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A legal update from Dechert's Financial Services and Securities Litigation, Financial Services, and White Collar Litigation Groups

SEC Issues Statement Concerning Financial Penalties

Introduction

On January 4, 2006, the Securities and Exchange Commission ("SEC" or the "Commission") issued a statement concerning the criteria that it applies in exercising its authority to seek monetary penalties from public corporations.¹ The statement coincided with the Commission's announcement that it had reached settlements involving two corporate issuers, McAfee, Inc.² and Applix, Inc.,³ where one settlement involved the payment of a civil monetary penalty and the other had not. With these two settlements as a catalyst, the SEC stated that it wanted to provide a higher degree of clarity, consistency, and predictability as to the circumstances in which it would exercise its penalty authority against corporations.⁴

The Commission's statement recognized that the Agency's authority to impose monetary penalties and its imposition of very large penalties were recent developments. It further recognized that its use of the penalty power in prior cases and the public statements of various SEC officials had generated uncertainty as to when and how the Commission would seek monetary penalties from corporations.

The Commission expressly noted that it had approved unanimously the two settlements and the statement on corporate monetary penalties. These carefully chosen words may be a signal that Chairman Cox intends to develop policies through consensus.

¹ *Statement of the Securities and Exchange Commission Concerning Financial Penalties*, Press Release, Securities and Exchange Commission (Jan. 4, 2006), available online at <http://www.sec.gov/news/press/2006-4.htm>.

² *Securities and Exchange Commission v. McAfee, Inc.*, Lit. Rel. No. 19520, Civ. A. No. 06-009 (PJH) (N.D. Cal., January 4, 2006), available online at <http://www.sec.gov/litigation/litreleases/lr19520.htm>.

³ *In the Matter of Applix, Inc.*, Exchange Act Rel. No. 53049 (Jan. 4, 2006), available online at <http://www.sec.gov/litigation/admin/33-8651.pdf>.

⁴ The SEC's statement noted that the Commission still believes that it often is appropriate to seek civil monetary penalties from individuals. Further, although the Commission's statement focused on public corporations, several of the principles articulated apply to non-public businesses, including broker-dealers, investment advisers, and other regulated entities. For example, in an enforcement action initiated the day before the Commission issued its statement on penalties,

Securities and Exchange Commission v. Karnig H. Durgarian, et al., Securities and Exchange Commission, Litigation Rel. No. 19517 (January 3, 2006), the Commission stated that "it would not bring any enforcement action against PFTC because of its swift, extensive and extraordinary cooperation in the Commission's investigation of the transactions that are the subject of the Commission's complaint. PFTC's cooperation consisted of prompt self-reporting, an independent internal investigation, sharing the results of that investigation with the government (including not asserting any applicable privileges and protections with respect to written materials furnished to the Commission staff), terminating and otherwise disciplining responsible wrongdoers, providing full restitution to its defrauded clients, paying for the attorneys' and consultants' fees of its defrauded clients, and implementing new controls designed to prevent the recurrence of fraudulent conduct."

Background

Originally, the SEC derived its authority to seek civil monetary penalties in enforcement cases from the Securities Enforcement and Penny Stock Reform Act (“Remedies Act”) passed by Congress in 1990. The SEC noted that Congress intended that the Remedies Act be used to deny improper benefits to violators, despite Congress’s awareness that shareholders could potentially bear the cost of penalties imposed on corporate issuers. The SEC made clear that it intends to continue considering whether the shareholders themselves received an improper benefit when examining situations where corporations have violated securities laws.

More recently, The Sarbanes-Oxley Act of 2002, Section 308 (“Fair Funds Provision”) changed the ultimate disposition of penalties by allowing the Commission to arrange for such funds to be routed to victimized shareholders. The SEC believes the clear purpose of the Fair Funds Provision is to provide an additional source of compensation to the victims of securities law violations and intends to use it as such.⁵

Statement of Factors Concerning Financial Penalties

The Commission laid out several factors that it believes serve the “fundamental principle that corporate penalties are an essential part of an aggressive and comprehensive program to enforce the federal securities laws, and that the availability of a corporate penalty, as one of a range of remedies, contributes to the Commission’s ability to achieve an appropriate level of deterrence through its decision in a particular case.”

There are two major considerations in the Commission’s determination of whether a penalty is appropriate.

⁵ These are well-documented inefficiencies in attempting to route money to shareholders through the Fair Funds Provision. Cynthia A. Glassman, SEC Commissioner, *SEC in Transition: What We’ve Done and What’s Ahead*, Washington, D.C. (June 15, 2005) (“Our use of so-called Fair Funds, provided by Sarbanes-Oxley, as a vehicle to return civil penalties to defrauded investors (previously, penalty amounts went to the Treasury) leads to the anomalous result that we have shareholders paying corporate penalties that end up being returned to them through a Fair Fund – minus distribution expenses. This gets a headline, but it makes no sense to me—it is form over substance.”) (available online at <http://www.sec.gov/news/speech/spch061505cag.htm>).

The Presence or Absence of a Direct Benefit to the Corporation

The SEC will look to whether the corporation itself has received a direct and material benefit from the offending conduct. Such a benefit, whether it be through reduced expenses, increased revenue, or any other unjust enrichment, will increase the likelihood that the SEC will impose a penalty. The SEC stated that the strongest case for a penalty would be one in which the current shareholders of the corporation have received an improper benefit from a violation and the weakest case would be one in which the current shareholders are the principal victims.

The Degree to which the Penalty will Recompense or Further Harm Injured Shareholders

The SEC has stated that it is more likely to use its penalty power when it has the opportunity to provide a meaningful source of compensation. Where a penalty would unfairly injure investors, the corporation or third parties, the SEC would be less likely to impose the sanction.

Additional Factors

Beyond these principal considerations, the SEC believes that additional elements may also factor into its decision to seek a civil monetary penalty.

The Need to Deter the Particular Type of Offense

The SEC has stated it will consider whether assessing a corporate penalty would likely deter others similarly situated. If the circumstances of the offense are highly unique and therefore unlikely to be repeated, the SEC may decide to go after the individuals rather than to assess a penalty on the corporation.

The Extent of the Injury to Innocent Parties

The SEC will examine the egregiousness of the harm done and the number of investors injured. The Commission also will examine the more nebulous ‘extent of societal harm’ that would result if the injury of innocent parties went unpunished.

Whether Complicity in the Violation is Widespread Throughout the Corporation

The SEC will consider whether participation in the offense was pervasive. Isolated conduct by only a few individuals would not tend to support the imposition of a

penalty, especially if the corporation has replaced the persons responsible for the violation.

The Level of Intent on the Part of the Perpetrators

The SEC will look to see whether there is manifest evidence of fraudulent intent and culpability. If the violation was not the result of deliberate and intentional fraudulent conduct, there is less need for a penalty against the corporation.

The Degree of Difficulty in Detecting the Particular Type of Offense

The SEC believes that offenses that are difficult to detect require a higher level of deterrence which can only be achieved by imposing penalties more frequently.

Presence or Lack of Remedial Steps by the Corporation

The SEC wants to encourage management of corporations accused of securities law violations to do everything within their power to take remedial steps. To that end, it will take into account steps taken from the first moment the violation is brought to their attention and other "exemplary" conduct in deciding whether to assess a penalty.

Extent of Cooperation with the Commission and Other Law Enforcement

The SEC will consider the degree to which a corporation has self-reported an offense or otherwise cooperated with the investigation and remediation of the offense.

In her remarks at the press conference announcing the Commission's statement, Linda Thomsen, the Director of the Division of Enforcement, described the facts of the two enforcement matters that the Commission had settled. In doing so, she noted that the company from which the SEC had not extracted a monetary penalty was "a relatively small company" and that "a large financial penalty could have a disproportionate effect on its financial situation."⁶ Whether "disproportionately" is a separate factor the Commission and the Staff will consider in evaluating whether to seek a monetary sanction, or is a variant of the other factors articulated, the concept is a pertinent addition to the discussion.

⁶ Linda Chatman Thomsen, Director of the SEC Division of Enforcement, *Statement regarding McAfee, Inc. and Applix, Inc.*, Washington, D.C., (January 4, 2006) (available online at <http://www.sec.gov/news/speech/spch010406lct.htm>).

Analysis

Although it is helpful that the Commission has publicly articulated the factors that it considers when deciding whether to impose a monetary penalty, it is not clear that the Agency's statement represents a substantive policy change. The Commission has announced that it will apply a "balancing test" in determining whether to seek monetary penalties and has described the considerations that it will balance.

Yet the list of factors is not surprising, and represents, essentially, the factors that have long been part of the Commission's (and the Staff's) internal thought processes. Further, the Commission has not described how it will balance these factors, the consequence being that the SEC (and the Staff) have retained substantial discretion as to the decision they would reach after considering any particular facts or circumstances.

The senior enforcement staff has stated that they believe that the purported "unfairness" of the Commission's seeking monetary penalties against public corporations is "overblown," in that the Agency has sought such penalties in only a relatively small number of instances.⁷ Even as to those matters, however, it is difficult to see how the result would have changed had the Commission issued its recent statement a few years previously.

The SEC and its senior staff have been clear: industry should not interpret the Commission's statement as a potential retrenchment of its intent to extract severe penalties (including monetary penalties) in what it considers to be appropriate cases. We believe that the statement, if anything, may support the Agency's pursuit of even greater sanctions, as it provides the Commission with at least a colorable defense against the charge that its decision-making in this area is "arbitrary and capricious" and lacking in defined criteria or a rational process. We also are concerned that the statement may cause more corporations to "sweep house" and fire officers and other employees precipitously at the first indication of an issue, because whether the

⁷ In an unpublished speech on November 5, 2005 before the Practising Law Institute's 37th Annual Institute on Securities Regulation, SEC Enforcement Director Linda Chatman Thomsen noted that the SEC has fined only 25 public issuers out of 2,000 cases brought over the last 3.5 years. See Phyllis Diamond, *Thomsen Defends Corporate Penalties, Expects to See More Hedge Fund Cases*, BNA Securities Regulation and Law Report (Vol. 37, No. 45), Nov. 14, 2005 (available online at <http://corplawcenter.bna.com/pic2/clb.nsf/id/BNAP-6HYVCN>).

company took prompt steps against responsible individuals is among the factors the Commission articulated as militating against the imposition of a penalty.⁸

Finally, it is interesting that the SEC stated that all Commissioners agreed with the principles enunciated in the statement. Several Commissioners had disagreed, both in dissenting in particular enforcement matters and in connection with public speeches⁹ from the posi-

tion, that the Commission should always (or predominantly) seek monetary penalties against corporations. Thus, the tone and substance of the SEC's statement may signal that the Commission under Chairman Cox will seek to pursue its agenda by consensus.

⁸ Of course, any personnel decisions are complicated by employment law and whistleblower considerations.

⁹ See Cynthia A. Glassman, SEC Commissioner, *SEC in Transition: What We've Done and What's Ahead*, *supra*. See also Paul S. Atkins, SEC Commissioner, *Remarks Before the SIA Industry Leadership Luncheon*, San Francisco, CA (June 8, 2005) ("Supporters of large corporate penalties justify them as necessary for deterrence. But whom are we deter-

ring? Corporations don't act, people do. Wouldn't stiff penalties against individuals have a larger deterrent effect?"') (available online at <http://www.sec.gov/news/speech/spch060805psa.htm>); Cynthia A. Glassman, SEC Commissioner, *Remarks at the 13th Annual Public Fund Boards Forum: The Challenges of Striking a Regulatory Balance*, San Francisco, CA (December 6, 2004) ("Corporate penalties, in my opinion, add insult to injury by further hurting the shareholders already victimized by the fraud.") (available online at <http://www.sec.gov/news/speech/spch120604cag.htm>).

Practice group contacts

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