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Much Ado About Nothing: SEC Announces Principles for Imposing Monetary Penalties On Issuers

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I. Introduction

On Jan. 4, 2006, the Securities and Exchange Commission took the unusual step of issuing a press release announcing the principles that it (and presumably its staff) will consider when determining whether and to what extent monetary penalties should be imposed on issuers in settled enforcement actions. *Statement of the Securities and Exchange Commission Concerning Financial Penalties* (Jan. 4, 2006) (*available at* http://www.sec.gov/news/press/2006-4.htm). The statement was prompted by the vociferous complaints by two Republican commissioners, the business community and the defense bar about the multimillion-dollar penalties that the commission was extracting from issuers settling securities fraud charges.

The commission published its statement against the backdrop of two settled enforcement actions involving allegations of financial fraud. In the first action, McAfee Inc., a Santa Clara, Calif.-based manufacturer and supplier of computer security and antivirus tools, agreed to pay $50 million to settle allegations that, from 1998 through 2000, it inflated its cumulative net revenue by $622 million. *SEC v. McAfee Inc.*, Litigation Release No. 19520 (Jan. 4, 2006).

In the second action, Applix Inc., a Westborough, Mass.-based company that develops, sells and supports business performance management software, engaged in a fraudulent scheme to improperly recognize $898,000 and $341,000 in revenues on two separate transactions that allowed Applix to meet its revenue projections for fiscal year 2001 and understate its net loss by more than 30 percent for the second quarter of 2002. *In the Matter of Applix Inc.*, Exchange Act Release No. 53049 (Jan. 4, 2006). Notwithstanding this conduct, the commission accepted an offer of settlement that did not include the imposition of a monetary penalty on Applix. *Id.*

In his speech announcing the McAfee and Applix settlements and the corporate penalties principles, SEC Chairman Christopher Cox, perhaps mindful that the issue of imposing multimillion-dollar penalties against issuers had divided the commission under his predecessor, emphasized that the commission "unanimously" agreed on the principles outlined in the statement. *See* Christopher Cox, Chairman, SEC, Statement of Chairman Cox Concerning Objective Standards for Corporate Penalties (Jan. 4, 2006) (*available at* http://www.sec.gov/news/speech/spch010406cc.htm). Cox further emphasized that it is the commission's "intention that these principles will establish objective standards that will provide the maximum degree of investor protection." *Id.*

II. The Principles

After tracing the history of the commission's authority to seek monetary penalties against issuers back to 1990 when Congress enacted the Securities Enforcement Remedies and Penny Stock Reform Act and the more recent fair-funds provisions under Section 308 of the Sarbanes-Oxley Act of 2002, the SEC outlined two principle factors and seven others that it will consider when deciding whether to impose monetary penalties on an issuer:

- The presence or absence of a direct benefit to the corporation as a result of the violation;
- The degree to which the penalty will recompense or further harm the injured shareholders;
- 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 commission and other law enforcement agencies.[1]

Statement at 3-5.

III. The Two Principal Factors

The SEC stated that, in deciding whether to impose a monetary penalty on an issuer, it will be guided by two principal factors. *First*, the commission will be guided by "the presence or absence of a direct benefit to the corporation as a result of the violation." *Id.* at 3. *Second*, the commission will look to "the degree to which the penalty will recompense or further harm the injured shareholders." *Id.*

With respect to the first principle factor, the SEC reasoned that the "fact that a corporation has received a direct and material benefit from the offense, for example through reduced expenses or increased revenue, weighs in support of the imposition of a [monetary] penalty." *Id.* Similarly, a monetary penalty would be appropriate if the issuer is in any other way "unjustly enriched." *Id.* At one end of the monetary penalty continuum, issuers whose shareholders have "received an improper benefit as a result of the violation" offer the strongest case for the imposition of a monetary penalty. *Id.* At the other end of the continuum, issuers whose shareholders are the "principal victims of the securities law violation" offer the weakest case for the imposition of a monetary penalty. *Id.*

To illustrate this point, Linda Chatman Thomsen, director of the SEC's Division of Enforcement, juxtaposed the allegations in the McAfee and Applix cases and reasoned that, in McAfee's case, the imposition of a $50 million penalty was justified because, among other things, McAfee (and presumably those investors who were fortunate enough to sell McAfee's stock at the height of the alleged violations) benefited from its fraudulent conduct through the acquisitions made with its inflated stock.[2] Conversely, Applix's shareholders did not similarly benefit from the allegedly violative conduct and the SEC did not find any evidence of other direct benefits to Applix. *Id.*

The second principal factor that the SEC stated that it would consider in determining whether a monetary penalty is appropriate is the "degree to which the penalty will recompense or further harm the injured shareholders." *Statement* at 3. According to the commission, notwithstanding that the "imposition of a penalty on the corporation itself carries with it the risk that shareholders who are innocent of the violation will nonetheless bear the burden of the penalty," in certain cases it is appropriate to seek and obtain a monetary penalty because the penalty may be "used as a source of funds to recompense the injury suffered by victims of the securities law violations." *Id.*

Again, using the McAfee and Applix settlements to illustrate the commission's thinking, Thomsen said the imposition of a monetary penalty against McAfee was appropriate because "today, McAfee is financially strong and the [$50 million] penalty it has agreed to pay is unlikely to cause McAfee shareholders undue hardship." *Statement Regarding McAfee Inc. and Applix Inc.* at 2. On the other hand, the SEC reasoned that it would not have been appropriate to impose a monetary penalty on Applix since it is a "relatively small company and a large penalty would have a disproportionate effect on [Applix's] financial situation with hardship flowing to its shareholders." *Id.*

Additionally, the commission's decision to impose a monetary penalty on an issuer will be influenced by the "presence of an opportunity to use the penalty as a meaningful source of compensation to injured shareholders." *Statement* at 3. However, the "likelihood a corporate penalty will unfairly injure investors, the corporation or third parties weighs against its use as a sanction." *Id.* In other words, "[b]ecause the protection of innocent investors is a principal objective of the securities laws," the SEC will not seek to impose a monetary penalty on an issuer where such a penalty is likely to disproportionately harm innocent investors. *Id.*

By way of illustration, in McAfee's case, the SEC accepted the company's offer to pay $50 million in penalty because the commission expects that the $50 million penalty (less administrative fees and expenses) can be effectively distributed to shareholders injured by McAfee's fraud.

Statement Regarding McAfee Inc. and Applix Inc. at 2. However, a monetary penalty was not sought against Applix because "it would be difficult to impose a penalty that would be large enough to make distribution to victims practical without causing undue harm to the company and its current shareholders." *Id.*

IV. The Other Factors

Leaning heavily on the statutory authority to seek monetary penalties (and the accompanying legislative history), the SEC outlined seven other factors that will influence its decision to impose monetary penalties in settled enforcement actions.

First, the commission will be influenced by the need to "deter the particular type of offense" for which the issuer is being charged. *Statement* at 4. Where a penalty will likely serve as a "strong deterrence to others similarly situated," the commission believes that a monetary penalty should be paid by the issuer. Conversely, where the facts underlying the alleged violation are unique and unlikely to be repeated in other contexts, a monetary penalty is better imposed on the individual rather that the issuer. *Id.*

Second, the extent of the injury to innocent parties will weigh on the commission's decision to seek monetary penalty against an issuer. *Id.* Here, the "egregiousness of the harm done, the number of investors injured, and the extent of societal harm if the corporation's infliction of such injury on innocent parties goes unpunished are significant determinants of the propriety of a [monetary] penalty." *Id.*

Third, where the alleged violative conduct is widespread, the SEC believes it more appropriate to impose a monetary penalty. *Id.* In the case of McAfee, the commission alleged that the allegedly violative conduct was pervasive and occurred over a significant period of time. *Statement Regarding McAfee Inc. and Applix Inc.* at 2. Presumably, where the allegedly violative conduct is pervasive and involves management, the SEC is likely to be more inclined to impose a monetary penalty. It remains to be seen whether widespread violative conduct featuring low-level employees will result in the imposition of a monetary penalty. On the other hand, where the allegedly violative conduct is isolated and involves only a few individuals, a monetary penalty would not be appropriate, particularly where the issuer has replaced those individuals responsible for the violative conduct. For example, in Applix's case, the conduct was limited to a few individuals and only involved two discrete contracts. *Id.*

Fourth, the SEC will weigh the level of intent on the part of the responsible individuals. In this regard, the "imposition of a corporate penalty is most appropriate in egregious circumstances, where the culpability and fraudulent intent of the perpetrators are manifest." *Statement* at 4. However, a monetary penalty on the issuer is "less likely to be imposed if the violation is not the result of deliberate, intentionally fraudulent conduct." *Id.*

Fifth, where the violative conduct is particularly difficult to detect, the SEC believes that a monetary penalty should be imposed. *Id.* For example, violations of the anti-bribery provisions of the Foreign Corrupt Practices Act are generally often difficult to detect. Thus, enforcement actions based on the anti-bribery provisions of the FCPA are more likely to lead to the imposition of monetary penalties.

Sixth, picking up on a theme it first articulated in the Seaboard report, the SEC stated that it will look to the presence or lack of remedial steps by the issuer in deciding whether to impose a monetary penalty.[3] Here, the commission stated that its "decisions in particular cases are intended to encourage the management of corporations accused of securities law violations to do everything within their power to take remedial steps, from the first moment that the violation is brought to their attention." *Id.* Where an issuer promptly takes the remedial steps outlined in the Seaboard report, the commission will likely decline to impose a monetary penalty.[4] Conversely "failure of management to take remedial steps is a factor supporting the imposition of a corporate penalty." *Id.*

Lastly, again drawing on the principles articulated in the Seaboard report, the SEC believes that when "securities law violations are discovered, it is incumbent upon management to report them to the commission and to other appropriate law enforcement authorities." *Id.* When considering whether to impose a monetary penalty, the commission will consider the degree to which a corporation has self-reported an offense or otherwise cooperated with the investigation and remediation of the offense. *Id.*

V. Implications of the Statement

Much like the Seaboard report before it, the SEC's monetary penalty statement should be commended for shedding light on a process that befuddles all but the most sophisticated of securities lawyers. While by no means novel concepts, the nine factors that will guide the commission's monetary penalties decisions are likely to better focus settlement discussions between issuers and the Enforcement Division staff.[5] At best, the statement represents a playbook that issuers and their counsel can use in structuring settlement negotiations with the SEC staff. For example, an issuer's ability to present a coherent analysis of the lack of benefit to the company as a result of the allegedly violative conduct will go a long way in focusing the Enforcement Division staff on the economic realities of the allegedly violative conduct.

Similarly, an analysis of the turnover of investors and the harm that is likely to result to current shareholders who did not benefit from the supposedly violative conduct is also likely to be instructive in settlement discussions. It is perhaps equally helpful to include in these analyses the potential settlement of other related state and federal civil and/or criminal actions and class-action lawsuits that typically result from SEC investigations. It remains to be seen how much weight the SEC staff will give to the nine mostly subjective factors enumerated by the commission in settlement discussions.

Rather disappointingly, what the SEC did not do is address the issue that generated the uproar in the first place: the ever-increasing size of monetary penalties that the commission was extracting from issuers settling allegations of securities law violations. For example, in July 2003 WorldCom Inc. agreed to pay $2.25 billion in penalties to settle allegations of financial fraud.[6] In December 2003 Vivendi Universal S.A. agreed to pay $50 million in penalties to settle allegations of financial fraud charges.[7]

Moreover, between March and December 2003, four financial services firms (Merrill Lynch, J.P. Morgan Chase, Citigroup and CIBC World Markets) agreed to pay a combined total of $197.5 million in civil penalties, ranging from $37.5 million to $65 million, to settle charges relating to the accounting fraud at Enron.[8] In the same period, the SEC settled charges relating to the global research analyst conflict-of-interest matters with Citigroup for a staggering $150 million and $75 million against Credit Suisse First Boston.[9]

In the words of then-SEC Enforcement Director Steven Cutler: "[P]enalties this size were once-a-decade occurrences, if that. Now, they are commonplace. Indeed, all but three of the 12 penalties of $50 million or more obtained in commission settlements since 1986 were obtained in the last 12 months."[10]

In response to these astronomical settlement amounts, Commissioner Paul S. Atkins publicly criticized the settlements and said: "In the name of deterrence, we have seen heavier and heavier fines against corporations in the securities law context. Shareholders are harmed if prosecutors have one eye on the public-relations effect of their actions. Shareholders are also harmed if management is all too willing to offer up the shareholders' money — after all, it is other people's money — in order to try to deflect personal responsibility of particular managers."[11]

Commissioner Cynthia A. Glassman echoed the same sentiments when stating that she disagrees with the appropriateness of imposing corporate penalties, "which, at the end of the day, are paid by the shareholders. If the shareholders have benefited from the fraud, then I would not normally oppose a penalty. But I cannot justify imposing penalties indirectly on shareholders whose investments have already lost value as a result of the fraud."[12]

Furthermore, Glassman was unconvinced by the "fair funds" argument because fair funds as a vehicle to return monetary penalties to defrauded investors (previously, penalty amounts went to the Treasury) "lead[] 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."[13]

Nothing in the SEC's statement addressed the size of the monetary penalties that the commission will seek in future cases. Perhaps the $50 million monetary penalty that McAfee agreed to pay is a tacit indication that change is not afoot. If that is the case, the SEC will do well to heed Atkins' fear that "if we are not careful, [] we might view ourselves as an extension of the plaintiffs' bar, with similar philosophies and tactics."[14]

Notes

1 For a detailed analysis of the Remedies Act, see Richard A. Spehr and Michelle J. Annuziata, *The Remedies Act Turns Fifteen: What Is Its Relevance Today?*, 1 NYU J. L. & Bus. 587 (2005). *See also* Claudius O. Sokenu, *Avoiding Civil Monetary Penalties in SEC Enforcement Actions*, 166 N.J.L.J. 1097 (Dec. 24, 2001).

2 *See* Linda Chatman Thomsen, *Statement Regarding McAfee Inc. and Applix Inc*. (Jan. 4, 2006) (*available at* http://www.sec.gov/news/speech/spch010406lct.htm).

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). *See also* Richard A. Spehr and Claudius O. Sokenu, *SEC Self-Policing Policy Presents Benefits and Pitfalls*, 7 Sec. Lit. & Reg. Rep. 17 (Feb. 27, 2002). The Seaboard report identified four broad factors that the SEC will consider when assessing the extent to which a company's self-policing and cooperation efforts, upon discovering that it may have violated the federal securities laws, will influence the commission's decision whether to bring an enforcement action against an issuer. Those factors are: (1) self-policing prior to the discovery of the misconduct, including establishing effective compliance procedures and an appropriate tone at the top; (2) self-reporting of misconduct when it is discovered, including conducting a thorough review of the nature, extent, origins and consequences of the misconduct, and promptly, completely and effectively disclosing the misconduct to the public, to regulators and to self-regulators; (3) remediation, including dismissing or appropriately disciplining wrongdoers, modifying and improving internal controls and procedures to prevent recurrence of the misconduct, and appropriately compensating those adversely affected; and (4) cooperation with law enforce-

ment authorities, including providing the SEC staff with all information relevant to the underlying violations and the company's remedial efforts. After outlining Seaboard's cooperative efforts, the Seaboard report listed 13 questions that the SEC believes will help its staff in determining whether to recommend enforcement action against a company under investigation for possible violations of the securities laws. Broadly, the commission flagged the following criteria as important: nature of the misconduct involved; how the misconduct arose; where in the organization the misconduct occurred; duration of the misconduct; how much harm the misconduct has inflicted upon investors and other corporate constituencies, and if the share price of the company's stock dropped significantly upon its discovery and disclosure; how the misconduct was detected and who uncovered it; how long after discovery of the misconduct it took to implement an effective response; what steps the company took upon learning of the misconduct; what processes the company followed to resolve many of these issues and ferret out necessary information; whether the company committed to learn the truth, fully and expeditiously; whether the company promptly made available to SEC staff the results of its review and provide sufficient documentation reflecting its response to the situation; what assurances there are that the conduct is unlikely to recur; and whether the company is the same company in which the misconduct occurred, or whether it has changed through a merger or bankruptcy reorganization.

[4] *See, e.g.*, *In the Matter of Rite Aid Corp.*, Exchange Act Release No. 46099 (June 21, 2002) (In *Rite Aid*, a financial fraud case involving two years of overstated income, and, at the time, the largest restatement of income by a public company, the SEC administrative order noted: "Rite-Aid cooperated in the commission's investigation of this matter, including declining to assert its attorney-client privilege with regard to various matters relevant to the investigation and voluntarily providing the commission staff with full access to an internal investigation conducted by Rite Aid's counsel," and "the commission has considered the value of this cooperation in determining the appropriate resolution of this matter.").

[5] *See* Stephen M. Cutler, Remarks at the 24th Annual Ray Garrett Jr. Corporate & Securities Law Institute(Apr. 29, 2004) (*available at* http://www.sec.gov/news/speech/spch042904smc.htm). *See also* Sokenu, *supra* note 1.

[6] *SEC v. WorldCom Inc.*, Litigation Release No. 18219 (July 7, 2003) (The WorldCom settlement was to be satisfied, post-bankruptcy, by the company's payment of $500 million in cash and common stock in the reorganized company valued at $250 million.).

[7] *SEC v. Vivendi Universal S.A.*, Litigation Release No. 18523 (Dec. 24, 2003).

[8] *SEC v. Merrill Lynch & Co. Inc.*, Litigation Release No. 18038 (Mar. 17, 2003); *SEC v. J.P. Morgan Chase & Co.*, Litigation Release No. 18252 (July 28, 2003); *In the Matter of Citigroup Inc.*, Exchange Act Release No. 48230 (July 28, 2003); *SEC v. CIBC World Mkts.*, Litigation Release No. 18517 (Dec. 22, 2003).

[9] *SEC v. Citigroup Global Mkts. Inc*., Litigation Release No. 18111 (Apr. 28, 2003); *SEC v. Credit Suisse First Boston LLC*, Litigation Release No. 18110 (Apr. 28, 2003).

[10] *Supra* note 5.

[11] *See* Commissioner Paul S. Atkins, Remarks before the Atlanta Chapter of the National Association of Corporate Directors (Feb. 23, 2005) (*available at* http://www.sec.gov/news/speech/spch022305psa.htm).

[12] *See* Commissioner Cynthia A. Glassman, SEC in Transition: What We've Done and What's Ahead (June 15, 2005) (*available at* http://www.sec.gov/news/speech/spch061505cag.htm).

[13] *Id*.

[14] *Supra* note 11.

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