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One of the important functions of the U.S. Securities and Exchange Commission ("the SEC") is enforcing the securities laws and punishing violators. Collecting damages for defrauded investors was not, historically, an important part of the agency's mission; rather, that was the function of private securities fraud class actions. Section 308 (the "Fair Fund provision") of the Sarbanes-Oxley Act of 2002 gives the SEC a more prominent role in compensating investors and allows the agency, in some circumstances, to distribute civil penalties to defrauded investors. The SEC has established Fair Funds in a number of high-profile cases and has taken pride in the large amounts of money it has obtained for investors. Meanwhile, section 308 has become an instrument in the business community's campaign against private securities fraud class actions.

This Article reviews the background of the SEC's disgorgement and penalty powers, the history and language of section 308, and SEC enforcement actions against corporations in financial fraud cases and then looks at the business community's reaction to section 308 and recent SEC enforcement actions. The Article concludes that the SEC's increased emphasis on section 308 could lead to a weakening of its effectiveness as an enforcement agency and further erode support for private securities litigation—an unfortunate outcome for investors.

INTRODUCTION

One of the important functions of the U.S. Securities and Exchange Commission ("SEC" or "Commission") is protecting investors[1] from fraud through

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1. The SEC describes its mission as threefold: "[t]o protect investors; maintain fair, orderly, and efficient markets; and facilitate capital formation." *See* U.S. Securities and Exchange Commission, About the SEC, What We Do, http://www.sec.gov/about/whatwedo.shtml (last visited Jan. 22, 2008); U.S. SEC. & EXCH. COMM'N, 2004–2009 STRATEGIC PLAN 4 (2004) [hereinafter "STRATEGIC PLAN"], *available at* http://www.sec.gov/about/secstratplan0409.pdf. The Strategic Plan also sets forth four agency-wide goals: to enforce compliance with federal securities laws, to sustain an effective and flexible regulatory environment, to encourage and promote informed investment decision making, and to maximize the use of SEC resources. *Id.* at 3.

The SEC's identification of its mission is consistent with that of international securities regulators. *See* INT'L ORG. OF SEC. COMM'NS (IOSCO), OBJECTIVES AND PRINCIPLES OF SECURITIES REGULATION (1998), http://www.riskinstitute.ch/144440.htm (identifying objectives as protecting investors, ensuring that markets are fair, efficient, and transparent, and reducing systemic risk) [hereinafter "IOSCO, OBJECTIVES & PRINCIPLES"].

enforcement of the securities laws and punishment of violators.[2] Historically, the SEC has not considered collecting damages for injured investors as an important part of its mission.[3] Recovering money for investors' losses, instead, has been the function of private securities fraud class actions.[4]

Section 308 (the "Fair Fund provision") of the Sarbanes-Oxley Act of 2002 ("SOX"),[5] however, gives the SEC a more prominent role in compensating defrauded investors. The statute allows the agency, in some circumstances, to distribute civil penalties for federal securities law violations, ordinarily paid into the U.S. Treasury, to investors who have been harmed by those violations.[6] The SEC embraced section 308 enthusiastically, stating that it "intends to use [section 308] whenever reasonably possible, *consistent with its mission to protect investors.*"[7] It has established Fair Funds in a number of high-profile cases involving financial fraud by corporate defendants,[8] and it has taken pride in the large amounts of money it

2. The SEC protects investors in many ways in addition to enforcement. For example, the SEC regulates to improve the quality of markets, market participants, and corporate governance and to improve the quality of information available to investors. *See* STRATEGIC PLAN, *supra* note 1, at 3.

3. John D. Ellsworth, *Disgorgement in Securities Fraud Actions Brought by the SEC,* 1977 DUKE L.J. 641, 644 n.15 ("The Commission attempts to avoid being a collection agency for injured investors...." (quoting SEC Commissioner Richard B. Smith in 1968)). In the 1960s, Professor Louis Loss criticized the SEC for not seeking restitution as a remedy on behalf of small investors. *See id.* at 644. After the enactment of the Sarbanes-Oxley Act of 2002 ("SOX"), the SEC continued to emphasize the subsidiary role of compensating investors. *See* U.S. SEC. & EXCH. COMM'N, REPORT PURSUANT TO SECTION 308(c) OF THE SARBANES OXLEY ACT OF 2002 19–20 (2003) [hereinafter "SECTION 308(c) REPORT"], *available at* http://www.sec.gov/news/studies/sox308creport.pdf. Shortly after SOX was enacted, however, SEC Chairman Harvey L. Pitt described the agency's "principal goal of taking care of innocent investors and trying to make them whole when they have been defrauded." *See* Harvey L. Pitt, Chairman, U.S. Sec. & Exch. Comm'n, Remarks Before the U.S. Department of Justice Corporate Fraud Conference (Sept. 26, 2002), www.sec.gov/news/speech/spch585.htm.

4. On the relationship between private and public securities law actions, see IOSCO, OBJECTIVES & PRINCIPLES, *supra* note 1 (standard 8.3) (stating that "[a]s a general matter, [a securities regulator's] enforcement powers should not compromise private rights of action. Private persons should be able to seek their own remedies."). Professor John Coffee, however, argues that private securities fraud class actions do a poor job of compensating investors and their principal function should be deterrence. *See generally* John C. Coffee, Jr., *Reforming the Securities Class Action: An Essay on Deterrence and Its Implementation,* 106 COLUM. L. REV. 1534 (2006).

5. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 308, 116 Stat. 745, 784 (codified at 15 U.S.C. § 7246 (Supp. V 2005)) [hereinafter "section 308"].

6. *Id.*

7. SECTION 308(c) REPORT, *supra* note 3, at 22 (emphasis added). The SEC, in its *2003 Annual Report,* notes the SEC's efforts to increase sanctions and, whenever practical, return the recovered funds to investors. *See* U.S. SEC. & EXCH. COMM'N, 2003 ANNUAL REPORT 24 (2003) [hereinafter "2003 REPORT"], *available at* http://www.sec.gov/about/annrep03.shtml. The SEC has reiterated this intention in subsequent annual reports. *See* U.S. SEC. & EXCH. COMM'N, 2005 PERFORMANCE AND ACCOUNTABILITY REPORT 5 (2005) [hereinafter "2005 PAR"], *available at* http://www.sec.gov/about/secpar2005.shtml; U.S. SEC. & EXCH. COMM'N, 2006 PERFORMANCE AND ACCOUNTABILITY REPORT 6 (2006) [hereinafter "2006 PAR"], *available at* http://www.sec.gov/about/secpar2006.shtml.

8. *See infra* Part II.B.3. The SEC has also used section 308 to create Fair Funds in enforcement actions involving market timing and other abuses in mutual funds. *See, e.g., In re* Evergreen Inv. Mgmt. Co., Exchange Act Release No. 56462, at 14–15 (Sept. 19, 2007) ($28.5 million in disgorgement and $4 million in penalties), *available at* http://www.sec.gov/litigation/admin/2007/34-56462.pdf. This Article does not discuss these actions, as these cases, similar to insider trading cases, generally involve identifiable gains to the wrongdoers and do not present the same issues as the financial fraud cases.

has obtained for distribution to investors.[9] Meanwhile, section 308 has become an instrument in the business community's campaign against private securities fraud class actions. Business community leaders argue that the SEC's power to collect funds for injured investors makes private litigation unnecessary.[10] The U.S. Supreme Court, in *Stoneridge Partners, LLC v. Scientific-Atlanta, Inc.*, referred to SEC collections under the Fair Fund provision as a policy ground for not expanding outside actors' Rule 10b-5 liability to private parties.[11]

Providing compensation to defrauded investors is a laudable goal that makes quarreling with section 308 difficult, and indeed academic commentators have viewed it favorably.[12] If, however, compensating investors is an appropriate charge for an enforcement agency like the SEC,[13] it bears asking why Congress never seriously considered augmenting the agency's mission in this way prior to SOX despite numerous amendments to the securities laws to enhance the agency's enforcement powers and expand its remedies.[14] We do not know whether congressional enactment of section 308 was merely political happenstance or part of a new vision for SEC enforcement.

If section 308 is indeed part of a new vision for SEC enforcement, Congress chose to give the agency a function that recognized international principles of securities regulation do not identify as a responsibility of securities regulators.[15] Accordingly, it is appropriate to consider whether expanding the SEC's role to include recovering losses for defrauded investors is compatible with the agency's longstanding emphasis on enforcing securities laws, sanctioning securities law

9. For example, SEC Chairman Christopher Cox stated: "[i]n 2006, we continued to order record monies to be returned to harmed investors... $50 million in McAfee; $50 million in Tyco; $55 million in Hartford; $153 million in Security Brokerage; $250 million in Bear Stearns; $270 million in Prudential; $350 million in Fannie Mae; and $800 million in AIG.... [D]uring my 80-week tenure with the Commission, we have distributed over a billion dollars to injured investors." Christopher Cox, Chairman, U.S. Sec. & Exch. Comm'n, Opening Remarks to the Practicing Law Institute's SEC Speaks Series (Feb. 9, 2007), http://www.sec.gov/news/speech/spch020907cc.htm.

10. *See infra* notes 156–58 and accompanying text.

11. 128 S. Ct. 761, 773 (2008).

12. *See, e.g.*, James D. Cox & Randall S. Thomas, *SEC Enforcement Heuristics: An Empirical Inquiry*, 53 DUKE L.J. 737, 742 (2003). Professor Cunningham views the goal more skeptically. *See* Lawrence A. Cunningham, *The Sarbanes-Oxley Yawn: Heavy Rhetoric, Light Reform (and It Just Might Work)*, 35 CONN. L. REV. 915, 971 n.263 (2003).

13. While other federal agencies have the power to collect damages for private parties who have been injured by the regulated party's misconduct, I have found no other statute that authorizes payment of civil penalties collected by an agency to victims. The Commodities Futures Trading Commission (the "CFTC"), for example, has statutory authority to require commodities brokers to make "restitution to customers of damages proximately caused by [statutory] violations" and to impose sanctions, including civil penalties. *See* 7 U.S.C. § 9 (2000); Press Release, Commodities Futures Trading Comm'n, CFTC Administrative Law Judge Orders Civil Monetary Penalty of $1.77 Million, Revocation of Registration, Permanent Trading Ban, and Cease and Desist Order Against Michael F. Staryk of Florida (June 11, 1996), http://www.cftc.gov/opa/enf96/opastaryk-a.htm. The penalties are paid to the United States. 17 C.F.R. § 143.1 (2007).

14. *See, e.g., infra* notes 18, 23–25 and accompanying text.

15. Instead, the IOSCO recognizes in its standards that investors should have access to "a neutral mechanism" (courts or an alternative dispute resolution forum) to seek compensation for their injuries. *See* IOSCO, OBJECTIVES & PRINCIPLES, *supra* note 1 (standard 4.2.1).

violators, and deterring future frauds.[16] Otherwise, there is a danger that section 308 will ultimately lead to a weakening of the effectiveness of the SEC as an enforcement agency as well as further erosion of support for private securities fraud class actions.

Part I of this Article reviews the history of the SEC's disgorgement and penalty powers. Part II examines the background and statutory language of section 308, SEC enforcement actions utilizing the Fair Fund provision, and the advantages the statute gives the SEC over private litigants. Part III examines the business community's support for section 308 at the same time that business has pressured the SEC to reduce the size of corporate penalties. Part IV examines the SEC's mission and other policy implications from the increased attention given to its role in compensating investors. This Article concludes that the outcome that the business community is advocating—that the primary mechanism for compensating investors is section 308—would be an unfortunate one for investors.

I. A Brief History of the SEC's Disgorgement and Penalty Powers

A. Disgorgement

For much of the SEC's existence its statutory remedies were very limited, and the agency relied on the courts' equitable powers to fashion "ancillary relief" to bolster its enforcement powers.[17] Before the Securities Enforcement Remedies and Penny Stock Reform Act of 1990 ("1990 Act"),[18] the SEC had no express authority to collect and distribute funds to defrauded investors in either judicial or administrative proceedings. *SEC v. Texas Gulf Sulphur Co.*[19] was the first case in which an appellate court recognized the disgorgement remedy and required corporate insiders who traded on material nonpublic information to disgorge their illegal trading profits. The insider trading cases were compelling opportunities for the SEC to seek the disgorgement remedy because they involved identifiable gains from illegal conduct and requiring disgorgement was a logical deterrent to future violations. The court in *SEC v. First City Financial Corp., Ltd.*[20] confirmed that

16. *See, e.g.*, SEC v. Gemstar-TV Guide Int'l, Inc., 401 F.3d 1031, 1037, 1047 (9th Cir.) (noting the deterrent effect of SEC enforcement actions), *cert. denied sub nom.* Yuen v. SEC, 546 U.S. 933 (2005).

17. For earlier literature discussing the SEC's enforcement remedies, see generally George W. Dent, Jr., *Ancillary Relief in Federal Securities Law: A Study in Federal Remedies*, 67 Minn. L. Rev. 865 (1983); Arnold S. Jacobs, *Judicial and Administrative Remedies Available to the SEC for Breaches of Rule 10b-5*, 53 St. John's L. Rev. 397 (1979); Ellsworth, *supra* note 3; James R. Farrand, *Ancillary Remedies in SEC Civil Enforcement Suits*, 89 Harv. L. Rev. 1779 (1976); Arthur F. Matthews, *Recent Trends in SEC Requested Ancillary Relief in SEC Level Injunction Actions*, 31 Bus. Law. 1323 (1976); James C. Treadway, Jr., *SEC Enforcement Techniques: Expanding and Exotic Forms of Ancillary Relief*, 32 Wash. & Lee L. Rev. 637 (1975).

18. Pub. L. No. 101-429, 104 Stat. 931 (codified as amended in scattered sections of 15 U.S.C.) [hereinafter "1990 Act"].

19. 446 F.2d 1301, 1307–08 (2d Cir.), *cert. denied*, 404 U.S. 1005 (1971).

20. 890 F.2d 1215, 1229–32 (D.C. Cir. 1989). The court found that the defendant had profited from its section 13(d) violation because it was able to buy another corporation's stock at prices lower than they would have been had its position in the corporation been disclosed. *Id.* at 1231.

the disgorgement remedy was not limited to insider trading violations when it required a corporate defendant to disgorge its profits that resulted from a Williams Act violation. Significantly, the SEC viewed disgorgement as an enforcement tool and not as a means to compensate investors.[21] Because the agency's focus was to take the money from the defendants, it was less concerned with what happened to the funds.[22]

The 1990 Act gave the SEC express authority to order disgorgement as a remedy in administrative proceedings;[23] the Act's legislative history makes clear that Congress assumed that disgorgement was already available as a remedy in judicial proceedings.[24] The 1990 Act also authorized the SEC to adopt rules to implement the disgorgement provision, including procedures for distributing the funds to investors.[25]

In the pre-SOX era, the SEC sought disgorgement in judicial actions against corporate issuers and insiders disseminating materially misleading information into the marketplace in two categories of cases. In the first category, a corporation that was not selling its securities released materially misleading (usually optimistic) misstatements into the marketplace through press releases or Securities Exchange Act of 1934 ("Exchange Act") reports that affected the price at which secondary traders (usually buyers) traded in the securities and resulted in their injury, usually because they overpaid for the securities.[26] In these situations, the SEC sought disgorgement from corporate insiders who profited from trading in the corporation's securities during the period in which prices were affected by the misinformation.[27] The SEC also occasionally required disgorgement of insiders' performance-based compensation when the compensation was inflated as a result

21. *See* SEC v. Cavanagh, 445 F.3d 105, 117 (2d Cir. 2006) (stating that the purpose of the disgorgement remedy is to take profits away from violators, not primarily to compensate investors).

22. *See* Rory C. Flynn, *SEC Distribution Plans in Insider Trading Cases*, 48 Bus. Law. 107, 110 (1992). The U.S. Government Accountability Office (formerly the U.S. General Accounting Office) (the "GAO") found in 1994 that the SEC did not maintain aggregate information on the amount of disgorged funds collected from defendants and distributed to investors or to the U.S. Treasury. *See* U.S. Gov't Accountability Office, Report to the Chairman, Subcommittee on Oversight and Investigations, Committee on Energy and Commerce, House of Representatives, Securities Enforcement: Improvements Needed in SEC Controls over Disgorgement Cases 3 (Aug. 1994), *available at* http://archive.gao.gov/t2pbat2/152354.pdf.

23. 1990 Act, *supra* note 18, §§ 202(a), 203, 104 Stat. at 937–40 (codified at 15 U.S.C. §§ 78u-2(e), 78u-3(e) (2000)).

24. *See* S. Rep. No. 101-337, at 8 (1990) [hereinafter "Senate Report"].

25. 1990 Act, *supra* note 18, §§ 202(a), 203, 104 Stat. at 937–40 (codified at 15 U.S.C. §§ 78u-2(e), 78u-3(e) (2000)).

26. In *Basic Inc. v. Levinson*, 485 U.S. 224, 241–49 (1988), the U.S. Supreme Court adopted the "fraud-on-the-market" theory and established that secondary traders could sue an issuer without any showing of reliance and thus no semblance of privity with the issuer. While *Dura Pharmaceuticals, Inc. v. Broudo*, 544 U.S. 336, 342–46 (2005), and its requirement of loss causation established that simply overpaying for securities did not establish a Rule 10b-5 claim, the opinion does not detract from the central point that the focus is on the injury to secondary traders and there is no requirement of gain to the corporation.

27. For recent examples, see *SEC v. Maxxon, Inc.*, 465 F.3d 1174, 1177 (10th Cir. 2006) (holding that company founder and chief executive officer had to disgorge profits from sale of stock made after fraudulent press release), *cert. denied*, 127 S. Ct. 2116 (2007); *SEC v. Johnson*, 174 F. App'x 111, 113 (3d Cir. 2006) (finding that corporate insider had to disgorge profits from trading after he fraudulently caused his company to file two false registration statements with the SEC).

of the misinformation.[28] The SEC, however, did not seek disgorgement from entity defendants in these cases because while the entity may have benefited in many ways from its increased market capitalization, it is hard to identify any "profits" or "ill-gotten gains" in the absence of the entity's sale of its securities. The SEC does not appear ever to have argued that the definition of "profits" includes the increase in the entity's value resulting from increased market capitalization or improper accounting practices. Indeed, requiring a corporation to disgorge amounts other than assets received by the corporation would raise serious questions about inflicting undue harm on the corporation or, more pertinently, its innocent shareholders who did not benefit from the fraud.

The second category of cases where the SEC sought disgorgement were instances in which the entity made materially misleading statements in connection with selling its securities. In those situations, the entity directly benefited from the fraud, and the disgorgement remedy was viewed as comparable to the remedies of rescission and restitution because of at least a semblance of privity between the corporation and the investor.[29] The most egregious of these frauds involved Ponzi schemes where the SEC routinely sought to shut down the enterprise and appoint a receiver in an attempt to recover any available funds for the defrauded investors.[30] In those situations, disgorgement was appropriate because the entire enterprise was fraudulent and there was an identity of interest between the enterprise and the principals; accordingly, the SEC did not need to concern itself with preserving a legitimate business to protect the interests of innocent shareholders. In other instances, the SEC sought disgorgement from an entity-issuer when it sold securities in violation of the conditions of the offering.[31] Even in situations in which the entity sold securities whose value had been inflated by the corporation's misleading disclosures, however, the SEC frequently sought disgorgement only from those insiders who had profited from the fraud.[32]

These cases illustrate that prior to the adoption of section 308, the SEC used the disgorgement remedy: (1) only where there were identifiable profits resulting from the fraud; and (2) primarily as an enforcement tool.[33]

28. *See, e.g.*, SEC v. Gemstar-TV Guide Int'l, Inc., 401 F.3d 1031, 1037, 1047 (9th Cir.) (requiring corporate insiders to disgorge bonuses), *cert. denied sub nom.* Yuen v. SEC, 546 U.S. 933 (2005).

29. *See, e.g.*, SEC v. First Pac. Bancorp, 142 F.3d 1186, 1192–93 (9th Cir. 1998) (holding that where disgorgement resulted from violations of "mini-max" offering conditions, there was no need to distinguish between disgorgement and restitution), *cert. denied sub nom.* Sands v. SEC, 525 U.S. 1121 (1999).

30. *See, e.g.*, SEC v. JT Wallenbrock & Assocs., 440 F.3d 1109, 1112 (9th Cir. 2006) (appointing receiver and disgorging gains from Ponzi scheme); SEC v. Rose Fund LLC, 156 F. App'x 3, 4 (9th Cir. 2005) (finding that no jury trial was required on whether defendant had to disgorge profits).

31. *See, e.g.*, *First Pac. Bancorp*, 142 F.3d at 1190; SEC v. Manor Nursing Ctrs., Inc., 458 F.2d 1082, 1104 (2d Cir. 1972) (affirming district court's order requiring disgorgement of proceeds of offering).

32. *See, e.g.*, SEC v. United Energy Partners, Inc., 88 F. App'x 744, 745 (5th Cir.), *cert. denied sub nom.* Quinn v. SEC, 543 U.S. 1034 (2004); SEC v. Carrillo, 325 F.3d 1268, 1270 (11th Cir. 2003); SEC v. Alliance Leasing Corp., 28 F. App'x 648, 651 (9th Cir. 2002).

33. In contrast, the purpose of the CFTC's restitution remedy is to compensate the injured customers of the commodities broker, and the total amount of the compensation is limited by requirements of privity and reliance. *See supra* note 13.

B. Civil Penalties

Although in 1979 Professor Colin Diver, an eminent administrative law scholar, stated that it was "almost inconceivable that Congress would authorize a major administrative regulatory program without empowering the enforcing agency to impose civil monetary penalties as a sanction,"[34] the SEC's broad authority to seek civil penalties is of more recent origin.[35] As with disgorgement, insider trading was the impetus; Congress first gave the SEC statutory authority to impose civil penalties for insider trading violations in 1984.[36] Congress did so again in 1988.[37] Not until the 1990 Act did Congress, citing "the disturbing levels of financial fraud, stock manipulation and other illegal activity in the U.S. markets,"[38] grant the SEC broad power, both in court and in administrative proceedings, to seek penalties for any violation of the federal securities statutes.[39] Congress expected that civil penalties would "deter unlawful conduct by increasing the financial consequences of securities law violations."[40] In particular, it noted that penalties would help deter conduct that otherwise would produce financial returns to the violator,[41] provide financial disincentives for violations in cases in which the violator was unwilling to incur compliance costs,[42] and create additional deterrence for recidivist violators.[43] Congress also anticipated that to satisfy its objective of deterrence, civil penalties might not be necessary in instances where criminal penalties had been imposed.[44]

The congressional goals thus conformed with the general purpose of penalties: to "discourage conduct that the government wishes to discourage and encourage conduct that it wishes to encourage."[45] Professor Diver also thought that penalties

34. Colin S. Diver, *The Assessment and Mitigation of Civil Money Penalties by Federal Administrative Agencies*, 79 Colum. L. Rev. 1435, 1436 (1979).

35. In contrast, the U.S. Department of Justice ("DOJ") has had the power to seek criminal penalties for securities violations since 1934; the maximum amount for a criminal corporate penalty is currently $25 million. *See* 15 U.S.C. § 78ff (Supp. V 2005). As discussed at *infra* notes 97–137 and accompanying text, recent civil corporate penalties have substantially exceeded that amount.

36. Insider Trading Sanctions Act of 1984, Pub. L. No. 98-376, § 2, 98 Stat. 1264, 1264–65 (codified as amended at 15 U.S.C. § 78u (2000 & Supp. V 2005)).

37. Insider Trading and Securities Fraud Enforcement Act of 1988, Pub. L. No. 100-704, § 2, 102 Stat. 4677, 4677 (codified as amended at 15 U.S.C. § 78u-1 (2000 & Supp. V 2005)).

38. Senate Report, *supra* note 24, at 1. For background on the 1990 Act, see generally James Treadway, *Looking for the Perfect Enforcement Remedy: Old Wine in New Bottles or: Have I Seen This Movie Before?*, 48 Wash. & Lee L. Rev. 859 (1991).

39. 1990 Act, *supra* note 18, § 202(a), 104 Stat. at 937–38 (codified as amended at 15 U.S.C.A. § 78u-2 (West 1998 & Supp. 2007)).

40. Senate Report, *supra* note 24, at 1.

41. *Id.* at 10.

42. *Id.*

43. *Id.* at 11. For an assessment of whether the SEC followed these guidelines in the early years after enactment of the 1990 Act, see Arthur B. Laby & W. Hardy Callcott, *Patterns of SEC Enforcement Under the 1990 Remedies Act: Civil Money Penalties*, 58 Alb. L. Rev. 5, 46, 48 (1994) (concluding that the SEC has not followed many of the congressional factors and also noting that the availability of penalties has dramatically changed the SEC's approach to enforcement).

44. *See* H. Rep. No. 101-616 (1990), at 18–19, *as reprinted in* 1990 U.S.C.C.A.N. 1379, 1384, 1385–86.

45. Diver, *supra* note 34, at 1456.

could be used to serve a "general" compensatory function, which he defined as "compensating 'society' at large for harm that it has suffered at the hands of a violator."[46] According to Professor Diver, however, "[b]y definition, a civil monetary penalty does not serve a 'specific' compensatory function of making whole an identifiable individual specifically injured by the offending conduct."[47]

The 1990 Act gives the SEC the authority to seek penalties against all defendants in federal district court[48] for any securities violation and, in turn, gives the court broad discretion to determine whether to impose a penalty and in what amount.[49] The statute classifies penalties and establishes dollar limits on the amounts of penalties in accordance with the severity of the offense.[50] Despite the monetary caps, the amount of the penalty may equal the "gross amount of pecuniary gain" to the defendant as a result of the violation.[51] According to the legislative history of the 1990 Act, this phrase means "the amount by which the defendant was unjustly enriched,"[52] an apparent reference to disgorgement.

The 1990 Act's legislative history reflects a recognition that the costs of corporate penalties are ultimately borne by the corporation's shareholders. Corporate penalties, therefore, are appropriate "when the violation result[ed] in an improper benefit to shareholders."[53] In situations where the shareholders are "the principal

46. *Id.* Alternatively, the payment of a penalty can be seen as compensating the government for the costs it incurs in enforcing the law. *Id.*

47. *Id.*

48. 1990 Act, *supra* note 18, § 201(2), 104 Stat. at 936 (codified as amended at 15 U.S.C. § 78u(d)(3) (2000 & Supp. V 2005)). In addition, the SEC has the power to seek penalties in administrative proceedings against regulated entities and securities industry professionals, *see* 15 U.S.C.A. § 78u-2(a) (West 1998 & Supp. 2007), except that, in some circumstances, it can seek a penalty in a cease and desist proceeding against anyone who was a cause of a violation of 15 U.S.C. section 78j-1 (Supp. V 2005) (audit requirements). There must be a finding that the penalty is in the public interest, taking into account a number of factors. *See* 15 U.S.C. § 78u-2(c) (2000).

49. 1990 Act, *supra* note 18, § 201(2), 104 Stat. at 936 (codified as amended at 15 U.S.C. § 78u(d)(3)(B)(i) (2000 & Supp. V 2005)).

50. 1990 Act, *supra* note 18, § 201(2), 104 Stat. at 936 (codified as amended at 15 U.S.C. § 78u(d)(3)(B) (2000 & Supp. V 2005)). Penalties for violations other than insider trading are classified as Tier I, Tier II, and Tier III depending on the severity of the offense (with Tier III providing for the largest penalties):

- *Tier I:* $5,000 for a natural person or $50,000 for any other person or the gross amount of pecuniary gain to such defendant as a result of the violation (whichever is greater).
- *Tier II:* $50,000 for a natural person or $250,000 for any other person or the gross amount of pecuniary gain to the defendant as a result of the violation (whichever is greater) if the violation involved "fraud, deceit, manipulation, or deliberate or reckless disregard of a regulatory requirement."
- *Tier III:* $100,000 for a natural person or $500,000 for any other person or the gross amount of pecuniary gain to the defendant as a result of the violation (whichever is greater) if the violation "involved fraud, deceit, manipulation, or deliberate or reckless disregard of a regulatory requirement" *and* it resulted in "substantial losses or created a significant risk of substantial losses to other persons."

Id. (The amounts are adjusted for inflation.)

51. *See id.*

52. SENATE REPORT, *supra* note 24, at 13. Professor Diver questioned penalty statutes that tied the amount of the penalty to the severity of the harm "since the harms involved are 'specific' harms that can be, and presumably are, compensated directly." Diver, *supra* note 34, at 1468.

53. SENATE REPORT, *supra* note 24, at 17.

victims of the violation,"[54] however, penalties against individual wrongdoers[55] are more appropriate. So, for example, the SEC should not impose a penalty on an entity that perpetrated a Ponzi scheme; instead, it should return any recovered funds to the defrauded investors and impose penalties on the individuals responsible for the fraud. Furthermore, in deciding against whom to assess penalties, it is proper for the SEC to take into account whether the penalties "will ultimately be paid by shareholders who were themselves victimized by the violations" and "the extent to which the passage of time has resulted in shareholder turnover."[56]

The appellate courts that have reviewed either lower court or SEC-imposed penalties do not provide much guidance as to the scope, target, and amount of civil penalties except to confirm the discretionary nature of the remedy.[57] The statutory limitations on the amount of the penalty are applicable "for each violation"; there is, however, a considerable degree of interpretation about what constitutes a "violation," particularly in the typical financial fraud situation where many defendants have made numerous misstatements that allegedly violate a number of different statutory provisions.[58] Rather than addressing these issues of statutory interpretation, courts frequently focus on the defendant's gain in assessing a penalty,[59] which presents the same difficulty of calculating gain as do the disgorgement cases[60] when the corporation is not selling its securities.

II. Section 308's Fair Fund Provision (Disgorgement Plus Penalty)

A. The Statute

In enacting SOX in 2002, Congress explicitly authorized the SEC to collect funds to compensate investors for their losses.[61] First, SOX bestows broad authority for "any equitable relief that may be appropriate or necessary for the benefit of

54. *Id.*

55. *Id.*

56. *Id.* The legislative history does not elaborate on the significance of shareholder turnover, but presumably the burden of corporate penalties should be borne by the shareholders at the time of the wrongdoing if they were the beneficiaries of the corporation's misconduct.

57. *See, e.g.*, Clawson v. SEC, No. 03-73199, 2005 WL 2174637, at *2 (9th Cir. Sept. 8, 2005) (upholding administrative penalty on corporate insider as well within the SEC's discretion); SEC v. Amazon Natural Treasures, Inc., 132 F. App'x 701, 703 (9th Cir.) (holding that district court did not abuse its discretion in imposing third-tier penalty), *cert. denied sub nom.* Sylver v. SEC, 546 U.S. 1076 (2005).

58. *See, e.g.*, SEC v. Haligiannis, 470 F. Supp. 2d 373, 386 (S.D.N.Y. 2007) (stating that each of the quarterly statements sent to each of the investors is a materially false statement that technically constitutes a separate violation). *See also* Ralph C. Ferrara, Thomas A. Ferrigno & David S. Durland, *Hardball! The SEC's New Arsenal of Enforcement Weapons*, 47 Bus. Law. 33, 44–46 (1991) (discussing the interpretive issues involving "violation").

59. *See, e.g.*, *Haligiannis*, 470 F. Supp. 2d at 386 (ordering penalty in the approximate amount of the defendant's ill-gotten gains because of difficulty in calculating total number of violations). Laby and Callcott observe, however, that in cases involving financial reporting violations, the defendant's gain may be impossible to calculate. Laby & Callcott, *supra* note 43, at 49.

60. *See supra* notes 26–28 and accompanying text.

61. Section 308, *supra* note 5. Two other provisions enhance the SEC's power to collect funds for investors. Section 1103 gives the SEC the power, during an investigation, to seek a temporary order

investors,"[62] thus removing any lingering doubt about the availability of disgorgement in judicial proceedings.[63] Second, section 308 provides that:

> If in any judicial or administrative action . . . the Commission obtains an order requiring disgorgement against any person . . . , or such person agrees in settlement of any such action to such disgorgement, and the Commission also obtains . . . a civil penalty against such person, the amount of the civil penalty shall, on the motion or at the direction of the Commission, be added to and become part of the disgorgement fund for the benefit of the victims of such violation.[64]

The statute thus sets forth two conditions for the creation of the fund—disgorgement by a violator and a civil penalty paid by the same violator. In these circumstances, the statute confers upon the SEC the authority to include the civil penalty, along with the disgorgement amount, in a Fair Fund for distribution to the victims of the violation.[65]

The genesis for section 308 was contained in a House bill that provided for creation of a fund consisting of the proceeds of any enforcement actions against Enron and Arthur Andersen, including civil penalties, with former Enron employees who were participants in Enron's retirement funds having priority in the allocation of the fund.[66] While the Senate-passed bill that was the source for most provisions of SOX did not include a comparable provision, the House members of the SOX Conference Committee added section 308 in the joint House-Senate negotiations that produced the final legislation.[67] The Conference Committee did not produce a report on the legislation, and SOX was adopted virtually without debate.[68]

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requiring a company to escrow "extraordinary payments" to insiders. SOX § 1103, 15 U.S.C. § 78u-3(c)(3) (Supp. V 2005). Section 304 requires reimbursement to the company by insiders of any performance-based bonuses or profits from sales of the company's securities if the company is required to restate its financial statements. SOX § 304, 15 U.S.C. § 7243 (Supp. V 2005).

62. SOX § 305(b), 15 U.S.C. § 78u(d)(5) (Supp. V 2005).

63. *See* SEC v. Cavanagh, 445 F.3d 105, 116–20 (2d Cir. 2006) (holding that district court has ancillary jurisdiction to enter a disgorgement order).

64. *See* Section 308, *supra* note 5.

65. The SEC is not required to create a disgorgement fund. *See* Official Comm. of Unsecured Creditors of Worldcom, Inc. v. SEC, 467 F.3d 73, 82 (2d Cir. 2006). In instances where distribution would not be an efficient use of resources, the SEC has remitted both the disgorged amount and the penalty to the U.S. Treasury. SECTION 308(c) REPORT, *supra* note 3, at 14. However, one district court reviewed the SEC's decision not to establish a fund under its general equitable powers to ensure that a plan was "fair and reasonable" and declined to approve disbursement of funds to the U.S. Treasury without a better estimate of the expense and difficulty involved in compensating injured investors. *See* SEC v. Hoberg, No. 03-04135 HRL, slip op. at 3 (N.D. Cal. Jan. 07, 2007) (on file with *The Business Lawyer*).

Section 308 also authorizes the SEC to accept and administer gifts for a disgorgement fund. SOX § 308(b), 15 U.S.C. § 7246(b) (Supp. V 2005). A church that received a $2.3 million donation from a man later charged in an investment scam gave that amount to a Fair Fund set up for victims of the fraud. *Business Briefing*, WASH. POST, Mar. 18, 2006, at D2.

66. H.R. 3763, 107th Cong. § 13 (2002), *reprinted in* JOHN T. BOSTELMAN, THE SARBANES-OXLEY DESKBOOK app. J (2006) [hereinafter "DESKBOOK"].

67. Richard A. Oppel, Jr., *Corporate Conduct: The Overview; Negotiators Agree on Broad Changes in Business Laws*, N.Y. TIMES, July 25, 2002, at A1, *available at* http://select.nytimes.com/gst/abstract.html?res=F50A1FFB3B5C0C768EDDAE0894DA404482.

68. BOSTELMAN, DESKBOOK, *supra* note 66, at § 2:6.3.

Because of SOX's absence of legislative history, we do not know why Congress, for the first time, explicitly authorized the SEC to seek compensation on behalf of defrauded investors. We also do not know why Congress chose to condition the distribution of a penalty to investors on obtaining disgorgement from the same violator. Perhaps that decision stemmed from congressional focus on the specific facts of Enron[69]—one of the classic situations for disgorgement—in which the employee-investors purchased securities while the corporate insiders personally profited from their fraud by selling their shares[70] and receiving inflated performance-based compensation.[71] More abstractly, Congress may have thought that the requirement of disgorgement would ensure that corporate violators had measurable ill-gotten gains that justified the impact of corporate penalties on the then-current innocent shareholders. Alternatively, Congress may have viewed ill-gotten gains as the equivalent of restitution and seen disgorgement as a proxy for investor harm, so that distribution of the penalty to investors would not be a windfall recovery.[72] For whatever reason, disgorgement by a violator was a condition to that violator's penalties (and only that violator's penalties) being included in the Fair Fund. Unless the corporation committing the fraud has identifiable profits to disgorge, the statute requires that any corporate penalty be paid into the U.S. Treasury.

Section 308's two conditions seemingly impose a substantial limitation on the effective use of a Fair Fund in market fraud enforcement actions against corporations that do not sell their securities during the period in which they make the material misstatements or omissions.[73] The SEC has sought an amendment to section 308 to allow distribution of civil penalties in the absence of disgorgement or, failing that, to permit penalties paid by any co-defendant to be put into a Fair Fund with the profits disgorged from another co-defendant.[74] To date, Congress has not taken any action on the proposed amendment.

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69. As of February 2008, although there was $440 million in the Fair Fund for Enron investors, distributions had not yet begun. *See* Enron Victim Trust, http://www.enronvictimtrust.com (last visited Feb. 1, 2008).

70. Throughout 2001, prior to public disclosure of Enron's financial problems, Enron chief executive officer Kenneth Lay reportedly sold substantial amounts of his Enron stock. In contrast, after public disclosure of Enron's problems in the latter part of 2001 and the company's collapse, Enron employees were prohibited from selling their Enron shares in their 401(k) plans because of a change in plan administrator. Enron employees participating in the plans reportedly had an average of 62% of their plan balances invested in Enron stock. *See* Bostelman, Deskbook, *supra* note 66, at § 2:2.2.

71. As of December 31, 2000, Enron had nearly 13% of all its common shares outstanding under stock option plans that apparently had no restrictions on the subsequent resale of the shares. *See* John C. Coffee, Jr., Gatekeepers: The Professions and Corporate Governance 24 (2006).

72. *See* SEC v. Fischbach Corp., 133 F.3d 170, 176 (2d Cir. 1997) (agreeing with SEC that amount disgorged by officers who looted a corporation should be paid to the U.S. Treasury and not to the corporation because the current owners purchased the corporation at a price reflecting the fraud).

73. SEC Director of Enforcement Stephen M. Cutler referred to this limitation as "technical." *See It's Only Fair: Returning Money to Defrauded Investors: Hearing Before the Subcomm. on Capital Markets, Insurance, and Government Sponsored Enterprises of the H. Comm. on Financial Services*, 108th Cong. 7 (2003) (statement of Stephen M. Cutler, SEC Director of Enforcement), *available at* http://www.sec.gov/news/testimony/022603tssmc.htm.

74. Section 308(c) Report, *supra* note 3, at 33. This former alternative was included in the Securities Fraud Deterrence and Investor Restitution Act of 2004, H.R. 475(I), 108th Cong. § 8(a) (2004), *available at* 2004 WL 934533, which Congress did not enact.

B. SEC ENFORCEMENT ACTIONS

In the five complete fiscal years since the enactment of SOX, the SEC has brought from 218 to 335 judicial enforcement actions per year.[75] It has obtained (in judicial and administrative proceedings) orders requiring disgorgement of profits of roughly $1.6 billion per year and penalties of roughly another $1.1 billion per year.[76] Many of the judicial actions that the SEC has highlighted as significant or key cases or major accomplishments[77] are financial fraud cases.[78]

In addition, the SEC does not operate alone in these high-profile financial fraud cases but instead engages in coordinated efforts with other regulators (states and self-regulatory organizations[79]), prosecutors (U.S. Department of Justice ("DOJ") and state attorneys general), and the private plaintiffs' securities bar to maximize the collection of funds for injured investors.[80] For its part, the SEC has aggressively employed section 308 in two ways to create sizable distribution funds for investors harmed by corporate financial fraud. First, it has created distribution funds without disgorgement of corporate profits as traditionally measured; and, second, it has increased the amounts of corporate penalties. This part critically examines some of these actions and concludes by questioning whether the SEC's advantages as a plaintiff in enforcement actions make sense in the context of section 308 actions.

75. In addition, the SEC can bring administrative proceedings against broker dealers, associated persons, and regulated entities. *See* 15 U.S.C.A. § 78u-2 (West 1998 & Supp. 2007). The number of proceedings for each fiscal year is as follows (numbers in parentheses show civil injunction actions first, administrative proceedings second): FY03—636 (271, 365); FY04—639 (264, 375); FY05—629 (335, 294); FY06—574 (218, 356); FY07—656 (262, 394). The numbers are from the SEC's Annual Reports, Performance and Accountability Reports ("PARs"), and Select SEC and Market Data for the applicable years. *See* U.S. Securities and Exchange Commission, About the SEC, http://www.sec.gov/about.shtml (last visited Jan. 24, 2008).

76. Disgorgement amounts by fiscal year: $900 million (FY03); $1.9 billion (FY04); $1.6 billion (FY05); $2.3 billion (FY06); $1.093 billion (FY07). Penalties: $1.1 billion (FY03); $1.2 billion (FY04); $1.5 billion (FY05); $975 million (FY06); $507 million (FY07). *Id.*

77. In each Annual Report or PAR, the SEC highlights certain cases as significant or key cases or major accomplishments. Although it does not set forth its criteria for selecting these cases, the SEC appears to include high-profile cases in terms of publicity and monetary relief. *See id.*

78. Enron and Xerox were identified in the *2003 Annual Report*, 2003 REPORT, *supra* note 7, at 16; Computer Associates and Lucent Technologies in the *2004 Performance and Accountability Report*, U.S. SEC. & EXCH. COMM'N, 2004 PERFORMANCE AND ACCOUNTABILITY REPORT 6 (2004) [hereinafter "2004 PAR"], *available at* http://www.sec.gov/about/secpar.shtml; Qwest Communications, Time Warner, and Adelphia in the 2005 PAR, *supra* note 7, at 7–8; McAfee, AIG, Fannie Mae, and Tyco in the 2006 PAR, *supra* note 7, at 8–9; and Mercury Interactive, ConAgra, and Cardinal Health in the *2007 Performance and Accountability Report*, U.S. SEC. & EXCH. COMM'N, 2007 PERFORMANCE AND ACCOUNTABILITY REPORT 6 (2007) [hereinafter "2007 PAR"], *available at* http://www.sec.gov/about/secpar2007.shtml.

79. The self-regulatory organizations are principally the exchanges on which stock is traded.

80. *See* Deborah Solomon, *For Wronged Investors, It's Payback Time—The SEC Begins Doling Out Funds from Settlement Pools, but the Wait Can Be Long*, WALL ST. J., July 7, 2005, at D1 (reporting that the SEC pairs Fair Funds with related class action settlements whenever possible to save time and money).

1. *Disgorgement.* In enforcement actions against third parties (e.g., investment banks[81] and accounting firms[82]) for aiding and abetting corporate fraud, at least some portion of the firms' fees, consistent with the disgorgement remedy, can be designated as ill-gotten gains, and penalties paid by the firm can be included in a Fair Fund in accordance with section 308. In addition, in actions against corporate insiders, some portion of their compensation, particularly performance-based bonuses as well as any profits derived from trading in the company's securities while the fraud was ongoing,[83] can, consistent with the equitable remedy of disgorgement, be designated as ill-gotten gains, permitting penalties paid by the insiders to be added to a Fair Fund.

A corporate defendant, however, does not experience what has traditionally been considered ill-gotten gains in the absence of sales of its own securities.[84]

81. *See, e.g.*, SEC Charges J.P. Morgan Chase in Connection with Enron's Accounting Fraud, Litigation Release No. 18252 (July 28, 2003) (noting that the firm paid a total of $135 million in disgorgement, penalties, and interest in connection with Enron-related misconduct), *available at* http://www.sec.gov/litigation/litreleases/lr18252.htm; *In re* Citigroup, Inc., Exchange Act Release No. 48230 (July 28, 2003) (announcing firm paid $52.750 million in disgorgement and $48.5 million as a penalty for Enron-related misconduct; firm paid $9.750 million in disgorgement and $9 million in penalty for Dynergy-related misconduct); *available at* http://www.sec.gov/litigation/admin/34-48230.htm; SEC Charges Merrill Lynch, Four Merrill Lynch Executives with Aiding and Abetting Enron Accounting Fraud; Merrill Lynch Simultaneously Settles Charges for Permanent Anti-Fraud Injunction and Payment of $80 Million in Disgorgement, Penalties and Interest, Litigation Release No. 18038 (Mar. 17, 2003) (publicizing that firm paid $37.5 million in disgorgement, $5 million in interest, and $37.5 million as a penalty in connection with Enron-related misconduct), *available at* http://www.sec.gov/litigation/litreleases/lr18038.htm.

82. *See, e.g.*, KPMG Pays $22 Million To Settle SEC Litigation Relating to Xerox Audits, Litigation Release No. 19191 (Apr. 19, 2005) (announcing that firm paid nearly $10 million in disgorgement, over $2.5 million in interest, and $10 million as a penalty in connection with Xerox audit), *available at* http://www.sec.gov/litigation/litreleases/lr19191.htm. However, in the settlement paid by Deloitte & Touche in connection with its audits of Adelphia, none of the $50 million obtained in judicial and administrative proceedings was designated as disgorgement amounts. *See In re* Deloitte & Touche LLP, Litigation Release No. 19202 (Apr. 26, 2005) (stating that $25 million was paid as a penalty to settle a judicial proceeding and an additional $25 million was paid in a related administrative proceeding), *available at* http://www.sec.gov/litigation/admin/34-51606.pdf.

83. Xerox executives paid $22 million in disgorgement, interest, and penalties. *See* KPMG Pays $22 Million To Settle SEC Litigation Relating to Xerox Audits, Litigation Release No. 19191 (Apr. 19, 2005), *available at* http://www.sec.gov/litigation/litreleases/lr19191.htm. The SEC brought civil actions against several Healthsouth Corp. executives for penalties, disgorgement, and interest. *See* SEC Charges William T. Owens and Weston L. Smith in Connection with the Healthsouth Corp. Accounting Fraud; Commission Action Seeks Injunctions, Money Penalties, Officer and Director Bars, Litigation Release No. 18059 (Apr. 1, 2003), *available at* http://www.sec.gov/litigation/litreleases/lr18059.htm; *see also* SEC v. Owens, Litigation Release No. 19743 (June 28, 2006) (noting the former CFO of Healthsouth Corp. paid approximately $16 million in disgorgement and interest but because of his financial condition no penalty was required), *available at* http://www.sec.gov/litigation/litreleases/2006/lr19743.htm; SEC v. Kumar, Litigation Release No. 18891 (Sept. 22, 2004) (announcing that the SEC brought actions against Computer Associates insiders for disgorgement, interest, and penalties), *available at* http://www.sec.gov/litigation/litreleases/lr18891.htm. In the *Kumar* proceedings, the former Computer Associates chief executive officer did not have to make any payments in the civil action because of his obligation to make restitution payments of $798,600,000 in the criminal proceeding. *See* Final Judgment Entered Against Defendant Sanjay Kumar, Litigation Release No. 20082 (Apr. 19, 2007), *available at* http://www.sec.gov/litigation/litreleases/2007/lr20082.htm.

84. *See supra* notes 26–32 and accompanying text.

Accordingly, pursuant to section 308, in the absence of disgorgement of profits, a corporate penalty cannot be distributed to investors.[85] The SEC, however, has consistently evaded section 308's limitation by including a nominal $1 disgorgement amount to allow distribution of corporate penalties to investors.[86] It has done this even in cases where it may have been able to establish a disgorgement amount under established principles.[87] Corporate defendants apparently agree to this, even though they might have an advantage in designating some amounts as disgorgement instead of a penalty,[88] and no court appears to have questioned this practice.

2. *Penalties.* 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.[89] Shortly thereafter, a $10 million penalty seemed "antiquated"[90] and, indeed, it was asserted, would constitute a success for the attorney representing the corporate defendant.[91] In 2003, Worldcom paid a $2.25 billion penalty

85. *See supra* notes 64–65 and accompanying text.

86. *See, e.g.*, SEC Charges Lucent Technologies Inc. and Ten Defendants for a $1.1 Billion Accounting Fraud; Lucent Will Pay a $25 Million Penalty; Three Individuals Also Settle Securities Fraud Charges, Litigation Release No. 18715 (May 17, 2004), *available at* http://www.sec.gov/litigation/litreleases/lr18715.htm.

87. In *SEC v. McAfee*, for example, the SEC alleged in the complaint stock sales by the corporation during the time of the fraud, but the settlement included only a $1 nominal disgorgement amount that allowed the SEC to put the $50 million penalty into a Fair Fund. *See* Complaint at 20, SEC v. McAfee, Inc., No. 06-009 (PJH) (N.D. Cal. Jan. 4, 2006), *available at* http://www.sec.gov/litigation/complaints/comp19520.pdf; SEC Sues McAfee, Inc. for Accounting Fraud, McAfee Agrees To Settle and Pay a $50 Million Penalty, Litigation Release No. 19520 (Jan. 4, 2006), *available at* http://www.sec.gov/litigation/litreleases/lr19520.htm.

88. The settlements provide that the penalty amounts cannot be offset against any amounts paid in class action settlements. *See, e.g.*, SEC Charges Time Warner with Fraud, Aiding and Abetting Fraud by Others, and Violating a Prior Cease-and-Desist Order; CFO, Controller, and Deputy Controller Charged with Causing Reporting Violations; Time Warner Agrees to $300 Million Penalty, Antifraud Injunction and Order To Comply with Cease-and-Desist Order; Will Restate Its Financial Results and Engage Independent Examiner; CFO, Controller and Deputy Controller Consent to Cease-and-Desist Order, Litigation Release No. 19147 (Mar. 21, 2005) [hereinafter "Time Warner Litigation Release"], *available at* http://www.sec.gov/litigation/litreleases/lr19147.htm. Pre-SOX case law allowed defendants that disgorged profits in an SEC enforcement action to offset that amount against damages in private litigation when the plaintiffs were seeking disgorgement of profits. *See* Litton Indus. Inc. v. Lehman Bros. Kuhn Loeb Inc., 734 F. Supp. 1071, 1076 (S.D.N.Y. 1990) (stating that "once ill-gotten gains have been disgorged to the SEC, there remains no unjust enrichment and, therefore, no basis for further disgorgement in a private action"). Courts did not extend that offset to financial fraud actions, however, where the investors' theory of damages was based on the inflated value of their securities. *See In re* Spear & Jackson Sec. Litig., 399 F. Supp. 2d 1350, 1360 (S.D. Fla. 2005) (holding that disgorgement of profits to the SEC and plaintiffs' securities fraud damages are different remedies). One commentator argued that Fair Fund distributions should be taken into account in compensating investors in class actions; *see* Kenneth M. Lehn, Commentary, *Private Insecurities*, WALL ST. J., Feb. 15, 2006, at A16, *available at* http://online.wsj.com/article/SB113996764865374191.html.

89. Stephen M. Cutler, Dir., Div. of Enforcement, U.S. Sec. & Exch. Comm'n, Speech by SEC Staff: 24th Annual Ray Garrett Jr. Corporate & Securities Law Institute (Apr. 29, 2004), http://www.sec.gov/news/speech/spch042904smc.htm [hereinafter "Cutler Speech"].

90. *Id.*

91. *See* Paul S. Atkins, Comm'r, U.S. Sec. & Exch. Comm'n, Remarks Before the U.S. Chamber Institute for Legal Reform (Feb. 16, 2006), http://www.sec.gov/news/speech/spch021606psa.htm [hereinafter "Atkins Remarks"].

(discounted to $750 million because of its bankruptcy proceeding),[92] and penalties against other entities in the range of $50 million were not unusual.[93] Business interests criticized the escalating amounts of corporate penalties,[94] which resulted in an intense debate about the SEC's use of its penalty powers against corporate entities.[95] The SEC's reaction to this criticism is discussed in Part III.

Moreover, the increased penalty amounts and the distribution of these funds to compensate investors create exactly the wealth transfer problems that Professor Coffee and others argue is the principal flaw in securities fraud class actions.[96] The effect is to take corporate funds away from one group of investors, the current shareholders, and pay it to another group of investors, those who traded in the securities during the class damages period. This can be described as "robbing Peter to pay Paul" and is more complicated because there is some identity between the two groups, so the result may even be "robbing Peter to pay Peter." If wealth transfer problems make the federal securities class action a poor instrument to achieve investor compensation, then section 308 actions raise the same objection.

3. *Section 308 Actions.* A careful examination of financial fraud settlements against four corporate defendants—Worldcom, Time Warner, AIG, and Fannie Mae—illustrates how the SEC's efforts to create Fair Fund distributions for investors have resulted in an evasion of the disgorgement requirement and the imposition of sizable penalties to the possible detriment of innocent stakeholders.

SEC v. Worldcom, Inc.[97] The Worldcom settlement of "perhaps the largest accounting fraud in history"[98] produced the only appellate opinion to date in which a court has discussed section 308. The district court approved the creation of a Fair Fund of $2.25—discounted to $750 million because of Enron's bankruptcy (still 75 times greater than the previous largest financial fraud settlement)—of which $500 million was paid in cash and the rest in common stock of the reorganized corporation.[99] In reviewing the settlement, the district court framed the issue as balancing the need to punish the corporation with the desire not to undermine the possibility of the corporation emerging from bankruptcy as a viable company.[100]

The district court first addressed the amount of the penalty. The numbers in Worldcom illustrate the discrepancy between the shareholders' losses and the

92. *See infra* notes 97–105 and accompanying text.

93. *See* Cutler Speech, *supra* note 89.

94. *See, e.g.*, Alix Nyberg Stuart, *Penalty Box: The SEC Is Handing Out Bigger and Bigger Fines for Misdeeds. But Is This the Right Approach?*, CFO MAG., Feb. 1, 2006, at 79, *available at* http://www.cfo.com/article.cfm/5435460/c_5461573?f=singlepage; *see also* Richard A. Spehr & Michelle J. Annunziata, *The Remedies Act Turns Fifteen: What Is Its Relevance Today?*, 1 N.Y.U. J. L. & Bus. 587, 611 (2005) (criticizing the SEC for failure to follow the penalty statute).

95. *See infra* Part III.

96. *See* Coffee, *supra* note 4, at 1556–62. *See also* Richard A. Booth, *The End of the Securities Fraud Class Action as We Know It*, 4 BERKELEY BUS. L.J. 1, 3 (2007) (arguing that in diversified portfolios investors will be both winners and losers with respect to investing in corporate securities violators).

97. 273 F. Supp. 2d 431 (S.D.N.Y. 2003). The distribution plan was approved by the district court in *Official Comm. of Unsecured Creditors of Worldcom, Inc. v. SEC*, No. 02 Civ. 4963(JSR), 2004 WL 1621185 (S.D.N.Y. July 20, 2004), *aff'd*, 467 F.3d 73 (2d Cir. 2006).

98. *Worldcom, Inc.*, 273 F. Supp. 2d at 431.

99. *Id.* at 434–35.

100. *See id.* at 431, 433–34.

corporation's gain. The court said that although the SEC could take the shareholders' losses (estimated by the plaintiffs in the class action litigation at "as much as $200 billion") into account in determining the amount of the penalty, such losses could not be the primary factor.[101] Rather, the maximum amount of the penalty was the corporate gain from the fraud,[102] which the court estimated as $10–17 billion.[103] The court did not state how it derived the $10–17 billion range; although, since the court had previously stated that income was overstated by an estimated $11 billion,[104] that overstatement may have been the source for the "corporate gain." If this is correct, the court did not calculate the gain consistent with the 1990 Act's legislative history.[105]

Second, the SEC did not specify, and the court did not require, any disgorgement amount apart from a nominal $1 to ensure the applicability of section 308.[106] The court did not explain any discrepancy between it finding a "corporate gain" for purposes of determining the amount under the penalty statute and its failure to find more than a nominal disgorgement amount for purposes of section 308. Worldcom thus set the pattern for subsequent settlements.

Worldcom's Official Committee of Unsecured Creditors challenged the SEC's Fair Fund distribution plan as unfair and argued that the district court's review of the settlement was too deferential to the SEC.[107] The U.S. Court of Appeals for the Second Circuit, however, rejected the plaintiff's argument that section 308 required the district court's independent review and held that the standard of review for Fair Fund distribution plans was the "fair and reasonable" standard previously adopted for pre-SOX disgorgement plans.[108] More specifically, "so long as the district court is satisfied that 'in the aggregate, the plan is equitable and reasonable,'"[109] it should defer to the SEC's expertise in determining how to distribute the funds because "hard choices" have to be made with limited funds.[110] The Second Circuit also specifically found that the SEC did not have to follow bankruptcy priorities.[111] The case thus illustrates the courts' and SEC's failure, in Fair Fund

101. *Id.* at 431, 434.

102. This was apparently a reference to the penalty statute, 15 U.S.C. § 78u(d)(3) (2000 & Supp. V 2005). *See supra* notes 50–52 and accompanying text.

103. *Worldcom, Inc.*, 273 F. Supp. 2d at 434.

104. *Id.* at 431. In the same sentence, the court also referred to the balance sheet's overstatement by more than $75 billion, *see id.*, but that number does not appear to figure in the court's calculation of corporate gain.

105. *See supra* notes 51–52 and accompanying text.

106. Worldcom had sold debt instruments during the period of the fraud, but there was apparently no attempt to quantify the corporate gain in that sale resulting from the fraud. *See* SEC v. Worldcom, Inc., First Amended Complaint, Civ. No. 02-CV-4963 (JSR) (S.D.N.Y. Nov. 5, 2002), http://www.sec.gov/litigation/complaints/comp17829.htm.

107. *See Official Comm. of Unsecured Creditors of Worldcom, Inc.*, 467 F.3d at 75.

108. *See id.* at 82; *see also* SEC v. Wang, 944 F.2d 80, 85 (2d Cir. 1991) (finding that district court must only satisfy itself that SEC's disgorgement plan is "fair and reasonable").

109. *Id.* at 83 (quoting *Wang*, 944 F.2d at 88).

110. *Id.* at 84 (quoting the district court's opinion). The appellate court, in turn, reviews the district court's decision using an "abuse of discretion" standard. *See id.*

111. *See id.* at 84–85. For why bankruptcy priorities should be followed in Fair Fund cases, see generally Zack Christensen, Note, *The Fair Funds for Investors Provision of Sarbanes-Oxley: Is It Unfair*

cases, to appreciate sufficiently the impact on other innocent stakeholders—in this case the creditors who would otherwise have had bankruptcy priority.

In October 2006, the federal district court authorized the distribution agent to begin distributions from the Worldcom fund; three cash distributions have been made to eligible claimants, and a fourth is expected in 2008.[112] An estimated 5.5–6% of eligible losses are expected to be paid.[113]

SEC v. Time Warner.[114] On March 21, 2005, Time Warner settled SEC charges that from October 2000 through February 2003, the corporation materially overstated its online advertising revenue and the number of its Internet subscribers and aided and abetted three other securities frauds, thus violating a May 2000 cease-and-desist order.[115] It agreed to pay a $300 million penalty.[116] No publicly available document explains how the $300 million penalty was calculated,[117] and there was no attempt to establish a "disgorgement" amount.[118] The distribution of the Fair Fund was coordinated with the plan of allocation in a class action settlement in a similar case.[119]

SEC v. American International Group, Inc.[120] In February 2006, the SEC announced settlement of charges that American International Group, Inc. ("AIG") fraudulently

to the Creditors of a Bankrupt Debtor?, 2005 U. ILL. L. REV. 339. The district court that approved the settlement, however, was cognizant of bankruptcy policy: "[w]hat the [SEC] may not do, at least in a case in which the company is in bankruptcy, is determine the size of the penalty primarily on the basis of how much shareholder loss will thereby be recompensed, for this would not only be adverse to the priorities established under the bankruptcy laws but also would run contrary to the primary purposes of S.E.C. fraud penalties themselves." *Worldcom, Inc.*, 273 F. Supp. 2d at 434.

112. *See* Worldcom Victim Trust, http://www.worldcomvictimtrust.com (last visited Jan. 29, 2008).

113. *Id.*

114. Time Warner Litigation Release, *supra* note 88.

115. *Id.*

116. *Id.*

117. The inflation of the bottom line was substantially in excess of $300 million. *Id.* As part of the settlement, Time Warner agreed to reduce its reported online advertising revenues by approximately $500 million in addition to the $190 million already restated. *Id.* The SEC presumably took into account the fact that Time Warner was a recidivist offender.

118. Time Warner agreed to pay $1 in disgorgement. SEC v. Time Warner, Inc., No. 1:05CV00578(GK) (D.D.C. Mar. 21, 2005) (final judgment).

119. In settlement of the securities fraud class action, *In re* AOL Time Warner, Inc. Sec. & ERISA Litig., No. 02 Civ. 5575 (SKW) (S.D.N.Y. 2002), Time Warner agreed to ask the SEC to distribute the $300 million penalty along with the class settlement, and the SEC agreed to do so. *See* AOL Time Warner Securities Litigation Settlement 19–20, http://www.aoltimewarnersettlement.com/pdf/altw1stip.pdf (last visited Jan. 23, 2008). The relevant time period for the class of purchasers who received Fair Fund distributions was shorter than the damages period in the class action settlement, the ninety-day look-back cap on damages required by 15 U.S.C. section 78u-4(e)(1) (2000) and applied in the class action settlement was not applicable to the Fair Fund distributions, and those who opted out of the class action could file Fair Fund claims. *See* AOL Time Warner Securities Litigation Settlement, http://www.aoltimewarnersettlement.com/pdf/altw1stip.pdf (last visited Jan. 23, 2008). The fund also included $150 million from a DOJ settlement. *Id.* at 19. Distribution of the fund commenced on July 13, 2007. *See* AOL Time Warner Securities Litigation Settlement, July 16 Update, http://www.aoltimewarnersettlement.com (last visited Jan. 23, 2008).

120. SEC v. Am. Int'l Group, Inc., Litigation Release No. 19560 (Feb. 9, 2006) [hereinafter "AIG Litigation Release"], *available at* http://www.sec.gov/litigation/litreleases/lr19560.htm. This was part of a global settlement with the New York Attorney General, the New York Superintendent of Insurance, and the DOJ. *Id.*

improved its financial results in the amount of $2.26 billion.[121] Unlike Worldcom and Time Warner, a portion of AIG's settlement payments—$700 million—was designated as disgorgement, while another $100 million was paid as a civil penalty.[122] The $700 million disgorgement amount can be deduced mathematically. AIG entered into three transactions allegedly for the sole purpose of improving its financial bottom line—two transactions that added $500 million in phony loss reserves and another transaction that concealed $200 million in underwriting losses.[123] However, if these constitute "ill-gotten gains," then any company's inflation of the bottom line could constitute ill-gotten gains, a view not previously advanced by the SEC.[124] This novel view of disgorgement may have stemmed from the agency's desire to create a substantial fund for distribution to investors, while keeping the amount designated as a penalty relatively low to reflect the SEC's new Financial Penalties policy[125] and AIG's substantial cooperation in the investigation.[126] Thus, by creative reasoning, the SEC reduced what could have otherwise been a heavier penalty and yet provided a substantial fund for investors. The company paid the money into a fund to be available to resolve shareholders' claims against the company.[127] The funds have not yet been distributed.[128]

SEC v. Federal National Mortgage Association ("Fannie Mae").[129] On May 23, 2006, the SEC settled an enforcement action charging Fannie Mae with a six-year financial fraud to create the misleading appearance of stable earnings growth.[130] If the SEC had, in AIG,[131] been developing novel theories to designate payments as disgorgement, it did not continue the experiment in Fannie Mae. Although the SEC alleged specifically in the complaint that, in 1998, the accounting fraud was carried out to maximize executives' bonuses,[132] the entire $400 million payment was designated as a corporate penalty.[133] The Distribution Plan was approved in April 2007,[134] and the SEC announced that distributions would begin shortly

121. *Id.*

122. *Id.*

123. *Id.*

124. *See supra* notes 26–28 and accompanying text.

125. *See infra* notes 170–74 and accompanying text.

126. AIG Litigation Release, *supra* note 120. AIG was also a recidivist. *See* Complaint at 2–3, SEC v. Am. Int'l Group, Inc., No. 06 Civ. 1000 (S.D.N.Y. Feb. 9, 2006) (providing details about two recently settled SEC actions with AIG that involved substantial penalties and disgorgement), *available at* http://www.sec.gov/litigation/complaints/comp19560.pdf.

127. Am. Int'l Group, Inc., Annual Report (Form 10-K), at 19 (Mar. 1, 2007), *available at* http://www.sec.gov/Archives/edgar/data/5272/000095012307003026/y27490e10vk.htm.

128. Am. Int'l Group, Inc., Quarterly Report (Form 10-Q), at 15 (Nov. 7, 2007), *available at* http://www.sec.gov/Archives/edgar/data/5272/000095012307015058/y38903e10vg.htm.

129. Fannie Mae To Pay $400 Million Penalty for Accounting Fraud, SEC and OFHEO Settle Action Against Fannie Mae, Litigation Release No. 19710 (May 23, 2006) [hereinafter "Fannie Mae Litigation Release"], *available at* http://www.sec.gov/litigation/litreleases/2006/lr19710.htm.

130. *Id.*

131. *See supra* notes 120–28 and accompanying text.

132. Complaint at 1–2, SEC v. Fed. Nat'l Mortgage Ass'n, No. 1:06CV00959 (RBW) (D.D.C. May 23, 2006), *available at* http://www.sec.gov/litigation/complaints/2006/comp19710.pdf.

133. Fannie Mae Litigation Release, *supra* note 129.

134. Press Release, U.S. Sec. & Exch. Comm'n, SEC Announces Start of $357 Million Fair Fund Distribution Process in Fannie Mae Settlement (Apr. 30, 2007), http://www.sec.gov/news/press/2007/2007-81.htm [hereinafter "Fannie Mae Press Release"].

thereafter.[135] In an apparent response to criticisms about SEC delays in making distributions in other cases,[136] Linda Chatman Thomsen, Director of the SEC's Division of Enforcement, announced: "[t]his expeditious distribution process illustrates the Commission's continuing commitment to improving the speed with which funds are returned to defrauded investors in SEC enforcement actions."[137]

These four settlements support the suspicion that the SEC is reacting to pressure to negotiate large funds for distribution to investors at the expense of any coherent policy on disgorgement and penalties and with an underappreciation of the consequences for a corporation's innocent stakeholders—the current shareholders or, in the case of Worldcom, its creditors.

4. *The SEC as Plaintiff.* In recovering funds for investors, the SEC has important advantages over private plaintiffs because it is not encumbered by the restrictions that the U.S. Supreme Court has imposed on private plaintiffs in Rule 10b-5 actions. The SEC does not need to be a purchaser or seller,[138] does not have to establish reliance[139] or loss causation,[140] and can bring actions against aiders and abettors.[141] The agency is not subject to the same statute of limitations as private plaintiffs.[142] In addition, investors can receive more in Fair Fund distributions than in class action settlements because the SEC takes the position that the ninety-day look-back cap on damages required by the Private Securities Litigation Reform Act ("PSLRA") does not apply to Fair Fund distributions[143] and attorney's fees do not reduce the amount available for Fair Fund distributions.[144] Finally, according to the United States Court of Appeals for the Second Circuit,[145] Fair Fund

135. *Id.* Payments began in October 2007 and will amount to approximately 3.9% of eligible loss amounts. *See* SEC Fannie Mae Settlement Fund, Recent Settlement Events, http://www.secfanniemae settlement.com/events.html (last visited Feb. 28, 2007).

136. *See infra* note 190 and accompanying text.

137. Fannie Mae Press Release, *supra* note 134.

138. *See* Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 737–38 (1975) (holding that only a purchaser or seller of securities can bring a private action under Rule 10b-5).

139. In *Stoneridge Investment Partners, LLC v. Scientific-Atlanta, Inc.*, the U.S. Supreme Court established that reliance is an element in all private Rule 10b-5 actions. 128 S. Ct. 761, 769 (2008).

140. *See* 15 U.S.C. § 78u-4(b)(4) (2000). Loss causation became a substantial obstacle for private plaintiffs after *Dura Pharmaceuticals, Inc. v. Broudo*, 544 U.S. 336, 342–46 (2005). *See* Oscar Private Equity Invs. v. Allegiance Telecomm., Inc., 487 F.3d 261, 264 (5th Cir. 2007).

141. After the U.S. Supreme Court held in *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164, 191 (1994), that there was no aiding and abetting liability under Rule 10b-5, Congress amended the Exchange Act to allow the SEC to bring aiding and abetting claims. *See* Private Securities Litigation Reform Act of 1995, Pub. L. No. 104-67, § 104, 109 Stat. 737, 757 (codified as amended at 15 U.S.C. § 78t (2000)).

142. No private action can be brought later than the earlier of two years after the discovery of the facts constituting the violation or five years after such violation. 28 U.S.C. § 1658(b) (2000 & Supp. V 2005). There is a five-year statute of limitations when the government seeks enforcement of any civil fine, penalty, or forfeiture. *See* 28 U.S.C. § 2462 (2000). *See also* SEC v. Jones, 476 F. Supp. 2d 374, 381 (S.D.N.Y. 2007) (holding that the statute is applicable to "civil penalties and equitable relief that seek[] to punish" but not to equitable relief that "seeks to remedy a past wrong or protect the public from future harm").

143. *See supra* note 119.

144. *See* Atkins Remarks, *supra* note 91 (stating that "[the SEC does] not allow any of the funds from the SEC action[s] to be paid to private lawyers").

145. *See supra* note 111 and accompanying text.

distributions are not subject to the bankruptcy priorities that would otherwise eliminate many investors' recoveries from a bankrupt corporation.

To the extent that the SEC's role is to be a surrogate for private parties rather than an enforcement agency, these distinctions may appear untenable, and defendants may argue that the restrictions applicable to private party litigation should apply to the SEC as well.[146] While, to date, Fair Fund distributions have been the product of settlement, at some point an aggressive corporate defendant's attorney may decide to press this argument. How the courts respond to this argument may depend on whether any dislike of securities fraud class actions stems from their view of the plaintiffs as unworthy plaintiffs,[147] their distaste for plaintiffs' securities attorneys,[148] or their concerns about innocent shareholders of corporate defendants.[149]

Moreover, it is a valid question of policy whether investors should be able to receive money from Fair Fund distributions that they cannot obtain in private actions. The SEC does limit the eligibility of claimants in the distribution plans to conform to some of the legal restrictions on class action plaintiffs; thus, eligible claimants have been defined as purchasers and sellers,[150] and the distribution plans take loss causation into account in calculating to what extent price inflation is attributable to the defendant's misrepresentations.[151] While this lacks some transparency, it may be no different than how these issues are addressed in settled class actions.

In the case of aiders and abettors, however, an SEC policy of negotiating large penalties in order to compensate investors raises some of the same policy concerns that the U.S. Supreme Court found so troubling in *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*[152] The Court noted that the uncertainty of the governing rules regarding aiding and abetting liability could lead entities to settle claims of dubious merit and could even cause professionals to price their services beyond the ability of small and new businesses to pay.[153] While the Court was addressing the dangers of private litigation, the concerns are similarly relevant to SEC enforcement actions where the SEC has the power and the incentive to exact a large penalty. After *Central Bank*, Congress determined that the SEC (but not private parties) should have the power to bring aiding and abetting

146. *See* Ellsworth, *supra* note 3, at 650.

147. *See In re* Merrill Lynch & Co., Inc., 273 F. Supp. 2d 351, 358 (S.D.N.Y. 2003) (stating that "[t]he record clearly reveals that plaintiffs were among the high-risk speculators who, knowing full well or being properly chargeable with appreciation of the unjustifiable risks they were undertaking in the extremely volatile and highly untested stocks at issue, now hope to twist the federal securities laws into a scheme of cost-free speculators' insurance"), *aff'd sub nom.* Lentell v. Merrill Lynch & Co., Inc., 396 F.2d 151 (2d Cir.), *cert. denied,* 546 U.S. 935 (2005).

148. *See* Hillary A. Sale, *Judging Heuristics,* 35 U.C. DAVIS L. REV. 903, 946 (2002) (noting that rhetoric of some judicial opinions suggests disdain for plaintiffs' attorneys).

149. *See supra* notes 53–56 and accompanying text.

150. The Worldcom distribution plan excluded "holders' claims." *See* SEC v. Worldcom, Inc., No. 02-CV-4963 (JSR), 2004 WL 1621185, at *1 (S.D.N.Y. July 20, 2004).

151. *See* SEC v. Worldcom, Inc., Civ. No. 02-CV-4963 (JSR) (S.D.N.Y. July 20, 2004) (further order approving distribution plan), *available at* http://www.worldcomvictimtrust.com/Downloads/DistributionPlan.pdf.

152. 511 U.S. 164 (1994).

153. *Id.* at 189.

actions for Rule 10b-5 violations,[154] which, coupled with section 308, confers on the agency the broad authority to bring actions against deep-pocket defendants on behalf of investors. Perhaps Congress had confidence that the agency, unlike private parties, was less likely to bring unmeritorious claims. The U.S. Supreme Court recently acknowledged the distinction between SEC and private actions and specifically referred to the SEC's power to collect damages for investors as a reason why "[t]he enforcement power is not toothless."[155] The fact that the law treats private parties and the SEC differently, however, explains, but does not necessarily rationalize, the anomalous results.

III. Business Community's Response to Section 308

As the SEC has vigorously employed section 308 to collect funds for defrauded investors, section 308 has become an instrument in the business community's campaign against securities fraud class action litigation. The securities industry and other constituencies hostile to private securities fraud litigation, in amici briefs filed to restrict private remedies in recent years, have cited section 308 as an example of why private securities fraud litigation is a costly duplication of the SEC's efforts.[156] President Bush reportedly expressed the view that the scope of private shareholders' litigation should not be expanded because of the ability of regulators to bring enforcement actions,[157] and the President of the Securities Industry and Financial Markets Association ("SIFMA") captured that sentiment when he stated that expansion of private remedies is unwarranted because regulators have the tools to return money to investors.[158] The U.S. Supreme Court in *Stoneridge Investment Partners, LLC v. Scientific-Atlanta, Inc.* referred to the SEC's power to collect from investors as a policy reason not to extend private parties' ability to recover from outside actors.[159] Academic commentators[160] and the SEC

154. *See supra* note 141.

155. Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc., 128 S. Ct. 761, 773 (2008).

156. An illustrative example:

"The SEC's broad powers and lengthy record of pursuing wrongdoers and returning funds to investors further belie . . . the argument that the government is 'ill-equipped' to enforce the securities laws on a large scale. . . . The FAIR Funds provision's sponsor sought to compensate investors without incurring the high legal fees associated with private class-action litigation . . . ." Brief for the Securities Industry and Financial Markets Association and the Futures Industry Association as Amici Curiae in Support of Respondents at 25–26, Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc., No. 128 S. Ct. 761 (2008) (No. 06-43). Similar language is found in the Brief for the Securities Industry and Financial Markets Association (SIFMA) and the Chamber of Commerce of the United States of America (Chamber of Commerce) as Amici Curiae in Support of Petitioners at 11, Tellabs, Inc. v. Makor Issues & Rights, Ltd., 432 F.2d 588 (7th Cir. 2006), *cert. granted*, 75 U.S.L.W. 3349 (U.S. Jan. 5, 2007) (No. 06-484), and in the Brief of the Chamber of Commerce as Amicus Curiae in Support of Petitioner at 27, Merrill Lynch, Pierce, Fenner and Smith, Inc. v. Dabit, 547 U.S. 71 (2006).

157. *See* Carrie Johnson, *Bush Weighs in Against Investors in Fraud Case*, Wash. Post, June 13, 2007, at D1.

158. *See* Press Release, Sec. Indus. & Fin. Mkts. Ass'n, SIFMA Opposes Third-Party Class Action Lawsuits (June 13, 2007), http://www.sifma.org/news/46297159.shtml.

159. 128 S. Ct. 761, 773 (2008).

160. Professor Coffee sets forth statistics comparing private and SEC actions and recoveries to demonstrate that "private enforcement seems to dwarf public enforcement." Coffee, *supra* note 4, at 1543.

itself,[161] however, do not believe that the SEC's expanded powers make private litigation superfluous. First, the SEC does not and never will have the necessary resources to investigate and bring enforcement actions against every securities violator, much less pursue every enforcement action that may result in recovery for investors.[162] Second, as discussed in Part IV, the SEC has important enforcement goals other than compensating investors.

Two recent reports that express alarm over the anti-competitive effect of U.S. securities regulation raise a related, though more limited, argument and advocate that amounts paid by corporations in Fair Fund distributions should be offset against damages obtained by investors in private litigation.[163] Otherwise, they assert, there is the possibility of a "wasteful double-recovery by shareholders that would undermine the original purpose of Section 308 by permitting overcompensation and, likewise, over-deterrence."[164] In the financial fraud cases like Worldcom, however, the shareholders' losses greatly exceed the settlement amounts,[165] so the possibility of double recovery is exceedingly remote. Moreover, before the enactment of SOX, courts established that payments to shareholders from all sources cannot exceed the shareholders' losses.[166]

Finally, Republican sponsors of SOX and Paul Atkins, the SEC Commissioner most closely identified with the pro-business agenda, have asserted that actions under section 308 provide better value than private securities fraud suits because investors' recoveries are not reduced by attorney's fees.[167] The significance of this

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Professors Cox and Thomas said, "[h]ere we have cause to find the obvious: the SEC cannot and does not prosecute all violations and the private suit picks up the slack." Cox & Thomas, *supra* note 12, at 779.

161. SECTION 308(c) REPORT, *supra* note 3, at 20.

162. *See* Cox & Thomas, *supra* note 12, at 757.

163. *See* COMMISSION ON THE REGULATION OF U.S. CAPITAL MARKETS IN THE 21ST CENTURY, REPORT AND RECOMMENDATIONS 88–90 (Mar. 2007) [hereinafter "CAPITAL MARKETS REPORT"], *available at* http://www.uschamber.com/NR/rdonlyres/eozwwssfrqzdm3hd5siogqhp6h2ngxwdpr77qw2bogptzvi5we u6mmi4plfq6xic7kjonfpg4q2bpks6ryog5wwh5sc/0703capmarkets_full.pdf. The Commission is an independent, bipartisan committee established by the U.S. Chamber of Commerce. *Id.* at 1. For the other report, see COMMITTEE ON CAPITAL MARKETS REGULATION, INTERIM REPORT OF THE COMMITTEE ON CAPITAL MARKETS REGULATION 82 (Nov. 30, 2006) [hereinafter "INTERIM CAPITAL MARKETS REPORT"], *available at* http://www.capmktsreg.org/pdfs/11.30Committee_Interim_ReportREV2.pdf. Established by Secretary of the U.S. Treasury Henry M. Paulson, Jr., the Committee is an independent, bipartisan committee composed of twenty-two corporate and financial leaders. *See id.* at vii.

164. INTERIM CAPITAL MARKETS REPORT, *supra* note 163, at 82. Similarly, the *Capital Markets Report* expresses a need to avoid a potential "doubling" of the costs for each violation and to avoid the "duplicate investor compensation problem." CAPITAL MARKETS REPORT, *supra* note 163, at 88–89. *See also* Lehn, *supra* note 88, at A16.

165. *See supra* notes 97–105 and accompanying text.

166. *See, e.g.*, SEC v. Risman, 7 F. App'x 30, 31 (2d Cir. 2001) (holding that disgorgement payments made to victims cannot duplicate payments already made in criminal restitution proceedings).

167. *See* Atkins Remarks, *supra* note 91. *See also* Jonathan Peterson, *Corporate Fraud Fund on Track, Officials Say; $2.6 Billion Collected for Investors*, CHI. TRIB., Sept. 28, 2004, at C1 (quoting Rep. Oxley saying, "[w]hen corporate executives make out like bandits, the money ought to go back to the investors, not to trial lawyers"); Rep. Richard Baker, *The Election and Your 401(k)*, NAT'L REV. ONLINE (Nov. 2, 2006), http://article.nationalreview.com/?q=YzBmZWRhZmRhOTUyYjU1ZGUyMTNkNGU4MTkwZWU1YWI=#moret (contrasting SEC's collections under the Fair Fund provision with "runaway litigation" and criticizing Milberg Weiss); Ted Frank, Opinion, *'Arbitrary and Unfair,'* WALL ST. J., May 31, 2007, at A14 (the author,

advantage to investors, however, is diminished if, as is likely, securities plaintiffs' attorneys have greater incentives than government attorneys to negotiate a larger amount because their compensation depends on it. Professor Coffee sets forth statistics showing that defendants pay much more in securities class action settlements than in public monetary sanctions.[168]

Simultaneous with the business community's support for section 308, there has been substantial criticism of the dramatic increase in the size of the SEC's corporate penalties in the post-Enron era, both for the agency's failure to set forth a consistent policy and also for its insufficient appreciation for the impact of penalties on current shareholders.[169] As a result, in January 2006, the SEC issued a Statement Concerning Financial Penalties (the "Statement"),[170] stating the "fundamental principle" that corporate penalties are a necessary component of an effective enforcement program as they "contribute[] to the Commission's ability to achieve an appropriate level of deterrence."[171] Yet, relying heavily on the 1990 Act's legislative history, the SEC recognized that if the shareholders did not benefit from the fraud, imposition of a penalty on the corporation worked a hardship on the shareholders.[172] Following from that realization, the SEC stated that the appropriateness of a corporate penalty turns principally on two considerations: the "presence or absence of a direct benefit to the corporation as a result of the violation" and the "degree to which the penalty will recompense or further harm the injured shareholders."[173] The SEC also listed other factors it would take into account, including 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."[174]

resident fellow at the American Enterprise Institute, says; "[o]ne can help investors without paying billions to the likes of Mr. Lerach").

168. *See* Coffee, *supra* note 4, at 1542–43.

169. As expressed by SEC Commissioner Cynthia A. Glassman, "I cannot justify imposing penalties indirectly on shareholders whose investments have already lost value as a result of the fraud. Our use of so-called Fair Funds... 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." *See* Cynthia A. Glassman, Comm'r, U.S. Sec. & Exch. Comm'n, Speech by SEC Commissioner: SEC in Transition: What We've Done and What's Ahead (June 15, 2005), http://www.sec.gov/news/speech/spch061505cag.htm. *See also* Stuart, *supra* note 94, at 81 (quoting former SEC Commissioner Joseph Grundfest that in some cases "these fines punish the victims twice," particularly if those responsible for the violations have been removed).

170. Press Release, U.S. Sec. & Exch. Comm'n, Statement of the Securities and Exchange Commission Concerning Financial Penalties (Jan. 4, 2006), http://www.sec.gov/news/press/2006-4.htm [hereinafter "SEC Financial Penalties Press Release"].

171. *Id.*

172. *See id.*

173. *Id.*

174. *Id.* In April 2007, Chairman Cox confirmed that, effective January 2007, SEC enforcement attorneys were required to get pre-approval from the Commission before initiating settlement negotiations that might result in a corporate penalty. *See* Christopher Cox, Chairman, U.S. Sec. & Exch. Comm'n, Speech by SEC Chairman: Address to the Mutual Fund Directors Forum; Seventh Annual

These principles are generally consistent with the factors set forth in the 1990 Act's legislative history, except that the SEC omitted one factor and introduced another. The Statement does not address the congressional comment that if there are criminal violations, civil penalties may not be necessary;[175] the SEC frequently brings enforcement actions and collects penalties against defendants who also pay criminal penalties.[176] By introducing a new factor—"*[t]he presence of an opportunity to use the penalty as a meaningful source of compensation to injured shareholders is a factor in support of its imposition*"[177]—the SEC acknowledged that section 308 could provide an incentive for larger penalties. The SEC did not, however, give any indication of how it would resolve the tension between compensating injured investors and avoiding harm to innocent shareholders.

It is still too soon to determine the effect on corporate penalties of the Statement and the requirement that SEC enforcement attorneys seek approval from the Commission before commencing negotiations that are likely to include a corporate penalty.[178] Although it was generally expected that the Statement and the requirement of Commission approval would result in lower corporate penalties, Chairman Cox denied that this was the intent.[179] The largest corporate penalty in post-Statement financial fraud settlements was $50 million, paid by Freddie Mac to settle what the SEC described as a four-year, "multi-billion dollar accounting fraud."[180] While this is a large penalty, it is significantly less than previous corporate penalties in high-profile cases.[181] The volume of high penalty financial fraud cases was down in fiscal year 2007.[182] Frustratingly, the SEC releases do not typically provide much explanation for calculation of the amount of the penalty.[183] In all instances of financial fraud cases that settled with corporate penalties, the corporation paid no

Policy Conference (Apr. 13, 2007), http://www.sec.gov/news/speech/2007/spch041207cc.htm [hereinafter "Cox Address"].

175. *See supra* note 44 and accompanying text.

176. *See, e.g.*, AIG Litigation Release, *supra* note 120.

177. SEC Financial Penalties Press Release, *supra* note 170 (emphasis added).

178. *See* Cox Address, *supra* note 174.

179. *Id.*

180. Freddie Mac and Four Former Accounting Executives Settle SEC Enforcement Action in Connection with Multi-Billion Dollar Accounting Fraud, Litigation Release No. 20304 (Sept. 27, 2007), *available at* http://www.sec.gov/litigation/litreleases/2007/lr20304.htm.

181. *See supra* notes 97–137 and accompanying text.

182. 2007 PAR, *supra* note 78, at 15, 18.

183. In 2007, the SEC settled, in addition to Freddie Mac, eight financial fraud cases that included corporate penalties. *See* MBIA To Pay $50 Million To Settle Securities Fraud Charges for Misuse of Reinsurance Contracts, Litigation Release No. 19982 (Jan. 29, 2007) ($50 million penalty; SEC stated that it elected not to apply SEC's new policy on corporate penalties because the settlement was negotiated before its release), *available at* http://www.sec.gov/litigation/litreleases/2007/lr19982.htm; SEC Charges ConAgra Foods, Inc. in Financial Fraud and Accounting Case; ConAgra Agrees To Pay $45 Million Penalty To Settle Charges, Litigation Release No. 20206 (July 25, 2007), *available at* http://www.sec.gov/litigation/litreleases/2007/lr20206.htm; Nortel Network Pays $35 Million To Settle Financial Fraud Charges, Litigation Release No. 20333 (Oct. 15, 2007) ($35 million penalty; SEC acknowledged the company's "substantial remedial efforts and cooperation," which presumably reduced the penalty), *available at* http://www.sec.gov/litigation/litreleases/2007/lr20333.htm; SEC Sues Cardinal Health, Inc. for Fraudulent Earnings and Management Revenue Scheme, Litigation Release No. 20212 (July 26, 2007) ($35 million penalty; SEC acknowledged the company's "cooperation," which presumably reduced the penalty), *available at* http://www.sec.gov/litigation/litreleases/2007/lr20212.

disgorgement amounts (in excess of $1), and the SEC announced its intention to create a Fair Fund to distribute the penalty to investors.[184]

IV. Assessing the SEC's Mission in Light of Section 308

A. The SEC's and the Judiciary's View of the Agency's Mission

Protecting investors by enforcing compliance with the securities laws has been an important part of the SEC's mission, while obtaining compensation for investors historically has not.[185] While Chairman Cox[186] and SEC Directors of Enforcement[187] have pointed with pride to the large amounts the SEC has allocated to Fair Fund distributions, the agency has resisted any suggestion that section 308 changes its mission in any fundamental way. Moreover, neither the SEC[188] nor the judiciary has recognized the possibility that there could be a conflict between enforcing securities laws and compensating investors.

Congress included in section 308 a requirement that the SEC review its enforcement proceedings involving collection of money for the five years preceding the enactment of SOX and report its findings.[189] Congressional concern likely stemmed from a U.S. General Accountability Office ("GAO") report, issued the same month

htm; Reinsurer Settles Accounting Fraud Case Involving Sham Reinsurance Transaction, Litigation Release No. 19989 (Feb. 6, 2007) ($15 million penalty; SEC stated that it elected not to apply the new policy because the settlement was negotiated before its release), *available at* http://www.sec.gov/litigation/litreleases/2007/lr19989.htm; SEC v. Nicor Inc., Litigation Release No. 20060 (Mar. 29, 2007) ($10 million penalty), *available at* http://www.sec.gov/litigation/litreleases/2007/lr20060.htm; SEC v. Tenet Healthcare Corp., Litigation Release No. 20067 (Apr. 2, 2007) ($10 million penalty), *available at* http://www.sec.gov/litigation/litreleases/2007/lr20067.htm; First BanCorp Settles Financial Fraud Charges with SEC and Agrees To Pay $8.5 Million Penalty, Litigation Release No. 20227 (Aug. 7, 2007) ($8.5 million penalty), *available at* http://www.sec.gov/litigation/litreleases/2007/lr20227.htm.

184. *See id.*

185. *See supra* notes 1–4 and accompanying text.

186. *See supra* note 9 and accompanying text. Commissioner Cynthia Glassman, in contrast, thought Fair Fund distributions of corporate penalties were "form over substance." *See supra* note 169.

187. For example, Linda Chatman Thomsen, Director of the SEC's Division of Enforcement, said, "'[w]ith this distribution, the Commission will have distributed over $2 billion in Fair Fund monies since the 2002 passage of the Sarbanes-Oxley Act, demonstrating our continued resolve to return money to injured investors where appropriate.'" Press Release, U.S. Sec. & Exch. Comm'n, SEC Announces $316 Million Fair Fund Distribution to Investors Harmed by Fraud at Time Warner (July 9, 2007), http://www.sec.gov/news/press/2007/2007-131.htm; *see also* Stephen M. Cutler, Dir., Div. of Enforcement, U.S. Sec. & Exch. Comm'n, Speech by SEC Staff: Remarks Before the District of Columbia Bar Association (Feb. 11, 2004), http://www.sec.gov/news/speech/spch021104smc.htm.

188. Although Commissioner Atkins has previously spoken approvingly of Fair Fund distributions, *see supra* note 91, more recently he gave a speech in which he expressed concern that the SEC "may become an extension of the plaintiffs' bar, with similar philosophy and tactics." Paul S. Atkins, Comm'r, U.S. Sec. & Exch. Comm'n, Speech by SEC Commissioner: The SEC's Role in Globalization of the Capital Markets (Oct. 16, 2007), http://www.sec.gov/news/speech/2007/spch101607psa.htm.

189. Specifically, the SEC was to "identify areas where such proceedings may be utilized to efficiently, effectively, and fairly provide restitution for injured investors," section 308, *supra* note 5, as well as to review and analyze "other methods to more efficiently, effectively, and fairly provide restitution to injured investors, including methods to improve the collection rates for civil penalties and disgorgements," SOX § 308(c)(1)(B), 15 U.S.C. § 7246(c)(1)(B) (Supp. V 2005). The required report was also to "include a discussion of regulatory or legislative actions that are recommended or that may

that SOX was enacted, that was critical of the SEC's efforts to collect and distribute disgorged funds.[190] In its review, the SEC outlined its agenda and set forth its priorities—swift enforcement actions ("real time" enforcement) and emergency measures like temporary restraining orders, asset freezes, and the appointment of receivers that are used both to shut down frauds and to increase the chances of returning funds to investors.[191] The SEC also asserted the need for aggressive assertion of disgorgement claims so that civil penalties could be added to the funds.[192] It expressed no conflict between its enforcement and collection efforts.[193]

Two years later, however, in its *2004–2009 Strategic Plan,* the SEC subtly de-emphasized the importance of collecting funds for investors when it set forth its vision, mission, and strategic goals for the next five years. It described its mission as threefold: "[t]o protect investors; maintain fair, orderly, and efficient markets; and facilitate capital formation."[194] To this end, it articulated four goals: enforce compliance with federal securities laws, sustain an effective and flexible regulatory environment, encourage and promote informed investment decision-making, and maximize use of SEC resources.[195] It did not explicitly identify returning money to defrauded investors as part of its mission or goals. Rather, consistent with the SEC's traditional view, collecting money on behalf of defrauded investors remains a subsidiary function of the agency.

While judicial scrutiny of section 308 is limited, courts share the SEC's view. The U.S. Court of Appeals for the Second Circuit, in *Official Committee of Unsecured Creditors of Worldcom, Inc. v. SEC,* rejected the plaintiff's argument that section 308 worked a "sea change" in the SEC's powers and responsibilities and changed its focus from deterrence to compensation.[196] To the contrary, in the view of the court, the Fair Fund provision merely increased the funds available for distribution at the SEC's discretion; it did not alter the SEC's discretion to determine whether to distribute funds and how to distribute them.[197]

Thus, neither the SEC nor the courts have addressed whether increased efforts to collect money on behalf of investors has any distorting effect on the agency's selection of enforcement cases. The next part turns to this question.

B. The Bigger Picture

The difficulty in tackling this question is that beyond global statements, the SEC provides little elaboration as to the implementation of its mission and goals. Indeed,

be necessary to address concerns identified in the study." SOX § 308(c)(2), 15 U.S.C. § 7246(c)(2) (Supp. V 2005).

190. *See* U.S. Gen. Accounting Office, Report to Congressional Requesters, SEC Enforcement: More Actions Needed To Improve Oversight of Disgorgement Collections (GAO-02-771) (July 2002), *available at* http://www.gao.gov/new.items/d02771.pdf.

191. Section 308(c) Report, *supra* note 3, at 22–23.

192. *Id.* at 23–24.

193. It acknowledged the costs involved in creating and administering distribution plans, *id.* at 23–24, as well as the need to improve collection rates. *Id.*

194. Strategic Plan, *supra* note 1, at 4.

195. *Id.* at 3.

196. 467 F.3d 73, 83 (2d Cir. 2006).

197. *Id.*

a recent congressional study criticized the SEC because it had "no mechanism for designating a case as critically important"[198] and recommended that the SEC establish standards for assessing the importance of enforcement actions.[199] Accordingly, although we can theorize about a conflict between the deterrence and compensation functions of the SEC, it is hard to assess whether there actually is a conflict without a better understanding of the process the agency uses to determine enforcement priorities.[200] The SEC states that its policy is that it must ensure that enforcement actions are not over—or underrepresented in the areas it regulates—no more than 40% in any one category—so as to maintain a "presence" in every area it regulates.[201] In recent years, the SEC has devoted a substantial amount of its resources to high-profile areas like insider trading and financial fraud and has emphasized "real-time enforcement." Accordingly, it describes its enforcement policy as follows:

> The SEC seeks to detect problems in the securities markets, prevent and deter violations of federal securities law, and alert investors to possible wrong-doing. When violations occur, the SEC aims to take prompt action to halt the misconduct, sanction wrongdoers effectively and, where possible, return funds to harmed investors."[202]

Beyond this, the fullest explanation comes not from the agency itself but from a GAO report that investigated human resources issues at the agency:

> [The] SEC generally prioritizes the cases in terms of (1) the message delivered to the industry and public about the reach of [the] SEC's enforcement efforts, (2) the amount of investor harm done, (3) the deterrent value of the action, and (4) [the] SEC's visibility in certain areas such as insider trading and financial fraud.[203]

There are a few principles to determining what constitutes an effective enforcement program. Most fundamentally, the SEC, as an agency with limited resources, has to make hard choices about the optimal use of its resources to enforce the securities laws. The SEC should continue to bring high-profile cases involving firms

198. MINORITY STAFF OF THE U.S. SENATE COMM. ON FINANCE AND THE U.S. SENATE COMM. ON THE JUDICIARY, 110TH CONG., THE FIRING OF AN SEC ATTORNEY AND THE INVESTIGATION OF PEQUOT CAPITAL MANAGEMENT 7 (Comm. Print 2007), *available at* http://www.finance.senate.gov/sitepages/leg/LEG%202007/36960.pdf.

199. *Id.*

200. Some indication that there is a problem is the fact that enforcement did not meet its 2007 performance measure for the number of first enforcement actions filed within two years of opening an investigation. The reasons given were that there was a higher percentage of complex cases involving issuer reporting and disclosure and significant resources were devoted to the distribution of Fair Funds. 2007 PAR, *supra* note 78, at 27.

201. 2006 PAR, *supra* note 7, at 11. "The Division of Enforcement aims to maintain an enforcement presence in each of the areas within its jurisdiction, while concentrating on particular problem areas." Ralph C. Ferrara & Philip S. Khinda, *SEC Enforcement Proceedings: Strategic Considerations for when the Agency Comes Calling*, 51 ADMIN. L. REV. 1143, 1146 (1999).

202. 2006 PAR, *supra* note 7, at 6.

203. U.S. GEN. ACCOUNTING OFFICE, TESTIMONY BEFORE THE SUBCOMMITTEE ON OVERSIGHT OF GOVERNMENT MANAGEMENT, RESTRUCTURING AND THE DISTRICT OF COLUMBIA, COMMITTEE ON GOVERNMENTAL AFFAIRS, U.S. SENATE, HUMAN CAPITAL: MAJOR HUMAN CAPITAL CHALLENGES AT SEC AND KEY TRADE AGENCIES (GAO-02-662T) 6 (Apr. 23, 2002), *available at* http://www.gao.gov/new.items/d02662t.pdf.

with large market capitalization in order to send a strong deterrence message.[204] It would be unthinkable if the SEC did not bring actions against the Enrons and the Worldcoms, even though these companies will also be the targets of private plaintiffs. The SEC, however, must also continue to bring enforcement actions against small market capitalization companies; since cases against these companies are unlikely to result in a sizable financial recovery, private parties are unlikely to file suits and there is a danger of insufficient deterrence if the SEC does not police them. Finally, the SEC plays an important role in shutting down Ponzi or other blatant frauds to prevent harm to the most unsophisticated investors. In many of these cases, there is not a great likelihood of recovering funds. It would not, however, be acceptable federal policy to cut back on protecting the most vulnerable of investors.[205]

The SEC should also bring more enforcement actions against individuals who violate the securities laws. People, after all, cause entities to violate the securities laws. Requiring the individual wrongdoers to disgorge profits and pay penalties avoids the harm to innocent shareholders and is consistent with recommendations of other commentators with respect to collecting damages in private actions from individual defendants.[206] The consequence of pursuing individuals, however, would be smaller penalties. Corporate executives may be wealthy individuals, but few of them have personal assets comparable to the corporation's wealth, and individual defendants would likely fight harder to keep their individual wealth than corporate managers fight to keep assets within the corporation. As a result, individuals would receive less money in Fair Fund distributions, and the SEC's "bragging rights" for collecting large sums on behalf of investors would be diminished.

Finally, the SEC should continue to bring aiding and abetting enforcement actions because private parties cannot. To the extent the aiders and abetters are investment firms and other deep-pocket defendants, this is a source of significant funding for Fair Fund distributions.

The above discussion illustrates that the SEC's enforcement policy must be shaped by many competing considerations. Accordingly, compensating investors should not be a primary factor in selecting enforcement actions because SEC enforcement actions serve important goals other than compensating investors—namely, deterrence and investor confidence.

204. Professors Cox and Thomas criticize the SEC for not pursuing more large market-capitalization defendants in the pre-Enron era. *See* Cox & Thomas, *supra* note 12, at 777–78. In their subsequent paper, they observe that, post-Enron, the SEC shifted its enforcement focus away from firms in financial distress to companies where investors may have suffered larger losses. *See* James D. Cox & Randall S. Thomas, *Public and Private Enforcement of the Securities Laws: Have Things Changed Since Enron?*, 80 NOTRE DAME L. REV. 893, 906 (2005).

205. *See generally* Margaret V. Sachs, *Materiality and Social Change: The Case for Replacing "The Reasonable Investor" with "The Least Sophisticated Investor" in Inefficient Markets*, 81 TUL. L. REV. 473 (2006).

206. Professor Coffee goes so far as to suggest that Rule 10b-5 should be "disimplied" with respect to the non-trading corporate defendants. *See* Coffee, *supra* note 4, at 1582–84.

The SEC faces similar competing considerations in negotiating settlements. It may have important goals besides achieving compensation for investors, such as ensuring that the corporation implements more effective internal controls or adopts measures to assure better corporate governance. In negotiations with tenacious, experienced defense attorneys, the SEC may have to make hard decisions about what remedies it should impose in a settlement. If the SEC is primarily motivated to obtain a large Fair Fund, it may be willing to sacrifice remedial measures that, in the long run, are more beneficial to investors.

Finally, important elements of an enforcement program are fair notice and consistency in assessing sanctions. The SEC needs to provide better guidance and transparency in its corporate penalty policy. Its Statement Concerning Financial Penalties was a useful first step that awaits further implementation.

V. Conclusion

The SEC's increased power under section 308 has, to date, not received much scholarly attention, but, as this Article seeks to demonstrate, it has important implications for the SEC's mission to enforce securities laws and punish violators as well as the ongoing debate over the future of the securities fraud class action. There is no doubt that the SEC can gain political capital from proclaiming that it is collecting and returning money to investors. However, a focus on compensating investors presents the danger that the SEC may give undue emphasis to the possibility of obtaining a large settlement in its selection of enforcement actions. Moreover, as its recent actions suggest, the SEC may sacrifice legal principles and consistency in its zeal to create large Fair Fund distributions. Deemphasizing or even eliminating the statutory requirement of disgorgement and increasing the amounts of corporate penalties may have deflected the SEC's attention from which investors have suffered the greater harm from corporate frauds—the shareholders who purchased the stock at the artificially inflated price or the shareholders who are harmed by the payment of the penalty. Therefore, there should be distribution of penalties to investors only where the SEC has identified the basis and amount of actual ill-gotten gains and only to the extent that the SEC acts consistently with its revised policy on corporate penalties. If the SEC follows its Statement Concerning Financial Penalties, then its ability to use section 308 to create a sizable fund for distribution to investors will be substantially reduced in financial fraud cases where the corporation has not gained a tangible benefit.

Thus, even in the unlikely event of political will for a substantially larger agency (which is particularly unlikely since a significant amount of civil penalties are no longer going into the federal coffers),[207] effective enforcement policy is not necessarily compatible with a dominant emphasis on recovering and returning funds to investors.

207. A payment of a certain percentage of penalties to the U.S. Treasury to offset the decrease in government revenues would be a reasonable policy, although it is very likely politically unpalatable.

The securities fraud class action has its flaws and has, on occasion, been misused. It remains, however, the most effective mechanism for shareholder compensation. The policy that the business community is advocating—that the SEC assume primary responsibility for collecting funds for investors—would not be a sensible choice for the protection of investors.