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Expert Analysis

Examining the SEC's Role In Returning Funds to Investors

It is no longer a surprise when the examination and enforcement efforts of the U.S. Securities and Exchange Commission (SEC) are the focus of popular and press attention. The financial meltdown of the past two years and frauds such as the Madoff scheme have brought the SEC's activities into the spotlight more than ever before. The examination staff ideally identifies fraud or potential frauds among registered entities before it becomes widespread, while the enforcement staff brings enforcement actions to redress and punish improper conduct.

However, one common aspect of the SEC's regulatory program that often goes unnoticed is the hard work connecting the proposed settlement amount to the amount of ill-gotten gain, and returning improperly gained funds to investors. The SEC's focus, after all, is on protecting investors and ensuring fairness in our securities markets. The SEC's "What We Do" Web page, for example, is titled The Investor's Advocate: How the SEC Protects Investors, Maintains Market Integrity, and Facilitates Capital Formation.[1]

A recent case brings the complexities in this area into sharp relief. On June 10, 2009, Judge William Pauley critically examined the SEC's application of its settlement amounts to investor harm in *SEC v. Bear, Stearns & Co. Inc.* The decision (NYLJ, June 11) has received little notice, but it sheds needed light on a vital part of the enforcement process.

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Statutory Background

Section 308 of Sarbanes-Oxley provides that the SEC may establish a Fair Fund into which disgorgement and civil penalties may be placed to compensate harmed investors. However, the underlying statutes—Section 20 of the 1933 Act and Section 21 of the 1934 Act—do not explicitly give the SEC authority to return money to investors that they have lost as a result of improper conduct. Rather, the SEC is authorized to take ill-gotten gains out of the hands of those who committed the misconduct, as well as to assess monetary penalties for egregious conduct. These two amounts may not be the same; that is, the amount of ill-gotten gain that is the subject of the SEC's enforcement power may have little relation to the amount investors lost as a result of the misconduct.

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This regulatory structure places unique stresses on the SEC enforcement staff. On the one hand, disgorgement and penalties are the only calculations the law allows the agency to make. Yet, on the other hand, they are often in the best position to identify and recompense investor harm. Since the enactment of the Fair Fund legislation, the SEC has collected and paid out more than $6.5 billion to investors.[2] The SEC has also begun initiatives to improve the tracking and recording of disbursements out of the Fair Fund to investors.[3] However, even with energetic fund administrators, settling defendants and a high-profile case, the central challenge of the initial calculation of the amounts to go into the Fair Fund remain, as the *Bear Stearns* case shows.

'SEC v. Bear, Stearns'

On April 28, 2003, the SEC filed civil actions against 10 investment banks, alleging violations of the Securities Act of 1933, among other things, alleging that the investment banking groups at the institutions exerted inappropriate influence over captive research analysts, compromising their objectivity and creating conflicts of interest.[4]

At the same time the complaints were filed, the parties submitted proposed consent judgments to obtain among other relief, disgorge ill-gotten gains, assess civil penalties, and compensate aggrieved investors.[5] The proposed judgments included combined payments of: (1) $460 million for independent investment research; (3) $528.5 million in disgorgement and penalties to the states; (4) $432.75 million in disgorgement and penalties as a federal payment; and (5) $85 million for investor education programs.[6] Except for the last, these amounts were deposited into a Fair Fund.

The U.S. District Court for the Southern District of New York did not immediately accept the proposed consent judgments. By orders dated June 2 and July 3, 2003, the court requested that the parties identify the relevant

securities and time periods that would provide the parameters for disbursement of funds as to each investment bank.[7] The parties eventually reached agreement on the relevant securities and time periods and presented amended consent judgments to the court. On Oct. 31, 2003, the court entered final judgments in the actions.[8]

In early 2004, the court appointed a fund administrator to propose a distribution plan for the funds earmarked for restitution, and on April 22, 2005, the court approved the Global Research Analyst Settlement Distribution Plan (the Distribution Plan).[9] The Distribution Plan proceeded in two phases. In Phase I, notice was published in multiple national newspapers and trade publications, certification and claim forms were mailed to investors, reminder letters were sent a few weeks before the deadline for filing claims to those investors who had not returned a certification or claim form, the reminder mailing was followed by phone calls whenever possible, a Web site and toll-free helpline were established, and an Internet link was posted on the SEC Web site. A total of $284,919,173, or 66 percent of the total available funds, was paid to investors in Phase I.[10]

Phase II began in September 2006 with a pre-notice letter, followed by the mailing of certification and claim forms in early October 2006. During Phase II, the fund administrator intensified its notification tactics, sending multiple reminder letters, providing multiple telephone reminders, and re-mailing the certification and claims forms to investors who failed to respond. A total of $92,956,548, or 21 percent of the original distribution funds, was paid to investors in Phase II.[11]

Despite the intensity of effort exerted by the fund administrator and the dual-Phase Distribution Plan, several of the investment banks had funds that remained virtually untouched. For example Bear Stearns paid $25 million, but the opinion revealed that, with accrued interest, $25.3 million were remaining after Phase II distribution. In total, approximately $75 million in unclaimed funds was accumulating interest at the Federal Reserve Bank of New York.[12]

Court Examines Settlement

Before deciding how to distribute the unclaimed funds, Judge Pauley presented his thoughts as to how the restitution efforts ended with residual funds. The court determined that the SEC did not perform the necessary due diligence in identifying relevant securities, time frames and potential claims before presenting the distribution plans to the court. To the court, there was a "complete disconnect between the amount of disgorgement and civil penalties on the one hand and investor losses on the other." Indeed, the SEC had acknowledged that the amounts the defendant banks paid were not necessarily connected to any measure of investor losses. The court stated that if the SEC had realized the disconnect earlier, the problem of excess funds may have been avoided.[13]

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Initially, the court adopted the fund administrator's proposal, which included (i) paying eligible claimants who initially did not receive a payment because their losses were less than $100; (ii) paying pre-judgment and post-judgment interest to all awardees; and (iii) additional payments to those awardees who initially received pro-rated distributions.[14] These proposals total approximately $13.8 million.[15]

In determining how to use the $61 million remaining, the court rejected proposals that the money either be refunded to the defendants or divided among the SEC and other regulatory agencies.[16] Finally the court rejected a proposal from several law schools that requested funds for their investor protection clinics. Instead, the court ordered that the remaining funds be transferred to the Department of Treasury.[17]

Practical Effect for SEC

The problems presented by the *Bear Stearns* case, deriving in part from the tension between what the securities laws allow the SEC to pursue and what the public perception is of what the SEC should be pursuing, is unlikely to abate anytime soon in the post-Madoff era.

The SEC has recognized the need for a more formal structure to oversee Fair Funds distributions. On Oct. 16, 2009, the SEC announced that its Enforcement Division would be restructured and named Adam Storch to the newly created position of managing executive of the SEC's division of enforcement.[18] Mr. Storch will be tasked with, among other things, overseeing the workflow and process associated with the collection and distribution of fair funds to investors.

1. SEC Website—What We Do, http://sec.gov/about/whatwedo/shtml.
2. See SEC Press Release, SEC Announces $35 Million Fair Fund Distribution to Defrauded Cardinal Health Investors, available at http://www.sec.gov/news/press/2009/2009-21.htm (2009).
3. See U.S. Gen. Accounting Office, SEC and CFTC Penalties: Continued Progress Made in Collection Efforts, but Greater SEC Management Attention Is Needed (2005).
4. Memorandum Opinion and Order at 2.
5. Id.
6. Id. at 2-3.
7. See *SEC v. Bear Stearns & Co.*, 03-Civ.-2937 (WHP), 2003 WL 21517973 (SDNY June 2, 2003); *SEC v. Bear Stearns & Co.*, 03-Civ.-2937 (WHP), 2003 WL 21513187 (S.D.N.Y. July 3, 2003).
8. *SEC v. Bear Stearns & Co.*, 03-Civ.-2937 (WHP), 2003 WL 22466156 (S.D.N.Y Oct. 31, 2003).
9. *SEC v. Bear Stearns & Co.,* 03-Civ.-2937 (WHP) 2005 WL 937621 (S.D.N.Y. April 22, 2005).
10. Memorandum Opinion and Order at 10.
11. Id. at 12-13.
12. Id. at 17.
13. Id. at 15-16.
14. Id. at 17-18.
15. Id. at 25.
16. Id. at 26.
17. Id. at 29-30.
18. See SEC Press Release, Adam Storch Named Managing Executive of SEC's Enforcement Division, available at http://www.sec.gov/news/press/2009/2009-220.htm.

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