

SECURITIES LITIGATION AND ENFORCEMENT

BY JOHN F.X. PELOSO AND BEN A. INDEK

The Current SEC Enforcement Landscape

IN THE WAKE of recent events, legislators, regulators and prosecutors are busy formulating new remedies to address past ills and prescriptions to deter misconduct in corporate executive suites and in the nation's securities markets. There are calls for and against legislation, debates as to the reasonable limits of corporate criminal prosecution and a clamor for reform. Where all this will lead remains to be seen, but one thing is clear: the Securities and Exchange Commission, on its own initiative, and at the urging of various interested parties, is proclaiming its toughness and letting the world know that its enforcement program is ready, willing and able to wage war on those who violate the securities laws.

This article highlights several current developments at and pronouncements by the SEC regarding the current enforcement landscape.

New, Tougher Tone at the SEC

Just about 100 years ago, at the Minnesota State Fair, Theodore Roosevelt invoked what he called a homely adage to advise our government in its world affairs to "speak softly and carry a big stick." It would seem that over the past few months, the SEC has decided to wield the big stick, but as vocally as possible. Recent enforcement initiatives and speeches by SEC Chairman Harvey L. Pitt and senior commission staff reflect a tougher tone and an amplified approach to the enforcement process.

To begin with, the commission has implemented a practice of "real time" enforcement, the significance of which has taken on greater meaning in light of the events of the last several months. Recent high-profile corporate meltdowns (and the ensuing large-scale enforcement investigations) have highlighted for Congress and the investing public the limits as well as strengths of the SEC's ability to monitor effectively the activity of public companies and the securities markets. As a result, there is pressure on the commission staff to do more — and to do it faster.

The stated goal of real-time enforcement is to provide quicker and more effective protection for investors and better oversight of the markets by halting unlawful conduct quickly and by alerting investors promptly to such activity. Furthermore, Chairman Pitt and the commission staff have made clear that, in addition to bringing cases more swiftly, recidivists will be punished more severely, and that delay or obstruction will not be tolerated. Egregious cases, in particular, will be put on the SEC's prosecutorial "fast track," and the agency will work more closely with U.S. Attorneys Offices where criminal charges may be appropriate.² The commission also has signaled its intention to seek civil penalties more often against public companies that are uncooperative during the course of an investigation and in those cases so egregious that the SEC believes that non-monetary sanctions alone are insufficient to



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address the severity of the misconduct and to deter others.

Stephen Cutler, the SEC's enforcement director, has said that in practice, real-time enforcement also means tighter deadlines in settlement negotiations and a reluctance to grant extensions for responding to subpoenas or presenting Wells submissions. The commission also will bring enforcement actions in pieces against various parties to facilitate the efficient disposition of cases.

Whether or not any of this is really "new" is open to debate. Somehow, the staff has always wanted testimony and documents "yesterday" and been reluctant to give extensions. Yet, the strident tone of these latest remarks suggests that the process will be ratcheted up by several notches. We are already seeing some of that. For example, the commission has been seeking temporary restraining orders (TROs) and asset freezes much more frequently. The agency sought 42 TROs in all of fiscal year 2001; in contrast, it has sought 20 TROs in the first one-third of fiscal year 2002.³ The commission also has initiated subpoena enforcement actions and sought contempt orders more frequently since real time enforcement was put in place.⁴ It has already brought 10 actions to enforce subpoenas for documents or testimony in fiscal year 2002 (this tool was used a total of 13 times in fiscal year 2001).⁵ Mr. Cutler observed at a recent conference that he has delegated authority from the commission to approve the filing of subpoena enforcement actions and will not hesitate to use that authority.⁶

A Focus on Officers, Directors, and Audit Committees. The SEC also has adopted a new, more aggressive approach to the corporate world in general and corporate executives in particular. Recent speeches by SEC staff indicate a renewed focus on the role and responsibility of officers, directors and audit committees of public companies. The commission has asked the New York Stock Exchange and Nasdaq to review their corporate governance and listing standards, including issues related to officer and director qualifications and codes of conduct of public companies. In addition, it has also requested Financial Executives International to review and revise its code of ethics.⁷

Moreover, the SEC has made clear that it intends to hold corporate executives responsible where they are alleged to have failed to fulfill their fiduciary duties to companies and shareholders. Mr. Cutler announced that he is "steadfastly determined to be more aggressive in seeking officer and director bars," and that he views "a single, serious breach of the public trust, [as] undeniably render[ing] one 'substantially unfit' for service as an officer or director."⁸ Audit committees, which in the past may have not been targets of SEC investigations, must now expect that their performance of that important function will be looked at carefully in the event that issues arise. The commission also will seek from corporate executives "unearned" or "undeserved" gains and compensation based on inflated earnings. Mr. Pitt recently stated, "we are going to go after compensation packages whenever

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we think the facts show disservice to the shareholders."⁹

The commission currently has the authority to seek officer and director bars in court, but has met with limited success. Chairman Pitt recently stated that "some courts have taken an inhospitable approach to the plain legislative language [regarding SEC authority to seek officer and director bars], thwarting our ability to prevent some officers and directors who inflict serious harm on investors from repeating that kind of conduct."¹⁰ As a result of this record, the commission is seeking new statutory authority and has asked Congress for several additional enforcement tools to use against officers and directors who violate the securities laws. First, with the support of President George W. Bush, the SEC is seeking administrative authority to impose officer and director bars directly where an executive violates his duties or where the individual is a recidivist. Such action would be subject to judicial review. Second, the commission wants the power to impose civil penalties on officers and directors and public companies in administrative proceedings. Pursuant to §21B of the Exchange Act, the commission has the authority to impose civil penalties only on regulated entities such as broker-dealers and their associated persons in administrative proceedings. This authority does not currently extend to unregulated entities, such as public companies, or individuals, as to whom the commission must go to district court to obtain penalties. The commission believes being able to impose penalties on officers and directors in administrative proceedings will help "deter corporate malfeasance and misfeasance."¹¹

Further, the SEC is asking Congress for statutory authority to pursue civil contempt penalties for recidivists who violate prior judicial or administrative sanctions and restrictions, and for simplified standards for criminal contempt proceedings,

which the SEC must ask the Department of Justice to pursue on its behalf. The commission is also asking Congress to increase penalty amounts, which, for natural persons, are capped at \$120,000 or the gross amount of pecuniary gain for each violation.

Additional Bills

In addition to the new power the commission is seeking, a number of bills have emerged in Congress that would give the SEC further authority. Among them, S. 2010 (the proposed "Corporate and Criminal Fraud Accountability Act of 2002") would impose harsher penalties, including fines and imprisonment, to deter fraud and encourage corporate accountability. This bill, among other things, would give state attorneys general and the SEC the authority to bring civil RICO cases with treble damages.

H.R. 3818 (the proposed "2002 Comprehensive Investor Protection Act") would grant the SEC the authority (and private litigants the ability) to bring an action against any person for aiding and abetting any provision of the Exchange Act based on reckless conduct. The Exchange Act currently only permits the SEC to sue aiders and abettors who knowingly provide substantial assistance to another person in violation of the act, or any rule thereunder.

The SEC is Seeking More Money to Fund Its Programs. With so many things going on at the commission in terms of overall reforms and enforcement initiatives, the SEC has asked Congress and the Bush Administration for more money for its fiscal year 2003 budget. In addition to the \$76 million that Chairman Pitt has requested to implement pay parity at the SEC, the chairman has also asked for \$15 million more to bring in new staff. Specifically, Mr. Pitt wants to add 100 new positions to meet the SEC's immediate resource needs. These positions would permit the SEC to add 35 accountants and lawyers to the enforcement division, 30 professional staff, including accountants and lawyers, to the division of cor-

poration finance and 35 accountants, lawyers and other professionals to other divisions, including the Office of the Chief Accountant.

The SEC's enforcement program clearly is in a state of high alert. New legislation and rulemaking could change the enforcement landscape even more in the future. These developments bear watching in the coming months.

(1) John Bartlett, *Familiar Quotations* (Emily Morrison Beck ed., Little, Brown and Co. 15th ed. 1980).

(2) See, e.g., *United States v. Patrick H. McCarthy III*, Litigation Rel. No. 17275, Dec. 17, 2001 (criminal charges filed against defendant for obstructing proceedings before the SEC); *United States v. Steven H. Adler*, Litigation Rel. No. 17238, Nov. 16, 2001 (indictment alleging mail and wire fraud with respect to defrauding investors and misappropriating investor funds).

(3) Stephen M. Cutler, Director, Division of Enforcement, SEC, "Remarks at the Glasser Legal-Works 20th Annual Federal Securities Institute," Hallandale, Florida, Feb. 15, 2002. See also *SEC v. Frank D. Gruttadauria*, Litigation Rel. No. 17369, Feb. 21, 2002 (seeking a TRO, a preliminary injunction, asset freezes, an accounting, the appointment of a receiver for the entities involved, as well as other emergency relief); *SEC v. Resource Development International, LLC*, et al, Litigation Rel. No. 17438, Mar. 26, 2002 (seeking TRO, asset freeze, an accounting, preservation of documents, repatriation of assets, surrender of passports, authorizing expedited discovery, and appointment of a receiver for all defendants and relief defendants).

The SEC also appears to be using its authority to suspend trading more frequently. Mr. Cutler noted that the SEC suspended trading in a stock just twice in fiscal year 2001, but has already used this authority four times since fiscal year 2002 began.

(4) See Mr. Cutler's remarks cited above. See also *SEC v. Charles Timson*, Misc. No. 02-MBD-10076-RCL (D. Mass.) (seeking subpoena enforcement); *SEC v. Marada Global Corp. Inc.*, Case No. 94-1504-CIV-T-21A (M.D. Fla.) (March 26, 2002) (seeking asset freeze, an accounting, appointment of a receiver, as well as a civil contempt order for violating prior permanent injunctions and a prior bar from the securities industry).

(5) See Mr. Cutler's remarks cited above.

(6) *Id.*

(7) Financial Executives International is an organization that advocates for the views of corporate financial management, representing 15,000 CFOs, treasurers and controllers from companies throughout the United States and Canada.

(8) See Mr. Cutler's remarks cited above.

(9) "The Reluctant Reformer," *Business Week* (March 25, 2002). See also *SEC v. John P. Gallo*, Civil Action No. 02-1087 (SMO) (D.N.J. March 13, 2002).

(10) Chairman Harvey Pitt, "Testimony Concerning Accounting and Investor Protection Issues Raised by Enron and Other Public Companies," before the Senate Committee on Banking, Housing and Urban Affairs, March 21, 2002.

(11) *Id.*