be gained or lost quickly. My experience with desperate people suggests that someone who stands to gain enormously from violating the law is more easily deterred than someone who can avert a catastrophic loss by illegal behavior. Sometimes these factors work against each other. Someone who violates the law ruthlessly and rationally is more amenable to deterrence than someone who acts impulsively or someone who gives in to enormous pressure.

Another issue is the variety of conduct required or forbidden under the federal securities laws. The federal securities laws are an accumulation of some seventy-nine years of legislation and regulation.<sup>10</sup> They contain thousands of requirements and cover subjects including: capital raising,<sup>11</sup> securities trading,<sup>12</sup> the regulation of broker-dealers<sup>13</sup> and investment advisers,<sup>14</sup> the regulation of investment companies,<sup>15</sup> public disclosures by public companies,<sup>16</sup> corporate governance,<sup>17</sup> proxy regulation,<sup>18</sup> auditor independence,<sup>19</sup> and the prevention of bribery of officials of foreign governments.<sup>20</sup> Above all, the SEC enforces the requirement that all

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10. The first significant federal securities law was the Securities Act of 1933, ch. 38, 48 Stat. 74 (codified as amended at 15 U.S.C. §§ 77a–77aa (2006)).

11. *See, e.g.*, Securities Act of 1933 § 5(c), 15 U.S.C. § 77e(c) (2006) (requiring the filing of a registration statement before offering a security for sale).

12. Securities Exchange Act of 1934 § 9, 15 U.S.C. § 78i (2006) (prohibiting the false or misleading appearance of trading activity on any national securities exchange).

13. *Id.* at § 15 (codified as amended at 15 U.S.C. § 78o (2006)) (regulating the registration of brokers and dealers).

14. Investment Advisers Act of 1940 § 206, 15 U.S.C. § 80b-6 (2006) (prohibiting investment advisors from engaging in certain transactions).

15. *See* Investment Company Act of 1940 §§ 3, 1–65, 15 U.S.C. §§ 80a-3, 80a-1 to -64 (2006) (defining an “investment company” as a company that engages in investing and offers its own securities to the public—which includes mutual funds—and laying out regulations of those companies).

16. Securities Exchange Act § 13 (codified as amended at 15 U.S.C. § 78m (2006)) (requiring periodic filing by issuers of regulated securities).

17. *See, e.g., id.* § 16(a)(1) (codified as amended at 15 U.S.C. § 78p(a)(1) (2006)) (requiring disclosure by directors and officers of a corporation).

18. *Id.* § 14 (codified as amended at 15 U.S.C. § 78n (2006)) (regulating proxies).

19. *See* Sarbanes-Oxley Act of 2002 § 303, 15 U.S.C. § 7242 (2006) (assuring the independence of auditors).

20. *See* Securities Exchange Act § 30A (codified as amended at 15 U.S.C. § 78dd-1(a) (2006)) (prohibiting the bribery of foreign officials).

participants in securities transactions tell the truth to one another and to the public.<sup>21</sup>

The following section discusses the evolution of the SEC's view on deterrence.

## II. The SEC and Deterrence

As is well known, the remedies available to the SEC for securities laws violations include injunctions and other court orders, disgorgement of ill-gotten gains, and civil penalties.<sup>22</sup> Courts also can bar persons from acting as officers or directors of public companies and can issue a variety of orders designed to enhance compliance by the defendant.<sup>23</sup> In appropriate cases, the SEC has obtained orders requiring an independent consultant to review a defendant's activities in a particular area and recommend enhanced procedural safeguards to prevent recurrences of violations.<sup>24</sup> In rare cases, the SEC has obtained orders requiring that a corporate defendant hire an independent monitor to supervise part of a company's business.<sup>25</sup>

The SEC can order certain sanctions without going to court. It can impose civil fines; enter cease-and-desist orders directing respondents to refrain from misconduct; bar individuals from serving as officers or directors of public companies; and suspend or bar persons from acting as broker-dealers, investment advisers, and other securities professionals.<sup>26</sup>

For over twenty years, the SEC's deterrence strategy has been focused principally on the severity of sanctions. From 1934 to 1984, the SEC's authority to sanction wrongdoers was said to be "remedial."<sup>27</sup> That is, the purpose of sanctions was to safeguard investors principally through specific deterrent measures designed to limit the capacity of respondents to injure investors.<sup>28</sup> That is not to say that the SEC sanctions were not thought to be

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21. *E.g.*, Securities Act of 1933 § 11(a), 15 U.S.C. § 77k(a) (2006) (imposing liability for SEC registration statements that contain an untrue statement of material fact); Securities Exchange Act § 15(c)(1) (codified as amended at 15 U.S.C. § 78o(c)(1) (2006)) (prohibiting fraud, manipulation, and deceptive practices by broker-dealers).

22. Securities Exchange Act §§ 21(d), 21A (codified as amended at 15 U.S.C. §§ 78u(d), 78u-1 (2006)).

23. *Id.* § 21(d)(2) (codified as amended at 15 U.S.C. § 78u(d)(2) (2006)).

24. *See, e.g.*, UBS Sec. LLC, Exchange Act Release No. 65,733, 2011 WL 5444407, at \*5 (Nov. 10, 2011) (requiring UBS to retain an independent consultant to review UBS's Securities Lending Desk policies); Morgan Stanley DW Inc., Securities Act Release No. 8339, Exchange Act Release No. 48,789, 81 SEC Docket 1993, 1999 (Nov. 17, 2003) (requiring Morgan Stanley to retain an independent consultant to review Morgan Stanley's disclosure policies and practices).

25. *See, e.g.*, Lovelock & Lewes, Exchange Act Release No. 64,184, 2011 WL 1295803, at \*24 (Apr. 5, 2011) (requiring PW India to retain an Independent Monitor in order to assess compliance with the orders).

26. Securities Exchange Act § 21B-21C (codified as amended at 15 U.S.C. §§ 78u-2 to -3 (2006)).

27. *See Decker v. SEC*, 631 F.2d 1380, 1384 (10th Cir. 1980) (stating that SEC disciplinary actions "are considered remedial in character").

28. *Id.*

severe. The Supreme Court characterized the injunction remedy—now often derided as a slap on the wrist—as “a drastic remedy, not a mild prophylactic.”<sup>29</sup> In the main, however, the focus of the SEC’s sanctions was not thought to be penal.<sup>30</sup>

The SEC’s view of the efficacy of its sanctions began to change in the early 1980s. This was a time of numerous mergers and acquisitions among public companies, often by tender offers.<sup>31</sup> Information about impending mergers and acquisitions was extremely valuable, and a significant number of people with that information traded on it.<sup>32</sup> Just how many did is unknowable, but it was enough in 1982 for incoming SEC Chairman John S.R. Shad to announce that the Commission was going to “come down on insider trading with hobnail boots.”<sup>33</sup>

The SEC significantly increased the number of insider trading cases it brought but soon concluded that, without authority to seek penalties, its enforcement actions would continue to be an insufficient deterrent.<sup>34</sup> Accordingly, in 1983, it asked Congress to enact what ultimately became the Insider Trading Sanctions Act of 1984 (ITSA).<sup>35</sup> That statute authorized federal courts, in cases brought by the Commission, to institute a civil penalty up to treble the profit gained or loss avoided as a result of the insider trading.<sup>36</sup>

ITSA was the first in a string of statutes that expanded the SEC’s enforcement remedies. Four years later, Congress passed the Insider Trading and Securities Fraud Enforcement Act of 1988 (ITSFEA).<sup>37</sup> ITSFEA authorized the SEC to seek civil penalties against supervisory personnel at broker-dealers, investment advisers, and other securities firms if they were aware of the likelihood that a person would engage in insider trading or if they failed to adopt procedures reasonably designed to prevent insider trading.<sup>38</sup> Congress also increased the amount of potential penalties that could be levied on a controlling person, rather than just the perpetrator of the

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29. *Aaron v. SEC*, 446 U.S. 680, 703 (1980) (Burger, J., concurring).

30. *See Decker*, 631 F.2d at 1384 (noting that, while SEC disciplinary actions have a “penal component,” their primary purpose is to protect the public, not punish the individual).

31. *See, e.g.*, Stephen M. Bainbridge, Note, *A Critique of the Insider Trading Sanctions Act of 1984*, 71 VA. L. REV. 455, 465–66 & n.74 (1985) (remarking that there was an increase in the number of takeovers and tender offers in the early 1980s).

32. *Id.* at 455, 466.

33. Leslie Wayne, *Inside Trading by Outsiders*, N.Y. TIMES, May 27, 1984, at F1 (internal quotation marks omitted).

34. *See* Bainbridge, *supra* note 31, at 455–56 (stating that the intended effect of the Insider Trading Sanctions Act of 1984 was to increase deterrence against insider trading).

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

36. *Id.* § 2 (codified as amended at 15 U.S.C. § 78u-1 (2006)).

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

38. *Id.* § 3 (codified as amended at 15 U.S.C. § 78u-1(b)(1) (2006)).

violation, to the greater of three times the profit gained or loss avoided or \$1 million per violation.<sup>39</sup>

Just two years later, Congress added substantial new remedies to the Commission's arsenal by means of the Securities Enforcement Remedies and Penny Stock Reform Act of 1990 (the Remedies Act).<sup>40</sup> The Remedies Act, among other things, empowered the Commission to obtain court orders imposing civil penalties upon violators of federal securities laws.<sup>41</sup> The Act also authorized the SEC to penalize, in administrative proceedings, securities firms and their associated persons and gave the SEC the power to issue cease-and-desist orders against anyone violating the securities laws.<sup>42</sup> The statute also authorized the SEC to apply to the federal district courts for orders barring persons from serving as officers or directors of public companies.<sup>43</sup>

These matters stood until 2002, when in response to Enron, WorldCom, and other corporate scandals, Congress enacted the Sarbanes-Oxley Act.<sup>44</sup> Among many other things, the Sarbanes-Oxley Act granted the SEC authority to freeze "extraordinary payments" (bonuses and incentive awards) to corporate executives even before filing an enforcement action.<sup>45</sup> It also contained provisions permitting the SEC to enforce so-called "clawbacks" to corporations of incentive compensation paid to chief executive officers (CEOs) and chief financial officers (CFOs) in the event of certain accounting restatements, even in the absence of fault by the CEOs and CFOs.<sup>46</sup>

The Sarbanes-Oxley Act also gave the SEC the authority to order officer and director bars in administrative proceedings and lowered the threshold for doing so.<sup>47</sup> Under the Remedies Act, the Commission had to persuade a court that a defendant had evidenced "substantial unfitness" to serve as an officer and director.<sup>48</sup> Because the courts proved reluctant to

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39. *Id.* (codified as amended at 15 U.S.C. § 78u-1(a)(3) (2006)).

40. Securities Enforcement Remedies and Penny Stock Reform Act of 1990, Pub. L. No. 101-429, 104 Stat. 931 (codified as amended in scattered sections of 15 U.S.C.).

41. *Id.* § 101 (codified as amended at 15 U.S.C. § 77t(d)(1) (2006)).

42. *Id.* § 202 (codified as amended at 15 U.S.C. § 78u-2(a) (2006)).

43. *Id.* § 203 (codified as amended at 15 U.S.C. § 78u-3(f) (2006)).

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

45. *Id.* § 1103 (codified as amended at 15 U.S.C. § 78u-3(c)(3) (2006)).

46. *Id.* § 304 (codified at 15 U.S.C. § 7243 (2006)).

47. *See id.* § 305 (codified at 15 U.S.C. §§ 77(t)(e) and 78(u)(d)(2) (2006)) (changing the standard to "unfitness" rather than "substantial unfitness").

48. Securities Enforcement Remedies and Penny Stock Reform Act § 101 (codified as amended at 15 U.S.C. § 77t(e) (2006)).

make these findings,<sup>49</sup> Congress changed the requisite finding to one merely of “unfitness.”<sup>50</sup>

Between 1982 and 2002, each enhancement of the SEC’s enforcement remedies was simply a matter of “more.”<sup>51</sup> One feature of the Sarbanes-Oxley Act took the SEC’s enforcement program in a direction that was both “more” and also different. Section 308 of the Act granted to the Commission the power to create “Fair Funds.”<sup>52</sup> These allow the Commission to add civil penalties collected in enforcement actions to disgorgement funds and distribute the funds to harmed investors.<sup>53</sup> The practice of returning disgorged funds was not new, but until passage of the Sarbanes-Oxley Act, all civil penalties the SEC collected were required by law to be sent to the U.S. Treasury.<sup>54</sup>

The advent of Fair Funds enabled the Commission to increase significantly the size of penalties and satisfy some of the public demand for greater accountability for malefactors.<sup>55</sup> The SEC took advantage of the opportunity and hugely increased the size of penalties. As one commentator put it:

When the SEC settled an enforcement action against Xerox in 2002, shortly before the enactment of SOX, the \$10 million civil penalty paid by Xerox was the largest penalty the SEC had ever imposed on an issuer in a financial fraud action. Shortly thereafter, a \$10 million penalty seemed “antiquated” and, indeed, it was asserted, would constitute a success for the attorney representing the corporate defendant.<sup>56</sup>

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49. *See, e.g.*, SEC v. Patel, 61 F.3d 137, 141–42 (2d Cir. 1995) (reversing the district court’s injunction barring the defendant from serving as an officer or a director).

50. Sarbanes-Oxley Act § 305 (codified at 15 U.S.C. §§ 77t(e) and 78(u)(d)(2) (2006)). *See also* Philip F.S. Berg, Note, *Unfit to Serve: Permanently Barring People from Serving as Officers and Directors of Publicly Traded Companies After the Sarbanes-Oxley Act*, 56 VAND. L. REV. 1871, 1884–89 (2003) (explaining the evolution of Sarbanes-Oxley in the House and Senate and the decision to change “substantial unfitness” to “unfitness”).

51. This impulse for “more” reminds me of the famous quote from *Key Largo*: “Yeah. That’s it. More. That’s right! I want more!” KEY LARGO (Warner Bros. Pictures 1948).

52. Sarbanes-Oxley Act § 308 (codified at 15 U.S.C. § 7246 (2006)).

53. *Id.*

54. Compare 15 U.S.C. § 78u(d)(3)(C)(i) (2000) (mandating all penalties be paid to the U.S. Treasury), with 15 U.S.C. § 78u(d)(3)(C)(i) (2006) (same but adding an exception to allow penalties to be directed to Fair Funds).

55. *See, e.g.*, SEC v. WorldCom, Inc., Litigation Release No. 18,219, 2003 WL 21523823, at \*1 (July 7, 2003) (approving a settlement where WorldCom would distribute \$500 million in cash and \$250 million in stock to defrauded investors).

56. Black, *supra* note 1, at 330 (footnotes omitted). The question raised by Professor Black is an important one. Though beyond the scope of this Article, it is not at all clear that it serves the public interest for the SEC to change from an entity that redresses harm to the public writ large to one dedicated to pursuing recompense for damaged investors. Among other things, it is far from clear that the SEC could ever have the resources to perform this role.

Under first Chairman Harvey L. Pitt and then Chairman William H. Donaldson,<sup>57</sup> the SEC embraced its new penalty authority with gusto.<sup>58</sup> But there were dissenting voices on the Commission, and a counter narrative emerged. That narrative was that increased penalties, especially those imposed upon corporations, were unfair.<sup>59</sup> It was argued that the Division of Enforcement used the Commission's prevailing enthusiasm for penalties to bludgeon parties into agreeing to settlements,<sup>60</sup> regardless of the merits of a case. Potential defendants were forced to settle cases of dubious merit in order to end extraordinarily expensive and disruptive investigations and to cap their exposure at the merely unprecedented, rather than taking on the possibility of the truly unimaginable. The Commission, it was argued, had little power to prevent these abuses, because it never saw the cases until already agreed-upon settlements were presented to the Commission for approval.<sup>61</sup>

Huge penalties were said to be particularly unfair to corporations, because their cost was borne by their shareholders, who had no part in any wrongdoing and who, in cases of disclosure violations, were themselves the ones defrauded.<sup>62</sup> Critics claimed that the Commission had become heavy-handed and unpredictable, motivated not so much by upsurging malfeasance as by upstaging by state attorneys general, particularly New York's Eliot Spitzer.<sup>63</sup>

Worst of all, the argument went, the Commission's enforcement program was part of an overall regulatory approach that was undermining the

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57. Harvey L. Pitt served as SEC Chairman from August 3, 2001 to February 17, 2003 and William H. Donaldson served as SEC Chairman from February 18, 2003 to June 30, 2005. *SEC Historical Summary of Chairmen and Commissioners*, U.S. SEC. & EXCHANGE COMMISSION (Feb. 22, 2012), <http://www.sec.gov/about/sechistoricalsummary.htm>.

58. Black, *supra* note 1, at 330–31 (explaining that penalties paid during the period shortly after SOX's passage made the largest pre-SOX penalty "seem 'antiquated'" and that penalties "in the range of \$50 million were not unusual"); David A. Skeel, Jr., *Welcome Back, SEC?*, 18 AM. BANKR. INST. L. REV. 573, 582 (2010) (stating that the SEC increasingly pursued penalties and disgorgement under the authority established by SOX).

59. See Black, *supra* note 1, at 331 ("Business interests criticized the escalating amounts of corporate penalties, which resulted in an intense debate about the SEC's use of its penalty powers against corporate entities." (footnotes omitted)); Park, *supra* note 1, at 153–54 ("After a period of increased enforcement, the SEC found itself criticized for its imposition of significant penalties and responded by seeking to limit the situations where such penalties would be sought." (footnote omitted)).

60. See Theodore A. Levine et al., *Revisiting the SEC Corporate Penalty Policy*, SEC. LITIG. REP., Sept. 2010, at 9 (claiming that the "sword of massive monetary penalties" is "dangled over corporations in settlement discussions").

61. Danné L. Johnson, *SEC Settlement: Agency Self-Interest or Public Interest*, 12 FORDHAM J. CORP. & FIN. L. 627, 644 (2007) ("In many instances, the Staff is also in a position to recommend the acceptance or rejection of an offer of settlement . . . [And] [t]he Commission approves most of the Staff's recommendations.").

62. Levine et al., *supra* note 60, at 4.

63. See Park, *supra* note 1, at 153 & n.174 (noting that in increasing its enforcement, "the SEC often played a reactive role to principle-enforcement actions brought by the New York Attorney General," Eliot Spitzer).

competitiveness of the very capital markets it was charged with regulating.<sup>64</sup> To the extent they could, American companies were seeking to avoid being subject to the burdens and cupidity of Commission regulation. Private companies raised money on the private markets and overseas.<sup>65</sup> Public companies, if they could, went private.<sup>66</sup> Those foreign private issuers that had registered in the United States to tap the American capital markets pressed to deregister their securities.<sup>67</sup> Foreign companies in need of capital were going elsewhere—mostly to London or Hong Kong—to avoid onerous Commission enforcement and regulation.<sup>68</sup>

The Commission pulled back, some, during the tenure of Chairman Christopher Cox. The Commission in 2006 announced a policy on corporate penalties that set forth a multifactor test for their imposition.<sup>69</sup> Under the policy—which is not legally binding on the Commission—the Commission would give greatest weight to the economic benefit to the corporation (and by extension to its shareholders) from corporate misconduct.<sup>70</sup>

Later, the Commission announced a policy of requiring the Division of Enforcement to get authority from the Commission before entering into settlement discussions with potential subjects of Commission enforcement actions.<sup>71</sup> This policy was clearly designed to give the Commission greater control over the settlement negotiations and to prevent bullying, which had been a source of complaint by the Commission's critics.

The effect of these changes in policy and attitude is uncertain. There continued to be blockbuster cases, including in controversial areas such as stock-option backdating.<sup>72</sup> And the Commission's penalty policy is capacious enough to accommodate a great variety of corporate-penalty

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64. Jonathan Macey, *The SEC's Publicity Hounds*, DEFINING IDEAS, HOOVER INSTITUTION (July 7, 2011), <http://www.hoover.org/publications/defining-ideas/article/84831>.

65. Clyde Stoltenberg et al., *The Past Decade of Regulatory Change in the U.S. and EU Capital Market Regimes: An Evolution from National Interests Toward International Harmonization with Emerging G-20 Leadership*, 29 BERKELEY J. INT'L L. 577, 588–89 (2011).

66. See Melinda Ligos, *When Going Public May Not Be Worth It*, N.Y. TIMES, June 3, 2004, at C7 (discussing how small public companies were going private to avoid compliance burdens).

67. See Samuel Wolff & Clarence D. Long IV, *Post-SOX Trends in Delistings and Deregistration*, 9 RICH. J. GLOBAL L. & BUS. 53, 59 (2010).

68. See *id.* at 58–59 (reporting that in terms of funds raised in 2007, the Hong Kong Stock Exchange was first, the London Stock Exchange was second, and the New York Stock Exchange was third).

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

70. See *id.* (listing the presence of a direct benefit to the corporation as one of the two principal factors in determining whether to impose a penalty).

71. DIV. OF ENFORCEMENT, U.S. SEC. ENFORCEMENT MANUAL 29 (2012), *available at* <http://www.sec.gov/divisions/enforce/enforcementmanual.pdf>.

72. See *Spotlight on Stock Options Backdating*, U.S. SEC. & EXCHANGE COMMISSION, <http://www.sec.gov/spotlight/optionsbackdating.htm> (last modified July 19, 2010) (listing enforcement actions related to options backdating).

outcomes. But the perceptions of the defense bar as well as the Enforcement staff were that controversial cases took longer to move through the Commission. Outcomes may not have been greatly different, but the Cox chairmanship put the brakes on any expansion in the Commission's enforcement activities or in the severity of the remedies it obtained in enforcement cases.

In the fall of 2008, the world abruptly changed, and with it the predominating narrative about the Commission's enforcement program. With the financial meltdown, the onset of the Great Recession, and most importantly the revelation of Bernard Madoff's Ponzi scheme, any public perception of ferociousness was blotted out by an image of fecklessness. Instead of an overreaching SEC, the SEC was seen as an agency afraid to bring tough cases.<sup>73</sup> Instead of deterring wrongdoers, it administered slaps on the wrist—"just [another] cost of doing business."<sup>74</sup> Instead of bringing wrongdoers to trial, where they would be wounded grievously by the sword of justice, the public perceived an SEC afraid to litigate, that settled cases for relief far milder than what could be obtained at trial.<sup>75</sup> And, worst of all, the SEC let wrongdoers settle without even admitting their guilt.<sup>76</sup>

In 2010, Congress enacted the Dodd-Frank Wall Street Reform and Consumer Protection Act, commonly known as the Dodd-Frank Act.<sup>77</sup> Among its many, many other provisions, the Dodd-Frank Act increased the enforcement powers and penalties available to the Commission.<sup>78</sup> For example, the Dodd-Frank Act amended the existing securities law regime to grant the Commission authority to bring aiding and abetting charges under

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73. See *The Securities and Exchange Commission: Growing Insecurities*, ECONOMIST, Jan. 15, 2009, available at <http://www.economist.com/node/12948655> ("What is the point of all the enforcement actions—a near-record 671 last year—if the whoppers slip through the net?").

74. Francesco Guerrera, *Slapped Wrist and Back to Business for Goldman*, FIN. TIMES, July 23, 2010, available at <http://www.ft.com/intl/cms/s/0/91354f24-9676-11df-9caa-00144feab49a.html#axzz1owFih6I8> (calling the largest fine levied by the SEC a slap on the wrist relative to the bank's regular earnings).

75. See Sewell Chan & Louise Story, *Goldman Pays \$550 Million to Settle Fraud Case*, N.Y. TIMES, July 15, 2010, available at <http://www.nytimes.com/2010/07/16/business/16goldman.html> (quoting a former Federal Reserve lawyer speaking about the SEC's Goldman settlement who said that the public wanted to see more financial pain for Goldman or an actual trial); Jesse Eisinger, *Needed: A Cure for a Severe Case of Trialphobia*, THE TRADE, PROPUBLICA (Dec. 14, 2011, 4:10 PM), <http://www.propublica.org/thetrade/item/needed-a-cure-for-a-severe-case-of-trialphobia> (arguing that the public wants the SEC to go to trial rather than settle cases); Jean Eaglesham & Brooke Masters, *SEC: No Longer a Doormat*, FIN. TIMES, Aug. 26, 2010, available at <http://www.ft.com/intl/cms/s/0/1d2fd850-b14d-11df-b899-00144feabdc0.html#axzz1pP5VVOom> (stating that some critics attacked the SEC for settling with Goldman rather than going to court).

76. See Edward Wyatt, *S.E.C., Responding to Critics, Defends 'No Wrongdoing' Settlements*, N.Y. TIMES, Feb. 23, 2012, at B3 (reporting that SEC chairman Mary L. Schapiro defended the Commission's longstanding practice of allowing wrongdoers to settle without admitting guilt).

77. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (codified as amended in scattered sections of 2, 5, 7, 12, 15, 18, 22, 26, 28, 31, 42, and 44 U.S.C.).

78. *Id.* § 929P (codified as amended in scattered sections of 15 U.S.C.).

the Securities Act of 1933 and the Investment Company Act of 1940.<sup>79</sup> In addition, the Dodd-Frank Act provided that a subpoena issued to compel the attendance of a witness or the production of documents may be served at any place within the United States in any action or proceeding instituted by the Commission.<sup>80</sup> The enforcement authority of the Commission was expanded by stating that the standard of knowledge applicable to aiding and abetting violations of the Exchange Act is satisfied by recklessness,<sup>81</sup> while the Commission's authority to bring actions was extended to persons formerly associated with registrants.<sup>82</sup> Also, the Commission was given the authority, after certain requirements are met, to bar a person from associating with a range of Commission-regulated entities, and not just entities regulated by the specific title that was violated.<sup>83</sup>

Despite a renewed emphasis on enforcement and the reversal of various policies put into place under Chairman Cox,<sup>84</sup> public disparagement of the Commission continues unabated to this day.<sup>85</sup> In the midst of public controversy and litigation surrounding its settlement of a negligence claim against Citigroup, Inc.,<sup>86</sup> the Commission has sought authority to increase the amount of civil penalties it can obtain in enforcement proceedings, up to "three times the gross amount of pecuniary gain."<sup>87</sup> The Commission has also sought authority to impose penalties based on losses to investors,<sup>88</sup> a new yardstick that would allow the Commission to obtain much larger

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79. *Id.* § 929M (codified at 15 U.S.C. §§ 77o, 80a-47 (Supp. IV 2011)).

80. *Id.* § 929E (codified at 15 U.S.C. §§ 77v, 78aa, 80a-43, 80b-14 (Supp. IV 2011)).

81. *Id.* § 929O (codified at 15 U.S.C. § 78t(e) (Supp. IV 2011)).

82. *Id.* § 929F (codified at 15 U.S.C. §§ 78o(b), 78o-4, 78q-1, 80b-3 (Supp. IV 2011)).

83. *Id.* § 925 (codified as amended in scattered sections of 15 U.S.C.).

84. *See* Eaglesham & Masters, *supra* note 75 (surveying the SEC's revitalized emphasis on enforcement). *See also* Renee M. Jones, *Corporate Governance and Accountability*, in *CORPORATE GOVERNANCE: A SYNTHESIS OF THEORY, RESEARCH, AND PRACTICE* 559, 563 (H. Kent Baker & Ronald Anderson eds., 2010) (explaining that the SEC "Pilot Program," which Schapiro ended in 2009, required staff to consult with the Commission before engaging in settlement discussions); Stephen Labaton, *S.E.C. Chief Pursues Reversal of Years of Lax Enforcement*, *N.Y. TIMES*, Feb. 23, 2009, at B1 (discussing Schapiro's reversal of her predecessor's decisions and her efforts to strengthen enforcement programs).

85. *See* Edward Wyatt, *S.E.C. Is Avoiding Tough Sanctions for Large Banks*, *N.Y. TIMES*, Feb. 3, 2012, at A1 (noting that the SEC has avoided imposing sanctions on some large financial firms over the past decade, which has allowed the firms to raise money more quickly and avoid costly litigation).

86. *See* Edward Wyatt, *Judge Blocks Citigroup Settlement with S.E.C.*, *N.Y. TIMES*, Nov. 28, 2011, <http://www.nytimes.com/2011/11/29/business/judge-rejects-sec-accord-with-citi.html?pagewanted=all> (reporting that a U.S. district court judge had unusually rejected the proposed settlement).

87. Letter from Mary L. Schapiro, Chairman, U.S. Sec. & Exch. Comm'n, to Jack Reed, Chairman of Subcomm. on Sec., Ins., & Inv., Comm. on Banking, Hous. & Urban Affairs, 2 (Nov. 28, 2011) (internal quotation marks omitted), *available at* <http://www.nabl.org/uploads/cms/documents/MarySchapiroLetter.pdf>.

88. *Id.* at 3.

penalties in all cases, including those involving unintentional misconduct.<sup>89</sup> Legislation to this effect is being developed in anticipation of being introduced in the Senate.<sup>90</sup>

### III. Are More Severe Sanctions Achievable Without Changing the Law?

#### A. *Whether Settlements Reduce Sanctions*

Critics argue that the SEC pulls its punches because it settles the vast majority of its cases. “Settlement” implies a bargain, it is said, so rather than have no truck with law violators, the Commission cuts deals with them and reduces the sting from its sanctions. It purportedly does so to avoid the risk and expense of going to trial. I have no studies at my disposal, but my experience suggests that this oft-repeated claim is quite false.

In my years of service at the SEC, I must have considered several thousand memoranda from the Division of Enforcement recommending that the Commission settle an enforcement case. I sat through closed Commission meetings in which over a thousand settlements were discussed. I do not recall a single instance in which the Division of Enforcement said it was recommending sanctions less severe than what it expected it would get in litigation (except in old or trivial cases). There must have been some, but not enough to make an impression.

To the contrary, my experience has been that the Division of Enforcement usually urges the Commission to approve a settlement precisely because through settlement the Commission can obtain *all* the relief the Division of Enforcement deems appropriate or would be likely to get in litigation. And sometimes the Division of Enforcement recommends settlement on the basis that it would provide for the most likely obtainable relief, discounted for the risk that the Commission would get less, and for the time and expense of litigating. In other words, my experience suggests that the Commission believes that defendants do not get any break on sanctions simply because they settle.

Similarly, my experience representing clients before the SEC—and the conventional wisdom among members of the defense bar—is that defendants do not avoid severe sanctions by settling cases. In fact, most defense lawyers I know routinely advise clients that they are more likely to get a favorable outcome, both on the merits and with respect to sanctions, through litigating than they are through settling.

If that is true, one would expect that large, sophisticated institutions would invariably litigate rather than settling cases. But the opposite is true. In an enforcement case, as a matter of pure calculation, it generally makes

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89. See Peter J. Henning, *S.E.C. Seeks More Power, but Does It Need It?*, DEALBOOK, N.Y. TIMES (Dec. 5, 2011, 4:05 PM), <http://dealbook.nytimes.com/2011/12/05/s-e-c-seeks-more-power-but-does-it-need-it/> (saying that such a provision could result in “enormous financial liability”).

90. Letter from Mary L. Schapiro to Jack Reed, *supra* note 87, at 4.

sense for an institutional defendant to settle rather than try it. To begin with, investigations are extremely time-consuming and expensive and have become much more so in the last decade with the advent of electronic discovery.<sup>91</sup> It is unsettling for scores of employees to have their computers imaged and their e-mails reviewed, and then to be subject to interviews by counsel trying to ascertain the best way to defend a case. It is even more unsettling for employees to see their personal e-mails turned over to the SEC and then having to testify before the SEC staff, an unpleasant experience if ever there was one. And the worst of it, from an institutional standpoint, is the uncertainty. What will the SEC do? Who will it charge? What relief will it seek? How long will this go on?

If investigations are bad, litigation is worse. Litigation generally takes years.<sup>92</sup> Pretrial discovery can replicate much of an investigation. Litigation is public, with the result that a company can face multiple blasts of highly negative publicity.<sup>93</sup> Publicity and controversy unsettle customers, managers, and boards of directors. While a company might achieve a better result when the SEC is put to its proof, it generally is not worth the costs arising from the diversion of resources, bad publicity, disruption of business, and risk of losing.

As a matter of calculation, it almost always makes sense to cap business costs—as opposed to just potential liability—by settling. The severity of the sanction is certainly significant but it is much less significant than the benefit of simply getting the matter over and done with. This is not merely an internal perception. Generally, when companies settle significant cases, their stock price goes up, at least for a few days.<sup>94</sup> The conventional wisdom is that the market hates uncertainty more than anything else, and the announcement of an enforcement settlement marks the end of uncertainty.<sup>95</sup>

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91. See Milberg LLP & Hausfeld LLP, *E-Discovery Today: The Fault Lies Not in Our Rules* . . . , 4 FED. CTS. L. REV. 131, 134 (2011) (explaining the high cost and lengthy duration of discovery in today's world); see also FED. R. CIV. P. 26(b)(5) advisory committee's note (acknowledging that, in the context of avoiding privilege waiver, electronic discovery exacerbates the costs and delay of discovery).

92. Cf. Mukesh Bajaj et al., *Empirical Analysis: Securities Class Action Settlements*, 43 SANTA CLARA L. REV. 1001, 1010, tbl.4 (2003) (providing statistical data showing that only a small fraction of securities class actions settle within one year).

93. See, e.g., Andria Cheng, *Avon Slumps on Result, SEC Investigations*, MARKETWATCH, WALL ST. J. (Oct. 27, 2011), [http://articles.marketwatch.com/2011-10-27/industries/30744456\\_1\\_shares-of-avon-products-beauty-sales-sec](http://articles.marketwatch.com/2011-10-27/industries/30744456_1_shares-of-avon-products-beauty-sales-sec) (explaining how the stock prices of Avon Products Inc. plummeted and management lost credibility partly due to an announcement of an SEC investigation against the company).

94. See, e.g., John Curran, *Goldman Sachs Settles with SEC, Stock Soars*, TIME, July 15, 2010, available at <http://business.time.com/2010/07/15/goldman-sachs-settles-with-sec-stock-soars/> (noting a 10% increase in the price of Goldman Sachs's stock after news leaked of an SEC settlement regarding a collateralized debt obligation matter).

95. See, e.g., *id.* (reporting gains in Goldman Sachs's stock after news of its SEC settlement); cf. Kate Gibson, *U.S. Stocks Rattled by Greek Bailout Move*, MARKETWATCH, WALL ST. J. (Nov. 1, 2011), [http://articles.marketwatch.com/2011-11-01/markets/30721396\\_1\\_greek-debt-](http://articles.marketwatch.com/2011-11-01/markets/30721396_1_greek-debt-)

For decades, defense lawyers have known that individuals are less likely to settle cases than corporate entities.<sup>96</sup> Here, the calculation is different, because there is more at stake than dollars and cents. Whether it is the prospect of economic loss, the loss of the ability to make a living, or the prospect of public humiliation (in my view, a very much underrated sanction), individuals are more prone to take on the uncertainty of litigation and roll the dice. Commentators often complain that the SEC is less likely to take enforcement actions against individuals than corporations. They complain, in particular, that the SEC seems reluctant to sue CEOs and other high-ranking corporate officials.<sup>97</sup> Those complaints have gotten louder and more strident in the aftermath of the financial crisis and the onset of the Great Recession.

The complaint may be factually accurate, but in my view these commentators draw the wrong conclusions. I have seen no indications that either the Commission staff or the Commission has any special solicitude for individuals as opposed to business entities. It has long been a common defense strategy to try to bundle a settlement in which the Commission imposes stringent sanctions on an entity with either no proceeding or a milder proceeding against individuals. But this is a trade that, in my experience, the Commission is rarely willing to make. Others have different views.<sup>98</sup>

If there is a disparity in the way the Commission treats entities and individuals, it is because, as noted above, individuals tend to fight harder than entities because it is harder to prove a case against individuals than against entities and the cases brought and settled by the agency are not as strong as they might appear. In some cases, it may well be harder to prove violations by individuals than to prove violations by the company. Many enforcement cases involve some sort of disclosure.<sup>99</sup> Take, for example,

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prime-minister-george-papandreou-drop-in-financial-stocks (discussing how uncertainty over the Greek debt plan crashed the markets).

96. See Jonathan R. Macey, *The Distorting Incentives Facing the U.S. Securities and Exchange Commission*, 33 HARV. J.L. & PUB. POL'Y 639, 646 (2010) (stating that corporations do not fight allegations as "vigorously as individuals do").

97. See, e.g., Andrew Ackerman & Jean Eaglesham, *SEC Pushes to Toughen Penalties for Offenders*, WALL ST. J., Nov. 30, 2011, available at <http://online.wsj.com/article/SB10001424052970204262304577068281927469216.html> (noting Sen. Grassley's call for more suits against individuals).

98. Compare Donald C. Langevoort, *On Leaving Corporate Executives "Naked, Homeless and Without Wheels": Corporate Fraud, Equitable Remedies, and the Debate Over Entity Versus Individual Liability*, 42 WAKE FOREST L. REV. 627, 654 (2007) (stating that the SEC's pattern of allowing dishonest executives to walk away without heavy sanctions is changing), with Steven M. Davidoff, *Despite Worries, Serving at the Top Carries Little Risk*, DEALBOOK, N.Y. TIMES (June 7, 2011, 5:58 PM), <http://dealbook.nytimes.com/2011/06/07/despite-worries-serving-at-the-top-carries-little-risk/> (indicating that top executives "have about the same chance of being held liable for their poor management of a public firm as they have of being struck by lightning").

99. See Press Release, U.S. Sec. & Exch. Comm'n, SEC Enforcement Division Produces Record Results in Safeguarding Investors and Markets (Nov. 9, 2011), available at

cases involving corporate misstatement of material facts in public disclosures. The easiest fact to prove is that a disclosure was inaccurate. It is generally easy to demonstrate who wrote or uttered the false statement. But it becomes more difficult to address what that person knew when he wrote the statement. And it becomes more difficult yet to prove at whose insistence the statement may have been made.

E-mails may show who knew about the offending statement, but what those individuals knew about the actual facts is often harder to prove. When one gets to the level of senior management or the board of directors, one can often put a strong emphasis on driving financial success and penalizing performance short of management expectations. In addition, it is often possible to show a personal economic motive to achieve strong financial performance. But proof—actual, admissible evidence—connecting a hard-driving senior manager with a particular statement is often very hard to obtain.

In this hypothetical (but not uncommon) situation, there plainly is a disclosure case to be made against the company, and there is probably a case to be made against intermediate managers as well. But even though the Enforcement Division staff has every incentive to make a case against a CEO or CFO, the evidence most often simply is not there. Under that circumstance, the staff may have to choose between either not suing any individuals or suing those only midway up the chain. My experience has been that generally the Commission sues anyone and everyone against whom it believes it can make a case and settles for whatever it believes it could get through litigation.

There is, to be sure, the occasional exception. As noted, the Commission, as a matter of practice, generally does not give a settlement discount to avoid litigation. But, in my view, there is a tendency at times to want to dispose of a matter completely and be done with it. If, for example, a case has been dragging on in court for years, the Commission may settle with the remaining defendants because it would rather use its resources elsewhere or because the lawyers most familiar with the case have left the Commission. Similarly, in a case of some significance where the Commission has obtained, by prelitigation settlement, complete relief against a corporate malefactor and the most complicit individuals, it may decide that litigating against nonsettling defendants is not worth the effort and thus enter into a nominal settlement and drop the matter entirely. The result is that sometimes the last to settle a matter gets a better bargain than the first. And, as noted, individuals are more likely to resist settling than are organizations.<sup>100</sup>

As one would expect, while the Commission, advised by the Enforcement staff, may consider the maximum sanctions it believes

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<http://sec.gov/news/press/2011/2011-234.htm> (indicating that 89 of 735 enforcement actions filed by the SEC in 2011 were primarily for disclosure violations).

100. See *supra* note 96 and accompanying text.

appropriate, in settling cases it often discounts them by the likelihood that it could obtain them without an undue expenditure of resources. It also discounts them by the risk that a court would not actually order the most appropriate sanction. In other words, the Commission, advised by the Enforcement staff, considers how a proposed settlement compares to what the Commission could get in court.

This in turn raises another question. Even assuming that the Enforcement staff and the Commission bring all the cases they think they can and insist on settlements that provide them with virtually all the relief they believe the Commission could get in court, is there reason to believe the Enforcement staff and the Commission evaluate the evidence before them too conservatively and forego cases that they could win in the courts? Certainly there are criticisms to this effect in the popular press.<sup>101</sup>

These are difficult criticisms to evaluate. Each case presents its own particular evidentiary record, and, absent litigation, the body of evidence is not available to the public. Indeed, the body of evidence is not really available to the Chairman or the SEC Commissioners. While it is available in theory, there are too many cases, too many other responsibilities, and too few hours in the day for the Chairman, the Commissioners, and their small staffs to double-check on any consistent basis the summary of a record given to them by the Enforcement staff. Certainly, defense counsel provide an advocate's contrary view in Wells Submissions on behalf of the potential defendant in the action,<sup>102</sup> but the Commission rarely seeks to resolve factual controversies in deciding whether to authorize bringing an enforcement action.

Without reviews of evidentiary records, few of the opinions about the Commission's risk aversion, no matter how confidently expressed, seem particularly well informed. The received wisdom in the defense bar, hardly the least biased group, is that the Enforcement Division consistently overstates the strength of its case and obtains settlements wherever it can get what it wants, as opposed to wherever it can get what it *should* want.<sup>103</sup>

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101. See, e.g., Eisinger, *supra* note 75 (arguing the SEC is biased against litigating cases because of misplaced fears it could lose).

102. See DIV. OF ENFORCEMENT, U.S. SEC, *supra* note 71, at 23–26 (discussing the Wells Notice process, including a Wells Submission).

103. See generally Thomas A. Zaccaro et al., *SEC Enforcement Division Has Most Productive Year in Its History*, DAILY J., Dec. 19, 2011, available at [http://www.paulhastings.com/assets/publications/2084.pdf?wt.mc\\_ID=2084.pdf](http://www.paulhastings.com/assets/publications/2084.pdf?wt.mc_ID=2084.pdf) (discussing the record year for enforcement actions brought by the SEC in 2011); Christian Bartholomew & Sarah Nilson, *Top SEC Enforcement Issues for Public Companies*, WEIL, GOTSHAL & MANGES, LLP 2 (Feb. 16–17, 2012), [http://www.weil.com/files/upload/Top\\_SEC\\_Enforcement\\_Issues\\_for\\_Public\\_Companies-2012.pdf](http://www.weil.com/files/upload/Top_SEC_Enforcement_Issues_for_Public_Companies-2012.pdf) (same); Matthew Nielsen & Crystal Jamison, *SEC Enforcement Actions: A Look at 2011 and What to Expect in the Next Year*, ANDREWS KURTH LLP (Feb. 28, 2012), <http://www.andrewskurth.com/pressroom-publications-881.html> (same); *SEC Enforcement Update*, KING & SPALDING LLP (Mar. 5, 2012), <http://www.kslaw.com/imageserver/KSPublic/library/publication/ca030512.pdf> (same).

While this is not a new view among the bar, it seems to have grown in consistency and intensity since the early part of this decade.

Though I would not want to exaggerate the point, my experience both inside and outside the Commission suggests that the Division of Enforcement, if anything, tends in all sincerity to overstate the strength of its cases rather than to understate it. If anything, the Commission facilitates this tendency. During my two stints at the SEC, the Commission was generally much more bullish than the Division of Enforcement, often prodding it to bring more cases and to increase sanctions. It is widely believed that during the tenure of Chairman Cox, the Commission was somewhat less enthusiastic about cases brought before it by the Division of Enforcement.<sup>104</sup> If true, that period was the exception. For the most part, the direction from the Commission to the Enforcement staff was some version of Chairman Richard Breeden's vow to leave violators "naked, homeless, and without wheels."<sup>105</sup>

Though the foregoing analysis would suggest that the fact that the SEC generally settles its cases does not affect the sanctions it obtains, there is one significant exception—the Commission's long-standing practice of permitting defendants to settle enforcement proceedings without either admitting or denying the Commission's allegations.<sup>106</sup> Interestingly, the Commission concedes that requiring admissions would impose a significantly greater cost on defendants than they bear without it.<sup>107</sup> This is because an admission in an SEC enforcement would have an issue-preclusion effect in subsequent litigation with private parties, most particularly in private class actions.<sup>108</sup>

The Enforcement staff justifies its "neither admit nor deny" policy in large part on the view that requiring admissions in every case would be *so*

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104. See Jesse Westbrook & David Scheer, *Cox's SEC Hindered Probes, Slowed Cases, Shrank Fines*, GAO Says, BLOOMBERG (May 6, 2009), <http://www.bloomberg.com/apps/news?pid=newsarchive&sid=aPus5C5B.JhQ> (discussing a GAO report that Cox instituted policies that "slowed cases and led enforcement-unit lawyers to conclude commissioners opposed fining companies").

105. Jonathan Eisenberg, *Enforcement Issues and Litigation: Litigating with the SEC—A Reasonable Alternative to Settlement*, 21 SEC. REG. L.J. 421, 421 (1994) (internal quotation marks omitted).

106. This Article considers the Commission's policy as it relates both to administrative and judicial proceedings. It does not address whether it is appropriate to invoke a federal district court's jurisdiction to obtain an injunction without an admission or evidence of wrongdoing, a point raised in *U.S. SEC v. Citigroup Global Markets Inc.*, No. 11 Civ. 7387 (JSR), 2011 WL 5903733 (S.D.N.Y. Nov. 28, 2011). As is well known, Judge Rakoff refused to issue an injunction in the absence of any admission or evidence, and the case is now on appeal to the Second Circuit. *Id.* at \*4.

107. See Robert Khuzami, Dir., Div. of Enforcement, U.S. Sec. & Exch. Comm'n, Remarks Before the Consumer Federation of America's Financial Services Conference (Dec. 1, 2011), available at <http://www.sec.gov/news/speech/2011/spch120111rk.htm> ("[T]he practical reality is that many companies would refuse to settle cases if they are required to admit unlawful conduct because that might expose them to additional lawsuits by litigants seeking damages.").

108. See *Parklane Hosiery Co. v. Shore*, 439 U.S. 322, 331–33 (1979) (concluding that broad discretion should be granted to trial courts to determine the application of collateral estoppel).

painful that many defendants would litigate rather than accept this consequence and with it the prospect of additional millions (or in some cases billions) of dollars of liability.<sup>109</sup> While the “neither admit nor deny” policy has little impact on the relief the Commission would obtain, it is argued, its repeal would result in so much litigation that the Commission would have to divert resources from investigating cases to litigating them.<sup>110</sup> The net effect of the repeal of the policy is that the Commission would get less relief for investors in the aggregate than it does with the policy in place.<sup>111</sup>

It is not clear what critics of the “neither admit nor deny” policy have in mind as an alternative. Apparently it is not necessarily requiring admissions that could be used to bind defendants in subsequent proceedings.<sup>112</sup> Nor is it clear whether the critics’ principal concern is with the role of the federal district courts in shaping the sanctions in SEC enforcement actions,<sup>113</sup> making sure that defendants do have to shoulder the impact of admissions in private securities litigation,<sup>114</sup> or simply in subjecting evildoers to ritual humiliation.<sup>115</sup>

For present purposes, there is clearly some pain for wrongdoers that the SEC leaves on the table by permitting them to settle without admissions.<sup>116</sup> Whether or not doing so is wise is a topic for another discussion.

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109. Khuzami, *supra* note 107.

110. *Id.*

111. *Id.*

112. Compare John C. Coffee, Jr., *Collision Course: The SEC and Judge Rakoff*, N.Y. L.J., Jan. 19, 2012, available at

<http://www.newyorklawjournal.com/PubArticleNY.jsp?id=1202538773586&slreturn=1> (noting that the “neither admit nor deny” clause has no legal significance and could be dropped from settlement agreements in favor of including a statement of facts, such as in the Bank of America settlement), with *Parklane*, 439 U.S. at 331 (concluding that broad discretion should be granted to trial courts to determine the application of collateral estoppel).

113. See U.S. SEC v. Citigroup Global Mkts. Inc., No. 11 Civ. 7387 (JSR), 2011 WL 5903733, at \*2 (S.D.N.Y. Nov. 28, 2011) (stating that a court must be satisfied that an agreement is fair, reasonable, adequate, and in the public interest before it can be accepted). The Court of Appeals for the Second Circuit recently granted a stay of the district court’s order requiring the SEC and Citigroup to proceed to trial on the merits and rejecting their settlement. U.S. SEC v. Citigroup Global Mkts. Inc., No. 11-5227-CV, 2012 WL 851807, at \*1 (2d Cir. Mar. 15, 2012) (per curiam). The court held that the SEC had shown, among other things, that it was likely to prevail in its appeal of the district court’s rejection of the settlement. *Id.* at \*9.

114. See Bruce Judson, *Why Isn’t the SEC Cracking Down Harder on Banks?*, NEW DEAL 2.0 (Dec. 15, 2011, 1:42 PM), <http://www.newdeal20.org/2011/12/15/why-isnt-the-sec-cracking-down-harder-on-banks-67400/> (discussing the increased deterrent effect that would occur if SEC judgments were binding in private litigation).

115. See Maureen Dowd, *Wall Street’s Socialist Jet-Setters*, N.Y. TIMES, Jan. 28, 2009 at A31 (“Let the show trials begin.”).

116. The amount of pain varies with the nature of the violation being charged and the nature of the conduct that otherwise would be admitted. From an issue-preclusion standpoint, for example, an admission of intentional misconduct would be devastating in a class action under Exchange Act § 10(b), while an admission of negligence would have little impact. See Securities Exchange Act of 1934 § 10(b), 15 U.S.C. § 78j(b) (2006) (making illegal the use of certain “manipulative or deceptive device[s] or contrivance[s]” when buying or selling securities, which is a standard that would be satisfied by an admission of intentional misconduct but not by an admission of

#### IV. Would Higher Sanctions Have a Significantly Increased Deterrent Effect?

One way or another, it is always possible to increase sanctions. Whether it would do any good is a fair question.

Have nearly thirty years of steadily increasing penalties improved compliance with the federal securities laws? To be sure, at the margin—wherever that is—some people who would commit fraud at the risk of five years in prison would not do so if the risk were incarceration for ten years. But few know where the margin is and how many people reside there. There is some contradictory research about, for example, the effect of increased sanctions on insider trading,<sup>117</sup> but plainly the question is a bit beside the point. The more relevant question is whether the march of ever-increasing sanctions has improved compliance with the federal securities laws “enough.” “Enough” in this context refers to an amount sufficient to prevent a significant number of violations of the federal securities laws.

Of course, there is not “enough” deterrence. If there were enough, we would not have rampant insider trading and investor losses from fraud in the billions.<sup>118</sup> At issue, though, is whether there is any reason for confidence that increasing sanctions against securities law violators will improve compliance appreciably more. Again, thirty years of experience suggests strongly that it would not. The contrary argument assumes that each time over the last thirty years that Congress has increased the sanctions for securities laws violations, it misapprehended the level of sanctions needed for effective deterrence but that now, perhaps for the first time, one more turn of the screw will do the trick. I am skeptical.

If we do not have enough deterrence, perhaps it would be better to cast around for reasons other than the supposed weakness of the SEC or the “fact” that SEC sanctions amount to little more than “a cost of doing business.” In my time practicing as a defense lawyer, I have yet to meet anyone who simply shrugs off SEC sanctions. This is true for individuals facing liability

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negligence). But depending on the circumstances, an admission of negligence could be devastating to a defendant facing liability under §§ 11 or 12(a)(2) of the Securities Act of 1933 in a misrepresentation case arising out of a public offering. *See* Securities Act of 1933 §§ 11, 12(a)(2), 15 U.S.C. §§ 77k, 77l(a)(2) (2006) (both providing an exemption from liability based upon a reasonable investigation and belief that facts were true, which is a standard that would be impossible to prove if negligence were admitted).

117. *E.g.*, Jin Xu, *New Evidence of the Effects of the Insider Trading Sanctions Act of 1984*, at 24–25 (Feb. 2008) (unpublished manuscript), *available at* [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1100641](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1100641) (finding the Act was successful in reducing insider trading).

118. *See, e.g.*, Michael Rothfeld et al., *Fund Titan Found Guilty*, WALL ST. J., May 12, 2011, *available at* <http://online.wsj.com/article/SB10001424052748703864204576317060246641834.html> (noting that “[n]ever before have there been so many major, unrelated insider-trading cases brought by authorities”); Andrew Longstreth, *Madoff Trustee’s Loss Calculation Method Upheld*, REUTERS (Aug. 16, 2011, 4:37 PM), <http://www.reuters.com/article/2011/08/16/us-madoff-2ndcircuit-idUSTRE77F51320110816> (citing investor losses of principal in the Madoff Ponzi scheme at \$17.3 billion).

on their own and those with responsibilities in operating a business. Where the SEC intends to inflict pain, it succeeds. Perhaps more pain would result in more deterrence, but that, in my view, is highly questionable.

## V. Other Steps that Could Increase Deterrence

As noted above, there are factors besides the severity of the sanction that appear to have as much if not a greater impact in deterring wrongdoing. As a reminder, those are (a) the degree of certainty that sanctions will be imposed, (b) celerity, which means the amount of time that lapses between the unlawful conduct and when sanctions are imposed, and (c) the extent to which there are extralegal consequences from the unlawful conduct.<sup>119</sup> There may be more that can be done to enhance deterrence with at least the first two of these factors.

### A. *Altering the Degree of Certainty that Sanctions Will Be Imposed*

It is a commonplace observation that for sanctions to deter, the person contemplating wrongdoing must believe that there is a significant likelihood that his wrongdoing will be detected and punished.<sup>120</sup> But, in the case of the federal securities laws, few believe that this is the case. The SEC's faults in failing to uncover the Madoff and Stanford frauds have been extensively chronicled.<sup>121</sup> But even assuming the SEC becomes a model of investigative acuity and efficiency, its resources are not remotely adequate to the task and are unlikely to be in the near future.

Enforcement comes in waves. Even among the evergreen components of the SEC's enforcement program such as insider trading, financial statement fraud, and penny stock fraud,<sup>122</sup> there are times when certain types

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119. See *supra* note 3 and accompanying text.

120. See Paternoster, *supra* note 3, at 815 (noting that people who believe that it is likely they will be caught are less likely to commit various crimes); cf. JEREMY BENTHAM, A FRAGMENT OF GOVERNMENT AND AN INTRODUCTION OF THE PRINCIPLES OF MORALS AND LEGISLATION 218 (Wilfrid Harrison ed., Oxford 1948) (1789) ("A motive is substantially nothing more than pleasure or pain, operating in a certain manner.").

121. E.g., DIANA B. HENRIQUES, THE WIZARD OF LIES: BERNIE MADOFF AND THE DEATH OF TRUST (2011) (chronicling the Madoff scandal); Melanie Waddell, *Stanford Fraud Trial Bigger 'Black Eye' for SEC, FINRA than Madoff*, ADVISORONE (Jan. 23, 2012), <http://www.advisorone.com/2012/01/23/stanford-fraud-trial-bigger-black-eye-for-sec-finr> (reporting on the red flags that were missed or ignored by the SEC).

122. See *The Investor's Advocate: How the SEC Protects Investors, Maintains Market Integrity, and Facilitates Capital Formation*, U.S. SEC. & EXCHANGE COMMISSION, <http://www.sec.gov/about/whatwedo.shtml> (last modified Oct. 24, 2011) [hereinafter *Investor's Advocate*] (noting that insider trading is a common violation that may lead to an SEC investigation, and that securities law prohibits various frauds in sales of securities); *Year-by-Year SEC Enforcement Actions*, U.S. SEC. & EXCHANGE COMMISSION, <http://www.sec.gov/news/newsroom/images/enfstats.pdf> (listing the number of SEC enforcement actions by category brought from 2002–2011 and including the categories: "Insider Trading," "Financial Fraud/Issuer Disclosure," and "Market Manipulation"); cf. *SEC Charges CEO of Las Vegas-Based Penny Stock Company and Several Consultants in Pump-and-Dump Scheme*, U.S. SEC. & EXCHANGE COMMISSION (Mar. 7, 2012),

of violations come to the forefront and times when they do not. It is of course possible that, after some sustained attention by the SEC, forms of misbehavior are utterly stamped out for a time. I doubt that and I have seen little evidence to suggest that it is so. It is the proverbial double-edged sword, but the SEC has managed to convince the public over many years that it has the capacity to do much more than it actually can.<sup>123</sup>

Managing the Enforcement Division is an exercise in triage.<sup>124</sup> The Division does not lack for leads. They come from the self-regulatory organizations, reports from auditors, tips from the public, the news media, whistleblowers, lawyers, and experience with the financial world.<sup>125</sup> Improved technology and management have boosted the productivity of the Enforcement Division, and there is reason to be optimistic about further improvements.<sup>126</sup> But given the billions of trades, transactions, offers, sales, and statements made every day in connection with the United States securities markets, the Division of Enforcement always will be understaffed.<sup>127</sup>

*1. Sending the Message.*—The Commission tries to leverage its resources by bringing cases with important messages. These messages are almost always sound public policy, but they often could be given with greater detail and clarity. It might be useful for the Commission to focus more attention on the clarity and detail of the messages it sends.

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<http://www.sec.gov/news/press/2012/2012-39.htm> (publicizing a penny stock fraud prosecution and noting that the SEC had filed more than 50 enforcement actions regarding penny stocks since the start of the 2011 fiscal year).

123. To be sure, in recent years the Commission has emphasized in the budget context its need for more resources. See, e.g., Mary Schapiro, Chairman, U.S. Sec. & Exch. Comm'n, Testimony Before the Subcommittee on Financial Services and General Government (Mar. 17, 2010), available at <http://www.sec.gov/news/testimony/2010/ts031710mls.htm> (claiming that the SEC needed additional resources in order to adapt to financial markets that had been growing in size and complexity).

124. Or, as one former Director of Enforcement put it to me, "Putting your finger in the dike and hoping to God that you don't drown."

125. See *Investor's Advocate*, supra note 122 (noting that the Division obtains information concerning possible violations from, among other sources, market-surveillance activities, self-regulatory organizations, and media reports); DIV. OF ENFORCEMENT, U.S. SEC., supra note 71, at 5, 10–11, 14 (noting that information sources for the Enforcement Division include the Treasury Department's Financial Crimes Enforcement Network, audit workpapers, whistleblowers, and complaints from the public).

126. See Mary Schapiro, Chairman, U.S. Sec. & Exch. Comm'n, Testimony on the President's FY 2012 Budget Request for the SEC (May 4, 2011), available at <http://www.sec.gov/news/testimony/2011/ts050411mls.htm> (noting enhancement of information technology to aid staff productivity and the creation of "national specialized units" in the Division of Enforcement).

127. This is certainly not to argue against additional resources for the SEC. The American public will get no more securities enforcement than it pays for.

Enforcement is at bottom a communicative activity.<sup>128</sup> The blunt instrument of sanctions is certainly a critical medium of communication.<sup>129</sup> But words count too. The suggestion here is that the Commission sharpen the words it uses to explain its actions.

The Commission has multiple audiences for its messages, and certainly not every case is directed at the same audience. To the extent the message is to the public at large, the Commission's message is transmitted largely through the news media, which read the Commission's public statements and the operative legal arguments, and distill them into a form that is attractive and comprehensible to the public.<sup>130</sup> Simplification improves clarity but not necessarily accuracy.

The Commission also writes for professionals who act as interpreters for nonprofessionals about what conduct can get them into trouble. These professionals include in-house compliance personnel, in-house and outside lawyers, accountants, and various consultants. Though, as we know, they do different things, I will refer to them collectively as the compliance community.

The Commission communicates with the compliance community through the operative legal documents in enforcement proceedings. In settled court proceedings, the document that matters most from a communication standpoint is the Commission's complaint. In settled administrative proceedings, the operative document is the Commission's order making findings and imposing remedial sanctions. Where matters are litigated, the operative documents are opinions of courts and the Commission, as well as jury verdicts.

The compliance community plays an important role in influencing the deterrent value of the Commission's enforcement actions. To a rather remarkable extent, in my experience, business people of all stripes understand the law to be what their lawyers tell them it is. Whether lawyers and others in the compliance community portray it accurately is to an extent beyond the Commission's control. But it is within the Commission's control to speak clearly to its interpreters and with sufficient detail and clarity to enable them to transmit the Commission's message.

When it comes to a deterrent message, the compliance community, if anything, overstates the terrible risk of Commission enforcement actions. No one in the compliance community gets a client, or gets a client to listen, by telling a client that following their advice does not matter. To the contrary, the general pitch to prospective clients is "the SEC is a dangerous mystery; it

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128. *See supra* Part I.

129. *See supra* Part I.

130. *See, e.g.,* Wayne, *supra* note 33, at F1 (describing several laws and legal theories underlying some major SEC prosecutions, and quoting the then Chairman of the Commission saying that one of the primary goals of the SEC is to "maintain a broad public perception that the public is being treated fairly").

can do dreadful things to you; and only I (or we) can protect you.” Members of the compliance community follow the Commission’s every inhalation and exhalation. They are nothing if not an attentive audience.

*a. More Carefully Crafted Orders.*—The Commission might do well to devote more attention to its orders in settled administrative proceedings. These orders are heavily negotiated between the Enforcement staff and respondents, but they do not receive as much attention from the Commission. Where there is a settlement, the principal incentive of the Enforcement staff and the respondents is to complete the bargain they have struck. While sending a message is important to the Enforcement staff, sending that message with precision and clarity is not always of principal concern. And it is of no concern to the settling respondent.

Reaching a settlement agreement involves compromise, and compromise in this context may involve leaving certain ambiguities unresolved. In the standard form of a settled Commission order, the Commission recites the facts in some detail, gives a recitation of the controlling legal principles, and concludes that, based on the given information, the Commission will order the relief noted.<sup>131</sup> This formulation is insufficiently informative to notify the legal community—including the Staff of the Commission—as to how the controlling legal principles intersect with the pertinent conduct.

The SEC has some institutional reluctance to being more precise and complete in its orders. In the context of a settlement, there is no immediate need to do so, and the Commission has plenty else to do. Moreover, sometimes the legal issues are hard. Working through them may be difficult, and there may well be division within the Commission. And, unfortunately, at times there is an aversion among Commission staff to specifying precisely where the line is between legal and illegal conduct. There are some on the staff who believe that telling the public where that line is located merely encourages people with bad motives to go right up to the line with behavior that is reprehensible, if not illegal.

I have heard, and disputed, that argument more than a few times. I am not sure whether it is true that, faced with unclear legal principles coupled with a risk of pain upon violation, people will stop shorter of some imagined line than they would if they knew where the line was drawn. My experience practicing law is that, absent a brightly drawn line, clients (and not just private clients) are more attentive to their hopes than their fears in locating the line between the legal and the illegal. And even if it were otherwise, it is both unseemly and harmful to the Commission’s moral authority, on which compliance ultimately depends, to depend more on power than on law.

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131. Lovelock & Lewes, Exchange Act Release No. 64,184, 2011 WL 1295803 (Apr. 5, 2011) (stating an order in a format that roughly follows the standard provided in this paper); UBS Sec. LLC, Exchange Act Release No. 65,733, 2011 WL 5444407 (Nov. 10, 2011) (same).

*b. Choice of Sanctions.*—Specifying its rationale for sanctions is particularly important and poses particular problems for the Commission. In some types of cases, the Commission has adopted a fairly consistent approach, so it is possible for the compliance community to predict with some confidence how the Commission will respond. Sanctions in insider trading cases are the paradigm, where the Commission’s “one plus one” policy is well known.<sup>132</sup> But in other cases, it may not be at all clear how the Commission derived the sanctions it imposed.

Specifying the reason for the choice of sanctions is not an easy thing. It requires, first of all, keeping track of the sanctions in each case and the facts that were salient to the Commission’s choices. While the Division of Enforcement keeps track of the Commission’s sanctions decisions in broad categories, it does not do so in a systematic way that takes into account the many factors that go into a choice of sanctions. To an extent, the Division does not know the reasons the Commission, as a body corporate, approves its recommendations. With five Commissioners, there are often multiple rationales. Sitting at the Commission table, sometimes it is quite clear that the Commissioners reached their decisions through rather different routes. The choice of sanctions in settled proceedings often reflects bargaining among the Commissioners and always reflects bargaining between the Commission and respondents.

Often, the Commission does not want to tip its hand. By no means would all of its cases be clear winners in court. In those instances, the Commission’s choice of sanctions may reflect the weakness of its case. Where the public sees a slap on the wrist, the Commission may see the best it can do with a weak hand. But, like any prosecutor, it does not want to announce that.

The Enforcement Division, and often the Commission, worry about the next case. Sanctions choices involve so many factors that the Commission fears having its discretion cabined by setting forth with precision how it arrived at a particular sanction. And so, it is a common experience for defense counsel to argue to Enforcement staff that a particular sanction is called for based on the sanction in some recent settlement only to be told: “You don’t understand. There were facts in that case which are very different from yours.” It is hard to argue with the black box, but it is also hard to learn from it.

I would observe that all these concerns are real and worthy of consideration. But I do not think that the current state of affairs represents the best the Commission can do. While leaving itself room to account for the multiplicity of circumstances, the diversity of Commissioner views, and the

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132. See, e.g., SEC v. Wren, Litigation Release No. 15,860, 67 SEC Docket 1940, 1941 (Aug. 27, 1998) (requiring a lawyer accused of insider trading to disgorge all profits the lawyer earned from the trade and pay an equivalent penalty).

evolution of Commission views over time, the Commission can lift some of the mystery and begin to explain itself.

The point here is not that the Commission's sanctions are inconsistent or unfair (though in particular instances they may be). Rather, it is that the process is opaque, and this opacity limits the capacity of the compliance community to tell its clients: "If you do *this*, *that* will happen to you." Clarity would serve the cause of deterrence.

*c. Inducing "Cooperation."*—The point is particularly acute to the extent the Commission attempts to induce businesses and individuals to cooperate with its investigations. Starting with its famous *Seaboard Report*, the Commission set forth circumstances that would induce it to mitigate its sanctions in a Commission proceeding, narrow the claims of violations, or drop the matter altogether.<sup>133</sup> In recent years, the Commission has added additional cooperation mechanisms, modeled on investigative practices of criminal prosecutors, in its enforcement manual.<sup>134</sup>

Whatever the virtues of these mechanisms, they are not especially helpful if the people whose cooperation they intend to induce remain unaware of what they stand to gain by availing themselves of the mechanisms. While the Commission sometimes notes the cooperation by respondents in its proceedings, it is grudging with the details. Sometimes it summarizes the nature of the cooperation—usually, in the case of a corporate defendant that conducted an internal investigation, fired the wrongdoers, self-reported, and provided all information requested by the Enforcement staff.<sup>135</sup> But the Commission rarely specifies the effect this cooperation has on the outcome of the proceeding.<sup>136</sup> It almost never specifies what action it would have taken in the absence of the cooperation provided by the respondent.<sup>137</sup>

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133. Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934 and Commission Statement on the Relationship of Cooperation to Agency Enforcement Decisions, Exchange Act Release No. 44,969, 76 SEC Docket 220 (Oct. 23, 2001) [hereinafter *Seaboard Report*], available at <http://www.sec.gov/litigation/investreport/34-44969.htm>.

134. See generally DIV. OF ENFORCEMENT, U.S. SEC., *supra* note 71, at 119–37 (setting forth cooperation mechanisms such as proffer agreements, non-prosecution agreements, deferred prosecution agreements, and immunity requests). The Manual is revised from time to time and is available on the Commission's website for downloading. *Id.* at 1.

135. See Press Release, U.S. Sec. & Exch. Comm'n, Tenaris to Pay \$5.4 Million in SEC's First-Ever Deferred Prosecution Agreement (May 17, 2011), available at <http://www.sec.gov/news/press/2011/2011-112.htm>.

136. See, e.g., *id.* (announcing that the SEC entered into a deferred prosecution agreement with Tenaris whereby the company was required to pay \$5.4 million in "disgorgement and prejudgment interest" in addition to "a \$3.5 million criminal penalty" to the Department of Justice, but failing to indicate how the amount of disgorgement and penalties may have been affected by Tenaris's cooperation and the deferred prosecution agreement, or what the SEC would have sought in the absence of cooperation). Indeed, this lack of specificity has been noticed by other commentators:

[I]n most cases, the precise benefits of the Company's cooperation, if any, cannot be known at the outset of an investigation. Indeed, many companies that have cooperated with the government have received stiff financial penalties, albeit perhaps lower than if no cooperation had been proffered. . . .

In the absence of more openness from the Commission, it is harder for the compliance community to convince its clients that it is in their interest to do what the Commission says it wants them to do. The Commission, for example, wants to encourage companies to investigate reports of possible wrongdoing and self-report to the Division of Enforcement.<sup>138</sup> This is an important element of “cooperation” as described in the *Seaboard* report.<sup>139</sup>

Senior managers and boards of directors want to be told the benefits for going through such an expensive, time-consuming, and potentially disruptive process. As much as advisors would like to tell them simply that they should do it because it is right, sometimes managers and boards need convincing on more utilitarian grounds. The Commission withholds its assistance when it is obscure about the benefits of full cooperation.

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While the number of DOJ-deferred prosecution or non-prosecution agreements has increased recently, many corporations and their counsel continue to believe that the benefits of cooperation have not been tangible and have, with certain DOJ divisions and sections or U.S. Attorney offices, been far too unclear.

Am. Coll. of Trial Lawyers, *Recommended Practices for Companies and Their Counsel in Conducting Internal Investigations*, 46 AM. CRIM. L. REV. 73, 81–82 (2009). See also Susan B. Heyman, *Bottoms-Up: An Alternative Approach for Investigating Corporate Malfeasance*, 37 AM. J. CRIM. L. 163, 172 (2010) (“[T]he SEC has provided less detailed descriptions of cooperation in their releases. Recent releases generally contain boilerplate language regarding cooperation . . . . The uncertainty surrounding the SEC’s practices leaves companies and their counsel at a loss when determining what is required to gain cooperation credit.” (footnote omitted)); Bruce Hinchey, *Punishing the Penitent: Disproportionate Fines in Recent FCPA Enforcements and Suggested Improvements*, 40 PUB. CONT. L.J. 393, 397–418 (2011) (comparing fines levied by the Department of Justice against companies that voluntarily disclose FCPA violations and those that do not, noting that voluntarily disclosing companies have occasionally received larger penalties, and concluding that the apparent randomness in the amount of disgorgement and penalties levied against voluntarily disclosing companies undermines any incentive to voluntarily disclose FCPA violations); Robert W. Tarun & Peter P. Tomczak, *A Proposal for a United States Department of Justice Foreign Corrupt Practices Act Leniency Policy*, 47 AM. CRIM. L. REV. 153, 154 (2010) (asserting that “corporations that must decide whether to report voluntarily bribery conduct confront considerable uncertainty as to the benefits (in the form of reduced sanctions) of self-reporting and cooperation”); *id.* at 157–58 (arguing that the SEC’s treatment of cooperating companies with informal leniency “is not transparent or instructive to decision-making bodies of corporations that are trying to make informed decisions in the best interests of the corporations and their shareholders about the benefits of fully investigating malfeasance, and voluntarily disclosing it to and fully cooperating with law enforcement”); *id.* at 169–70 (asserting that even with the SEC’s additional cooperation mechanisms “corporations and their legal counsel will, without specific clarification, continue to be uncertain as to the benefits of cooperating with the SEC in FCPA cases”).

137. See, e.g., Press Release, U.S. Sec. & Exch. Comm’n, *supra* note 135 (explaining that Tenaris’s cooperation made it a candidate for deferred prosecution but not explaining what action the SEC would have taken if Tenaris did not cooperate).

138. *Seaboard Report*, *supra* note 133, at 222.

139. See *id.* (explaining that investigation of wrongdoing and disclosure to regulators are criteria the SEC will consider in determining whether to credit cooperation). Cf. U.S. SENTENCING GUIDELINES MANUAL § 8B2.1 (2011) (including self-reporting as a reasonable step that an organization should take in responding to wrongdoing); FINRA, REGULATORY NOTICES 08-70: FINRA PROVIDES GUIDANCE REGARDING CREDIT FOR EXTRAORDINARY COOPERATION 1 (2008), available at <http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p117452.pdf> (discussing self-reporting as an important measure of cooperation).

In the decade since the *Seaboard* order, the Enforcement staff has seen scores of reports of internal investigations.<sup>140</sup> But the Commission has been silent about what in its view makes for an adequate, much less excellent, internal investigation. It has not described, except in the most general terms, how (if at all) a well-done internal investigation will speed up the Commission's disposition of a matter, something of critical concern to businesses. And it does not describe, except infrequently and in general terms, how the Commission's disposition of a matter would have been different absent a respondent's cooperation. The Commission seems to be moving in the right direction, albeit with some fits and starts. *SEC v. Elles*<sup>141</sup> is both a clear illustration of the limits of traditional Commission transparency on these matters and of increased transparency to come. In that case, the Commission sued a former Executive Vice President of Sales of Carter's, Inc. for his involvement in the financial fraud of the company and for insider trading.<sup>142</sup> The Commission did not sue the company, and instead, for the first time, used a non-prosecution agreement.<sup>143</sup> It gave the following explanation:

The non-prosecution agreement reflects the relatively isolated nature of the unlawful conduct, Carter's prompt and complete self-reporting of the misconduct to the SEC, its exemplary and extensive cooperation in the investigation, including undertaking a thorough and comprehensive internal investigation, and Carter's extensive and substantial remedial actions.<sup>144</sup>

One cannot tell from this description just what Carter's did to warrant the non-prosecution. All one knows is that its self-reporting was "prompt and complete"; its cooperation was "exemplary and extensive"; its internal investigation was "thorough and comprehensive"; and its remedial actions were "extensive and substantial." These are fine adjectives, to be sure, but they do not tell the public, particularly the compliance community, what Carter's did to earn them. And, as a result, the compliance community cannot tell its clients what they must do to gain the benefit.

In encouraging contrast, the Commission recently explained in some detail why it declined to take enforcement against a senior executive of AXA Rosenberg who had had some involvement in matters that gave rise to

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140. See, e.g., Press Release, U.S. Sec. & Exch. Comm'n, SEC Charges Former Carter's Executive with Fraud and Insider Trading (Dec. 20, 2010), available at <http://sec.gov/news/press/2010/2010-252.htm> (stating that Carter's undertook a "thorough and comprehensive internal investigation").

141. Complaint, *SEC v. Elles*, No. 1:10-CV-4118 (N.D. Ga. Dec. 20, 2010).

142. *SEC v. Elles*, Litigation Release No. 21,784, 2010 WL 5167672 (Dec. 20, 2010).

143. Press Release, U.S. Sec. & Exch. Comm'n, *supra* note 140.

144. *Id.*

enforcement proceedings several months earlier.<sup>145</sup> In a litigation release, the Commission noted the facts, among other things, that influenced its decision:

- The individual was the first to come to the Commission. (The release does not mention whether the individual brought to the Commission a matter of which it was otherwise unaware.)
- The individual requested to be considered for cooperation credit but did not request any particular outcome, thereby enhancing his credibility as a potential witness on behalf of the Commission.
- The evidence supplied by the Commission was truthful, complete, and reliable. It was detailed and important to the Commission's investigation.
- The underlying matter was important to the Commission's enforcement program. This was the first case to address errors in a quantitative investment model. The Commission's action resulted in the return of \$217 million to investors and \$27.5 million in penalties.
- The executive had little involvement in the underlying error and had advocated that the error be fixed and that investors be informed of the error.
- The senior executive is not associated with a regulated entity and is no longer in a position to commit violations of the federal securities laws.<sup>146</sup>

This statement is refreshing in its detail. It will prove useful to practitioners seeking to advise their clients as to the benefits to be gained by cooperating with the Commission. This, and more statements like it, will substantially assist the Commission's enforcement program in the future.

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145. See AXA Rosenberg Group LLC, Securities Act Release No. 9181, Investment Advisers Act Release No. 3149, Investment Company Act Release No. 29,574, 2011 WL 345493 (Feb. 3, 2011) (instituting proceedings against AXA Rosenberg and related corporations and announcing the settlement agreement); Barr M. Rosenberg, Investment Advisers Act Release No. 3285, Investment Company Act of 1940 Release No. 29,818, 2011 WL 4403981 (Sept. 22, 2011) (instituting proceedings against Barr M. Rosenberg and announcing the settlement agreement); SEC Credits Former AXA Rosenberg Executive for Substantial Cooperation During Investigation, Litigation Release No. 22,298 (Mar. 19, 2012), available at <http://www.sec.gov/litigation/litreleases/2012/lr22298.htm> (explaining that "[t]he SEC credited [a] senior executive for his cooperation by declining to take enforcement action against him based on certain factors"); see also Robert Khuzami, Dir., Div. of Enforcement, U.S. Sec. & Exch. Comm'n, Public Statement by SEC Staff: Commission Credits Individual Under Cooperation Initiative (Mar. 19, 2012), available at <http://sec.gov/news/speech/2012/spch031912rk.htm> (listing ways in which cooperating witnesses can enhance the SEC enforcement actions and claiming the AXA Rosenberg matter was one example of such cooperation).

146. SEC Credits Former AXA Rosenberg Executive for Substantial Cooperation During Investigation, *supra* note 145.

2. *Choosing Cases.*—The deterrence message that the Commission is intent on sending can be sent in different ways. One way that the Commission should consider is through its choice of case. *What* is enforced may well be as important as *how* it is enforced. This section considers how changes in the Commission’s caseload might enhance its overall deterrent effect.

*a. Cases Involving Prophylactic Provisions.*—One question worth examining is whether there is room within the agenda forced upon the Commission by circumstance to tinker with the mix of cases the Commission brings. There are some cases the Commission might bring that involve violations of law intended to forestall more serious violations.

The Commission would do well to consider whether there are lessons to be learned by “public order” policing. First advocated by George L. Kelling and James Q. Wilson in their March 1982 *Atlantic Monthly* article “Broken Windows,” public order law enforcement focuses on preventing serious crimes by vigorous law enforcement efforts against perpetrators of small offenses, before they can commit more serious violations.<sup>147</sup> Thus, though the rate of offenses may not be reduced, the seriousness of the violations is diminished.<sup>148</sup> Though by no means universally acclaimed,<sup>149</sup> the use of public order policing is often credited with a substantial reduction in New York City’s crime rate under Mayor Rudolph Giuliani.<sup>150</sup> Cases that involve how businesses in general, and regulated entities in particular, comply with prophylactic requirements may have the effect of deterring not only violations of those rules but also of deterring more serious offenses. After all, if these rules really do prevent various types of fraud, they are worthy of serious enforcement, and they are easier to investigate and prosecute than cases of fraud themselves.

Take, for example, cases involving internal accounting controls over financial reporting: Sections 13(b)(2)(A) and (B) of the Exchange Act<sup>151</sup> and

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147. James Q. Wilson & George L. Kelling, *Broken Windows: The Police and Neighborhood Safety*, ATLANTIC MONTHLY, Mar. 1982, at 29, 31–32.

148. *See id.* at 38 (arguing that a focus on civility and standards would reduce violent crime).

149. *See* FRANKLIN E. ZIMRING, *THE CITY THAT BECAME SAFE: NEW YORK’S LESSONS FOR URBAN CRIME AND ITS CONTROL* 116–47 (2012) (arguing that crime reduction in New York City in the 1990s and 2000s should be attributed to police tactics such as an emphasis on high-crime “hot spots” for aggressive law enforcement and the sustained effort to eliminate public drug markets rather than any effort to enforce public order through increased targeting of minor offenses, which Zimring argues was not a priority of the NYPD during that time period).

150. *See, e.g., New York’s Mayor: Long-Running Show Closes on Broadway; New One Previews*, ECONOMIST, Jan. 5, 2002, at 25 (characterizing the approach of the NYPD toward minor crimes under Giuliani as a “‘broken windows’ strategy,” and citing a study by the Manhattan Institute finding that “the number of arrests for misdemeanors, the best proxy for broken-windows policing, is closely correlated to levels of serious crime”).

151. Securities Exchange Act of 1934 §§ 13(b)(2)(A)–(B), 15 U.S.C. §§ 78m(b)(2)(A)–(B) (2006).

the “books and records” provisions of the Foreign Corrupt Practices Act.<sup>152</sup> Taken together, these provisions require issuers to keep accurate books and records and to devise a system of internal accounting control sufficient to assure that transactions are recorded in sufficient detail to permit the preparation of accurate financial statements.<sup>153</sup>

In 2003, in the wake of the accounting scandals that prompted the passage of Sarbanes-Oxley, the Commission promulgated Rule 13a-15,<sup>154</sup> which requires issuers to adopt disclosure controls and procedures and to evaluate their effectiveness quarterly.<sup>155</sup> Importantly, 13a-15(c) provides that issuers, with the participation of their CEOs and CFOs, must evaluate annually the effectiveness of their system of internal accounting control under a “recognized control framework.”<sup>156</sup>

These provisions are potentially fertile ground for the Division of Enforcement. For the most part, the Commission brings internal control cases as part of a broader action involving fraudulently prepared public disclosures.<sup>157</sup> It rarely brings control cases absent some other violation, generally fraud or a violation of the Foreign Corrupt Practices Act.<sup>158</sup> Control cases do not command the same level of sanctions or notoriety as fraud cases,<sup>159</sup> and there is an understandable tendency, I believe, to regard them as consolation prizes when more serious misconduct cannot be found.

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152. Foreign Corrupt Practices Act of 1977, 15 U.S.C. § 78m(b) (2006).

153. *Id.*; Securities Exchange Act §§ 13(b)(2)(A)–(B) (codified as amended at 15 U.S.C. §§ 78m(b)(2)(A)–(B) (2006)).

154. Rule 13a-15(a) and Rule 13a-15(f) of the Securities Exchange Act are codified at 17 C.F.R. §§ 240.13a-15(a) to -15(f) (2011).

155. *See* 17 C.F.R. §§ 240.13a-15(a) to -15(b).

156. 17 C.F.R. §§ 240.13a–15(c). By far the predominant “recognized control framework” comes from The Committee of Sponsoring Organizations of the Treadway Commission (COSO). Melvin A. Eisenberg, *The Board of Directors and Internal Control*, 19 *CARDOZO L. REV.* 237, 244 (1997); Kristen N. Johnson, *Addressing Gaps in the Dodd-Frank Act: Directors’ Risk Management Oversight Obligations*, 45 *U. MICH. J.L. REFORM* 55, 66 (2011).

157. *See, e.g.*, SEC v. Am. Italian Pasta Co., Litigation Release No. 20,715, 94 SEC Docket 323, 323 (Sept. 15, 2008) (announcing that the SEC had brought enforcement actions against the American Italian Pasta Company and its senior executives for securities fraud, noting that “the fraudulent accounting and other errors [arose] from inadequate internal controls”).

158. *See Investor’s Advocate, supra* note 122 (noting that the typical infractions for which SEC enforcement actions are brought include “insider trading, accounting fraud, and providing false or misleading information”).

159. *See generally* Black, *supra* note 1, at 335 (suggesting that the SEC “is reacting to pressure to negotiate large funds for distribution to investors” by focusing primarily on obtaining such funds rather than pursuing disgorgement and penalties related to other aspects of its enforcement authority); Erin Massey Everitt, *Sarbanes-Oxley’s Officer Certification Requirements—Has Increased Accountability Equaled Increased Liability?*, 6 *DEPAUL BUS. & COM. L.J.* 225, 236–37 (2008) (“Perhaps the most interesting development stemming from the implementation of officer certification requirements is the more significant role the Sarbanes-Oxley certifications are playing in allegations involving other provisions of the securities laws.”); Robert Khuzami, Dir., Div. of Enforcement, U.S. Sec. & Exch. Comm’n, Remarks Before the New York City Bar: My First 100 Days as Director of Enforcement (Aug. 5, 2009), *available at* <http://www.sec.gov/news/speech/2009/spch080509rk.htm> (discussing the SEC’s priorities by noting significant cases,

This view, I would submit, is somewhat mistaken. While there are certainly many instances in which offenders set out from the beginning to lie, cheat, or steal, these violations are more difficult because of the existence of a robust system of internal accounting controls.<sup>160</sup> To some extent, one can view internal controls as a filter that catches inappropriate behavior. Certainly, a major significance of controls is the almost mechanical sense in which they prevent inappropriate conduct.

Controls, though, have a more profound effect on the conduct of an organization. It is common to speak of an organization's "culture." SEC officials commonly urge businesses to adopt a "culture of compliance." In a 2003 speech, Chairman Donaldson famously urged corporate boards to implant such a culture in a company's DNA:

In my mind, the most important thing that a Board of Directors should do is determine the elements that must be embedded in the company's moral DNA, as one might call it. In humans, DNA encompasses the very building blocks of life and determines or influences almost every aspect of our physical development. So too should the moral DNA of a company.

It should be the foundation on which the Board builds a corporate culture based on a philosophy of high ethical standards and accountability. This culture should penetrate every level of the organization and influence all of the board's decisions including the selection of a CEO and the senior management team who will ultimately ensure that the company's operations reflect its philosophy.<sup>161</sup>

Controls are the mechanisms through which culture begets conduct. Culture is a somewhat elevated way of referring to habitual ways of doing things. And—starting with tone at the top—a system of controls describes how things are to be done within an organization.

By devoting more attention to enforcing legal requirements relating to disclosure and accounting controls, the SEC may enhance its deterrent impact. While this is by no means a binary choice, control cases are easier to

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including cases involving fraud and Ponzi schemes, without mentioning a single control case); Press Release, U.S. Sec. & Exch. Comm'n, *supra* note 99 (highlighting several cases and areas of enforcement that the SEC focused on in 2011 without mentioning a single control case); *SEC Enforcement Actions: Addressing Misconduct that Led to or Arose from the Financial Crisis*, U.S. SEC. & EXCHANGE COMMISSION, <http://www.sec.gov/spotlight/enf-actions-fc.shtml> (last updated Apr. 24, 2012) (describing several significant cases brought by the SEC related to the financial crisis but failing to mention a single control case).

160. See Robert Prentice, *Sarbanes-Oxley: The Evidence Regarding the Impact of SOX 404*, 29 CARDOZO L. REV. 703, 707–08 (2007) (stating that empirical studies show that firms with weak internal controls *restate* earnings more often, are subject to more SEC enforcement actions, and are systematically riskier).

161. William H. Donaldson, Chairman, U.S. Sec. & Exch. Comm'n, Remarks Before the Economic Club of New York (May 8, 2003), *available at* <http://www.sec.gov/news/speech/spch050803whd.htm>.

investigate and bring than fraud cases, where the question is not so much whether some person made a false statement as it is whether anyone did so intentionally. Further, it is quite possible (though perhaps not possible to prove) that the Commission could bring some number of control cases for every fraud case. Trading a few cases could well have the consequence of leveraging the effect on the Commission's antifraud enforcement.

The same is true with respect to the hundreds of requirements that govern the operations of broker-dealers,<sup>162</sup> investment advisers,<sup>163</sup> transfer agents,<sup>164</sup> exchanges,<sup>165</sup> clearing facilities,<sup>166</sup> and rating agencies<sup>167</sup> (among others). These rules both prohibit harmful activity—such as fraud, market manipulation, and misappropriation of customer funds—and are designed to prevent these things from happening.

To the extent that these rules do what they are supposed to, their violation brings with it the risk of serious harm to the public. The same trade-off—between lengthy investigations for the most serious violations and shorter and simpler ones involving the prophylactic rules—may be available.

*b. Taking Negligence Seriously.*—The Commission has authority to bring a broad variety of cases based on negligence. Among other things, it may bring cases involving fraud in the sale of securities under §§ 17(a)(2) and (3) of the Securities Act of 1933,<sup>168</sup> negligent misrepresentations against investment advisers under § 206 of the Investment Advisers Act of 1940 and implementing rules;<sup>169</sup> and false periodic reporting under § 13(a) of the Exchange Act—all without any showing of intentional misconduct.<sup>170</sup>

Most significantly, the Commission has broad authority under the cease-and-desist provisions of the Securities Act, the Exchange Act, and the Investment Advisers Act to issue orders against any violator of the relevant statute and against “any other person that is, was, or would be a cause of the violation, due to an act or omission the person knew or should have known

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162. Securities Exchange Act of 1934 § 15, 15 U.S.C. § 78o (2006) (regulating the registration of brokers and dealers).

163. Investment Advisers Act of 1940 § 206, 15 U.S.C. § 80b-6 (2006) (prohibiting investment advisers from engaging in certain transactions).

164. *See, e.g.*, Securities Exchange Act §§ 12(b), 17A(c)(1) (codified as amended at 15 U.S.C. §§ 78l(b), 78q-1(c)(1) (2006)) (establishing registration requirements for transfer agents).

165. *See* Securities Exchange Act § 1 (codified as amended at 15 U.S.C. § 78(a) (2006)) (regulating exchanges).

166. *See, e.g.*, Securities Exchange Act § 17 (codified as amended at 15 U.S.C. § 78q (2006)) (governing the clearance and settlement of transactions).

167. *See, e.g.*, Securities Exchange Act § 15E (codified as amended at 15 U.S.C. § 78o-7 (2006)) (laying out requirements for registration of nationally recognized statistical rating organizations (NRSROs)).

168. Securities Act of 1933 § 17(a)(2)–(3), 15 U.S.C. § 77q(a)(2)–(3) (2006).

169. Investment Advisers Act of 1940 § 206, 15 U.S.C. § 80b-6 (2006).

170. Securities Exchange Act § 13(a) (codified as amended at 15 U.S.C. § 78m(a) (2006)).

would contribute to such violation.”<sup>171</sup> “Knew or should have known” is the language of negligence, and the Commission has both settled and litigated cease-and-desist proceedings based on allegations of negligence.<sup>172</sup>

Historically, like control cases, negligence cases are often viewed by the Commission as consolation prizes. Often they are used as settlement vehicles in fraud investigations that produce equivocal evidence. It is relatively rare for the Commission to litigate a negligence case involving disclosure. Where there is significant litigation uncertainty on questions of intent, and potential defendants negotiate vigorously, they can negotiate a settlement in which the Commission alleges, or finds, only negligence, which of course carries with it less stigma and smaller penalties than intent-based violations.<sup>173</sup> And where settlement is impossible, and the Commission must litigate anyway, it will generally allege an intentional violation and hope to prove its course before a court or an administrative law judge.

Years ago, the Commission brought Rule 10b-5 enforcement cases based on negligent conduct.<sup>174</sup> That ended with the Supreme Court’s *Hochfelder* decision, which held that § 10(b) of the Exchange Act is violated only by intentional misconduct.<sup>175</sup> In the wake of the *Hochfelder* decision, Stanley Sporkin, then head of the Division of Enforcement, is famously said to have remarked, “If they want scienter, we’ll give them scienter.”<sup>176</sup> And so they did, and in the process they cut down dramatically on negligence-based misrepresentation claims.<sup>177</sup>

171. 15 U.S.C. §§ 77h-1(a), 80b-3(k)(1), 78u-3(a).

172. *E.g.*, *KPMG, LLP v. SEC*, 289 F.3d 109, 120 (D.C. Cir. 2002) (“Moreover, the Commission was virtually compelled by Congress’ choice of language in enacting Section 21C to interpret the phrase ‘an act or omission the person *knew or should have known* would contribute to such violation’ as setting a negligence standard.”).

173. Jean Eaglesham, *At SEC, Strategy Changes Course*, WALL ST. J., Sept. 30, 2011, available at <http://online.wsj.com/article/SB10001424052970203405504576601251693560910.html>.

174. *See Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 190 (1976) (“As revealed through discovery, respondents’ cause of action rested on a theory of negligent nonfeasance.”).

175. *Id.* at 212–14.

176. Interview by Kenneth Durr with Daniel Goelzer, in Washington, D.C. (Apr. 15, 2008) (quoting Stanley Sporkin), available at <http://sechistorical.org/museum/oral-histories/e-g/>. In part because the Supreme Court never resolved whether recklessness can constitute scienter, the view in certain quarters over the years has been that the brand of scienter that the Enforcement Division has served up has at times not been as robust as it could be. More than one wag has been heard to say that “there is real fraud, and then there is SEC fraud.”

177. *See* Russell G. Ryan, *To Err is Human . . . and Punishable by the SEC: The Securities Regulator Stretches Itself Thinner by Adding Negligence Cases to Its Docket*, CFO.COM (Nov. 1, 2011), <http://www.cfo.com/article.cfm/14606438>; (“Fortunately, the SEC has long exercised sound prosecutorial discretion by not charging people who were guilty of only negligent mistakes. Instead, the agency has historically prioritized its limited resources by mostly going after people it believes committed deliberate fraud. Contested SEC cases . . . have rarely involved only negligence charges.”); *see also* Nielsen & Jamison, *supra* note 103 (asserting that “[i]n 2011, the SEC showed an increased willingness to proceed against alleged negligent or nonscienter-based conduct as opposed to scienter-based fraud, especially in the context of CDO-related cases,” thus implying that the SEC has generally been less willing to pursue negligence-based misrepresentation claims); Ryan, *supra* (asserting that the SEC “intends to expand its enforcement reach” by pursuing “not

The Commission should consider whether it has missed an opportunity, and there are signs that it may be doing so.<sup>178</sup> The power to sanction persons who “should have known” that their conduct would contribute to the violation of others is considerable. Its contours are largely undeveloped. The phrase “should have known,” appearing as it does in federal statutes, bespeaks a standard of care that arises under federal law. What it means in various contexts is largely unexplored.

Where professionals are concerned, it seems that a violation of professional standards suffices.<sup>179</sup> But in other contexts, it remains unclear how the Commission demonstrates the existence of a particular standard of care and whether the statute gives the Commission any prescriptive power of its own.<sup>180</sup> It is unknown how the standard of care under the securities laws intersects with state law duties of care, particularly of corporate officials. For example, what is the extent of the duty of a senior corporate officer to review an SEC filing? Is the duty discharged by skimming a hundred-page document? If a corporate official reads an SEC filing and fails to notice a misrepresentation about her company’s financial performance, does that constitute a breach of a duty arising under the federal securities laws?

And where is the line between negligence and mistake? If a broker-dealer branch-office manager conscientiously reviews trading activity in his office but fails to pick up a number of abusive trades, is that actionable negligence or a mistake for which there is no enforcement case? Is a failure to invest sufficiently in an investment adviser’s compliance systems, under the belief that existing systems are adequate and the entity cannot afford more, negligence or simply a mistake in judgment?

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only its signature cases against deliberate and reckless fraudsters, but also cases against people who make merely negligent mistakes,” based on a settlement reached between the SEC and Citigroup that “alleged only that the bank had ‘negligently misrepresented key deal terms,’” thus implying that negligence-based misrepresentation claims have been relatively rare in the minds of both corporate executives and practicing attorneys).

178. See Joshua Gallu, *Khuzami Says Seeking Admissions of Guilt Would Slow Probes*, BLOOMBERG (Nov. 11, 2011), <http://www.bloomberg.com/news/2011-11-11/sec-s-khuzami-says-forcing-guilty-pleas-may-divert-resources.html> (discussing the possibility of the SEC bringing more negligence cases).

179. See DAN L. GOLDWASSER ET AL., ACCOUNTANTS’ LIABILITY § 4:2.3 (2011) (“Professional standards are commonly looked to as evidence of the appropriate standard of care in a negligence case, and generally establish the minimum standard by which liability will be determined.” (footnotes omitted)); see also RESTATEMENT (SECOND) OF TORTS: UNDERTAKING IN PROFESSION OR TRADE § 299A (1965) (“Unless he represents that he has greater or less skill or knowledge, one who undertakes to render services in the practice of a profession or trade is required to exercise the skill and knowledge normally possessed by members of that profession or trade in good standing in similar communities.”).

180. See SEC v. Shanahan, 646 F.3d 536, 545 (8th Cir. 2011) (upholding, in an options-backdating case, the district court’s determination that the Commission failed to show by expert testimony or otherwise that a director’s conduct departed from the standards of ordinary care, because it presented “no evidence” supporting the “degree of care that an ordinarily careful person would use under the same or similar circumstances”).

The Commission and the courts have not thought hard about these questions in the twenty years since the Remedies Act was enacted. That is unfortunate, I would submit, because I believe for every blatantly intentional violation of the securities laws there are ten acts of thoughtlessness that produce the same result. There is much useful work to be done in developing, articulating, and enforcing standards of care.

There is a risk in going down this path, namely that the Division of Enforcement simply asserts rather than demonstrates violations of standards of care when negotiating with potential defendants, who would rather end an investigation and settle. It is precisely because the consequences of a negligence settlement are less than a settlement for intentional misconduct that a defendant will simply cave in and be done with it.

Accordingly, the Commission should not start down the path of bringing more negligence cases unless it is willing to demand analytical rigor from the Division of Enforcement and add its own. Otherwise, while pursuing more negligence cases might increase the number of cases the Commission brings, the resulting muddle will engender more confusion than compliance.

All the foregoing suggestions as to how the Commission might change the mix of its enforcement cases come at a price. With limited resources, bringing more of one type of case means bringing less of others. Those are difficult decisions, and they change with the times.

#### *B. Moving More Quickly*

Bringing cases more quickly would increase their deterrent effect.<sup>181</sup> But doing so would involve serious trade-offs. From time to time, the

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181. See Joan MacLeod Heminway, *Hell Hath No Fury Like an Investor Scorned: Retribution, Deterrence, Restoration, and the Criminalization of Securities Fraud Under Rule 10b-5*, 2 J. BUS. & TECH. L. 3, 4 (2007) (“For deterrence to be effective, punishment must be perceived by actual and potential perpetrators as being rapid, sure, and severe.”). See also WILLIAM J. CORNELIUS, SWIFT AND SURE: BRINGING CERTAINTY AND FINALITY TO CRIMINAL PUNISHMENTS xi (1997) (“Swiftness and certainty of punishment rather than the severity of punishment, is the most effective deterrent to crime.”); Norman C. Bay, *Executive Power and the War on Terror*, 83 DENV. U. L. REV. 335, 357–58 (2005) (describing swiftness and sureness as “two of the hallmarks for criminal punishment to have the greatest deterrent effect”); G. Robert Blakey, *Mandatory Minimums: Fine in Principle, Inexcusable When Mindless*, 18 NOTRE DAME J.L. ETHICS & PUB. POL’Y 329, 330 (2004) (“Deterrence equals swift, sure, and severe punishment.”); Jeffrey A. Butts, *Speedy Trial in the Juvenile Court*, 23 AM. J. CRIM. L. 515, 517 (1996) (discussing the speed of disposition of cases in juvenile courts and noting an interest “among legislators, judges, attorneys, court administrators, and law enforcement personnel” in “accelerating the imposition of sanctions on juvenile law violators, under the assumption that swift sanctions are more effective sanctions”); Thad A. Davis, *A New Model of Securities Law Enforcement*, 32 CUMB. L. REV. 69, 75–76 (2002) (remarking on a study of investor awareness that “revealed that the investing public has potentially never been in need of greater protection than in the first decade of the [twenty-first] century” and declaring that “[t]his study points out the need for swift, high profile, and harsh punishment of violators in order to deter their abuses directed towards a largely unsuspecting, naïve, and badly informed public”). But see Paternoster, *supra* note 3, at 815–17 (acknowledging that “[t]raditional theory holds that only if the cost is expected to arrive quickly after the act—theoretically as quickly as the benefit” will the

Commission (like all prosecutorial agencies) announces new working groups, task forces, or “SWAT” teams—all designed to move certain types of cases (generally those in the public eye) more quickly.<sup>182</sup> From time to time, the Commission expresses serious displeasure with old cases and pressures the Division to move cases more quickly. Chairman Pitt was particularly successful in promoting “real time enforcement” by prodding the Division, in almost every matter that came before the Commission, to move more quickly, indeed often criticizing it for not having moved quickly enough.<sup>183</sup>

Sometimes this is wise, sometimes not. Many of the Commission’s cases take years to investigate.<sup>184</sup> Cases involving financial fraud, reconstructing trading, complex financial instruments, or insider trading conspiracies can take years to unravel. The most significant cases generally involve mountains of data (particularly in this era of electronic discovery), and numerous witnesses whose testimony must be scheduled, prepared for, and taken. It is not at all unusual for investigations to take unexpected turns, with new leads that must be run down without knowing whether it will be fruitful.

There is no reliable measure of whether the SEC takes too long to investigate these cases. Unless one is doing the investigating, almost any investigation takes too long. The Commission has been known to complain to the Division about stale cases, and the defense bar has been known to complain about time that appears wasted until there is a final rush to resolve a matter.

In large part, questions of productivity are management questions, and the Commission, including the Division of Enforcement, could be better managed. Management improvements are largely invisible to the public and generally not a high priority for the presidentially appointed Chairmen and Commissioners. Commissioners tend to have relatively short time horizons and are looking to have an impact quickly—and publicly.<sup>185</sup> Chairman

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deterrent effect be enhanced, but noting a study that would tend to indicate that “[swift]ness [c]ould have an inverse weight, such that delayed punishment is perceived to be more costly than more immediate punishment”); Dean J. Spader, *Megatrends in Criminal Justice Theory*, 13 AM. J. CRIM. L. 157, 179 fig.5 (1986) (categorizing the belief that “[c]ontrol of crime is obtained by certainty, [swift]ness, and severity of punishment” as a tenet of classicalism, as opposed to positivism, on the spectrum of punishment theory).

182. See, e.g., Gretchen Morgenson, *It Has a Fancy Name, but Will It Get Tough?*, N.Y. TIMES, Jan. 29, 2012, at BU1 (describing the SEC’s role in the Residential Mortgage-Backed Securities Working Group).

183. See Harvey L. Pitt, Chairman, U.S. Sec. & Exch. Comm’n, Speech by SEC Chairman: Remarks at the PLI 33rd Annual Institute on Securities Regulation (Nov. 8, 2001), available at <http://www.sec.gov/news/speech/spch520.htm>.

184. See, e.g., Peter J. Henning, *Closer Look at S.E.C.’s Mortgage Fraud Charges*, DEALBOOK, N.Y. TIMES (Dec. 19, 2011, 3:16 PM), <http://dealbook.nytimes.com/2011/12/19/closer-look-at-s-e-c-s-mortgage-fraud-charges> (noting that the Commission’s “investigation of Fannie and Freddie took a little more than three years”).

185. See JONATHAN G. KATZ, CTR. FOR CAPITAL MKTS. COMPETITIVENESS, U.S. CHAMBER OF COMMERCE, U.S. SECURITIES AND EXCHANGE COMMISSION: A ROADMAP FOR

Schapiro has been a conspicuous exception and has devoted much of her time and energy simply to making the Commission run better.<sup>186</sup> Policy aside, these efforts will be felt at the Commission for some years to come.

What is clear, though, is that to some degree this is within the Commission's control, if it is willing to make the necessary trade-offs. Some cases can be investigated and disposed of more quickly *if* the Commission is willing to tolerate a greater degree of uncertainty in the outcome. Investigations rarely reveal perfect knowledge, and the question becomes how much uncertainty an institution should tolerate.

Cutting short an investigation means a greater chance of missing something, perhaps proof of new, and more significant, violations. I remember years ago being admonished by an SEC staff lawyer that I had better settle a case quickly and quietly, because the staff had overwhelming evidence of every last bit of misbehavior by my client. "We know every time he's [relieved himself]," was the boast. In fact, there was much the SEC staff did not know. My client took the offered deal quickly and indeed quietly and in so doing avoided some major unpleasantness that probably would have resulted from further investigation.

Quick termination of an investigation can overlook exculpatory evidence as well. As noted above, some SEC critics as well as the defense bar complain that the Commission's capacity to coerce settlement enables it to bring too many settled cases of questionable merit,<sup>187</sup> a criticism I believe has some force.

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TRANSFORMATIONAL REFORM 21 (2011), *available at* [http://www.uschamber.com/sites/default/files/reports/16967\\_SECREport\\_FullReport\\_final.pdf](http://www.uschamber.com/sites/default/files/reports/16967_SECREport_FullReport_final.pdf) (attributing the disinterest of SEC Commission Chairmen "in bold changes to the agency" to "the short-term horizon of Commission Chairmen," noting that "[s]ince 1980 only two of the past eight Chairmen (2 of 13 from 1970) have stayed in office for four or more years"); *id.* at 21 (explaining that "a fundamental turnaround typically takes four or more years" and will limit the Chairman's "ability to complete whatever policy initiatives are a priority," and that "success will require a commitment from an unknown successor" who will receive the credit if the turnaround is successful); *see also* Anne Joseph O'Connell, *Vacant Offices: Delays in Staffing Top Agency Positions*, 82 S. CAL. L. REV. 913, 950 (2009) (explaining that "[p]olitical appointees . . . often have short tenures," and asserting that "[t]he short tenure permits mistakes but not the opportunity to learn from those mistakes"); *cf.* Jonathan G. Katz, *Reviewing the SEC, Reinvigorating the SEC*, 71 U. PITT. L. REV. 489, 499 (2010) (suggesting that the desire to have a public impact extends to SEC staff as well). Indeed, Katz correctly observes:

[E]veryone wants to conduct the hot investigation. During the 1980s, every member of the staff wanted to do insider trading or penny stock cases. In the 1990s, the staff looked for Internet frauds to investigate, no matter how small. A few years later, it was mutual fund late trading cases. Most recently, it was option-backdating cases. Today, post-Madoff, it is Ponzi schemes. And post-financial crisis, it is sub-prime securities.

*Id.* (footnote omitted).

186. *See* Mary L. Schapiro, Chairman, U.S. Sec. & Exch. Comm'n, Remarks at the Practising [sic] Law Institute's SEC Speaks (Feb. 24, 2012), *available at* <http://sec.gov/news/speech/2012/spch022412mls.htm> (noting that under her leadership "[a] first priority was to make better use of SEC resources, carefully investing overdue budget increases in people and technology and improving management in ways that allowed us to make the most of our funds").

187. *See supra* note 60 and accompanying text.

When something the Division of Enforcement has overlooked comes to light, there can be hell to pay. Particularly in the current climate—against the background of failures in the Madoff and Stanford Ponzi schemes,<sup>188</sup> the perceived failure of the SEC to head off the financial crisis,<sup>189</sup> and the comparisons with state attorneys general<sup>190</sup>—there is little room for mistakes. There is never any shortage of critics, and in this climate there is an abundance. For a member of the Enforcement staff, closing a case prematurely poses graver risks than investigating longer than necessary. Most of the time, the public is not aware of the matters under investigation. Where it is, and where it is impatient, any criticism is directed solely at the Commission and not at particular individuals, because the public almost never knows the identity of the people investigating particular cases. But where an investigation is closed and evidence of wrongdoing later appears, the staffer who missed the case can face severe public criticism—in Inspector General reports, the press, or hearings before committees of Congress. Though these things occur rarely, the unpleasant lessons are learned well by the Enforcement staff.

But a different balance could be struck here. The Commission can get the enforcement program it wants. If it wants to speed things up, and understands the risks it is taking in doing so, it can do that. There are already rough guidelines as to how long it should take for investigations to reach certain stages.<sup>191</sup> If the Commission wants, it can require greater adherence to these guidelines, ask the Division to shorten them in certain types of cases, and reject recommendations in cases that come to it after the deadlines. But the Commission must take responsibility for its choices and stand firm when there are the inevitable consequences.

Finally, the Commission could revisit how it administers the *Seaboard* factors, principally its encouragement of investigations and self-reporting by companies that discover wrongdoing.<sup>192</sup> A principal motivation behind the *Seaboard* order was not simply to encourage socially desirable behavior; it

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188. See *supra* note 121 and accompanying text.

189. Theo Francis, *SEC's Cox Catches Blame for Financial Crisis*, BUSINESSWEEK (Sept. 19, 2008, 12:01 AM), [http://www.businessweek.com/bwdaily/dnflash/content/sep2008/db20080918\\_764469.htm](http://www.businessweek.com/bwdaily/dnflash/content/sep2008/db20080918_764469.htm) (“[C]ritics argue that the agency has leaned toward a hands-off regulatory approach in recent years that has left it unprepared or unwilling to use the powers it has and slow to step in as trouble brewed.”).

190. See Jeremiah S. Buckley, *State Attorneys General Are the New Bank Regulators*, AM. BANKER (Feb. 1, 2012, 7:28 PM), <http://www.americanbanker.com/bankthink/state-attorney-generals-are-the-new-bank-regulators-1046277-1.html> (arguing that while “[b]anks have historically been regulated almost exclusively by Federal and State bank regulators” due to the financial crisis “state attorneys general appear to be carving out a new role as de facto bank regulators.”).

191. See DIV. OF ENFORCEMENT, U.S. SEC, *supra* note 71, at 6–7 (instructing Assistant Directors to consider “[w]hether target deadlines are being met, and identification of causes for any delay and development of a plan to address that delay and move the investigation toward resolution” in quarterly meetings with staff members).

192. See *supra* notes 133–34 and accompanying text.

was to leverage the Commission's resources.<sup>193</sup> Incentivizing companies to commission independent investigations of misconduct was intended in large part to free up investigative resources so that the Commission could bring more cases more quickly.<sup>194</sup> And as noted above, it is the very pendency of enforcement investigations, as much as their outcome, that provides a principal motivation for companies to settle cases and be done with the lengthy and disruptive process.<sup>195</sup>

It is widely believed among the defense bar—and as a result its clients—that the Division rarely accepts the results of an independent investigation or even merely spot-checks it. Rather, it is believed that often the Commission retraces the same steps more than it must. The perception at the Commission is a bit different—namely that internal investigations, even independent ones, vary widely in quality. The Division believes that some reflect barely disguised advocacy by persons who habitually defend institutional clients, some are just not very well done, and some reflect competence and the appropriate degree of skepticism. And to the extent that audit committees or other committees of boards of directors choose not to share all their conclusions and evidence with the Commission—which may frequently be a reasonable course—they can hardly complain about the delay caused by the Commission having to replough the same ground.

Again, to repeat an earlier point, the Commission should take opportunities to specify what it wants and its evaluation of what it gets. This point takes on additional importance given the Commission's new whistleblower rules, which implement Section 922 of the Dodd-Frank Act.<sup>196</sup> These rules provide powerful incentives for whistleblowers, and more importantly, their counsel, to report wrongdoing. One can expect not only more complaints but complaints in which experienced and skilled counsel

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193. See *Seaboard Report*, *supra* note 133, at 2 (justifying the Commission's decision not to take action against a company that had responded forcefully to apparent misconduct by noting that “[w]hen businesses seek out, self-report and rectify illegal conduct, and otherwise cooperate with Commission staff, large expenditures of government and shareholder resources can be avoided and investors can benefit more promptly”).

194. See Stephen M. Cutler, Dir., Div. of Enforcement, U.S. Sec. & Exch. Comm'n, Speech by the SEC Staff: Remarks Before the Investment Company Institute, Securities Law Developments Conference (Dec. 6, 2001), available at <http://www.sec.gov/news/speech/spch527.htm> (discussing the role of cooperation under the *Seaboard Report* as it pertains to the SEC's goal of “real-time enforcement,” declaring that real-time enforcement means “rewarding meaningful cooperation—because doing so will enable us to bring more cases faster”); see also Claudius O. Sokenu, Mayer Brown, LLP, *The Role of Corporate Internal Investigations*, in INTERNAL INVESTIGATIONS 2008: LEGAL, ETHICAL & STRATEGIC ISSUES 83, 93 (2008) (quoting Cutler as saying, “Furthermore, the Seaboard Report provides companies facing potential enforcement problems with new confidence to actively seek out the Commission and self-report. Acknowledging as much, then-SEC Director of Enforcement Stephen Cutler said the Commission ‘will bring in more cases and use fewer resources’ thereby offering ‘more protection for investors’”).

195. See *supra* notes 91–98 and accompanying text.

196. 17 C.F.R. § 240.21F-5 (2011) (providing a mechanism for whistleblowers to obtain awards from the Commission of between 10–30% of all penalties and disgorgements ordered against defendants in Commission enforcement cases).

advocate for Commission enforcement actions in which they will have a stake. It is too early to know how many of such cases there will be or the extent to which the Division will be reluctant to stand down in these cases and let internal and external company investigators look into the complaint.

It is possible that the Division may be faced with the choice either to do initial investigations itself in cases that it would have previously stood down, or to devote more investigative resources to cases prompted by whistleblowers than it would otherwise think appropriate. To the extent the Division would prefer to rely in the first instance on internal investigations, it may face a skeptical public.<sup>197</sup> The Commission could help allay that skepticism by educating the public and the bar about what constitutes an effective and appropriate internal investigation.

1. *The Nonlegal Consequences of Securities Violations.*—Because there is not much the Commission can do to affect the extralegal consequences of its enforcement actions, it will get little discussion here. These consequences, of course, depend to a large extent on the nature of the violation and the mores of the particular community of which the violator is a member.

Of interest, though, is the gulf between perceptions of those who enforce the federal securities laws and the objects of their interest. Over the years, I have met few clients who genuinely believe that they have behaved badly. Even those whose behavior is most loathsome protest that they are no worse than anyone else. But there are many who are genuinely puzzled at why the SEC would claim they had broken the law. To some extent this underscores the necessity for the SEC to communicate clearly when it takes enforcement actions—not that the violators themselves will read the SEC's orders, but their lawyers will.

Many of the SEC's enforcement actions are viewed by the business community the way the rest of us react to opening our mail to find that we have been caught speeding by a hidden camera: there is dismay at the penalty, irritation at the enforcer, and a level of outrage that nobody actually drives at twenty-five miles per hour and that safety does not require it.<sup>198</sup> This is a serious issue but not one within the SEC's capacity to resolve.

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197. See, e.g., David S. Hilzenrath, *Justice Department, SEC Investigations Often Rely on Companies' Internal Probes*, WASH. POST, May 22, 2011, available at [http://www.washingtonpost.com/business/economy/justice-department-sec-investigations-often-rely-on-companies-internal-probes/2011/04/26/AFO2HP9G\\_story.html](http://www.washingtonpost.com/business/economy/justice-department-sec-investigations-often-rely-on-companies-internal-probes/2011/04/26/AFO2HP9G_story.html) (quoting a former federal prosecutor who acknowledged that “very little” other than the investigator's integrity can prevent internal investigators from airbrushing facts or omitting crucial evidence from the report of the investigation).

198. See, e.g., *Court Upholds Disgorgement Order in SEC Enforcement Action*, BLT: BLOG OF LEGALTIMES (Oct. 31, 2011), <http://legaltimes.typepad.com/blt/2011/10/court-upholds-disgorgement-order-in-sec-enforcement-action-.html> (chronicling an SEC enforcement action against a Houston businessman that the defendant's lawyer characterized as unfairly punitive).

Where the allegations are serious, the informal consequences of an SEC enforcement action can be devastating. Having been a lawyer both for the SEC and for defendants in enforcement proceedings, I am quite certain that the people on either side do not understand what it is like to be on the other side of the witness table. Defendants overlook the difficulty of conducting investigations and the care with which the SEC does it; enforcers have little idea of the toll taken by an investigation, much less of a proceeding. Of all sanctions, public humiliation is the worst.

### Conclusion

Rigorous self-examination and regular reinvention are the hallmark of successful institutions. The tenures of Chairman Schapiro and Director Khuzami have been marked by significant changes in the way the Division of Enforcement does business.<sup>199</sup> My suggestions in this Article should not be taken as criticism of the Division of Enforcement under their watch and certainly not of the dedicated and motivated professionals with whom I served while at the SEC or with whom I have contended while in private practice.

This Article is an invitation to think about SEC enforcement in a slightly different way. Thinking of enforcement as “strong” or “weak” is not especially useful, and in any event one’s views seem to be shaped in large part by whether one is situated on the sending or receiving end of the message, or just sitting on the sidelines. And simply to be tougher, in my view, is something of a fool’s errand. The pertinent question is whether there are ways to be more effective.

It is not just a matter of threatening harsher consequences to more people. It is about intervening in a way that provides strong disincentives to the greatest number of people in a position to do the greatest harm, if possible before they are in a position to do it. To do that, one must think hard and rigorously about who those people are, what enables people to do what they do, and to the maximum extent possible, how to close down the avenues that provide the opportunity.

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199. *See supra* note 186 and accompanying text.