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NO LONGER "KINDER AND GENTLER": SEC RAISES THE STAKES IN SETTLED ENFORCEMENT ACTIONS

by

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Introduction. Late in the summer of 2003, the Securities and Exchange Commission (the "SEC" or the "Commission") announced that it will no longer allow defendants who settle injunctive fraud actions without admitting or denying the alleged wrongdoing to dispute the factual underpinnings of the settled action in follow-on administrative proceedings. *In re Marshall E. Melton*, Admin. Proc. File No. 3-9865, __ S.E.C. Docket __, (Jul. 25, 2003), available at http://www.sec.gov/litigation/opinions/ia-2151.htm (last visited Sept. 23, 2003).

This latest announcement by the Commission firmly shuts the door on what former Chairman Harvey Pitt described as a new "kinder and gentler SEC." Chairman Harvey Pitt, Remarks Before the AICPA Governing Council (Oct. 22, 2001), available at http://www.sec.gov/news/speech/spch516.htm (last visited Sept. 23, 2003). In the aftermath of Enron and WorldCom, the Commission has increasingly adopted a more aggressive stance in its enforcement program.[1] The "new approach" which the Commission describes as a "review and reconsider[ation] of its traditional approach" only serves to further raise the stakes for those who engage in settlement discussions with the Commission staff. *Marshall E. Melton*, Admin. Proc. File No. 3-9865

Under Sections 203(e)(4) and 203(f) of the Investment Advisers Act of 1940 ("Advisers Act") and

[1]For example, the Deputy Director of the Division of Enforcement, Linda Chatman Thomsen, recently remarked that an increase in officer and director bars sought "is probably the biggest trend. The Commission has indicated a keen interest in keeping people who have abused their trust from being in a position to do so again." Richard Hill, *SEC Enforcement Staff Says O&D Bars, Subpoenas, Insider Case Fines To Be Focus*, SECURITIES LAW DAILY (BNA), Mar. 4, 2003.

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Sections 15(b)(4)(C) and 15(b)(6)(A)(iii) of the Securities Exchange Act of 1934 ("Exchange Act"), the Commission may seek to bar – temporarily or permanently – a securities professional who has been enjoined from future violations of the federal securities laws. As the Commission rightly points out, the Advisers Act and Exchange Act do not treat consent injunctions any differently from "one issued after trial upon a determination of the allegations." *Id*. Accordingly, where the settled injunctive action is predicated on an alleged violation of the antifraud provisions of the federal securities laws, the Commission will now, in a follow-on administrative proceeding, rely on the facts alleged in the settled injunctive action as a basis for seeking an administrative bar.

The Traditional Approach. Generally, to obtain an administrative bar, the Commission must show that the proposed bar is in the public interest and that the defendant has been enjoined from future violations of the federal securities laws. *See generally Peter C. Lybrand,* Admin. Proc. File No. 3-11028, 80 S.E.C. Docket 2955-71 (Sept. 3, 2003); *Ralph W. LeBlanc*, Exchange Act Release No. 48254, 80 S.E.C. Docket 2207-44 (Jul. 30, 2003); *Robert G. Weeks*, Admin. Proc. File No. 3-9952, 76 S.E.C. Docket 2112-67 (Feb. 4, 2002).

Where a federal court has already enjoined a securities professional, the only question left to be determined is whether it is in the public interest to bar such a professional from the securities industry. The Commission recently outlined the factors that must be considered in determining whether a bar is in the public interest.

> Consistent with our traditional approach, in determining sanctions, including whether to impose a broker-dealer or a "penny stock" bar in a remedial proceeding that follows an injunction, we consider a range of relevant factors, including: the seriousness of the violation; the isolated or recurrent nature of the violation; the respondent's state of mind; the sincerity of the respondent's assurances against future violations; the respondent's recognition of the wrongful nature of the misconduct; the respondent's opportunity to commit future violations; the age of the violation; and the degree of harm to investors and the marketplace resulting from the violation.

Nolan Wayne Wade, Admin. Proc. File No. 3-10650, 76 S.E.C. Docket 2159-32 (Jul. 29, 2003); *see also KMPG Peat Marwick LLP*, Admin. Proc. File No. 3-9500, 74 SEC Docket 384 (Jan. 19, 2001); *Joseph J. Barbato*, Admin. Proc. File No. 3-8575, 69 S.E.C. Docket 166-60 (Feb. 10, 1999); *Donald T. Sheldon*, Admin. Proc. File No. 3-6626, 52 S.E.C. Docket 2496-341 (Nov. 18, 1992), aff'd, 45 F.3d 1515 (11th Cir. 1995). These factors are identical to those considered by a court in imposing an injunction or an officer and director bar. *SEC v. Patel*, 61 F.3d 137, 140-41 (2d Cir. 1995); *SEC v. Am. Bd. of Trade, Inc.*, 751 F.2d 529, 537 (2d Cir. 1984); *SEC v. Farrell*, No. 95-CV-6133T, 1996 WL 788367, at *8 (W.D.N.Y. Nov. 6, 1996); *SEC v. Wellshire Sec., Inc.*, 773 F. Supp. 569, 576 (S.D.N.Y. 1991).

In *Marshall E. Melton*, the Commission reviewed the decision of an administrative law judge to bar Melton from the securities industry and revoke the registration of Asset Management & Research, Inc. ("AMR").[2] Citing its decisions in *Kaye, Real & Company*, 36 S.E.C. 373, 375 (1955) and *Samuel O. Forson*, 53 S.E.C. 31, 32 (1997), the Commission ruled that the factual allegations in a settled injunctive action "may be given considerable weight" in determining whether it was in the public interest to bar Melton from the securities industry or revoke the registration of AMR. *Marshall E. Melton*, Admin. Proc. File No. 3-9865. This was so

[2]The administrative law judge relied on a May 4, 1998 consent injunction which permanently enjoined Melton and AMR from any future violations of Section 17(a) of the Securities Act (15 U.S.C. § 77q(a)), Section 10(b) of the Exchange Act and Exchange Act Rule 10b-5 (15 U.S.C. § 78j(b) and 17 C.F.R. § 240.10b-5), and Section 206 of the Advisers Act (15 U.S.C. § 80b-6). *Marshall E. Melton*, Initial Decision Release No. 169 (Jul. 7, 2000). This release is available on the SEC's website at http://www.sec.gov/litigation/aljdec/id169jtk.htm (last visited Sept. 23, 2003).

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notwithstanding the fact that the allegations in the complaint had never been substantiated. The Commission stated that it may also consider additional allegations of wrongdoing not included in the complaint but presented during the administrative proceeding. Applying what it described as its "traditional approach," the Commission determined that, based on the complaint and the additional evidence that was adduced at the hearing, it was appropriate in the public interest to (i) bar Melton from association with any investment adviser, broker, dealer, member of a national securities exchange, and member of a registered securities association, and (ii) to revoke the registration of AMR as an investment adviser.

The New "Refined and Expanded" Approach. More importantly, the Commission took the opportunity to refine and expand, for future cases, its policy for administrative disciplinary proceedings based on consent injunctions – particularly antifraud injunctions. *First*, pursuant to Commission Rule 202.5(e), the Commission will not accept any settlement offer in which the defendant denies committing the alleged violations. 17 C.F.R. § 202.5(e). *Second*, the Commission "will construe the 'neither admit nor deny' language as precluding a person who has consented to an injunction in a Commission enforcement action from denying the factual allegations of the injunctive complaint in a follow-on proceeding before this agency." *Id*. *Third*, in a follow-on administrative proceeding, the Commission will rely "on the factual allegations of the injunctive complaint in determining the appropriate remedial action in the public interest, taking into account what those allegations reflect about the seriousness of the underlying misconduct and the relative culpability of the respondent." *Id*. *Fourth*, the Commission's determination of "whether a remedial disciplinary sanction is in the public interest is based on consideration of the particular circumstances and entire record of the case and on the range of traditional factors." *Id*. *Fifth*, in considering these factors, the Commission "recognize[s] that conduct that violates the antifraud provisions of the federal securities laws is especially serious and subject to the severest of sanctions under the [federal] securities laws." *Id*. *Finally*, where a respondent has been enjoined from violating the antifraud provisions of the federal securities laws, the Commission believes that "ordinarily, and in the absence of evidence to the contrary, it will be in the public interest to revoke the registration of, or suspend or bar from participation in the securities industry, or prohibit from participation in an offering of penny stock, a respondent who is enjoined from violating the antifraud provisions." *Id*.

Future Cases. The Commission noted that "a defendant that settles a Commission injunctive action remains free to seek and receive concessions concerning the violations to be alleged in the complaint, the language and factual allegations in the complaint, and, by settling disciplinary matters at the same time as the injunctive action, the collateral, administrative consequences of the consent decree." *Id.* at fn. 22 (citing *SEC v. Clifton*, 700 F.2d 744, 748 (D.C. Cir. 1983)) (internal quotations omitted). Experienced practitioners before the Enforcement Division often request and are granted, as part of the settlement process, significant input in drafting the language of the complaint and SEC releases announcing the commencement of an enforcement action. *See, e.g.*, *Baker Hughes Inc.*, Exchange Act Release No. 44784 (Sept. 12, 2001); *International Business Machines Corporation*, Exchange Act Release No. 43761 (Dec. 21, 2000); *SEC v. Arthur Tab Williams, Jr.*, Litigation Release No. 16422 (Feb. 2, 2000). Furthermore, as a matter of policy, the Enforcement Division gives credit to those who cooperate with its investigation.[3]

This credit often translates to a reduction in the types of charges that the staff recommends that the Commission institute in an enforcement proceeding. For example, a cooperating target may be able to convince the staff to reduce the charges it plans to recommend from a fraud charge under the antifraud provisions of the

[3]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. 44969 (Oct. 23, 2001). The Report is available on the SEC's website at http://www.sec.gov/litigation/investreport/34-44969.htm.

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federal securities laws to a causing violation under Section 21C of the Exchange Act, 15 U.S.C. § 78u-3.[4] Alternatively, the staff may be willing to consider an aiding and abetting charge under Section 20(e) of the Exchange Act or other non-fraud based violations. 15 U.S.C. § 78t(e). It is unclear whether, under the new approach, a securities professional who has been enjoined from aiding and abetting a violation of the antifraud provisions of the Exchange Act can subsequently be suspended or barred by the Commission in a follow-on administrative proceeding based on the facts underpinning the settled injunctive action.

SEC investigations are often a precursor to shareholders' class action lawsuits. In that regard, regulated entities settling SEC enforcement actions must consider the impact of any such settlements on related investigations and class action suits. Several circuit courts have held that settled enforcement actions may be admissible to demonstrate, among others, scienter.[5] The Commission's new position is likely to encourage the plaintiffs' bar to pursue this argument with renewed vigor.

Conclusion. One of the Commission's reasons for announcing this new approach is to more efficiently allocate limited resources. Ironically, the Commission's new approach is likely to frustrate this very goal, and may bolster the determination of those facing enforcement actions to litigate rather than settle on more onerous terms. *See, e.g.*, *SEC v. Smath*, CV-99-0523 (TCP) (ETB), 2003 WL 21960660 (E.D.N.Y. Aug. 9, 2003) (awarding the Commission $1 in nominal damages, the court held that "it sees no basis to reward the SEC for spending tens of thousands of taxpayer dollars in the pursuit of this action"); *Teicher v. SEC*, 177 F.3d 1016 (D.C. Cir. 1999).

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[4]*Compare American International Group, Inc.*, Exchange Act Release No. 48477 (Sept. 11, 2003) (announcing that it had settled fraud charges against AIG, the Commission stated that "[t]he $10 million penalty against AIG reflects the gravity of its misconduct. It also reflects the fact that, in the course of the Commission's investigation, AIG did not come clean. On the contrary, AIG withheld documents and committed other abuses."); *Dynegy Inc.*, Exchange Act Release No. 46537 (Sept. 25, 2003) (settling fraud charges against Dynegy a Commission staff stated that "[t]he $3 million penalty imposed directly against Dynegy in this case reflects the Commission's dissatisfaction with Dynegy's lack of full cooperation in the *early stages* of the Commission's investigation, as discussed in the Commission's Order.") (emphasis added) and *SEC v. Xerox Corporation*, Exchange Act Release No. 45730 (Apr. 11, 2002) (fining Xerox a then unprecedented $10 million dollars for violating the antifraud provisions of the Exchange Act, the Commission cited Xerox's "lack of full cooperation" as a basis for imposing such a severe penalty) *with IGI, Inc.*, Exchange Act Release No. 45553 (Mar. 12, 2002) (rewarding IGI for cooperating fully with its investigation, the Commission declined to charge IGI with financial fraud relating to its earnings misstatement) and *Rite Aid Corp.*, Exchange Act Release No. 46099 (Jun. 21, 2002) (citing Rite Aid's full cooperation as a basis for declining to charge Rite Aid with financial fraud).

[5]*See generally Ariza v. City of New York*, 139 F.3d 132, 134 (2d Cir. 1998); *Bradford Trust Co. v. Merrill Lynch, Pierce, Fenner & Smith, Inc*., 805 F.2d 49, 54 (2d Cir. 1986); *United States v. Gilbert*, 668 F.2d 94, 97 (2d Cir. 1981*);In re Japanese Elec. Prods. Antitrust Litig*., 723 F.2d 238, 275 (3d Cir. 1983) *rev'd on other grounds sub nom. Matsushita Elec. Indus. Co. v. Zenith Radio Corp*., 471 U.S. 1002 (1985); *United States v. Heyward*, 729 F.2d 297, 299-300 346 (4th Cir. 1984); *Falcon v. General Tel. Co. of Southwest*, 626 F.2d 369, 382-83 (5th Cir. 1980); *Bank of Lexington & Trust Co. v. Vining-Sparks Sec., Inc*., 959 F.2d 606, 616 (6th Cir. 1992); *Johnson v. Yellow Freight System, Inc*., 734 F.2d 1304, 1309 (8th Cir. 1984); *Denny v. Hutchinson Sales Corp*., 649 F.2d 816, 821 (10th Cir. 1981); *Baker v. Firestone Tire & Rubber Co*., 793 F.2d 1196, 1199 (11th Cir. 1986).

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