

SECURITIES LAW

ALM

SEC statement clarifies
corporate penalties—a bit

January pronouncement sheds some sunlight on policy, but shadows remain in application.

By William R. Baker III and
Dane A. Holbrook
SPECIAL TO THE NATIONAL LAW JOURNAL

IN JANUARY, IN ONE of the first significant enforcement pronouncements since Chairman Christopher Cox assumed leadership, the Securities and Exchange Commission (SEC) moved to quiet what has been a controversial topic by issuing a statement on how it will impose civil penalties on corporations. SEC Press Release 2006-4, "Statement of the Securities and Exchange Commission Concerning Financial Penalties" (Jan. 4, 2006). The statement represents the SEC's attempt "to provide the maximum possible degree of clarity, consistency, and predictability in explaining the way that its corporate penalty authority will be exercised."

The SEC has made a significant effort to provide transparency to the enforcement process and to articulate its views on when a penalty is appropriate against a public company. However, for those directors and senior officers of public companies facing the possibility of an SEC enforcement proceeding, and for the lawyers who counsel them, some uncertainties remain.

Civil penalties levied against public corporations in enforcement proceedings brought by the SEC have grown dramatically

William R. Baker III is a partner in the Washington office of Latham & Watkins. Prior to joining Latham, he was an associate director of the Securities and Exchange Commission's Division of Enforcement. Dane A. Holbrook is an associate in the firm's Washington office. Both are members of the firm's securities litigation and professional liability practice group.

in amount and in frequency since the 2002 passage of the Sarbanes-Oxley Act. Since then, the SEC has obtained billions of dollars in penalties, the bulk of which were imposed on corporations in settled enforcement actions. The largest pre-Sarbanes-Oxley penalty imposed by the SEC against a public company that was not a regulated financial institution was the \$10 million penalty imposed against Xerox Corp. in April 2002. After Sarbanes-Oxley, corporate penalties against nonregulated-entity public companies have become far higher—including penalties against Qwest Communications International Inc. for \$250 million, Time Warner Inc. for \$300 million and the record-setting penalty against WorldCom Inc. for \$750 million.

Large corporate penalties also increased in frequency. Almost two years after passage of the Sarbanes-Oxley Act, Stephen M. Cutler, then-director of the SEC's Division of Enforcement, stated that the paradigm shift "from a regime in which monetary penalties were imposed only rarely to one in which large penalties seem to be part of virtually all significant settlements" represented an "evolution, if not revolution" in the SEC's thinking on enforcement sanctions. Stephen M. Cutler, Speech at the 24th Annual Ray Garrett Jr. Corporate & Securities Law Institute (April 29, 2004). See www.sec.gov/news/speech/spch042904smc.htm.

But this increase in the size and frequency of corporate penalties did not meet universal acclaim, even within the SEC itself.

According to the statement, "within the Commission itself a variety of views [on corporate penalties] have heretofore been expressed, but not reconciled." Disagreements about such penalties may have caused a deadlock among commissioners in certain contemplated enforcement actions. See, e.g., "No SEC Deal on Veritas Penalty," L.A. Times, June 9, 2005, at C2 (from Bloomberg News).

Critics have argued that large penalties harm shareholders.

Critics of corporate penalties argued that exacting large penalties from a corporation, rather than the culpable individuals, can have the perverse effect of harming shareholders twice—when the fraud is first uncovered and the stock price declines, and then again when the corporation

pays a significant penalty. For this reason, Commissioner Paul Atkins suggested that the better course is to "hold individuals accountable, not shareholders." Amy Borrus, "What Gets the SEC's Atkins Riled Up," Bus. Week Online, Feb. 14, 2005.

Other critics argued that the SEC's mechanism for assigning damages "has often been capricious in its determination of the amount of penalties." See Eric Larson, "Amid Criticism, SEC Sets Standard for Penalties," Sec. L. Bull. (Jan. 4, 2004). The U.S. Circuit Court of Appeals for the District of Columbia, for example, recently held—while striking down SEC-imposed penalties against an investment advisor, albeit not a public company—that the SEC acted "arbitrarily and capriciously" when it levied hundreds of thousands of dollars in penalties without stating the reasons for doing so. *Rockies*

Fund Inc. v. SEC, 428 F.3d 1088, 1098-99 (D.C. Cir. 2005).

In response to the argument that corporate penalties hurt shareholders, proponents asserted that the fair funds provision in the Sarbanes-Oxley Act ensures that shareholders “will not be further victimized by the imposition of a penalty” (see Cutler speech, *supra*), presumably because the penalty can be distributed to shareholders rather than sent to the U.S. Treasury. Proponents also argued that corporate penalties help to amplify the SEC’s message and help to deter illicit behavior by other public companies.

It is for this reason that virtually every SEC litigation release or press release announcing an enforcement action in which a large corporate penalty has been imposed trumpeted some variation of the phrase “this action will send a message.” According to Cutler, “[a] single enforcement action has the potential to effect change on an enormous scale, causing the development or enhancement of internal controls, supervisory procedures, and compliance functions at hundreds of other companies.” *Id.*

Two considerations

The SEC’s recent corporate-penalties statement attempts to explain the current commission’s philosophy in light of these competing views. According to the statement, which is reportedly the result of 40 hours of SEC meetings (see Floyd Norris, “Crime and Consequences Still Weigh on Corporate World,” *N.Y. Times*, Jan. 5, 2006, at C2), whether or not to impose a penalty on a corporation—as opposed to an individual—in a particular case “turns principally on two considerations.” The SEC first weighs “[t]he presence or absence of a direct benefit to the corporation as a result of the violation,” which includes assessing whether shareholders have received an improper benefit. The SEC then weighs “[t]he degree to which the penalty will recompense or further harm the injured shareholders,” which includes assessing whether innocent shareholders will bear the burden of the penalty and whether the penalty can be used to recompense injured shareholders.

Seven additional factors are identified by the statement as proper to consider in determining whether to impose a penalty on a corporation. These factors are the need to deter the particular type of offense; the extent

of the injury to innocent parties; whether complicity in the violation is widespread throughout the corporation; the level of intent on the part of the perpetrators; the degree of difficulty in detecting the particular type of offense; the presence or lack of remedial steps by the corporation; and the extent of cooperation with the SEC and other law enforcement agencies.

In connection with the release of the statement, the SEC also provided examples of these principles in action by contrasting two settled enforcement actions, one against McAfee Inc. and the other against Applix Inc. In the case against McAfee, the SEC charged that the corporation’s securities law violations—alleged improper revenue recognition, channel stuffing and fraudulent record-keeping—merited the imposition of a \$50 million civil penalty. *SEC v. McAfee Inc.*, SEC Litig. Release No. 19520 (Jan. 4, 2006).

According to the current director of the Division of Enforcement, Linda Chatman Thomsen, McAfee’s illicit conduct was not only “pervasive” but, in the SEC’s view, also benefited the company: “During the time period of the fraud, McAfee used its overvalued stock to acquire other companies, capitalizing on the artificial value it had created through its fraud.” Linda Chatman Thomsen, Speech by SEC Staff: Statement regarding McAfee Inc. and Applix Inc. (Jan. 4, 2006). See www.sec.gov/news/speech/spch010406lct.htm. Thomsen also pointed out that McAfee is “financially strong,” and thus a penalty would be unlikely to cause “undue hardship” to its shareholders and could be “effectively distributed” to injured investors. *Id.*

In contrast to McAfee, in *Applix*, the SEC did not find that the corporation’s securities law violations—alleged improper recognition of approximately \$1.2 million in revenue—merited the imposition of a civil penalty and instead imposed a cease-and-desist order. *In re Applix Inc.*, Exchange Act Release No. 53409 (Jan. 4, 2006). According to Thomsen, neither Applix nor its shareholders benefited from the company’s illicit conduct. Thomsen speech, *supra*. In addition, Applix—unlike McAfee—is a “relatively small company and a large financial penalty could have a

disproportionate effect on its financial situation with hardship flowing to its shareholders.” *Id.* Thomsen described the alleged fraudulent conduct in *Applix* as “more limited,” because the alleged fraud was limited to three responsible individuals. The SEC is pursuing charges against those individuals separately. *Id.*

In the most significant settled enforcement action since the release of the corporate-penalties statement—in which a \$100 million penalty was levied against American

\$100 million penalty against AIG seemed to apply the criteria.

International Group Inc. (AIG)—the SEC appeared to apply the criteria articulated in the statement. SEC Press Release 2006-19, “AIG to Pay \$800 Million to Settle Securities Fraud Charges by SEC” (Feb. 9, 2006). As to direct corporate or shareholder benefit, the publicly disclosed facts regarding the AIG settlement say very little, suggesting only that AIG distributed its stock in a stock-for-stock corporate acquisition during the period of the fraud. See Complaint, *SEC v. American International Group*, No. 06-CV-1000, ¶ 8 (S.D.N.Y.) (filed Feb. 9, 2006). (Whether this was the only putative improper benefit from the company’s alleged violative conduct is unclear.)

As to the effect on current shareholders, the SEC asserts that its settlement (which also included disgorgement of \$700 million) will “deliver meaningful monetary relief to those harmed by AIG’s prior conduct.” Other allegations in the SEC’s complaint and AIG-related press releases highlight several secondary factors that, if true, would tend to weigh in favor of imposing a penalty against AIG, including that there was widespread complicity in the violation, that fraudulent intent animated the actions of the individual violators and that there was a strong interest in deterring others similarly situated from misusing insurance and reinsurance transactions. In addition, the penalty amount reflects use of the statement’s mitigating factors, as it takes into account AIG’s substantial cooperation during the SEC’s investigation and the company’s remediation efforts.

Penalties in the future

The corporate-penalties statement is helpful because it provides a basic framework for analysis. Moreover, the discussion in the statement suggests a step back from the regime

where “large penalties seem to be part of virtually all significant settlements.” See Cutler speech, *supra*. But the statement’s real significance will not be known until the SEC has applied it over time in a series of enforcement actions. Even now, several important issues remain unresolved:

■ *A penalty should reflect cooperation, but who judges cooperation and what credit is given?* Cooperation, as defined by the SEC, has been a part of the corporate-penalty calculus since the Statement on the Relationship of Cooperation to Agency Enforcement Decisions in 2001 (known as the “Seaboard Report”), Exchange Act Release No. 44969 (Oct. 23, 2001). Cooperation can be in the eye of the beholder, however, and here the beholder is SEC staff.

Even after a corporation makes what it views as a good-faith effort to respond appropriately to possible corporate misconduct, SEC staff, with the clarity of 20-20 hindsight, may conclude that the response was inadequate and worthy of harsh sanction. Some SEC staffers seem not to appreciate the difficulties posed by uncertainties about underlying facts and by competition for scarce corporate resources. Unfortunately, in the settlement of an SEC investigation, there is rarely judicial oversight and thus no independent arbiter of disagreements about the extent of a corporation’s cooperation.

The corporate-penalties statement emphasizes again the importance of cooperation, and makes clear, if there was any doubt, the SEC’s view on a corporation’s obligation to self-report misconduct. This new statement, without additional analysis or support, states that “it is incumbent upon management to report” securities law violations when they are discovered. This rhetoric seems to suggest that a corporation cannot self-correct possible violations without self-reporting or other public disclosure.

Effects of cooperation

Since the cooperation statement in 2001, the SEC has, on multiple occasions, noted the effect of cooperation on the ultimate size of a penalty. Lucent Technology Inc.’s settlement with the SEC in 2004 for alleged improper revenue recognition exemplifies the commission’s treatment of companies it deems uncooperative. That settlement included a \$25 million penalty for Lucent’s “lack of

cooperation.” SEC Press Release 2004-67, “Lucent Settles SEC Enforcement Action Charging the Company with \$1.1 Billion Accounting Fraud” (May 17, 2004).

By contrast, “the Commission did not seek a penalty from [Royal] Ahold [N.V.]” in 2004 for alleged securities law violations it described as “yet another deplorable example of a massive, multifaceted fraud at a major corporation.” No penalties were imposed in part because of “the company’s extensive cooperation with the commission’s investigation.” SEC Press Release 2004-144, “SEC Charges Royal Ahold and Three Top Former Executives with Fraud” (Oct. 13, 2004).

What constitutes cooperation under the SEC’s statements has only been described in the abstract and is not easily distilled from SEC enforcement actions, which generally do not specify what level of cooperation a corporation provided. Thus, while it is clear that the SEC places a high value on cooperation, defining that value with precision is difficult.

■ *The SEC’s system for calculating corporate penalties remains a black box.* Public companies under investigation by the SEC, and their shareholders, are justifiably concerned about the size of recent payments required to settle enforcement actions. During the SEC’s past fiscal year, corporate penalties included two penalties of greater than \$250 million. Penalties against financial institutions directly regulated by the SEC (including those that are public companies), where the SEC has traditionally exacted tougher penalties, include at least 11 more penalties of more than \$25 million.

The statement is silent on how the SEC will determine the dollar amount of a penalty, but in a press briefing on Jan. 4, Cox clarified “that all of the factors enumerated in the statement are also applicable in determining the magnitude of a penalty, once it is decided that a penalty will be imposed.” See Rachel McTague, “SEC Unveils Corporate Penalties Policy,” *Sec. Law Daily (BNA)* (Jan. 5, 2006).

However, the approach taken by the SEC is still very different from that used when a corporation pleads guilty to a crime. The U.S. Sentencing Commission, for example, has prescribed much more specific parameters for assessing fines on corporations in its Guidelines Manual. See U.S.S.G., Ch. 8

and § 8A1.2, n.1 (November 2005). These guidelines provide for a range of fines that are dependent on the offending corporation’s offense level and culpability. *Id.*, § 8C2.4-6. The National Association of Securities Dealers has prescribed similar parameters on penalties in its Sanction Guidelines.

■ *How long will it take for shareholders to benefit from fair funds?* The corporate-penalties statement makes clear that shareholder interests should be considered carefully before a penalty is imposed. According to the statement, because the fair funds provision allows corporate penalties to be used to compensate defrauded shareholders, it provides an additional rationale for imposing a penalty against a corporation. See also Lyle Roberts, “End the Dual Approach,” *NLJ*, Oct. 24, 2005, at 27 (“The “Fair Funds” program...has provided an incentive for the SEC to seek significant penalties from corporations.”).

But more than three years after Sarbanes-Oxley, have penalty monies actually benefited victimized shareholders? A recent report by the Government Accounting Office suggests that the answer is no. The August 2005 GAO report surveyed the SEC’s distribution of penalty funds to victimized shareholders under fair funds, and noted that, by mid-2005, the SEC had “designated almost \$4.8 billion to be returned to harmed investors.” “SEC and CFTC Penalties: Continued Progress Made in Collection Efforts, but Greater SEC Management Attention is Needed,” GAO Reports, No. GAO-05-67, Aug. 31, 2005, at 28-29. However, at the time of the GAO report just “\$60 million from only three cases have been distributed to harmed investors, and funds totaling about \$25 million from only one other case were being readied for distribution.” *Id.*

The SEC should be commended for shedding light on the exercise of its authority to levy corporate penalties. However, several practical issues are lurking in the shadows for public companies facing the possibility of an SEC enforcement action. The resolution of those issues awaits future enforcement actions in which the commission applies the criteria articulated in the corporate-penalties statement. **NLJ**

This article is reprinted with permission from the March 13, 2006 edition of THE NATIONAL LAW JOURNAL. © 2006 ALM Properties, Inc. All rights reserved. Further duplication without permission is prohibited. For information, contact ALM Reprint Department at 800-888-8300 x6111 or visit almreprints.com. #005-03-06-0014

System for penalties calculation still remains a mystery.