

Mitchell L. Bach – Chair
Paul J. Masinter – Newsletter Chair
Norman E. Siegel – Newsletter Vice-Chair

**The Newsletter of the Business Law Section
Committee on Business and Corporate Litigation**
**Vol. 11 Issue 2
Summer 2003**

FEATURE ARTICLES

RECENT POLICY SHIFTS IN SEC ENFORCEMENT SETTLEMENTS

by Russell G. Ryan

Like most securities lawyers, the Securities and Exchange Commission and its staff have had a very busy year. Under the mandate of the Sarbanes-Oxley Act of 2002,¹ the SEC has proposed and promulgated an unprecedented flurry of new rules on a wide range of issues, including its controversial “up-the-ladder” reporting requirement for attorneys who appear and practice before the Commission.² On a more subtle level, the SEC and its Division of Enforcement have also made several changes in their policies and practices concerning the settlement of enforcement cases. SEC practitioners should appreciate the significance of these policy shifts when counseling clients during the settlement phase of enforcement investigations.

Higher Settlement Demands

During the past year, the SEC has taken a noticeably harder line in settlements than ever before, particularly in the area of public company accounting fraud and disclosure cases. The Commission’s \$500 million penalty settlement with WorldCom, for example, was 50

times higher than any previous penalty paid by a public company in an accounting fraud case.³

Likewise, recent settlements requiring the payment of penalties ranging from \$200,000 to \$1 million by executives of Xerox Corporation,⁴ HBO and Company,⁵ Sunbeam Corporation,⁶ and Rent-Way, Inc.⁷ are significantly higher than the more typical five-figure penalty settlements of only a few years ago.⁸ In several cases, moreover, the Commission has taken the relatively unusual step of demanding a civil penalty even against defendants who were not charged with fraud violations.⁹

In related program areas such as Regulation FD and Foreign Corrupt Practices Act cases, neither of which require an allegation or finding of fraudulent conduct by the defendant, the Commission has similarly obtained precedent-setting civil penalties in its settlements. In its first wave of Regulation FD cases, the Commission obtained a \$250,000 civil penalty against Siebel Systems, Inc.¹⁰ More recently, Schering-Plough Corporation agreed to pay a \$1 million penalty in settling SEC enforcement proceedings charging it with violating Regulation FD.¹¹ Also during the past year, the Commission obtained a \$500,000 penalty in a settled FCPA case against Syncor International Corporation, the highest civil penalty ever imposed in such a case.¹²

In addition to demanding higher penalties in settlements of accounting and disclosure cases, the SEC now frequently insists that the other common financial component of such settlements – “disgorgement” of illicit gains – include not only a defendant’s proceeds

from tainted stock sales, but also any bonuses and other incentive compensation the defendant received during the period of any wrongdoing.¹³ This demand is consistent with the spirit of Section 304 of Sarbanes-Oxley, which now requires chief executive and chief financial officers of public companies to forfeit certain bonuses and stock sale proceeds received during any period for which the company restates its financial statements.¹⁴ The Commission has also increasingly demanded in financial fraud settlements that executives responsible for the fraud agree to be barred from serving as an officer or director of any public company.¹⁵ Again, this trend is consistent with Sarbanes-Oxley, which lowered the standard for imposing such bars (by requiring the SEC to prove only that a defendant is “unfit” to serve as an officer or director, rather than “substantially unfit” to serve) and for the first time granted the Commission authority to impose such bars in administrative proceedings as an alternative to seeking them in federal court.¹⁶ Even before this statutory change, the SEC’s Director of Enforcement had declared that he was “steadfastly determined to be more aggressive” in seeking such officer-director bars.¹⁷

Finally, the SEC has also gotten tougher in insider trading settlements. Historically, the Commission has settled most insider trading cases if a defendant agreed to accept a fraud injunction, to disgorge all illicit profits or avoided losses, plus interest, and to pay a penalty equal to the disgorgement amount. More than ever before, the Commission is now insisting, for egregious offenses, that settling defendants pay more than the standard, single-multiple penalty. In several recent settlements, defendants have agreed to pay penalties equal to 1.5 times, 2 times, or even 3 times their disgorgement obligation.¹⁸

Collateral Consequences of “Neither-Admit-Nor-Deny” Settlements

A second recent change in SEC settlement policy affects the administrative and disciplinary proceedings that typically follow any judgments the Commission obtains in

federal courts against regulated persons (such as brokers and investment advisers) and professionals who appear and practice before the Commission (mostly accountants and attorneys). As most SEC enforcement practitioners know, typical court settlements with the SEC provide that the defendant neither admits nor denies the allegations of the Commission’s complaint. This provision has minimized the collateral consequences of the settlement in private litigation and in proceedings by other regulators, but its effect in subsequent disciplinary proceedings *before the SEC* has not been entirely clear until recently.

On July 25, 2003, the SEC clarified this issue in an important adjudicatory opinion in which it announced “a refined and expanded policy” for all future administrative disciplinary proceedings that are based on fraud injunctions previously entered in federal court with the consent of the defendant. Henceforth, the Commission stated, it “will rely on the factual allegations of the injunctive complaint in determining the appropriate remedial action,” and “will not permit a respondent to contest the factual allegations of the injunctive complaint” in the follow-on disciplinary proceeding.¹⁹ In practice, this policy may affect relatively few cases, because most follow-on disciplinary proceedings are resolved as part of an overall settlement between the Commission and the affected defendant. Nevertheless, SEC practitioners will see a new addition to the standard language included in settlement documents submitted to the Commission. This new language requires the settling defendant to acknowledge that, “in any disciplinary proceeding before the Commission based on the entry of the injunction in this action, Defendant understands that [he, she, it] shall not be permitted to contest the factual allegations of the complaint in this action.”

Other Settlement Policy Changes

Three other recent changes in SEC settlement policy warrant brief mention. First, the Commission has been indicating that, before it will consider a settlement recommended by

the staff of its enforcement division, a defendant must place into escrow sufficient funds to cover any disgorgement and penalty obligation being offered in settlement. The purpose of this new policy is to minimize the risk that the Commission will accept a settlement that ends up with an unpaid judgment.

Second, the SEC enforcement staff has recently begun a practice of requiring settling parties to certify under oath that they have, to the best of their knowledge, fully complied with all document requests and subpoenas received from the enforcement staff. The certification is designed to ensure that settlements are based on a full evidentiary record rather than a record unilaterally restricted by the settling party. Thus, before submitting a settlement offer to the Commission, the staff will require settling parties to sign a statement certifying that they have performed a diligent document search and that all responsive documents have either been produced to the staff or identified in a log of privileged documents withheld from production.

Finally, the SEC now typically insists that settling defendants renounce any intent to seek third-party reimbursement, insurance coverage, or tax deductions for the civil penalties they agree to pay, even if the penalties will be added to a fund to be distributed to victimized investors. Thus, the Commission's standard settlement documents now include a representation to this effect by the settling party.²⁰ This new provision is designed to prevent corporate executives from negating the financial consequences of their settlement by passing the burden on to shareholders or third parties.

Conclusion

In the post-Enron era, securities lawyers have been confronted with a number of significant changes in the substantive law governing their practice. As the foregoing discussion suggests, however, those who represent clients in SEC investigations also need to keep abreast of ongoing changes in policies and practices affecting the process of negotiating

settlements with the Commission and its enforcement staff.

Russell G. Ryan is an Assistant Director in the SEC's Division of Enforcement, where he has participated in several of the investigations and cases discussed in this article. He is also an Adjunct Professor at George Mason University School of Law, where he teaches a course on securities enforcement issues. The Securities and Exchange Commission, as a matter of policy, disclaims responsibility for any private publication or statement of any SEC employee. The views expressed herein are solely those of the author and do not necessarily reflect those of the Commission or other members of its staff.

¹ Pub. L. 107-204, 116 Stat. 745.

² Final Rule: Implementation of Standards of Professional Conduct for Attorneys, SEC Rel. Nos. 33-8185, 34-47276, and IC-25919 (Jan. 29, 2003) (available at www.sec.gov/rules/final/33-8185.htm), codified at 17 C.F.R. §§ 205.1-205.7.

³ *SEC v. WorldCom, Inc.*, No. 02-CV-4963 (S.D.N.Y.), SEC Lit. Rel. Nos. 18277 (Aug. 7, 2003) and 18219 (July 7, 2003).

⁴ *SEC v. Allaire, et al.*, No. 03-CV04987 (S.D.N.Y.), SEC Lit. Rel. No. 18174 (June 5, 2003) (penalties up to \$1 million).

⁵ *SEC v. Gilberson, et al.*, No. 00-CV-3570 (N.D. Cal.), SEC Lit. Rel. No. 18242 (July 22, 2003) (penalties up to \$1 million).

⁶ *SEC v. Rent-Way, Inc., et al.*, No. 03-CV-231E (W.D. Pa.), SEC Lit. Rel. No. 18241 (July 22, 2003) (penalties up to \$200,000).

⁷ *SEC v. Dunlap, et al.*, No. 01-8437 (S.D. Fla.), SEC Lit. Rel. No. 17710 (Sept. 4, 2002) (\$500,000 penalty).

⁸ In a recent speech, the Commission's Director of Enforcement referred to one of these settlements as "a step – but only a first step – toward ratcheting up financial fraud penalties and reversing the Commission's historical practice." Stephen M. Cutler, Remarks at the University of Michigan Law School, Nov. 1, 2002 (available at www.sec.gov/news/speech/spch604.htm).

⁹ See, e.g., *SEC v. Thomas & Betts Corp.*, No. 03CV0784 (D.D.C.), SEC Lit. Rel. No. 18058 (April 1, 2003) (\$25,000 penalty paid by settling defendant not charged with fraud); *SEC v. Wheeler*, No. 02CV601317 (S.D. Fla.), SEC Lit. Rel. No. 18078 and AAER-1756 (April 9, 2003) (\$20,000 penalty paid even though fraud charge dropped in settlement); *SEC v. Rent-Way, Inc., et al.*, No. 03-CV-231E

(W.D. Pa.), SEC Lit. Rel. No. 18241 (July 22, 2003) (\$25,000 penalty against defendant not charged with fraud).

¹⁰ *SEC v. Siebel Systems, Inc.*, No. 1:02CV2330 (D.D.C.), SEC Lit. Rel. No. 17860 (Nov. 25, 2002). The Commission simultaneously issued a cease-and-desist order against Seibel. *See Siebel Systems, Inc.*, SEC Rel. No. 34-46896 (Nov. 25, 2002).

¹¹ *SEC v. Schering-Plough Corp.*, No. 1:03CV1880 (D.D.C.), SEC Lit. Rel. No. 18330 (September 9, 2003). The Commission simultaneously issued a cease-and-desist order against Schering and its former chief executive officer, who agreed to pay his own \$50,000 penalty as part of the settlement. *See Schering-Plough Corp.*, SEC Rel. No. 34-48461 (September 9, 2003).

¹² *SEC v. Syncor International Corp.*, No. 1:02CV2421 (D.D.C.), SEC Lit. Rel. No. 17887, AAER No. 1688 (Dec. 10, 2002). The Commission simultaneously issued a cease-and-desist order against Syncor. *See Syncor International Corp.*, SEC Rel. Nos. 34-46979 and AAER-1687 (Dec. 10, 2002).

¹³ *See, e.g., SEC v. Goodwin, et al.*, No. 02-CV-11913 (D. Mass.), SEC Lit. Rel. No. 17758 (Oct. 1, 2002); *SEC v. Stringer, et al.*, No. 02-CV-1341 (D. Ore.), SEC Lit. Rel. No. 17760 (Oct. 1, 2002); *SEC v. Holden, et al.*, No. 01-CV-7463 (N.D. Ill.), SEC Lit. Rel. Nos. 17734 (Sept. 18, 2002) and 18142 (May 16, 2003); *SEC v. Bohan, et al.*, No. 03-CV-2834 (C.D. Cal.), SEC Lit. Rel. No. 18100 (Apr. 23, 2003).

¹⁴ Sarbanes-Oxley Act of 2002, Pub. L. 107-204, 116 Stat. 745, § 304.

¹⁵ *See, e.g., SEC v. Medi-Hut Co., et al.*, No. 03-CV-3921 (D.N.J.), SEC Lit. Rel. No. 18296 (Aug. 19, 2003); *SEC v. Rent-Way, Inc., et al.*, No. 03-CV-231E (W.D. Pa.), SEC Lit. Rel. No. 18241 (July 22, 2003); *SEC v. Allaire, et al.*, No. 03-CV04987 (S.D.N.Y.), SEC Lit. Rel. No. 18174 (June 5, 2003); *SEC v. Gilburn*, 03-AR-1087-S (N.D. Ala.), SEC Lit. Rel. No. 18139 (May 15, 2003).

¹⁶ Sarbanes-Oxley Act of 2002, Pub. L. 107-204, 116 Stat. 745, § 305, codified at § 20(e) of the Securities Act of 1933, 15 U.S.C. § 77t(e), and §§ 21(d)(2) and 21(d)(5) of the Securities Exchange Act of 1934, 15 U.S.C. §§ 78u(2) and 78u(5).

¹⁷ Stephen M. Cutler, Remarks at the Glasser LegalWorks 20th Annual Federal Securities Institute, Feb. 15, 2002 (available at www.sec.gov/news/speech/spch538.htm).

¹⁸ *See, e.g., SEC v. Evans*, No. 03-2367 (E.D.N.Y.), SEC Lit. Rel. No. 18133 (May 12, 2003) (2x penalty); *SEC v. Hendrix*, No. 00-20655 (N.D. Cal.), SEC Lit. Rel. No. 18129 (May 9, 2003) (3x penalty on tipper's own profits plus 1x penalty on his tippees' profits); *SEC v. Mahabir*, No. 02CV1809 (S.D.N.Y.), SEC Lit. Rel. No. 17619 (July 17, 2002) (1.5x penalty); *SEC v. Goldberg*, No. 02CV3488 (S.D.N.Y.), SEC Lit. Rel. No. 17505 (May 7, 2002) (2x penalty); *SEC v. Villa Manzo*, No. 02CV1766 (S.D.N.Y.),

SEC Lit. Rel. Nos. 17485 (April 24, 2002) and 17395 (March 6, 2002) (2x penalty).

¹⁹ *In re Melton, et al.*, Admin. Proc. File No. 3-9865, SEC Rel. Nos. 34-48228 and IA-2151 (July 25, 2003).

²⁰ For prominent examples of the new settlement language, see the settlement consents of Henry Blodget and Jack Grubman in the global settlement of the research analyst conflict-of-interest cases (available at www.sec.gov/litigation/litreleases/consent_blodget.pdf and www.sec.gov/litigation/litreleases/consent_18111b.htm, respectively).