

THE SECURITIES AND EXCHANGE COMMISSION'S NEW COURSE ON PENALTIES

By Christian J. Mixer¹

In an April 13, 2007 speech to the Seventh Annual Policy Conference of the Mutual Fund Directors Forum, SEC Chairman Christopher Cox mapped out a different course for SEC enforcement cases that involve civil money penalties against public companies.² That course may very well lead to a better destination for many companies that find themselves on the receiving end of an SEC enforcement recommendation. But there are some rocks along the way, and this article considers how those rocks might be removed, or at least avoided.

As Chairman Cox noted in his April 13 speech, the SEC's rules contemplate some involvement by the Commission at the front end of the settlement process: "In the course of the Commission's investigations, civil lawsuits, and administrative proceedings, the staff, *with appropriate authorization*, may discuss with persons involved the disposition of such matters by consent, by settlement, or in some other manner."³ Nevertheless, since 1990, when the SEC first gained broad-scale authority to seek civil money penalties against public companies, penalty cases typically have followed a familiar route: the SEC's Enforcement Staff would propose a civil money penalty along with the other aspects of a proposed settlement, and all the terms of the proposed settlement would be hashed out in discussions between the Staff and counsel for the company. If the Staff and the company reached agreement, the company would execute an offer

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² Available on the SEC's Website at www.sec.gov/news/speech/2007/spch041207cc.htm. The comparatively short section of the Chairman's speech that deals with penalties in enforcement cases appears on pages 7-8.

of settlement (or its equivalent in settled injunctive cases, a Consent and Undertakings) that then would be submitted to the Commissioners for approval. If the Commission declined to approve the settlement as submitted, the Staff would bring that news – perhaps with guidance from the Commissioners on the size and shape of a settlement that the Commissioners would support -- back to counsel for the company, who could either resume settlement negotiations or elect to litigate the case.

Under the approach sketched out in Chairman Cox’s speech, the Staff will not even begin to discuss a civil money penalty with a company until the Staff has first sought the input of the Commissioners on the size of the penalty, which apparently is expected to take the form of a range of penalty amounts that the Commissioners believe should apply. If the penalty actually negotiated comes in within the range specified by the Commissioners, the settlement containing it will receive faster, or “seriatim,” approval by the Commissioners. If the specified range is violated, then the case goes onto a slower track, with other possible complications that are explored below.

The Purpose of Pre-Review

Some commentators have suggested that Chairman Cox’s speech bespeaks an effort by the Commissioners to rein in the Division of Enforcement, particularly regarding oversized penalties.⁴ Chairman Cox himself offered different reasons for the change, describing its aims as providing “a guarantee of fairness and of horizontal equity in a nationwide program,” making settlement negotiations move faster, and boosting both the confidence and the credibility of the Enforcement Staff by creating a situation in which, by virtue of the Commissioners’ pre-review

³ Rule 202.5(f) of the SEC’s Informal and Other Procedures, 17 C.F.R. § 202.5(f) (emphasis added).

of the Staff's penalty proposal, "the wind [would be] at the backs of our staff across the country." Far from predicting a lowering of penalty amounts, Chairman Cox guessed that "if anything, the penalties you will see imposed in future cases will be stiffer."

Given Chairman Cox's statements, defense counsel and their public company clients can be forgiven for wondering whether the wind at the backs of the SEC staff will be wind in the faces of public companies who become the subject of enforcement actions – in other words, whether the process of obtaining pre-review of the staff's penalty proposal will lead to a prejudgmental hardening of the Commissioners' receptivity to defense arguments that there should be no penalty in a particular case, or that the penalty should be below the lower end of the range that the Commissioners have provided to the Staff.⁵ As discussed below, there are certain measures that the Commission, the Staff, and defense counsel can and should take to alleviate that concern.

The Problem of Prejudgment

Whatever its shortcomings, the current system of negotiating civil money penalties has the cardinal virtue of access: where the SEC Staff proposes, and then negotiates, the penalty, company counsel has the ability to make all his or her arguments to the same person who is deciding (subject, of course, to ultimate approval by the Commission) what the penalty should be. As a result of vigorous advocacy and the Staff's ability to listen, it is a comparatively rare case in which the discussion of corporate penalty amounts with the Staff starts and ends at the same figure. And once a settlement has been signed up and delivered to the Staff, company counsel can count on that same Staff to recommend the penalty to the Commission.

⁴ See Otis Bilodeau, "SEC's Cox Tightens Reins on Enforcement Division," Bloomberg, April 13, 2007.

Since January 2006, the discussion of penalties with the Staff has been given greater structure by the Commission's Statement Concerning Financial Penalties (the "Penalties Statement").⁶ The Penalties Statement represented the Commission's first attempt to state publicly, and unanimously, how the Commission would go about determining what financial penalties to seek against public companies. It identified two principal considerations – the presence or absence of a direct benefit to the corporation as a result of the violation, and the degree to which the penalty will recompense or further harm injured shareholders -- along with the following "additional considerations":

- The need to deter the particular type of offense;
- The extent of the injury to innocent parties;
- Whether complicity in the violation is widespread throughout the corporation;
- The level of intent on the part of the perpetrators;
- The degree of difficulty in detecting the particular type of offense;
- Presence or lack of remedial steps by the corporation;
- Extent of cooperation with Commission and other law enforcement.

When it issued the Penalties Statement, the Commission expressed the hope "that the elucidation of these principles will provide a high degree of transparency to our decisions," "and will be of assistance to the Commission's professional staff, to corporate issuers and their counsel, and to the public." But while the corporate community and its advisors greeted the Penalties Statement as a useful step, the considerations laid out in the Penalties Statement – like every policy statement of its type, including the 2001 "Seaboard" Release on cooperation – are

⁵ In this article, the term "prejudgment" is used in its practical sense, and not in the technical sense embodied in Rule 240(c)(5) of the SEC's Rules of Practice, 17 C.F.R. § 201.240(c)(5).

⁶ Available on the SEC's Website at www.sec.gov/news/press/2006-4.htm.

not a simple checklist. Instead, the presence or absence of any given consideration in any given case, and the respective weights to be given to each consideration, are legitimately the subject of debate and, yes, advocacy. In fact, the application of the Penalties Statement has apparently been sufficiently uncertain that the Chairman Cox worries that the Enforcement Staff, in the existing system of Staff-negotiated penalties, is left “wondering whether the Commission will later on back them up, or rather cut them off at the knees.”

Against this background, corporate defense counsel can justifiably be concerned about a process in which the Enforcement Staff, at a time when the Staff has no motivation but to seek the maximum penalty that can be supported by the facts as it sees them, and when no one has even heard the company’s point of view, gets together with the Commissioners to seek direction on the penalty range that should apply to a given case, and then announces the outcome of those *ex parte* discussions to the company. What happens in a case where the company legitimately believes that no penalty should be assessed in a case where the Commissioners and the Staff have concluded that a penalty should be levied? What happens in a case where the company could agree to a penalty, but at a level below the bottom of the range that the Commission and its Staff have arrived at? In both instances, there is of course a glib answer – “just say no” to the settlement. But if “just saying no” means telling the Commissioners that there is no deal to be had and that the case may very well litigate, such an outcome may not be healthy for either the company or, if repeated enough times, for the Enforcement program, which last year relied upon the settlement of three quarters of its cases.

Possible Antidotes to Prejudgment

It would be useful if the Commission would explicitly provide defense counsel with notice that the Enforcement Staff is about to engage the Commissioners in a “pre-review” of

penalties and, equally important, an explicit opportunity to be heard on the money penalty issue. Absent such a provision, the company is left to guess the point during an investigation when it should intervene with the Commissioners in order to avoid *ex parte* prejudice. Once the company is on notice, the Commission's existing Wells rule at least permits it to make its views known:

Persons who become involved in preliminary or formal investigations may, *on their own initiative*, submit a written statement to the Commission setting forth their interest and position in regard to the subject matter of the investigation. Upon request, the staff, in its discretion, may advise such persons of the general nature of the investigation, including the indicated violations as they pertain to them, and the amount of time that may be available for preparing and submitting a statement prior to the presentation of a staff recommendation to the Commission for the commencement of an administrative or injunction proceeding. Submissions by interested persons should be forwarded to the appropriate Division Director or Regional Director ... with a copy to the staff members conducting the investigation and should be clearly referenced to the specific investigation to which they relate. In the event a recommendation for the commencement of an enforcement proceeding is presented by the staff, any submissions by interested persons will be forwarded to the Commission in conjunction with the staff memorandum.⁷

Thus, the mechanism is there for the company to make its views known to the Commissioners regarding penalties. The problem – and it is a substantial one – is determining when the “pre-review” of penalties is likely to take place. Only the Commission or its Staff can provide reasonable notice of the pre-review and thus prevent the premature (and perhaps wholly unnecessary) service of “Penalty Wells Submissions” or, worse yet from the standpoint of fairness, the unknowing failure to make such a submission until it is too late.

Solving the second problem identified above – where the Staff has presented a “pre-reviewed” penalty range that is above what the company is willing to pay, but where the company is willing to settle to a lesser penalty, or to relief other than a penalty – requires a

⁷ 17 C.F.R. § 202.5(c) (emphasis added)..

solution that is, once again, permitted by the SEC's rules but somewhat "outside the box" under current SEC practice. In this situation, Chairman Cox's April 13 speech, while giving no specifics, apparently contemplates the company submitting a nonconforming offer of settlement, presumably accompanied by a Wells submission advocating that settlement. One must suppose, however, that the Enforcement Staff, having received the Commission's "bottom line" on penalty and now faced with a proposed settlement below that "bottom line," will not support the settlement but at best will simply serve as an honest broker in transmitting the offer to the Commission. In the context of administrative proceedings, Rule 240(c)(3) of the SEC's Rules of Practice⁸ explicitly provides for the submittal of offers of settlement that are opposed by the Division of Enforcement. Outside the administrative context, for example in the case of contemplated injunctive proceedings, authorization for "opposed" settlements is less clear (*see, e.g.*, Rule 202.5(f) quoted above), but in that context counsel can at least outline his or her client's proposed settlement in the body of the Wells submission or, if greater formality is desired, submit the pre-litigation equivalent of an Offer of Judgment under Federal Rule of Civil Procedure 68.

Conclusion

Chairman Cox's approach to the negotiation of corporate penalties promises greater involvement by the Commissioners and less post-settlement dissonance. From the SEC's institutional point of view, it is difficult to quarrel with those goals. From a process point of view, however, the Commission should recognize that if "pre-review" is going to take on the importance that the Commission apparently wishes it to have, steps must be taken to avoid the ills of prejudgment, which is the antithesis of the "fairness and horizontal equity" that the SEC

⁸ 17 C.F.R. § 201.240(c)(3).

seeks to foster. As the “pre-review” program goes forward, the Commission could largely eliminate those ills by giving companies in the program notice that a “pre-review” is about to take place so that the company can make its views known before too many pre-conceived (and perhaps ill-conceived) notions about the case are cast in stone. Even without such notice, companies that get wind of an approaching “pre-review” should, as noted above, consider whether to submit a pre-Wells submission addressing settlement. At a minimum, companies can hope that the Commissioners bear in mind, at the “pre-review” stage, that there are two sides to most stories, that they have heard only one, and that their minds should remain open to the company’s perspective.