THE PRACTITIONER'S GUIDE TO THE SARBANES-OXLEY ACT

VOLUME 1

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CHAPTER 2

Sarbanes-Oxley and the SEC's Enforcement Program

William R. McLucas and Paul R. Eckert

Beginning in 2000, the domestic capital markets underwent a virtually unprecedented period of upheaval. Already faced with a substantial market decline and a seemingly endless stream of financial restatements by some of the nation's largest public companies, investors soon were confronted with how to respond to the collapse of Enron, Adelphia, WorldCom and a series of scandals involving corporate officers and directors, investment banks, and the accounting profession. Market participants, regulators, and the financial press perceived a failure of the safeguards that were historically considered reliable checks on corporate misconduct. The gatekeeping role played by auditors, the securities regulators, the self-regulatory bodies, and securities lawyers all came under scrutiny. As the number of restatements and scandals rose, support for strong action to address real or perceived root causes mounted.

In early 2002, members of Congress and investor advocacy groups urged the overhaul or elimination of the role played by the American Institute of Certified Public Accountants in the oversight of public accounting firms. The Commission itself and the securities self-regulatory organizations (such as the New York Stock Exchange and the National Association of Securities Dealers) also came under examination for perceived failures of oversight in identifying, preventing, or policing the conflicts of interest associated with investment bank research analysts, the IPO allocation practices of Wall Street underwriters, and even the efficacy of the role played by the nationally recognized statistical rating organizations. As the crisis of confidence has deepened, concern has expanded to include the membership and expertise of public company audit committees and a myriad of questionable practices observed by corporate boards in connection with executive compensation and other so-called "corporate governance" issues. Even as this Chapter is being written, new revelations about alleged abuses in the

mutual fund industry and questions about governance at the NYSE with respect to executive compensation matters have contributed to the weakening confidence in the domestic capital markets.

The Sarbanes-Oxley Act of 2002, passed on July 30, 2002, reflected perhaps a classic American approach to the escalating crisis. Remedial legislation addressing perceived statutory inadequacies was cobbled together at remarkable speed and passed after a flurry of round-the-clock activity, just before a scheduled congressional recess. With very little legislative history or pre-vote analysis of the Act's ramifications, its reach and potential impact will not be known for years to come. Certain provisions of the Act may come to be seen as legislative overreactions (the scope and reach of some of the criminal sanctions are simply breathtaking), certain provisions raise questions (the absence of Commission authority to fine accounting firms in administrative proceedings), and still other provisions may continue as enduring mysteries (why, for example, did the Congress tinker with the definition of "statutory disqualification"—a collateral consequence applicable to broker-dealers—without explanation or apparent rationale).

The Act is unquestionably the product of a unique period of time for our capital markets. Public outcry for prompt and meaningful accountability for corporate misconduct energized the Congress and the Commission to do more than tinker with the federal securities laws. In the wake of WorldCom's June 2002 announcement that it had understated over $3.8 *billion* in expenses, it certainly seemed that Congress and the Commission believed that no penalty or consequence was too severe for those found to have committed serious misconduct. Indeed, then-Commission Chairman Harvey L. Pitt—with the case against WorldCom still pending—remarked that "prison may be too good" for those responsible for the reporting violations.[1] The Act certainly reflects this appetite for severity. It contrasts starkly with the congressional attitude at the time of the enactment (over a veto) of the Private Securities Litigation Reform Act of 1995 just seven years earlier.[2] That Act, which was designed to reduce the incidence and impact of meritless private securities class action litigation and the dampening effect such cases had on the entrepreneurial efforts of business people, adopted a number of hurdles to cases seeking to impose civil liability on public companies and auditors. It is hard to believe that the Sarbanes-Oxley Act and the Private Securities Litigation Reform Act were passed by the same legislative body.

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1. Peter Morton, *WorldCom's Survival Depends on Bankers: CEO Apologizes: But Sidgmore Won't Rule Out Filing for Bankruptcy,* Nat'l Post, July 3, 2002.

2. Pub. L. No. 104-67, 109 Stat. 737.

In a remarkably short time, certain of the Sarbanes-Oxley Act's provisions have already become cornerstones of the Commission's enforcement program. This Chapter will review the significant law enforcement provisions of the Act and discuss what we may expect from the Commission in connection with its enforcement program.

INCREASED ENFORCEMENT AUTHORITY TO ADDRESS ISSUES OF CORPORATE, PROFESSIONAL, AND SECURITIES INDUSTRY RESPONSIBILITY

One objective of the Sarbanes-Oxley Act was to strengthen the Commission's ability "to accomplish its mission of assuring the integrity of the markets and protecting investors."[3] The following provisions particularly enhanced the Commission's authority to regulate issues of corporate, professional, and securities industry responsibility.

Forfeiture of Certain Bonuses and Profits (Section 304)

In either civil actions or administrative proceedings alleging violations of the federal securities laws, the Commission may seek disgorgement of the pecuniary benefits of illegal conduct.[4] The federal securities laws do not, however, define or otherwise provide what constitutes improper enrichment. Federal case law and Commission settlements have offered limited guidance on the reach of the disgorgement remedy. In recent years, the Commission expanded the disgorgement remedy through a series of settled enforcement actions that sought recovery of (1) bonuses obtained by individuals from conduct that violated the securities laws[5] and (2) all "unjust enrichment" received by individuals

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3. Public Company Accounting Reform and Investor Protection Act, S. Rep. No. 107-205, at 39-40 (2002).

4. *See* Exchange Act § 21C(e); Securities Act § 8A(e).

5. *See, e.g., SEC v. Daws,* Litig. Rel. No. 17564, AAER No. 1577, 77 SEC Docket (CCH) 2795 (June 14, 2002) (settlement requiring the disgorgement of a $30,000 "performance bonus"); *SEC v. Tarkenton,* Litig. Rel. No. 16306, AAER No. 117, 70 SEC Docket (CCH) 1677 (Sept. 28, 1999) (settlement requiring the disgorgement of "incentive compensation" received on the basis of "overstated quarterly earnings"); *SEC v. Welch,* Litig. Rel. No. 17165, AAER No. 1461, 75 SEC Docket (CCH) 2380 (Sept. 28, 2001) (settlement requiring the disgorgement of bonuses paid based on misstated earnings); *SEC v. Bergonzi,* Litig. Rel. No. 17577, AAER No. 1581, 77 SEC Docket (CCH) 3003 (June 21, 2002) (pending civil action seeking the disgorgement of "performance-based bonus" based on misstatement of net income).

from their employment after the occurrence of the violation, including salary, options, and bonuses (on the apparent theory that the culpable individual should have been fired).[6] Federal courts had yet to address whether, under the law prior to the passage of the Sarbanes-Oxley Act, otherwise standard performance bonuses and ordinary salaries could and should, under any particular set of facts, constitute improper enrichment subject to disgorgement.[7]

In response to the financial reporting frauds of 2001-2002, President Bush recommended in his ten-point plan that "CEOs or other officers should not be allowed to profit from erroneous financial statements."[8] Specifically, the President proposed that "CEO bonuses and other incentive-based forms of compensation should be disgorged in cases of accounting restatement or misconduct."[9] Congress codified this proposal in Section 304 of the Act, granting to the Commission statutory authority to seek disgorgement of bonuses and other incentive compensation gained in violation of the securities laws.[10] The provision provides that, if an issuer is required to prepare an accounting restatement due to material noncompliance with Commission financial reporting requirements, the CFO and CEO shall reimburse the issuer for (1) any bonus, incentive, or equity-based compensation received from that issuer during the 12 month period following the filing that was required to be restated and (2) any profit realized by them from sales of the issuer's securities during that period.[11]

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6. *See, e.g., In the Matter of Kealy,* Exchange Act Rel. No. 35499, 58 SEC Docket (CCH) 2623 (Mar. 16, 1995) (settlement ordering the disgorgement of all "salary, bonuses, [and] commissions" received during the time of the fraud); *SEC v. Gallo,* Litig. Rel. No. 17410, AAER No. 1521, 77 SEC Docket (CCH) 310 (Mar. 13, 2002) (pending civil action seeking disgorgement of all "compensation, remuneration and trading profits, with prejudgment interest, and [the] surrender of all unexercised stock options" received as a result of the misreporting of financial information); *SEC v. Buntrock,* Litig. Rel. No. 17435, AAER No. 1532, 77 SEC Docket (CCH) 695 (Mar. 26, 2002) (pending civil action seeking disgorgement of performance-based bonuses, salaries, and "enhanced retirement benefits" received during the course of the alleged fraud).

7. We understand that the SEC Staff has suggested that a line of authority under New York's "faithless servant doctrine" supports its pre-Act position on disgorgement of compensation. This doctrine, which provides for the forfeiture of "compensation paid during the time period of disloyalty," was recently addressed by the Second Circuit. *See Phansalker v. Andersen Weinroth & Co., LP,* 344 F.3d 184, 205 (2d Cir. 2003). In the absence of comparable precedent under the federal securities acts, federal courts' willingness to embrace such a common law extension of the disgorgement remedy remains uncertain.

8. *See President's Plan To Improve Corporate Responsibility,* at http://www.whitehouse.gov/infocus/corporateresponsibility (June 28, 2002).

9. *Id.*

10. Sarbanes-Oxley Act § 304, 116 Stat. 778.

11. Sarbanes-Oxley Act § 304, 116 Stat. 778 (codified at 15 U.S.C.A. § 7243 (2003)).

The manner in which Section 304 of the Act will be used remains unclear. To date, there have been no reported cases under this provision. Whether, for example, the Commission will take the position that disgorgement made under Exchange Act Section 21C(e) cannot be used to offset claims under this provision remains an open issue. Commission settlement provisions, which restrict "offsets" for penalty amounts only, suggest that this is unlikely. Also unclear is whether corporate boards of directors, under state law fiduciary obligations, may exercise their business judgment as to whether to advance claims under this provision.

Officer and Director Bars and Penalties (Section 305, Section 1105)

Prior to the enactment of the Sarbanes-Oxley Act, the Commission's statutory authority to obtain an officer and director bar required a civil injunctive action in federal district court. The Commission had no express statutory authority to prohibit individuals from serving as officers or directors of public companies in administrative proceedings.[12] As a result, the Commission generally would either (1) petition a federal court to issue an order in connection with an injunctive action, temporarily or permanently barring a defendant officer or director from serving in such capacity because he or she had demonstrated "substantial unfitness" to hold the position and had violated Section 17(a)(1) of the Securities Act or Section 10(b) of the Exchange Act[13] or (2) seek an undertaking that a defendant or respondent would not serve as an officer or director of a public company in a settled action or proceeding.[14]

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12. Although early versions of the Securities Enforcement Remedies and Penny Stock Reform Act of 1990, Pub. L. No. 101-429, 104 Stat. 931, would have granted the Commission independent authority to issue so-called officer and director bars in administrative proceedings, the provision was removed after substantial criticism by the American Bar Association. *See* Jayne Barnard, *The SEC's Suspension and Bar Power in Perspective,* 76 Tul. L. Rev. 1253, 1256-57 (2002).

13. *See* Securities Act § 20(e); Exchange Act § 21(d)(2). The Remedies Act of 1990 granted federal courts the express statutory authority to bar individuals from serving as an officer or director "if the person's conduct demonstrates substantial unfitness to serve as an officer or director." Exchange Act § 21(d)(2). Prior to the Remedies Act, the Commission sought officer and director bars by invoking the inherent equitable powers of federal courts. *See SEC v. Techni-Culture,* No. C-73-473, 1974 WL 385, at *2 (D. Ariz. Apr. 2, 1974).

14. *See, e.g., SEC v. Barber,* Litig. Rel. No. 17314, AAER No. 1498, 76 SEC Docket (CCH) 1756 (Jan. 15, 2002) (permanently barring defendant from serving as an officer or director of any public company); *SEC v. Mitchellette,* Litig. Rel. No. 16553, 72 SEC Docket (CCH) 1102 (Mar. 15, 2000) (same); *SEC v. Itex Corp.,* Litig. Rel. No. 16841, AAER No. 1357, 73 SEC Docket (CCH) 3194 (Dec. 26, 2000) (same); *SEC v. Caserta,* Litig. Rel. No. 17115, AAER No. 1436, 75 SEC Docket (CCH) 1772 (Sept. 5, 2001) (barring defendant from serving as an officer or director of any public company for 5 years).

Perhaps because of the Exchange Act's "substantial unfitness" standard for the imposition of officer and director bars, courts generally had been reluctant to issue permanent bars orders (or bars of significant duration) unless confronted with particularly egregious misconduct. The "particularly egregious" standard was strongly suggested by the legislative history of the Remedies Act, including testimony given by Commission chairmen David S. Ruder[15] and Richard C. Breeden,[16] and by an influential article proposing various considerations.[17] For example, in *SEC v Farrell,* the court limited its bar against the defendant director to banking or financial institutions, stating that the defendant "should not be permanently prevented from using his talents to rebuild his life."[18]

In the aftermath of the Enron accounting scandal and bankruptcy, the Commission actively lobbied for the authority to issue officer and director bars in administrative proceedings. Stephen Cutler, the Commission's Director of the Division of Enforcement, suggested that "[s]uch an expansion of Commission authority would help make impo-

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15. Hearings on a Bill To Amend Federal Securities Laws in Order To Provide Additional Enforcement Remedies for Violations of these Laws: H.R. 975 Before the Subcomm. on Telecommunications and Finance of the House Comm. on Energy and Commerce, 101st Cong., 1st Sess. 65 (1989) (statement of then-Chairman David S. Ruder) ("In general, the most egregious cases would probably cause us to file an injunctive action and proceed in that manner.").

16. The Securities Law Enforcement Remedies Act of 1989: Hearings Before the Subcomm. on Securities of the Senate Comm. on Banking, Housing and Urban Affairs on S. 647, 1st Sess. 62 (1990) (statement of then-Chairman Richard C. Breeden) ("[T]he Commission would in any event seek this remedy, as it generally has in the past, only in those cases that warrant the bringing of a civil injunctive action and that involve egregious fraudulent conduct.").

17. Jayne W. Barnard, *When Is a Corporate Executive "Substantially Unfit To Serve"?,* 70 N.C. L. Rev. 1489, 1510-11 (1992) ("In lobbying for the Remedies Act, both SEC Chairman Richard Breeden and his predecessor, David Ruder, assured Congress that the Commission would seek executive suspension and bar orders only in cases of 'egregious' misconduct or of repeated violations of the securities laws.").

18. SEC v. Farrell, No. 95-CV-6133T, 1996 WL 788367, at *8 (W.D.N.Y. Nov. 6, 1996); *see also* SEC v. McCaskey, 2001 WL 1029053 (S.D.N.Y. Sept. 6, 2001) (holding that a permanent officer and director bar was not warranted notwithstanding a finding by that court that "there is a likelihood that McCaskey would, if not enjoined from doing so, continue to violate the federal securities laws"); *SEC v. Patel,* 61 F.3d 137, 142 (2d Cir. 1995) (reversing district court's imposition of a permanent officer and director bar in the absence of a finding that a conditional bar was not warranted). *Compare with SEC v. Softpoint,* 958 F. Supp. 846, 867 (S.D.N.Y. 1997) (issuing a permanent bar order); *SEC v. Posner,* 16 F.3d 520, 521-22 (2d Cir. 1994) (affirming the issuance of a permanent bar order); *SEC v. First Pacific Bankcorp,* 142 F.3d 1186, 1188-89 (9th Cir. 1998) (affirming the issuance of a permanent bar order).

sition of officer and director bars swifter and more certain."[19] Then-Chairman Harvey L. Pitt testified that the remedy was needed because courts had refused to enforce the plain legislative language, frustrating Commission efforts to prevent officers and directors who inflicted serious harm on investors from repeating their actions.[20]

Congress and the President responded.[21] Section 1105 of the Act granted the Commission the authority in administrative proceedings to issue orders prohibiting individuals from serving as an officer or director of any public company if the individual (1) has violated Securities Act Section 17(a)(1) or Exchange Act Section 10(b) and (2) has demonstrated unfitness to serve as an officer or director.[22] Section 305 of the Act also amended the standard applicable to civil actions by reducing the required showing from "substantial unfitness" to "unfitness" for service as an officer or director.[23] The lower threshold has resulted in these bars being sought almost as a matter of routine by the Commission.

Fair Funds Provision (Section 308)

In civil actions and administrative proceedings alleging violations of the securities laws, the Commission may seek disgorgement of ill-gotten gains, civil monetary penalties, or both.[24] Prior to the Act, disgorgement

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19. Stephen Cutler, Director, Division of Enforcement, SEC, Address at the Glasser LegalWorks 20th Annual Federal Securities Institute (Feb. 15, 2002) (stating that the remedy had been "sought too infrequently by the Commission, has been imposed on too limited a basis by the Courts, and is needed now, more than ever to respond to large financial frauds").

20. *Accounting and Investor Protection Issues Raised by Enron and Other Public Companies: Hearing Before the Senate Comm. on Banking, Housing and Urban Affairs*, 107th Cong. (2002) ("The President also endorsed our need for a administrative authority to bar officers and directors who seriously violate their duties to public shareholders.") (written statement of Harvey L. Pitt, Chairman, SEC).

21. President Bush recommended that "CEOs or other officers who clearly abuse their power should lose their right to serve in any corporate leadership positions." *President's Plan To Improve Corporate Responsibility*, at http://www.whitehouse.gov/infocus/corporateresponsibility (June 28, 2002). A Senate report accompanying an early version of the Act stated that federal courts had been reluctant to impose prospective bars against service as an officer or director, partially because the "substantially unfitness" standard was too high. Public Company Accounting Reform and Investor Protection Act of 2002, S. Rep. No. 107-205, at 26 (2002).

22. Sarbanes-Oxley Act § 1105, 116 Stat. 809-10.

23. Sarbanes-Oxley Act § 305(a) (amending Exchange Act § 21(d)(2)&(e)), 116 Stat. 778-79.

24. The Commission has statutory authority to impose civil monetary penalties in administrative proceedings only against registered persons (principally securities firms and their associated personnel).

payments received from administrative proceedings could be distributed to injured investors, but monetary *penalties* recovered in administrative proceedings and civil injunctive actions were transferred automatically to the U.S. Treasury.[25]

Congress enacted Section 308 of the Act, called the "Fair Funds Provision" (for "Federal Account for Investor Restitution Funds"), in an effort to increase the monetary recoveries of defrauded investors.[26] The Fair Funds Provision provides that, in any administrative proceeding or civil action brought by the Commission, if an order or settlement requires the payment of *both* disgorgement and a civil penalty, the Commission, in its discretion, may direct that all money recovered be added to a victim disgorgement fund.[27] Since the adoption of this provision, the Commission has adopted a policy of prohibiting parties to settlements of administrative proceedings and injunctive actions from receiving any "offset" for civil monetary penalties in related private litigation.[28]

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25. *See* Report Pursuant to Section 308(c) of the Sarbanes-Oxley Act of 2002, at 4-5 (Jan. 24, 2003), *available at* www.sec.gov/news/studies/sox308creport.pdf.

26. Baker Proposes New Federal Investor Restitution Fund (July 17, 2002), *available at* www.baker.house.gov/News/fair_fund.htm.

27. *See* Sarbanes-Oxley Act § 308(c), 116 Stat. 785 (codified at 15 U.S.C.A. § 7246 (2003)).

28. This policy is implemented through a mandatory provision included in all settlements involving civil monetary penalties, such as the following language from a recent settlement:

> Regardless of whether any such Fair Fund distribution is made, amounts ordered to be paid as civil money penalties pursuant to this Order shall be treated as penalties paid to the government for all purposes, including all tax purposes. To preserve the deterrent effect of the civil penalty, MFS agrees that it shall not, in any Related Investor Action, benefit from any offset or reduction of any investor's claim by the amount of any Fair Fund distribution to such investor in this proceeding that is proportionately attributable to the civil penalty paid by MFS ("MFS Penalty Offset"). If the court in any Related Investor Action grants such an offset or reduction, MFS agrees that it shall, within 30 days after entry of a final order granting the offset or reduction, notify the Commission's counsel in this action and pay the amount of the MFS Penalty Offset to the United States Treasury or to a Fair Fund, as the Commission directs. Such a payment shall not be deemed an additional civil penalty and shall not be deemed to change the amount of the civil penalty imposed against MFS in this proceeding. For purposes of this paragraph, a "Related Investor Action" means a private damages action brought against MFS by or on behalf of one or more investors based on substantially the same facts as alleged in the Order in this proceeding.

In the Matter of Massachusetts Fin. Servs. Co., John W. Ballen, and Kevin R. Parke, Advisers Act Rel. No. 2213, 82 SEC Docket (CCH) 341 (Feb. 5, 2004).

Section 308(c) of the Act directed the Commission to file a report with the House Committee on Financial Services to identify areas where enforcement proceedings could be used to provide restitution to injured investors, to study other ways in which restitution could be effected, and to recommend legislative and regulatory changes to address concerns within the study.[29]

The Commission filed its report on January 24, 2003, and made the following findings regarding the effectiveness of disgorgement proceedings:[30] (1) significant payments or non-payments by a small number of defendants had a disproportionate impact on the Commission's overall collection success[31]; (2) both the use of emergency orders freezing assets and receivers have had a positive impact on the Commission's ability to obtain money from defendants[32]; (3) where the amount of money collected is too small, or the number of defrauded investors is too large, it is not economically feasible to distribute funds[33]; (4) the Commission has had difficulty securing disgorgement when defendants have spent or hidden their money, or insufficient evidence exists to justify disgorgement[34]; and (5) private litigation remains the best mechanism for investor recovery of losses.[35] The report stated that the Commission intended to make greater use of its asset freeze authority, vigorously seek orders requiring the payment of disgorgement and civil money penalties, and make greater use of collection litigation, the U.S. Treasury Referral Program, and private collection agencies to improve collection rates.[36]

To improve victim recovery rates, the Commission also sought several statutory changes. First, the Commission sought the authority to distribute civil monetary penalties without any predicate disgorgement orders.[37] Second, the Commission sought amendments to the Bankruptcy Code making debts arising out of certain types of federal securities law violations nondischargeable under state law property protections.[38] Third, the Commission sought the authority to contract with

29. Sarbanes-Oxley Act § 308(c), 116 Stat. 785 (codified at 15 U.S.C.A. § 7246 (2003)).

30. The Commission limited its survey to a representative sample of 513 enforcement actions within the five years preceding July 31, 2002. *See* Report Pursuant to Section 308(c) of the Sarbanes-Oxley Act of 2002 (Jan. 24, 2003), *available at* www.sec.gov/news/studies/sox308creport.pdf.

31. *Id.* at 6-8.

32. *Id.* at 9, 11.

33. *Id.* at 14.

34. *Id.* at 18-21.

35. *Id.* at 19-20.

36. *Id.* at 22-32.

37. *Id.* at 33-34.

38. *Id.* at 35-36.

private collection attorneys.[39] Finally, the Commission sought the authority to impose civil monetary penalties on persons and entities not directly regulated by the Commission.[40] Congress continues to consider many of these proposals.[41]

Temporary Freeze Authority (Section 1103)

Companies seeking bankruptcy protection regularly grant so-called retention bonuses to key employees that provide a financial incentive to continue working for a failing or struggling business.[42] Historically, the practice has not been subject to Commission oversight.[43]

Although retention bonuses have always been somewhat controversial, the retention bonuses given by Enron to five hundred of its employees just a few days before filing for bankruptcy protection triggered significant attention and criticism. Enron paid almost $100 million dollars in retention bonuses to induce these employees to continue working only three months past the petition date. These bonuses were paid immediately before the company's bankruptcy caused its share price to drop and shortly before Enron fired almost four thousand employees.[44] Outrage over the payments was immediate. The public and press denounced the bonuses as the "looting" of Enron by corporate executives, many of whom kept the bonus despite finding new jobs before the ninety day period ended.[45]

Subsequently, in connection with WorldCom Inc.'s announcement some six months later in June 2002 that it had understated expenses by several billion dollars, the Commission moved quickly to prevent any

39. *Id.* at 34-35.

40. *Returning Monies Lost by Defrauded Investors: Hearing Before the House Subcomm. on Capital Markets, Insurance, and Government Sponsored Enterprises, Comm. on Financial Services,* 108th Cong. (2003) (written statement of Stephen Cutler, Director, Division of Enforcement, SEC).

41. *See* H.R. 2179, 108th Cong. (2003). H.R. 2179 was approved on July 10, 2003 for full committee consideration, considered by the full House Committee on Financial Services and reported out on February 25, 2004, and, at the time of writing, awaits further action by the full House of Representatives.

42. Almost 50% of all companies in bankruptcy offer retention bonuses to employees during bankruptcy. *See* A. Mechele Dickerson, *Approving Employee Retention and Severance Programs: Judicial Discretion Run Amok?,* 11 Am. Bankr. Inst. L. Rev. 93, 96 (2003).

43. Bankruptcy courts generally regulate the issuance of retention bonuses by debtor companies. *Id.*

44. Chris Woodyard & Martin Kasindorf, *Enron Execs Pocket Big Bonuses,* USA Today, Feb. 1, 2002, at B1.

45. Kathryn Kranhold & Mitchell Pacelle, *About Those Big Enron Bonuses,* Wall St. J., June 12, 2002, at C1 ("'They got money wired to them on the eve of bankruptcy. Everyone else got frozen. . . . There is no more fundamentally unjust act.'") (quoting an AFL-CIO representative).

recurrence of Enron-type payments. The agency sought a federal court order preventing WorldCom from granting extraordinary payments to its employees. The U.S. District Court for the Southern District of New York granted the Commission's motion and ordered the appointment of a court monitor to prevent unjust enrichment of executives involved in the fraudulent conduct and to ensure that the company's assets were not dissipated by unnecessary payments to employees.[46] As a result, WorldCom's ability to pay retention bonuses upon its bankruptcy filing was severely constrained.[47]

In early July 2002, Congress and the President moved to codify the Commission's authority to prevent senior management "from treating the corporation as a personal piggybank."[48] Section 1103 of the Act amended Exchange Act Section 21(c) to provide that the Commission may petition a federal district court to freeze temporarily extraordinary payments to employees in an interest bearing escrow account for forty five days[49] when (1) the issuer or its directors, officers, partners, controlling persons, agents, or employees are being lawfully investigated for a violation of federal securities law, and (2) it appears to the Commission that the issuer will likely make extraordinary payments to those being investigated.[50] If the issuer or employee is charged with violation of federal securities laws before the expiration of the temporary restraining order, the freeze shall remain in effect, subject to court approval, until the legal proceeding ends.[51]

The Commission's authority under Section 1103 is limited to extraordinary payments *by an issuer* to its employees during an investigation. In *SEC v. HealthSouth Corp,* the Commission sought permission to

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46. *SEC v. WorldCom, Inc.*, Litig. Rel. No. 17594, AAER No. 1586, 77 SEC Docket (CCH) 3121 (June 28, 2002).

47. *Id.*

48. *See Grassley Seeks Accountability for WorldCom Executive Bonuses,* 34 Sec. Reg. & Law (BNA) 28, at 1121 (2002) (quoting Sen. Grassley). As Senator Lott stated in proposing the reform, "We have also seen that there are some cases where the law had some loopholes or where it was not timely or where it was not strong enough. . . . Another example is the very bad image of corporate executives taking increased payments, extraordinary payments, while they are being investigated. You can't have that sort of thing." 728 Cong. Rec. S6545 (daily ed. July 10, 2002); *see also* President George W. Bush, Remarks by the President on Corporate Responsibility (July 9, 2002), *available at* www.whitehouse.gov/news/releases/2002/07/print/20020709-4.html.

49. The freeze may be extended for no longer than 45 days for good cause shown. Sarbanes-Oxley Act § 1103(a) (adding Exchange Act § 21C(c)(3)(A)(iv)), 116 Stat. 808.

50. The temporary order shall be granted after notice and hearing, unless the court determines it would be impracticable or contrary to public interest to give the notice or hearing. Sarbanes-Oxley Act § 1103(a) (adding Exchange Act § 21C(c)(3)(A)(i)), 116 Stat. 807.

51. Sarbanes-Oxley Act § 1103 (adding Exchange Act § 21C(c)(3)(B)).

freeze the assets of Richard Scrushy, CEO and Chairman of HealthSouth, while he was under investigation for violations of the federal securities laws, citing its authority under Section 1103. The court refused, holding that the Commission's statutory authority is limited to the assets of issuers, not individuals.[52] Recent Commission action has been consistent with this holding.[53]

The wisdom as well as the effect of the Commission having temporary freeze authority on issuers that seek bankruptcy protection is unclear. The Commission announced in January 2003 that Section 1103 would be used to maximize assets available to compensate shareholder victims of securities fraud.[54] By focusing—however understandably—on the needs of defrauded investors, without fair consideration of the needs of the company facing bankruptcy and its non-shareholder creditors, Congress (and the Commission) have elevated a particular type of unsecured creditor, the equity stakeholder, to a priority typically reserved to those such as secured creditors or trade creditors. As a result, holders of debt securities, trade creditors, and other types of commercial counterparties who may not have understood themselves to have undertaken the same level of enterprise risk as equity shareholders, may find themselves on the same (or worse) footing in the event the Commission orders the company to pay fines and disgorgement in favor of shareholder "victims."[55] At the same time, actions preventing or otherwise constraining companies from providing immediate retention bonuses to key employees may well exacerbate

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52. *SEC v. HealthSouth Corp.*, [2002-2003 Transfer Binder] Fed. Sec. L. Rep. (CCH) § 92,428 n. 7 (N.D. Ala. 2003).

53. *See, e.g.*, SEC Obtains Order Compelling Vivendi Universal, S.A. To Escrow Payments to Former CEO Jean-Marie Messier. Court Also Halts Efforts To Collect on $23 Million Judgment in Messier's Favor, Litig. Rel. No. 18373, 81 SEC Docket (CCH) 615 (Sept. 29, 2003); Court Orders Escrow of Extraordinary Payments by Gemstar-TV Guide Int'l Under the Sarbanes- Oxley Act, Litig. Rel. No. 18135, 80 SEC Docket (CCH) 616 (May 13, 2003).

54. *See* Report Pursuant to Section 308(c) of the Sarbanes-Oxley Act of 2002, at 23 (Jan. 24, 2003), *available at* www.sec.gov/news/studies/sox308creport.pdf.

55. Frank H. Easterbrook & Daniel R. Fischel, *Limited Liability and the Corporation*, 52 U. Chi. L. Rev. 89, 91 (1985) ("Moreover, though creditors may sometimes possess superior information, this will not always be true. To the contrary, we expect creditors to know less. The equity investors have the residual claim. They stand to gain or lose almost the whole value of modest fluctuations in the fortunes of the firm. The residual claimants therefore have incentives to invest in the amount of monitoring likely to produce these gains (or avoid the losses), net of the costs of monitoring. Debt claimants, protected by the 'equity cushion,' are more likely to be ignorant. They might do more monitoring if debt claims were more concentrated than equity claims, so that there would be less free riding on information, but no data show dramatic differences in the concentration of holdings.").

an already bad situation and cause them to lose workers whose skill, training, or institutional knowledge are necessary for the company to stay in business and emerge from bankruptcy. In short, the Enron situation notwithstanding, not all such retention payments are bad and how the Commission uses this power will be significant.

Regulating the Bar and Accountants—Appearance and Practice Authority (Section 602)

Without any direct statutory authority from Congress, the Commission adopted rules of practice applicable to lawyers and accountants in 1936 pursuant to which it could "deny admission to, or disbar any person who is found by the Commission not to possess the requisite qualifications to represent others, or to be lacking in character, integrity, or proper professional conduct."[56] The version of the rule in effect at the time of the Act's passage provided that the Commission "may censure a person or deny, temporarily or permanently, the privilege of appearing or practicing before it in any way to any person found by the Commission": (1) not to possess the requisite qualifications to represent others; (2) to have engaged in improper or unethical conduct; or (3) to have willfully violated or willfully aided and abetted a violation of federal securities laws.[57]

These rules of practice also affected accountants and lawyers, and were challenged for years because of the lack of any explicit statutory authority for the Commission to promulgate them.[58]

Perhaps in response to the criticism, the Commission voluntarily limited its application of 102(e) against attorneys. In *In the Matter of William R. Carter,* better known as "the Carter-Johnson case," the Commission held that an attorney did not violate professional standards, in a manner justifying an appearance ban, for negligently preparing documents that he did not know contained materially false information.[59]

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56. SEC Rules of Practice, 1 Fed. Reg. 1753 (1936).

57. 17 C.F.R. § 201.102(e) (2002). Until the rule was revised in 1995, the provision was commonly referred to as Rule 2(e).

58. Among the critics of Rule 2(e) was SEC Commissioner Roberta Karmel, who issued a series of dissents criticizing Commission proceedings censuring attorneys under the rule. *See, e.g., In the Matter of Keating, Muething & Klekamp,* Exchange Act Rel. No. 15982, 1979 WL 186370 (July 2, 1979) (Karmel, dissenting). Articles questioned the validity of proceedings under the rule for years. *See, e.g.,* Joseph C. Daley & Roberta S. Karmel, *Attorneys' Responsibilities: Adversaries at the Bar of the SEC,* 24 Emory L. J. 747 (1975); Norman S. Johnson, *The Dynamics of SEC Rule 2(e): A Crisis for the Bar,* 1975 Utah L. Rev. 629 (1975); Roberta S. Karmel, *A Delicate Assignment: The Regulation of Accountants by the SEC,* 56 N.Y.U. L. Rev. 959 (1981); Robert A. Downing & Robert L. Miller, *The Distortion and Misuse of 2(e),* 54 Notre Dame L. Rev. 774 (1978-79).

59. *In the Matter of William R. Carter,* Exchange Act Rel. No. 17597, 22 SEC Docket (CCH) 292 (Feb. 28, 1981) (holding that an attorney may be censured only for a knowing violation of the federal securities laws).

Following *Carter*, the Commission announced that, as a matter of practice, that it would initiate 102(e) proceedings only against attorneys first adjudged by an Article III court to have been guilty of wrongdoing in connection with the federal securities laws.[60] In short, the Commission would not try to police substantive attorney conduct on its own. It would act only after a court had acted.

At the same time, however, accountants and accounting firms continued to be subject to far more substantive scrutiny, review and discipline under Rule 102(e). The accounting profession, whose members act less as advocates than as a type of "public watchdog,"[61] bristled at the seemingly disparate approach to professional discipline. In a challenge to the SEC's authority in *Checkosky v. SEC,* the D.C. Circuit overturned an accountant's censure under Rule 102(e), holding that the rule failed to set forth a clear or coherent standard of intent as part of the rule proscribing improper professional conduct, making it impossible for accountants to know what activities violated the standard.[62] Following *Checkosky,* the Commission revised 102(e), clarifying the standard for improper professional conduct for accountants as (1) intentional conduct that results in knowing violation of professional standards, (2) negligent conduct involving a single instance of highly unreasonable conduct that results in violation of professional standards when the person or firm knew or should have known that heightened scrutiny was required, or (3) negligent conduct involving repeated instances of unreasonable conduct, each resulting in violation of applicable professional standards, indicating a lack of competence to practice before the commission. The continued legitimacy of the Commission's authority to police professionals, however, remained subject to both considerable resistance and some doubt.

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60. *See* Disciplinary Proceedings Involving Professionals Appearing or Practicing Before the Commission, Securities Act Rel. No. 2175, 41 SEC Docket (CCH) 388 (1988). After *Carter* an attempt was made to bar attorneys under other provisions, including Exchange Act § 15(c)(4). This approach was rejected in *In the Matter of George C. Kern, Jr.,* Exchange Act Rel. No. 29356, 49 SEC Docket (CCH) 422 (June 21, 1991).

61. *United States v. Arthur Young,* 465 U.S. 805, 817-18 (1984) ("By certifying the public reports that collectively depict a corporation's financial status, the independent auditor assumes a *public* responsibility transcending any employment relationship with the client. The independent public accountant performing this special function owes ultimate allegiance to the corporation's creditors and stockholders, as well as to the investing public. This 'public watchdog' function demands that the accountant maintain total independence from the client at all times and requires complete fidelity to the public trust.") (emphasis in original).

62. *Checkosky v. SEC,* 139 F.3d 221, 225 (D.C. Cir. 1998); *see also* Report of the Task Force on Rule 102(e) Proceedings: Rule 102(e) Sanctions Against Accountants, 52 Bus. Law. 965 (1997).

In the aftermath of Enron and the other financial scandals of the past several years, the spotlight on the alleged actions of the attorneys and accountants has largely ended the debate. To strengthen the Commission's authority to regulate these gatekeepers, Congress codified all of Rule 102(e) into Section 602 of the Act.[63] This codification has put to rest any questions surrounding the SEC's authority to bar and censure attorneys and accountants practicing before it. The future use of the Commission's power in this regard remains to be seen. This statutory provision, however, represents a sea change in express authority, and carries with it the presumed expectation that the Commission will weigh in heavily in the future oversight of the bar.

Federal Court Authority to Impose Penny Stock Bars (Section 603)

Section 603 of the Act is primarily a housekeeping provision. The Penny Stock Reform Act of 1990 granted the Commission administrative authority to bar any person from participating in a penny stock offering after violating the federal securities laws in connection with such an offering, but did not grant the authority to federal courts.[64] Because certain injunctive relief for penny stock fraud had been available only from the federal courts, the Commission had been forced to initiate parallel civil actions and administrative proceedings in penny stock fraud cases.[65] To allow the Commission to seek relief more efficiently, Congress extended the authority to impose penny stock bars to the federal courts.[66]

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63. Sarbanes-Oxley Act § 602, 116 Stat. 794.

64. *See* Exchange Act § 15(b)(6)(A). Penny stocks are low-priced securities, sold over the market and highly susceptible to manipulation. Thomas L. Hazen and Jerry W. Markham, *Penny Stock Scandals and Regulatory Reforms,* in 23 Broker-Dealer Operations Under Securities and Commodities Law § 2.34 (Sec. Law Series 2002). The Exchange Act defines a penny stock as any equity security *other than* (1) most securities listed and traded on NASDAQ or a national securities exchange; (2) any security issued by a registered investment company; (3) any security with a price of $5.00 or more; (4) any security of a company that meets minimum requirements for net tangible assets or average revenues; and (5) any put or call option issued by the Options Clearing Corporation. Exchange Act § 3(a)(51), 15 U.S.C.A. § 78c(a)(51) (2003).

65. Public Company Accounting Reform and Investor Protection Act of 2002, S. Rep. No. 107-205, at 41 (2002).

66. Sarbanes-Oxley Act § 603(a) (amending Exchange Act § 21(d)), 116 Stat. 794-95; *id.* § 603(b) (amending Securities Act § 20(g)), 116 Stat. 795.

INCREASED ENFORCEMENT AUTHORITY OVER PUBLIC ACCOUNTING FIRMS

As discussed in detail in Chapter Four, Sarbanes-Oxley subjected accounting firms that audit the financial statements of public corporations (so called "Public Accounting Firms" or "PAFs") to the oversight of a new self-regulatory organization ("SRO"), the Public Company Accounting Oversight Board (the "PCAOB" or the "Board").[67] The Act established the PCAOB as the principal standard setting body for PAFs[68] and the primary enforcer of PAFs' compliance with the Board's rule-based requirements.[69]

In addition to the enforcement and regulatory powers granted to the PCAOB, however, Sarbanes-Oxley retained and expanded the Commission's enforcement authority over the auditors of public companies (the PAFs). By rendering PAFs and their associated persons subject to the full range of the Commission's administrative enforcement authority, Section 3 of the Act brought about two important changes to the Commission's enforcement arsenal. First, the Act granted the Commission the authority to enforce the PCAOB's rules directly, rather than relying on the PCAOB to act in the first instance.[70] Second, as with other self-regulatory organizations, the Act authorized the Commission to initiate enforcement actions against the PCAOB itself in the event the Board fails to enforce its own rules appropriately.[71]

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67. Sarbanes-Oxley Act of 2002, § 101(a), Pub. L. No. 107-204, 116 Stat. 750. The PCAOB has no jurisdiction over accountants or firms who do not audit companies subject to SEC reporting obligations. Sarbanes-Oxley Act § 2(a)(11) (defining "public accounting firm"), 116 Stat. 748; *id.* § 2(a)(7) (defining "issuer"), 116 Stat. 747; *id.* § 101(c)(1) (limiting the PCAOB's registration authority to public accounting firms that "prepare audit reports for issuers"), 116 Stat. 750; *id.* § 102(a) (limiting mandatory registration to those public accounting firms that prepare or issue audit reports for an "issuer"), 116 Stat. 753.

68. Pursuant to § 101(c) of the Act, the PCAOB must "establish or adopt, or both, by rule, auditing, quality control, ethics, independence, and other standards relating to the preparation of audit reports for issuers." 116 Stat. 750. Proposed PCAOB rules must be approved by the Commission pursuant to the procedures set forth in Exchange Act § 19. Sarbanes-Oxley Act § 106(b)(4), 116 Stat. 766.

69. The Board must "conduct investigations and disciplinary proceedings concerning, and impose sanctions where justified upon, registered public accounting firms and associated persons of such firms." Sarbanes-Oxley Act § 101(c)(4), 116 Stat. 750. § 105 of the Act details the Board's investigatory and disciplinary authority. *Id.* 105, 116 Stat. 759-64.

70. *See infra* pages VII-2-17 to VII-2-19.

71. Sarbanes-Oxley Act § 107(d)(2), 116 Stat. 767.

DIRECT COMMISSION ENFORCEMENT OF PCAOB RULES

Section 3 of Sarbanes-Oxley amended Exchange Act Section 21 by making any violations of PCAOB rules by accounting firms or their associated persons subject to the Commission's statutory enforcement authority.[72] This would include investigations,[73] civil actions,[74] and temporary cease and desist proceedings based on alleged violations of PCAOB rules.[75] Sarbanes-Oxley did not, however, change the Commission's existing administrative cease-and-desist authority. This authority, which continues to apply to PAFs and their associated persons, authorizes the initiation of administrative proceedings against "any person" who "is violating, has violated, or is about to violate" the federal securities laws or who "is, was, or would be a cause of the violation."[76] Section 3(c) also made clear that the PCAOB's role as the primary SRO for PAFs in no way diminished the Commission's authority to regulate PAFs directly.[77]

In recent years the Commission has shown an increasing willingness to enforce SRO rules directly in negotiated settlements that involve parallel federal district court action and SRO proceedings against regulated entities such as broker-dealers.[78] The Commission's authority to enforce SRO rules directly is set forth in Exchange Act Sections 21(d) and (e), which, prior to Sarbanes-Oxley, was limited to the initiation of civil injunctive actions in federal district court "[w]henever it shall appear to the Commission that any person is engaged or is about to engage in acts or practices constituting a violation of . . . the rules of a *national securities exchange* or *registered securities association*."[79] Sarbanes-Oxley added the violation of PCAOB rules to the grounds for Commission action.[80]

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72. Sarbanes-Oxley Act § 3, 116 Stat. 749.

73. Sarbanes-Oxley Act § 3(b)(2)(A), 116 Stat. 749 (amending Exchange Act § 21(a)(1)).

74. Sarbanes-Oxley Act § 3(b)(2)(B)&(C), 116 Stat. 749 (amending Exchange Act § 21(d)(1)& 21(e)).

75. Sarbanes-Oxley Act § 3(b)(3), 116 Stat. 749 (amending Exchange Act § 21C(c)(2)).

76. Exchange Act § 21C(a). The Commission may not seek civil money penalties under this provision, however. The Commission's administrative fining authority extends only to administrative proceedings instituted against certain types of broker-dealers, clearing agencies, and investment advisers. *See* Exchange Act § 21B(a); Investment Advisers Act of 1940 § 203(i).

77. Sarbanes-Oxley Act § 3(c)(3), 116 Stat. 750.

78. *See, e.g., SEC v. Credit Suisse First Boston Corp.*, No. 02 CV 0090 (D.D.C. Jan. 29, 2002), [2001-2002 Trans. Binder] Fed. Sec. L. Rep. (CCH) § 91,695 (2002); SEC Joint Press Release, Ten of Nation's Top Investment Firms Settle Enforcement Actions Involving Conflicts of Interest Between Research and Investment Banking, SEC Press Rel. No. 2003-54, 2003 WL 1961696 (Apr. 28, 2003).

79. Exchange Act § 21(d)(1) (emphasis added).

80. Sarbanes-Oxley Act § 3(b)(2)(B)&(C), 116 Stat. 749 (amending Exchange Act § 21(d)(1)& 21(e)).

The Commission has structured several recent settlements under this authority to penalize conduct that fell short of traditional securities fraud (which generally requires proof of a duty to make disclosure, a material disclosure failure, and scienter) but which nevertheless may have violated technical or aspirational SRO rules, such as the obligation to "observe high standards of commercial honor and just and equitable principles of trade."[81]

For example, the Commission initiated a civil injunctive action against Credit Suisse First Boston in January 2002 for alleged violations of NASD rules based on the firm's IPO allocation practices.[82] The settlement, which involved CSFB's payment of $100 million in civil monetary penalties and disgorgement, addressed alleged violations of NASD rules that (a) prohibited the sharing of profits with brokerage clients without following specified procedures and (b) mandated the observation of just and equitable trade practices.[83] The Commission did not allege any violations of the federal securities laws other than rules relating to broker-dealer books and records.[84] More recently, the Commission's so-called "global settlement" with a number of the nation's largest broker-dealers similarly relied heavily on violations of technical SRO rules governing the distribution of research analyst reports.[85] The Commission's action in connection with the global settlement, which also resolved coordinated investigations by NASD Regulation, the New York Stock Exchange, the New York Attorney General's office, and state securities administrators, resulted in the issuance of injunctions against the alleged misconduct and resulted in the award of over $1 billion in civil monetary penalties and disgorgement.[86] The Commission charged very few direct violations of the securities laws or regulations.[87]

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81. *See, e.g.,* NASD Rule 2110 ("Standards of Commercial Honor and Principles of Trade").

82. *See SEC v. Credit Suisse First Boston Corp.,* No. 02 CV 0090 (D.D.C. Jan. 29, 2002), [2001-2002 Trans. Binder] Fed. Sec. L. Rep. (CCH) 91,695 (2002) (enjoining CSFB from future violations of NASD Rules 2330 and 2110); see also *SEC v. Credit Suisse First Boston,* SEC Litig. Rel. No. 17327, 76 SEC Docket (CCH) 1875 (Jan. 22, 2002). The settlement was coordinated with a parallel NASD disciplinary proceeding. *See In the Matter of Credit Suisse First Boston Corp.,* Letter of Acceptance, Waiver and Consent, No. CAF020001 (Jan. 22, 2002).

83. *SEC v. Credit Suisse First Boston Corp.,* No. 02 CV 0090 (D.D.C. Jan. 29, 2002), [2001-2002 Trans. Binder] Fed. Sec. L. Rep. (CCH) 91,695 (2002).

84. *Id.*

85. *See, e.g., SEC v. Bear, Stearns & Co., Inc.,* SEC Litig. Rel. No. 18109 (Apr. 28, 2003) (charging violations of NASD Rule 2110 ("just and equitable principles of trade"), NYSE Rule 401 ("good business practice"), NASD Rule 2210 ("communications with the public"), and NYSE Rule 472 ("communications with the public")); *SEC v. UBS Warburg LLC,* SEC Litig. Rel. No. 18112, 80 SEC Docket (CCH) 314 (Apr. 28, 2003) (charging violations of NASD Rule 2110, NYSE Rule 401, NASD Rule 2210, and NYSE Rule 472).

86. *See generally* SEC Joint Press Release, Ten of Nation's Top Investment Firms Settle Enforcement Actions Involving Conflicts of Interest between Research and Investment Banking, 2003 WL 1961696 (2003); SEC Fact Sheet on Global Analyst Research Settlements, *available at* www.sec.gov/news/speech/factsheet.htm.

The authority to enforce SRO rules directly affords the Commission's Division of Enforcement greater flexibility to address perceived misconduct quickly and in concert with responsible SROs (which may already have commenced investigations). Particularly in the current regulatory environment, in which the Commission is under considerable pressure from Congress, investor groups, and the financial press to address aggressively perceived misconduct in the capital markets, this authority may prove to be an increasingly used weapon to facilitate prompt settlements with, among others, PAFs and their associated persons.

Commission Enforcement Authority over the PCAOB

Section 107 of the Act provided that "the Commission shall have oversight and enforcement authority over the Board" and that "[t]he Commission may . . . censure or impose limitations upon the activities, functions and operations of the Board."[88] This provision is virtually identical to the Commission's longstanding statutory authority over securities SROs,[89] and therefore its prior invocation of this authority may be instructive.

Over the years the Commission has initiated administrative proceedings against a number of securities SROs to bring about stricter regulatory oversight and surveillance of their member firms.[90] These

87. SEC Fact Sheet on Global Analyst Research Settlements, *available at* www.sec.gov/news/speech/factsheet.htm.

88. Sarbanes-Oxley Act § 107, 116 Stat. 745. An accompanying Senate report provided that the PCAOB would be "generally subject to the same degree of control by the Commission as the [NASD] or the [NYSE]." Public Company Accounting Reform and Investor Protection Act of 2002, S. Rep. No. 107-205, 107th Cong. 2d Sess. 49-50 (2002).

89. Exchange Act § 19(h)(1).

90. *In the Matter of The Chicago Stock Exchange,* Exchange Act Rel. No. 48566, 81 SEC Docket (CCH) 490 (Sept. 30, 2003) (censuring the Exchange and imposing undertakings for failure to have surveillance and enforcement mechanisms for violations of the priority rule, firm quote rule, and the limit order display rule); *In the Matter of Certain Activities of Options Exchanges,* Exchange Act Rel. No. 43268, 73 SEC Docket (CCH) 530 (Sept. 11, 2000) (censuring four options exchanges and imposing undertakings for creating an anticompetitive environment for the multiple listings of certain options and failing to have surveillance and enforcement mechanisms for violations of the priority rule, firm quote rule, and the limit order display rule); *In the Matter of New York Stock Exchange, Inc.,* Exchange Act Rel. No. 41574, 70 SEC Docket (CCH) 106 (June 29, 1999) (imposing undertakings against the NYSE for failure to have appropriate surveillance of independent floor brokers' proprietary trading activities); *In the Matter of Stock Clearing Corp. of Philadelphia and Philadelphia Depository Trust Co.,* Exchange Act Rel. No. 38918, 65 SEC Docket (CCH) 377 (Aug. 11, 1997); *In the Matter of the National Ass'n of Securities Dealers,* Exchange Act Rel. No. 37538, 62 SEC Docket (CCH) 1346 (Aug. 8, 1996) (censuring the NASD and imposing undertakings for failing to have surveillance mechanisms for market makers' anticompetitive proprietary trading and for failing to have appropriate procedures for avoiding conflicts of interest between the Board of Governors and member firms); *In the Matter of Chicago Board Options Exchange,* Exchange Act

proceedings may well be instructive as to how the Commission will exercise its enforcement authority over the PCAOB. We discuss three such proceedings below. First, the Commission settled an administrative proceeding against the Chicago Board Options Exchange (the "CBOE") in 1989.[91] That proceeding involved allegations that the CBOE failed to enforce compliance with its rules governing trading in option contracts "for the purpose of creating or inducing a false, misleading, or artificial appearance of activity."[92] The Order required the CBOE to expand its market surveillance procedures, provide specified advice to its member firms, and revise its orientation materials about disciplinary procedures."[93]

In 1996 the Commission settled an administrative proceeding against the NASD for enforcement failures arising out of market making activity on the Nasdaq market.[94] The undertakings set forth in the Order required the NASD, among other things, to make significant modifications to its governance, its regulatory organization, its trading rules, and its order audit trail system and to adopt improvements to its market surveillance and trade reporting systems.[95] The Commission also accepted the NASD's representation that it would spend $100 million over five years to improve its oversight systems in lieu of seeking a monetary penalty.[96]

Finally, in 1997 the Commission settled an administrative proceeding against two registered clearing agencies[97] for a variety of oversight

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Rel. No. 26809, 43 SEC Docket (CCH) 1267 (May 11, 1989) (censuring the CBOE and imposing undertakings for failure to pursue regulatory actions against market makers who created and reported fictitious trades to artificially inflate trading volume, thereby creating the appearance of liquidity); *In the Matter of Boston Stock Exchange, Inc.*, Exchange Act Rel. No. 17183, 21 SEC Docket (CCH) 22 (Oct. 1, 1980) (censuring the BSE and imposing undertakings for the failure to have surveillance mechanisms to detect instances of exchange specialists' creating fictitious trades to apparently meet Exchange margin calls); *In the Matter of Philadelphia Stock Exchange, Inc.*, Exchange Act Rel. No. 16648, 19 SEC Docket (CCH) 876 (Mar. 13, 1980) (censuring the PHLX and imposing undertakings for failure to make quotations available to vendors and to adequately enforce rules regarding the permissible size of quotation spreads).

91. *In the Matter of Chicago Board Options Exchange, Inc.*, Exchange Act Rel. No. 26809, 43 SEC Docket (CCH) 1267 (May 11, 1989).

92. *Id.*

93. *Id.*

94. *In the Matter of Nat'l Ass'n of Sec. Dealers, Inc.*, Exchange Act Rel. No. 37538, 62 SEC Docket (CCH) 1346 (Aug. 8, 1996).

95. *Id.*

96. *Id.*

97. Registered clearing agencies are securities SROs that offer a range of depository, custodial, settlement, and transfer services for their member firms. *See* Exchange Act § 3(a)(23)(A) (defining "clearing agency"), 3(a)(26) (defining "self-regulatory organization"), 17A (governing clearing agency registration).

failures.[98] The Commission Order required that both clearing agencies adopt and implement a number of changes to its rules, reporting, clearance, and settlement systems.[99]

The PCAOB will be subject to the same Commission oversight as the SROs mentioned above. Should significant audit failures or misconduct by PAFs arise, the Board should expect significant Commission scrutiny of its enforcement program and the adequacy of its response.

ADDITIONAL COLLATERAL CONSEQUENCES

Qualifications of Brokers and Dealers and their Associated Persons (Section 604)

Section 604 of the Act added, as additional bases for Commission bar proceedings against regulated entities and individuals under both Exchange Act Section 15(b) and Advisers Act Section 203(e), certain enforcement actions by state and federal regulators.[100] Under existing law, the Commission was able to address misconduct by certain types of investment professionals and their employing firms by initiating administrative proceedings. In these proceedings, a number of remedies were available, such as an order revoking the registration of an investment firm or professional, an order censuring the firm or individual, a temporary suspension, and other unspecified limitations on activities related to the registrant. Under both the Exchange Act and the Advisers Act, the Commission was able to initiate such administrative proceedings in the first instance or simply proceed on the basis of some previously adjudicated misconduct, such as a conviction or a court order or an injunction against a firm or individual. Prior to the Act, however, a prior proceeding initiated by a state securities administrator or state or federal banking or insurance regulators involving findings of misconduct was not a stand-alone basis for such a proceeding.

Pursuant to Section 604 of the Act, the Commission may now initiate administrative proceedings under the Exchange Act or Advisers Act against regulated securities firms and their associated persons if they are subject to a final order of any state or federal securities, banking, or insurance regulator that (1) "bars such person from association with an

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98. *In the Matter of Stock Clearing Corp. of Philadelphia and Philadelphia Depository Trust Co.*, Exchange Act Rel. No. 38918, 65 SEC Docket (CCH) 377 (Aug. 11, 1997).

99. *Id.*

100. Sarbanes-Oxley Act § 604, 116 Stat. 795-96 (codified at Exchange Act § 15(b)(4); Advisers Act § 203(e)).

entity regulated from such commission, authority, agency, or officer, or from engaging in the business of securities, insurance, banking, savings association activities, or credit union activities"; or (2) "constitutes a final order based on violations of any laws or regulations that prohibit fraudulent, manipulative, or deceptive conduct."[101]

Section 604 reflected the increasingly active role played by state securities administrators in several high-profile investigations and settlements. These securities regulators, led by New York State Attorney General Eliot Spitzer and members of the North American Securities Administrators Association ("NASAA"), have both investigated and led the charge on a number of Wall Street practices[102] and were able to force settlements from securities firms for millions of dollars relating to research analyst practices[103] and performance advertising[104] using a variety of state statutes and codes. Prior to the Act, state securities administrators regularly initiated follow-on proceedings under state securities codes upon the completion of Commission enforcement actions. Section 604 essentially permits the Commission to take similar action in the wake of enforcement action by the states or by other federal agencies.

One little-discussed change brought about by Section 604 is its amendment to Exchange Act Section 3(a)(39), the provision governing "statutory disqualification" from membership in securities self-regulatory organizations such as registered national securities exchanges (*e.g.*, the New York Stock Exchange) and registered securities associations (*e.g.*, the NASD). Section 604 made two changes to Exchange Act Section 3(a)(39). First, it added as a basis for statutory disqualification the same state and federal agency proceedings which were included as the basis for Commission bar proceedings.[105] Second,

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101. Sarbanes-Oxley Act § 604, 116 Stat. 795-96 (codified at Exchange Act § 15(b)(4); Advisers Act § 203(e)).

102. *See, e.g.*, Office of New York State Attorney General Eliot Spitzer, Investor Protection and Securities Bureau, From Wall Street to Web Street: A Report on the Problems and Promise of the Online Brokerage Industry (Nov. 1999); Office of New York State Attorney General Eliot Spitzer, Report on Micro-Cap Stock Fraud (Dec. 1997).

103. *See generally* SEC Joint Press Release, Ten of Nation's Top Investment Firms Settle Enforcement Actions Involving Conflicts of Interest between Research and Investment Banking, 2003 WL 1961696 (2003); SEC Fact Sheet on Global Analyst Research Settlements, *available at* www.sec.gov/news/speech/factsheet.htm.

104. *See, e.g.*, Settlement Agreement, In the Matter of The Dreyfus Corp. and Michael L. Schonberg, New York Bureau of Investor Protection and Securities (Publicly avail. May 10, 2002) (resolving allegations of inadequate disclosure of so-called bootstrapping—bootstrapping the first year return of a new fund with small net asset size by using favorable allocations of hot initial public offering shares).

105. Sarbanes-Oxley Act § 604(c)(1)(A)(i), 116 Stat. 796 (codified at Exchange Act § 3(a)(39)(F)).

and far more significantly, Section 604 amended the standard applicable to statutory disqualification under the Exchange Act.[106] Prior to the Act, a broker-dealer (or associated person) was subject to a "statutory disqualification" under Exchange Act Section 3(a)(39) if, among other things, it had been *expelled from membership* by an SRO,[107] was *subject to a bar or revocation order* of the Commission or the CFTC,[108] had been *convicted of certain offenses,*[109] was the *subject of an injunction,*[110] or had "*committed* or *omitted*" a violation of the federal securities laws.[111] Because of the "committed or omitted" standard set forth in the statutory definition prior to the Act, registrants that settled Commission administrative proceedings (such as cease-and-desist proceedings in which the respondent neither "admits nor denies" the findings) generally had not considered themselves subject to a statutory disqualification under the Exchange Act. This interpretation and conclusion was supported by the legislative history accompanying the Securities Enforcement Remedies and Penny Stock Reform Act of 1990.[112]

Section 604 of the Act, however, added to the grounds for statutory disqualification any "order or finding" of a violation specified in Exchange Act Section 15(b)(4)(D), which includes any "willful violation" of the federal securities laws. Because even the standard "neither admits nor denies" settlement typically involves a "finding" of a willful violation if accompanied by a fine or censure, virtually every administrative proceeding against a broker-dealer or investment adviser (or any associated person) will trigger a statutory disqualification.[113] The administrative burdens placed on regulated entities that are subject to a statutory disqualification are considerable. Such registrants must follow complicated notification and membership procedures specified by Exchange Act Rule 19h-1, by each of the stock exchanges to which they belong,[114] and by the NASD.[115]

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106. Sarbanes-Oxley Act § 604(c)(1)(A)(ii), 116 Stat. 796 (codified at Exchange Act § 3(a)(39)(F)).

107. Exchange Act § 3(a)(39)(A).

108. Exchange Act § 3(a)(39)(B).

109. Exchange Act § 3(a)(39)(F).

110. *Id.*

111. *Id.*

112. *See* The Securities Law Enforcement Remedies Act of 1990, Report of the Comm. on Banking, Housing, and Urban Affairs, S. Rep. No. 645, 101st Cong., 2d Sess. at 18 (1990) (noting that, unlike injunctive actions, cease and desist proceedings would not trigger the statutory disqualification provisions of the Exchange Act).

113. *See, e.g.,* Exchange Act § 21B(a)(1) (civil monetary penalties in administrative proceedings must be predicated upon a willful violation of the federal securities laws); Advisers Act § 203(i)(1)(A) (same); Exchange Act § 15(b)(4)(D) (orders of censure in administrative proceedings must be predicated upon a willful violation of the federal securities laws); Advisers Act § 203(f) (same).

114. *See, e.g.,* NYSE Rules 346(f), 351(a)(9); NYSE Form RE-3.

115. *See* NASD By-Law Art. III, § 3(a), 4(h); NASD Rules 9520-27; NASD Form MC-400A.

Nondischargeability of Debts Incurred as a Result of Securities Law Violations (Section 803)

Section 803 of the Act makes debts resulting from judgments or settlements for violations of federal or state securities laws nondischargeable under the Bankruptcy Code.[116] Although Section 803 is captioned "Debts Nondischargeable If Incurred In Violation of Securities Fraud Laws," the statute provides that debts incurred as a result of a violation of *any* federal or state securities laws (including common law fraud) are nondischargeable.[117] Under prior practice, the Commission sought to prohibit debtors from discharging debts arising from securities law violations through nondischargeability proceedings under Section 523(a)(2)(A) of the Bankruptcy Code, which prohibits the discharge of any debt for money, property, or services obtained by false pretenses, a false representation, or actual fraud.[118] Section 803 of the Act was designed to close a perceived "loophole" that permitted "wrongdoers to discharge their obligations under court judgments or settlements based on securities fraud and other securities violations."[119] By making debts arising out of any securities law violation nondischargeable—whether or not they are the product of intentional or reckless misconduct—Congress appears to have created a category of misconduct set apart from the general bankruptcy policy that "the honest but merely mistaken debtor" is entitled to relief and a "fresh start."[120]

Section 803 sets forth a list of the determinations that render a debt arising from a securities law violation nondischargeable: (1) "any

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116. Sarbanes-Oxley Act § 803, 116 Stat. 801. Corporations are not affected by § 803, which only applies to individuals. *See* John J. Huber & Thomas J. Kim, *The Response to Enron: The Sarbanes-Oxley Act of 2002 And Commission Rulemaking,* 1348 PLI/Corp. 641, 733 (2002); Daniel R. Cowans, Bankruptcy Law and Practice 182 (7th ed. 1998) ("The exceptions to dischargeability under Section 523 apply to individual debtors but not to corporations.").

117. *See* 11 U.S.C. § 523(a)(19)(A)(i); see also Alan N. Resnick & Henry J. Sommer, Bankruptcy Code, Collier Pamphlet Edition, at 443 (Comment on Amendments) ("Section 523(a)(19) expands the scope of nondishargeable conduct beyond that which has been historically rooted in section 523(a)(2) in that some of the securities laws to which it is applicable do not require proof of scienter or common law fraud."); *In re Gibbons,* 289 B.R. 588, 592 (S.D.N.Y. 2003) (holding that 523(a)(19) "by its terms, applied to both statutory claims under the securities law and common law fraud, so long as it arises in connection with the purchase or sale of a security").

118. 11 U.S.C. § 523(a)(2)(A). 11 U.S.C. § 523(a)(7) also exempts from discharge debts for fines, penalties, or forfeitures payable to the benefit of a government unit, provided the payment is not compensation for actual pecuniary loss. Some securities law violations were also subject to 11 U.S.C. § 523(a)(4), which exempts from discharge debts resulting from fraud while acting in a fiduciary capacity.

119. The Corporate and Criminal Fraud Accountability Act of 2002, S. Rep. No. 107-146 (2002).

120. Daniel R. Cowans, Bankruptcy Law and Practice 183, 201 (7th ed. 1998).

judgment, order, consent order, or decree entered in any Federal or State judicial or administrative proceeding"; (2) "any settlement agreement entered into by the debtor"; (3) "any court or administrative order for any damages, fine, penalty, citation, restitutionary payment, disgorgement payment, attorney fee, cost, or other payment owed by the debtor."[121]

Prior to the Act, the Commission and private plaintiffs (as judgment creditors) were forced to litigate before bankruptcy courts to establish that particular debts arising from judgments, arbitration awards, or settlements were nondischargeable and therefore should survive a liquidation of the debtor's estate. Although Section 523(a)(2)(A) of the Bankruptcy Code generally operated to preclude the discharge of judgments obtained on the basis of securities fraud, both the Commission and private litigants had to demonstrate that the operative judgment satisfied the requirements of collateral estoppel for determining "fraud" under Section 523(a)(2)(A).[122] The Commission regularly faced protracted litigation to prohibit those found to have committed violations of the antifraud provisions of the federal securities laws from discharging fines and disgorgement. For example, the Commission spent years in litigation with Paul Bilzerian to prohibit the discharge of a $60 million disgorgement order arising out of adjudicated securities fraud.[123]

Prior to the Act, judgment creditors in securities fraud cases were required to demonstrate that the proceeding establishing the debt (*e.g.*, an arbitration, civil action, administrative proceeding, or settlement) involved sufficiently specific findings to establish nondischargeability under Section 523(a)(2)(A) of the Bankruptcy Code: "(1) the debtor made a false representation with intent to deceive the creditor; (2) the creditor relied on the representation; and (3) the creditor sustained a loss as a result of the representation."[124]

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121. *See* 11 U.S.C. § 523(a)(19)(B).

122. *See, e.g., In re Wiggins et. al.*, Litig. Rel. No. 15373, 64 SEC Docket (CCH) 1624 (May 22, 1997) (finding judgment nondischargeable); *In re Schulte*, SEC Initial Dec. Rel. No. 110, 64 SEC Docket (CCH) 704, 1997 WL 173668, *5 (Apr. 10, 1997) (same); *In re Blizerian*, 153 F.3d 1278, 1282-83 (11th Cir. 1998) (same); *In re Goldbronn*, 263 B.R. 347 (M.D. Fla. 2001) (refusing to find that an arbitration award for a state securities law violation was nondischargeable); *In re Miller*, 276 F.3d 424 (8th Cir. 2002) (holding that control person liability under Exchange Act § 20(a) does not provide a basis to find individuals' debts nondischargeable).

123. *See SEC v. Blizerian*, 131 F. Supp. 2d 10 (D.D.C. 2001) (discussing Blizerian disgorgement awards); *see also SEC v. Blizerian*, 29 F.3d 689 (D.C. Cir. 1994); *In re Blizerian*, 153 F.3d 1278, 1282-83 (11th Cir. 1998).

In addition to the Commission's civil actions, Blizerian was also convicted of securities fraud. United States v. Bilzerian, 926 F.2d 1285 (2d Cir.) *cert. denied*, 502 U.S. 813 (1991).

124. *See In re Blizerian*, 100 F.3d 886, 892 (11th Cir. 1996).

Moreover, settlements and certain arbitration awards lacked sufficient findings to support the necessary showing for nondischargeability. Section 803 of the Act was designed to remove this obstacle to nondischargeability by doing away with the need to "reprove" fraud cases in bankruptcy court.[125]

A recent decision applying Section 803 of the Act demonstrates its effect. The case, *In re Gibbons,* involved the chief legal and compliance officer for a brokerage firm's efforts to discharge an NASD arbitration award.[126] The plaintiff's arbitration award included findings that the brokerage firm and various employees committed common law fraud,[127] but that the compliance officer had had no direct contact with the plaintiff and no knowledge of the activity in her account.[128] The court, however, held that the arbitration award was nondischargeable under new-Section 523(a)(19) of the Bankruptcy Code because the arbitration award included a finding of fraud in connection with the purchase and sale of securities.[129] A case decided before the Act on strikingly similar facts came to the opposite result.[130]

Section 803 of the Act may be largely symbolic because difficulties associated with collecting from bankrupt individuals remain.[131] Section 803 of the Act may, however, ease the burdens for those seeking to ensure that an individual cannot discharge debts associated with securities laws violations. First, these creditors are no longer restricted to evidencing debts based on actual fraud because the violation of *any* federal securities law or state securities law now provides a basis for nondischargeability. Second, the list of the types of determinations that can render a securities violation nondischargeable found in Section 523(a)(19)(B) of the Bankruptcy Code should greatly reduce if not eliminate litigation over whether a certain form of adjudication provides a sufficient basis to establish the elements of nondischargeability. Third, creditors will no longer have to try to recast the elements of securities fraud into those associated with common law fraud.

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125. The Corporate and Criminal Fraud Accountability Act of 2002, S. Rep. No. 107-146 (2002).

126. *In re Gibbons,* 289 B.R. 588 (S.D.N.Y. 2003).

127. *Id.* at 590.

128. *Id.* at 591.

129. *Id.* at 597.

130. *In re Miller,* 276 F.3d 424, 429 (8th Cir. 2002) (holding that the Bankruptcy Code "provides other specific exceptions to discharge, which do not include an exception for liability under the securities laws" and, as supervisors, the debtors did not participate in the "bad acts").

131. Daniel R. Cowans, Bankruptcy Law and Practice 183-84 (7th ed. 1998).

THE CONTINUED USE OF STATE HOMESTEAD EXEMPTIONS TO PROTECT AGAINST COLLECTION OF FINES AND DISGORGEMENT ORDERS

Homestead provisions allow an individual who has filed for bankruptcy protection to shield his or her house from creditors, subject to certain conditions and, potentially, monetary or acreage limitations.[132] Section 522(d)(1) of the Bankruptcy Code protects up to $17,425 of a debtor's interest in his or her home.[133] Debtors, however, may elect whether to use the federal or the state homestead exemption. Additionally, states remain free to "opt-out" of the federal provision, leaving state law provisions governing the amount (if any) of a debtor's interest that is exempt.[134] State homestead provisions vary widely—some states do not have homestead exemptions, other states exempt all of a debtor's residence without any meaningful limitation.[135] In states with so-called unlimited homestead exemptions, a debtor's primary residence, regardless of value, generally cannot be reached by creditors.[136] These unlimited state homestead provisions prompted the Commission to ask Congress to eliminate the ability to shield assets from judgments in favor of the Commission (or orders issued by the Commission) that require the payment of fines or disgorgement.[137]

The Securities Fraud Deterrence and Investor Restitution Act, H.R. 2179 ("H.R. 2179"), would amend the Sarbanes-Oxley Act by adding Section 309, captioned "Recovery of Securities Law Judgments; Removal of State Law Impediments":

> If in any judicial or administrative action brought by the Commission under the securities laws the Commission obtains a judgment or order

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132. Homestead provisions only apply to individuals, not corporations, partnerships or other business organizations.

133. 11 U.S.C. § 522(d)(1) (dollar amount changes from year to year).

134. 11 U.S.C. § 522(b); Nathan F. Coco & David C. Christian II, *Squirreling It Away*, 12 Bus. L. Today 29, (Jan./Feb. 2003).

135. Texas, Florida, Iowa, Kansas and South Dakota generally have unlimited homestead exemptions. *See* John K. Eason, *Developing the Asset Protection Dynamic: A Legacy of Federal Concern*, 31 Hofstra L. Rev. 23, 65 n.180 (2002); *see also* Jon Swartz, *Sullivan Estate Might Not Be Exempt; Home Must be Done, Occupied to be Protected*, USA Today, Aug. 13, 2002.

136. Requirements for the unlimited homestead exemption vary between states.

137. *See* Hearings Before the House Subcomm. on Capital Markets, Insurance, and Government Sponsored Enterprises, Comm. on Fin. Servs. (Feb. 26, 2003) (testimony of Stephen M. Cutler, Director, Division of Enforcement, SEC) (asking Congress to "remove state law impediments to the Commission's collection of judgments and administrative orders."); *see also* The Securities Fraud Deterrence and Investor Restitution Act, H.R. 2179, 108th Cong. (2003); Hearings Before the House Subcomm. on Capital Markets, Insurance, and Government Sponsored Enterprises, Comm. on Fin. Servs. (June 5, 2003) (testimony of Stephen M. Cutler, Director, Division of Enforcement, SEC).

> (either by litigation or settlement) against any person based upon an alleged fraudulent, deceptive, or manipulative act or practice in violation of such laws or the rules or regulations thereunder, the Commission may obtain the foreclosure and forced sale of any property owned in whole or in part by that person, or by any person to whom such ownership was transferred without adequate consideration, to satisfy that judgment or order in a Federal or State court notwithstanding any homestead provision of any State constitution or any other State law that exempts or protects property from either foreclosure and forced sale under any process of court or from any lien thereon for the payment of debts.[138]

Congress has yet to vote on H.R. 2179, although, at the time of writing, the bill continues to be the principal vessel for many of the Commission's legislative proposals and was considered and reported out favorably by the House Financial Services Committee in February 2004.[139] H.R. 2179 would enable the Commission to reach assets unavailable to any other creditors—including other tort victims and trade creditors—and dramatically alter traditional priorities under the Bankruptcy Code. H.R. 2179 would also eliminate the security offered by certain types of state law tenancies that prohibit creditors from forcing the sale of a property without the consent of all co-owners (such as a tenancy by the entirety), placing innocent spouses and dependants at risk if an individual subject to a Commission order is a co-owner of the property. Similarly, under Section 308 of the Act, the Commission would be able to allocate the sale proceeds of collected property otherwise subject to a state's homestead exemption to equity shareholders (including institutional investors and other sophisticated market participants), who typically fall well below other creditors and represent the so-called "equity cushion."

Perceived abuses of state unlimited homestead exemptions by those involved in some more notorious frauds have received attention in the past, but never resulted in the abolition of the exemption.[140] The press accounts of the expensive homes owned by former Enron and

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138. The Securities Fraud Deterrence and Investor Restitution Act, H.R. 2179, 108th Cong. (2003).

139. Reforming the federal homestead provision was also part of an attempted overhaul of the Bankruptcy Code that was debated during the spring of 2002. The proposed homestead reform placed an across the board cap on the exemption for convicted felons and individuals with debt as a result of violating federal or state securities laws, among other proposed limitations. *See* Philip Shenon, *Congress Panel Agrees to Limit Home Shield In Bankruptcy*, N.Y. Times, Apr. 24, 2002; H.R. 333, 107th Cong. (2001).

140. *See* Jill Barton, *Execs' Ritzy Mansions on Shaky Ground Lawmakers go after Exemptions*, Chi. Trib., Sept. 15, 2002 (describing Paul Bilzerian's untouchable $5 million mansion in Florida, even though he reportedly owes creditors $300 million after being convicted of fraud and serving prison time).

WorldCom executives have renewed the concern over unlimited homestead laws.[141] Not surprisingly, the Commission has expressed its support of H.R. 2179, citing examples of past difficulties in collecting judgments because of state homestead exemptions.[142]

THE SEC'S ENFORCEMENT STUDY AND ADDITIONAL ENFORCEMENT RESOURCES

SARBANES-OXLEY'S FUNDING FOR ADDITIONAL ENFORCEMENT PROFESSIONALS (SECTION 601)

Section 601 of the Act authorized additional funding to the Commission, including funds earmarked for increased salaries ($102 million), for technology and security enhancements ($108 million), and for the hiring of at least an additional 200 qualified professionals to provide enhanced oversight of auditors and audit services and to improve Commission investigative, compliance, and inspection programs.[143] While staff turnover was often cyclical at the Commission, prior to the enactment of the Sarbanes-Oxley Act and the Capital Markets Fee Relief Act of 2002[144] the Commission was facing relatively high levels of employee turnover, a tight budget, and a regulatory burden that was growing in an increasingly complex securities industry.[145] In March 2002, then-Chairman Harvey L. Pitt testified that "the SEC cannot afford to continue suffering the staffing crisis it has endured for the past decade at

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141. *See, e.g.*, Jon Swartz, *Sullivan Estate Might Not be Exempt; Home Must be Done, Occupied to be Protected*, USA Today, Aug. 13, 2002.

142. *See* Hearings Before the House Subcomm. on Capital Markets, Insurance, and Government Sponsored Enterprises, Comm. on Fin. Servs., at 2 (Feb. 26, 2003) (testimony of Stephen M. Cutler, Director, Division of Enforcement, SEC).

143. Sarbanes-Oxley Act § 601, 116 Stat. 793-94.

144. Pub. L. No. 107-123, 115 Stat. 2390. The Act is also known as the "Pay Parity Act" and was designed to equalized pay levels between federal banking and securities regulators.

145. *See* Testimony Before the Senate Subcomm. on Oversight of Government Management Restructuring and the District of Columbia, Comm. on Governmental Affairs, (Apr. 23, 2002) (testimony of James M. McConnel) *available at* www.sec.gov/news/testimony/042302tsjmm.htm; Michael Steel, *House Committee Votes to Raise SEC Pay*, Gov.Exec.Com (Apr. 2, 2001) (noting that the bill would raise SEC pay to equal that of other financial agencies); James V. Gromaldi, *The Legal Eagles Are Taking Wing; Agencies Losing Recruiting Fight With Law Firms as Salaries Soar*, Wash. Post (May 9, 2002); Jackie Spinner, *SEC Seeks Money for Hiring, Raises; Pitt Says Agency Has a 'Staffing Crisis,'* Wash. Post (Mar. 8, 2002) (citing a GAO report determining that the SEC's lack or resources caused delays in processing filings, issuing guidance, and investigating fraud).

such an important juncture."[146] While prior Commission appeals for additional funding and salary increases went unanswered, the market scandals of the past several years made Congress more than receptive to a funding increase. Congress responded by enacting Section 601 of the Act, which increased the Commission's authorized funding significantly.

Study of Enforcement Actions (Section 704)

Pursuant to Section 704 of the Act, the Commission conducted a study of "all enforcement actions by the Commission involving violations of the reporting requirements imposed under the securities laws, and restatements of financial statements, over the 5-year period" prior to the Act's passage.[147] The purpose of the study was to "identify areas of reporting that are most susceptible to fraud, inappropriate manipulation, or inappropriate earnings management, such as revenue recognition and the accounting treatment of off-balance sheet special purpose entities."[148] Congress instructed the Commission to include in its report recommendations for possible regulatory or legislative action that may help the Commission achieve its enforcement objectives.[149]

The Commission issued its Report on January 26, 2003.[150] The Report covered 515 enforcement actions for financial reporting and disclosure violations arising out of 227 investigations conducted by the Division of Enforcement.[151] Of the 227 investigations, over half involved financial reporting restatements.[152] The Report identified a number of recurring issues, such as improper revenue recognition, fraudulent reporting of sales, and improper expense reporting.[153] The Report noted that the number of investigations involving public companies concerning inadequate disclosures in the Management Discussion and Analysis ("MD&A") section of SEC filings, failure to disclose related party transactions, and improper use of off-balance sheet arrangements were increasing.[154] The Report also found that, in many of these cases, members of senior management were often charged in connection with accounting fraud cases.[155]

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146. Jackie Spinner, *SEC Seeks Money for Hiring, Raises; Pitt Says Agency Has a 'Staffing Crisis,'* Wash. Post (Mar. 8, 2002).

147. Sarbanes-Oxley Act § 704.

148. *Id.*

149. *See id.; see also* The Corporate and Criminal Fraud Accountability Act of 2002, S. Rep. No. 107-146, at II.E (2002) ("Congress must act now to restore confidence in the integrity of the public markets).

150. *See* Report Pursuant to Section 704 of the Sarbanes-Oxley Act of 2002 (Jan. 24, 2003), *available at* www.sec.gov/news/studies/sox704report.pdf.

151. *Id.* at 1.

152. *Id.* at 2.

153. *Id.* These matters accounted for 126 of the 227 enforcement investigations. Of these 126 actions, 106 involved fraud charges. *See id.* at 2, 6.

154. *Id.* at 1-2.

155. At least one senior manager was charged in 157 of the 227 enforcement matters analyzed throughout the study. *See id.* at 2.

The Report recommended: (1) uniform reporting of restatements; (2) additional Commission guidance on MD&A of Financial Condition and Results of Operations[156]; (3) statutory provisions permitting companies to make internal reports available to the Commission without waiving the attorney-client privilege; (4) statutory relief from the grand jury secrecy rules such as to permit Commission access to federal grand jury materials; and (5) nationwide service of process for testimony in Commission litigation.[157] Congress continues to consider these recommendations.[158]

CONCLUSION

The Sarbanes-Oxley Act marks another incremental enlargement of the Commission's statutory enforcement authority. In 1990, the Securities Enforcement Remedies and Penny Stock Reform Act significantly changed the manner in which securities enforcement matters proceeded from investigation to litigation or settlement. The Remedies Act empowered the Commission to bring more cases administratively, to order civil monetary penalties against regulated entities and disgorgement in those proceedings, and to police a wider range of conduct through its cease-and-desist authority. Building upon the Remedies Act, the Sarbanes-Oxley Act increased the Commission's authority to order disgorgement, to bar individuals from serving as officers and directors of public companies, to establish investor restitution funds, to seek asset freezes, to regulate securities professionals, to police accountants and accounting firms, and to ensure that the collateral consequences of securities law violations are meaningful and lasting.

The Commission has embraced many if not all of the Act's provisions concerning its increased enforcement authority. The Commission has initiated a record number of enforcement actions since the Act's passage and regularly seeks sanctions as a matter of course that would have been extraordinary before the Act. Most settlement negotiations with the Staff now occur against a backdrop of concern over criminal referrals and almost always involve a focus on individual accountability, aggressive disgorgement claims, and officer and director bars. Securities

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156. *Id.* at 44. The SEC has issued a final rule on Disclosure in Management's Discussion and Analysis about Off-Balance Sheet Arrangements and Aggregate Contractual Obligations, Securities Act Rel. No. 8182; 68 Fed. Reg. 5982 (Feb. 5, 2003).

157. *See* Report Pursuant to Section 704 of the Sarbanes-Oxley Act of 2002 (Jan. 24, 2003), *available at* www.sec.gov/news/studies/sox704report.pdf; see also Hearings Before the House Subcomm. on Capital Markets, Insurance, and Government Sponsored Enterprises, Comm. on Fin. Servs., at 2 (Feb. 26, 2003) (testimony of Stephen M. Cutler, Director, Division of Enforcement, SEC).

158. *See* Securities Fraud Deference and Investor Restitution Act, H.R. 2179, 108th Cong. (2003). H.R. 2179 was reported out of the House Financial Services Committee in late February 2004.

SROs and state securities administrators compete with the Commission Staff to initiate investigations and obtain monetary penalties that often go to the agency's or state's general coffers. And, in case one were to think that we had reached the high-water mark of Commission power, the Commission is actively lobbying for increased fining authority in administrative proceedings and for the statutory authority to override state homestead exemptions and other protections designed to shield family assets from creditors and, among other things, protect innocent spouses and dependents from losing their homes.

It is entirely possible that, should the Commission's post-Sarbanes-Oxley Act legislative proposals be adopted, the Commission will have the statutory authority (1) to initiate an investigation of a public company and to seek and receive a temporary asset freeze prohibiting that company from paying retention or other bonuses without having established a securities law violation (under Section 1103 of the Act); (2) to initiate an administrative proceeding against that company, its officers and directors, and its auditors (under its existing cease-and-desist authority); (3) to order civil monetary penalties against each of the respondents administratively, *i.e.,* without the involvement of a federal court (under H.R. 2179) as previously required by the Remedies Act; (4) to order administratively that the company's officers and directors be barred for life from ever serving as officers or directors (under Section 1105 of the Act) also without resort to a judicial forum, as previously required by the Remedies Act; (5) to order administratively that the officers disgorge all bonuses for the past 5 years (under Section 304 of the Act); (6) to bar the company's auditors and attorneys from appearing before the Commission for life (under Section 602 of the Act); (7) to preclude the company's officers or directors from ever serving as an investment professional (under Section 604 of the Act); (8) upon bankruptcy, to compensate the company's "defrauded" investors at the expense of the company's other secured or unsecured creditors (under Section 308 of the Act); (9) to seize the house of an officer or director who has not paid his or her fine, whether or not the house is owned in a state with an unlimited homestead exemption or pursuant to a tenancy-by-the-entirety with an innocent spouse (under H.R. 2179); (10) to seek the payment of Commission-ordered fines and disgorgement without the need to relitigate the Commission "findings" of misconduct in a federal court proceeding (under Section 803 of the Act); (11) to continue to demand payment of Commission-ordered fines and disgorgement for the remainder of an individual's natural life, notwithstanding a discharge in bankruptcy (under H.R. 2179); and (12) to bring charges against the PCAOB and its members for having failed to adopt procedures that would have identified the misconduct (under Section 107 of the Act). And almost all of these actions can be taken by the Commission acting alone, without the involvement of—or immediate recourse to—an Article III tribunal.

What should we make of the new enforcement tools granted to the Commission by the Act? As with most questions concerning the authority of an administrative agency—particularly an independent agency like the Commission—the answer depends on how one views the character of the agency and its staff. It is beyond cavil that the Act confers unprecedented discretion on the Commission—discretion made all the more powerful because of the effectively unreviewable prosecutorial authority associated with the Commission's enforcement function (*e.g.*, which cases to litigate, which cases to settle, which respondents to name, which charges to bring, *etc.*). Since the passage of the Securities Exchange Act of 1934, the Commission's authority has ebbed and flowed based in large part on the discovery of abuses in the stock market. Just after the agency was created, following the so-called "capital strike," then-Chairman Joseph Kennedy reassured business that "[w]e do not start off with the belief that every enterprise is crooked and that those behind it are crooks." Kennedy championed the self-regulatory model that has continued through today.[159] Kennedy's conciliatory tone contrasted starkly with that of the Commission's third Chairman, William O. Douglas, who, years later, compared investors to squirrels and issuers and their investment professionals to coyotes.[160] It certainly seems that the Douglas view of the markets is far more in vogue today at the Commission than the Kennedy view.

That is not to say that Commission proceedings or investigations are rigged or unfair; simply put, the process reflects, as much as the Sarbanes-Oxley legislation, the times in which we now live. A respondent in a Commission case in the late 1970s or early 1980s may well have taken refuge in the assertion that the contemplated Commission enforcement action would have a deleterious effect on the market or free market processes; a respondent in today's regulatory climate is more likely to face concern (on the part of the Commission and its staff) that any contemplated sanction will be perceived as too soft or a proposed fine as too low. In 1910, Woodrow Wilson warned that government actions should be focused on individual wrongdoers and that fines and convictions against corporate entities disproportionately harmed the company's

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159. Donald A. Ritchie, James M. Landis: Dean of the Regulators 65 (Harv. Univ. Press 1980) ("Successful regulation, he argued, depended primarily on the exchanges themselves. 'In large measure we would have the exchanges do their own policing,' he explained. 'They are in much better shape to do this than to have the government send in the staff.'").

160. William O. Douglas, Go East Young Man 272 (Random House 1974) ("The large percentage of stockholders on the small side accentuated the mantle for investor protection. The problem reminded me of the golden-mantled ground squirrel in the Cascades who is the anchor man in the food chain. He is to predators what hamburger is to man. His enemies are many, including the coyote. In the capitalistic system the unsophisticated small stockholder is the ground squirrel, and the coyote had always been numerous. In the Far West coyotes, however, were for years poisoned or trapped.").

shareholders and employees.[161] In the last two years, we have observed the ramifications of the Andersen indictment and regularly have seen the risk of indictment of other public companies (and individuals) for the alleged misdeeds of a small number of managers or employees.

The Commission's enforcement program has yet to reach equilibrium in implementation of the new Sarbanes-Oxley powers. It is difficult to predict with any confidence how the Commission and its Staff will exercise the considerable power and authority to police the domestic capital markets once the rhetoric of the post-Enron, post-WorldCom environment wanes. What *is* certain is that the powers granted to the Commission by the Act—likely in a manner intended by the Congress—are being brought to bear in virtually all of the Commission's current cases. Whether the Act (and the Commission's administration of it) has *also* chilled entrepreneurial initiative, discouraged business risk-taking, reduced the willingness of qualified professionals to serve on corporate boards or in particular capacities, discouraged consultation with corporate or outside attorneys, or the ability of attorneys or accounting professionals to render meaningful advice—and meaningful advocacy—on the propriety of novel practices will have to be addressed in the years to come.[162]

More than perhaps ever before, the Commission and its staff bear a considerably heavy burden for balance and fairness. That responsibility, which is in direct proportion to the immense power the agency now wields, should not be taken lightly by the agency, the corporate defense bar, or the courts that will ultimately pass judgment on some of the cases the agency will bring.

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161. Woodrow Wilson, Address to the ABA Annual Meeting, 1910 ("Corporations do not do wrong. Individuals do wrong, the individuals who direct and use them for selfish and illegitimate purposes, to the injury of society and the serious curtailment of private rights. Guilt, as has been very truly said, is always personal. You cannot punish corporations. Fines fall upon the wrong persons; more heavily upon the innocent than upon the guilty; as much upon those who knew nothing whatever of the transaction for which the fine is imposed as upon those who originated and carried them through—upon the stockholders and the customers rather than upon the men who direct the policy of the business. If you dissolve the offending corporation, you throw great undertakings out of gear. You merely drive what you are seeking to check into other forms or temporarily disorganize some important business altogether, to the infinite loss of thousands of entirely innocent persons and to the great inconvenience of society as a whole. Law can never accomplish its objects in that way. It can never bring peace or command such respect by such futilities.").

162. In a September 2003 interview with *Business Week,* New York Attorney General Eliot Spitzer questioned whether the Act had "made oversight too stringent." *Straight Talk From Eliot Spitzer,* Bus. Week, Oct. 6, 2003 ("[Q.] Are you concerned that in a bid to address corporate corruption, the government through Sarbanes-Oxley has made oversight too stringent? [A.] Absolutely. The concern relates to the unintended consequences of well-meaning statutes. . . . Sarbanes-Oxley may go too far. I hear complaints all the time from executives, from lawyers, that too much time is being wasted on ministerial activity. We have to see how it plays out. There will be time to change it, but we're worried about that.") (omission in original).