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ENFORCEMENT

Rethinking SEC Injunctions After Appeals Court Reprimand

By RUSSELL G. RYAN

The summer of 2005 was not especially kind to the SEC in the federal courts of appeals. Most securities practitioners are well aware of the D.C. Circuit's June 21st decision in *Chamber of Commerce v. SEC*,¹ which remanded the Commission's controversial rule imposing new independence requirements on mutual fund boards of directors. In its decision, the court held that the SEC violated the Administrative Procedure Act by failing adequately to consider either the costs of complying with the new rule or the merits of an alternative proposal endorsed by two dissenting SEC Commissioners.²

¹ 412 F.3d 133 (D.C. Cir. 2005).

² *Id.* at 145. The SEC added fuel to the controversy, and suffered another setback, with its response to the court's decision. Less than ten days after the decision—on the final day of out-

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While *Chamber of Commerce* was clearly a significant setback for the SEC's rulemaking agenda, a relatively overlooked decision from the Eleventh Circuit on August 10th could have an even more profound impact on the Commission's enforcement agenda. In footnoted dictum at the conclusion of its opinion in *SEC v. Smyth*,³ that court essentially declared unenforceable nearly every injunction the SEC has obtained in recent memory. In doing so, the court raised serious questions about the continuing utility of a remedy that has been the cornerstone of the SEC's enforcement program for more than 70 years.

This article briefly discusses the *Smyth* case and its ramifications, with a particular focus on the Eleventh Circuit's largely gratuitous broadside against the SEC's most basic enforcement tool. It then suggests that the Commission welcome *Smyth* as an opportunity to reassess the continuing efficacy of the agency's longstanding practice of seeking broad, "obey-the-law" in-

going Chairman Donaldson's tenure with the agency—a divided Commission reaffirmed the rule as originally adopted, but several weeks later the D.C. Circuit stayed the rule's effect pending further appellate review. See, e.g., Judith Burns, "Fund-Board Rule is Dealt Setback," *Wall Street Journal*, Aug. 11, 2005, p. C11.

³ No. 04-11985, 2005 U.S. App. LEXIS 16721 (11th Cir. Aug. 10, 2005).

junctions in nearly every case it files in federal court.⁴ The article further suggests that, given the SEC's present-day powers to seek monetary penalties, disgorgement, and other equitable remedies in federal court—either in addition to or in lieu of injunctions—the Commission should adopt a more flexible and selective approach in determining which cases truly require the injunctive remedy, and should seek to enjoin only particularized conduct in such cases.

Smyth's Mischievous Footnote. The *Smyth* case began as a relatively ordinary securities fraud and insider trading case. In June 2001, the SEC filed a complaint in the United States District Court for the Northern District of Georgia against three former officers and the outside auditor of Vista 2000, Inc., a now defunct consumer products company that was based in Roswell, Georgia. The Commission charged the defendants with various violations of the anti-fraud, periodic reporting, recordkeeping, and internal accounting controls provisions of the securities laws. Based on these charges, the Commission sought from all defendants the usual remedies of injunctions, disgorgement, and monetary penalties.⁵

Ultimately, the former outside auditor defaulted, and each of the three former officers reached partial settlements in which they consented to the injunctions sought by the Commission but reserved the right to litigate the amounts they would have to pay in disgorgement and monetary penalties.⁶ Notably, the injunctions were identical in form and language to virtually all other injunctions the SEC has obtained in recent decades. That is, they simply tracked the language of the statutes and rules alleged to have been violated, and ordered the defendants (along with others acting in concert with them or on their behalf) not to violate those statutes and rules again.

After the district court adjudicated the defendants' outstanding monetary liabilities and entered final judgments, one of the defendants appealed, arguing that the district court denied him due process by adopting the SEC's disgorgement calculation without an evidentiary hearing. The Eleventh Circuit agreed, vacated the dis-

trict court's judgment, and remanded the case for further proceedings.⁷

As if that result was not bad enough for the SEC, the appeals court dropped a lengthy and mischievous footnote at the end of its opinion. In it, the court first acknowledged the appealing defendant's voluntary consent to the injunction imposed by the district court, and thus his waiver of any right to challenge that injunction on appeal.⁸ Nevertheless, the court went on to say that it "would be remiss" if it did not inform the district court that all of the injunctions it had issued in the case were "unenforceable."⁹ Having previously characterized those injunctions as "sweeping," the court now also described them as "quintessential 'obey-the-law' injunction[s]."¹⁰ Citing several Fifth and Eleventh Circuit precedents from outside the securities field, the court continued:

This Circuit has held repeatedly that "obey the law" injunctions are unenforceable. The specificity requirement of Rule 65(d) [of the Federal Rules of Civil Procedure] is no mere technicality; "[the] command of specificity is a reflection of the seriousness of the consequences which may flow from a violation of an injunctive order." An injunction must be framed so that those enjoined know exactly what conduct the court has prohibited and what steps they must take to conform their conduct to the law.¹¹

To be sure, this startling reprimand was technically dictum, inasmuch as it addressed an issue that was not before the court and was not determinative of the outcome of the appeal. But the injunctive language criticized by *Smyth* was indistinguishable from that of nearly every injunction the SEC has obtained from federal courts in recent memory, particularly those it has obtained through settlements. In virtually every case it files in federal court, the SEC invariably insists on similarly "sweeping" injunctive language that merely tracks the text of each statute and rule the defendant is alleged to have violated and orders the defendant and his or her cohorts not to violate them again. Thus, if other circuit courts adopt the Eleventh Circuit's dim view of the SEC's classic injunctive locution—or if district courts are prompted by *Smyth* to fly-speck the injunctive language submitted for their approval in future SEC settlements—the enforceability of nearly all existing SEC injunctions, as well as the agency's success in seeking similar injunctions going forward, will be in considerable doubt.

Opportunity for Reassessment. The SEC is said to be "studying" the *Smyth* decision,¹² undoubtedly concerned about its potential implications, at least with respect to pending and future cases within the Eleventh Circuit. With any luck, the Commission will forego any right to seek rehearing or *certiorari*, and will instead welcome *Smyth* as an opportunity to candidly reassess

⁴ To this author's knowledge, there is only one limited type of circumstance in which the SEC will occasionally file a complaint in federal court that does not demand an injunction as part of the final judgment. These are settlements in which the Commission agrees to charge its case in an administrative cease-and-desist order while insisting that the settling party pay a civil monetary penalty as part of the settlement. In such cases, the Commission gets the administrative equivalent to an injunction with its cease-and-desist order, but has to file a companion complaint in federal court to obtain the monetary penalty because the relevant statutes do not authorize the Commission to order the payment of civil penalties in a cease-and-desist proceeding. Some recent examples include *SEC v. Flowserve Corp.*, SEC Litigation Release No. 19154 (D.D.C. March 24, 2005), *SEC v. Syncor International Corp.*, SEC Litigation Release No. 17887 (D.D.C. Dec. 10, 2005), and *SEC v. Siebel Systems, Inc.*, SEC Litigation Release No. 17860 (D.D.C. Nov. 25, 2002).

⁵ See SEC Litigation Release No. 17044 (June 21, 2001). The Commission also sought an officer-director bar against one of the former officers.

⁶ See SEC Litigation Release Nos. 17175 (Oct. 5, 2001), 17211 (Oct. 30, 2001), 17566 (June 17, 2002), and 17824 (Nov. 1, 2002).

⁷ *SEC v. Smyth*, No. 04-11985, 2005 U.S. App. LEXIS 16721 at *20 (11th Cir. Aug. 10, 2005).

⁸ *Id.*, No. 04-11985 slip op. at 17 n.14, 2005 U.S. App. LEXIS 16721 at *20 n.14.

⁹ *Id.*

¹⁰ *Id.*

¹¹ *Id.* (citations omitted).

¹² "11th Cir. Vacates Disgorgement Order, Sends Case Back for Evidentiary Hearing," 37 Sec. Reg. L. Rep. (BNA) 1409, Aug. 22, 2005; see also Deborah Solomon, "Court Ruling May Prompt SEC to Alter Its Use of Civil Injunctions," Wall St. Journal, Aug. 25, 2005, p. C3.

not just the utility of the agency's standard injunctive language, but more fundamentally its persistence in seeking injunctive relief in virtually every complaint it files in federal court. Such a reassessment is long overdue for a number of reasons.

First, the basic point of the *Smyth* footnote is well-taken: The lack of specificity in most SEC injunctions does raise serious due process concerns in the context of subsequent contempt proceedings. By way of specific example, *Smyth* posits a hypothetical scenario in which the enjoined defendant commits an unrelated violation of one of the same statutes recited in his injunction, but the subsequent violation involves no conduct within the state of Georgia (where the district court is located). In such a scenario, the enjoining court could, upon the SEC's motion, order the defendant to appear and face contempt charges in Georgia even though that court would lack personal jurisdiction over the defendant in a plenary action involving the same facts.¹³ *Smyth* further observes that the contempt proceeding would place at risk several other basic procedural rights the defendant would enjoy under the Federal Rules of Civil Procedure in a plenary action.¹⁴

The *Smyth* footnote is also right to question whether the "sweeping" language of a typical SEC injunction complies with Rule 65(d), which requires all injunctions to be "specific in terms" and to "describe in reasonable detail, and not by reference to the complaint or other document, the act or acts sought to be restrained."¹⁵ In a similar vein, although not specifically mentioned in *Smyth*, the SEC's own authorizing statutes provide that courts, upon the Commission's application, may enjoin "such acts or practices" that constitute a violation of the federal securities laws,¹⁶ suggesting that sweeping language enjoining any and all future violations of a given statute or rule may exceed the intended reach of these statutes.

Let's face it: The statutes and rules most often cited in SEC injunctions can be violated by an almost infinite variety of future misconduct. For example, a person can violate Section 10(b) of the Securities Exchange Act of 1934 (the "Exchange Act"), and Rule 10b-5 thereunder, through conduct ranging from accounting misstatements to insider trading to market manipulation to ponzi schemes, just to name a few of the most common types of cases. Likewise, Exchange Act Section 13(a) and the rules thereunder—which generally don't even require proof of scienter—can be violated by all kinds of material misstatements or omissions in various required filings with the Commission—and even by failures to make such filings on a timely basis, thus sweeping in all violations of Regulation FD as well. At a minimum, injunctions based on such versatile statutes and rules should restrain future conduct only to the extent that it is of the same general nature as the conduct constituting the underlying offense.

¹³ *Smyth*, No. 04-11985 slip op. at 17-18 n.14, 2005 U.S. App. LEXIS 16721at *20 n.14.

¹⁴ *Id.*

¹⁵ Fed. R. Civ. P. 65(d).

¹⁶ See, e.g., Securities Act of 1933 § 20(b), 15 U.S.C. § 77t(b), and Securities Exchange Act of 1934 § 21(d)(1), 15 U.S.C. § 78u(d)(1).

Rethinking the Injunctive Habit. Any reassessment of the SEC's approach to injunctions should not stop with the issue of injunctive locution. Rather, *Smyth* presents an excellent opportunity for the Commission to take a broader look at its existing practice of demanding injunctions in virtually every case it files in federal court, and hopefully to adopt a more flexible and selective approach.

The Commission should start by acknowledging that, unlike in its early years, it no longer needs to seek injunctions to gain entry to the federal courts. When Congress created the SEC in 1934, and continuing through the first 50 years of its existence, the agency's only explicit statutory weapon against wrongdoers outside the regulated securities industry was an injunctive action in federal court. Although the Commission eventually convinced courts to grant "ancillary" equitable remedies such as appointment of receivers,¹⁷ disgorgement of illicit gains,¹⁸ and officer-director bars,¹⁹ the agency could reasonably have assumed that such remedies were available only in an injunctive action brought pursuant to its explicit statutory authority.

The SEC is not nearly so constrained today. With the Insider Trading Sanctions Act of 1984,²⁰ the Insider Trading and Securities Fraud Enforcement Act of 1988,²¹ and the Securities Enforcement Remedies and Penny Stock Reform Act of 1990,²² Congress has given the Commission explicit statutory authority to sue all kinds of securities law violators for civil monetary penalties in either an injunctive or stand-alone action in federal court. The 1990 legislation also granted the SEC a powerful arsenal of new administrative remedies it can impose without going to court at all, including cease-and-desist orders that serve many of the same purposes as injunctions.²³ Finally, Section 305(b) of the Sarbanes-Oxley Act of 2002 explicitly codified the Commission's ability to obtain ancillary equitable remedies in any federal court action, whether injunctive or not.²⁴ Nearly all of these modern-day enforcement tools are more comprehensible to the general public than injunctions, and in most cases they have at least as much deterrent value.

In addition to being anachronistic, routine requests for injunctions have led both the SEC and the courts to highly dubious interpretations of the securities law provisions that authorize such relief. The literal text of these provisions is quite stringent about the circum-

¹⁷ See, e.g., *Los Angeles Trust & Deed Mortgage Exchange v. SEC*, 285 F.2d 162 (9th Cir. 1960); *SEC v. S&P Nat'l Corp.*, 360 F.2d 741 (2d Cir. 1966); see generally Daniel J. Morrissey, *SEC Injunctions*, Tenn. L. Rev. 427, 443-47 (2001).

¹⁸ See, e.g., *SEC v. Texas Gulf Sulphur Co.*, 446 F. Supp. 1301 (2d Cir. 1971).

¹⁹ See, e.g., *SEC v. Nelson*, SEC Litigation Release No. 7347 (E.D.N.Y. Apr. 12, 1976).

²⁰ Pub. L. No. 98-376, 98 Stat. 1264, codified in relevant part as Exchange Act § 21A, 15 U.S.C. § 78u-1.

²¹ Pub. L. No. 100-704, 102 Stat. 4677, codified in relevant part as Exchange Act §§ 21A(a)(1)(B), 21A(a)(3), and 21A(b), 15 U.S.C. §§ 78u-1(a)(1)(B), 78u-1(a)(3), and 78u-1(b).

²² Pub. L. No. 101-429, 104 Stat. 931, codified in relevant part as Securities Act § 20(d), 15 U.S.C. § 77t(d) and Exchange Act § 21(d)(3), 15 U.S.C. § 78u(d)(3).

²³ See, e.g., Securities Act § 8A, 15 U.S.C. § 77h-1, and Exchange Act § 21C, 15 U.S.C. § 78u-3.

²⁴ Sarbanes-Oxley Act of 2002 § 305(b), codified at 15 U.S.C. § 78u(d)(5).

stances in which the Commission may seek an injunction: “Whenever it shall appear to the Commission that any person is engaged or is about to engage in” a violation of the federal securities laws.²⁵

A plain reading of this text would seem to allow injunctions only when unlawful conduct is ongoing or imminent, yet the Commission frequently seeks and obtains them long after violations have ceased, particularly in settled cases. Worse yet, courts have muddied the water with loose multi-factor tests that have only emboldened the SEC in its aggressive pursuit of injunctions,²⁶ with some courts going so far as suggesting that injunctions can be predicated on little more than a past violation of the securities laws.²⁷ This approach arguably stretches the statute to the point of contradiction, doing no credit to either the Commission or the courts that have facilitated its requests for injunctions in marginal cases.

²⁵ Securities Act § 20(b), 15 U.S.C. § 77t(b), and Exchange Act § 21(d)(1), 15 U.S.C. § 78u(d)(1) (emphasis added).

²⁶ See, e.g., *SEC v. Bonastia*, 614 F.2d 908, 912-13 (3d Cir. 1980); *SEC v. Youmans*, 729 F.2d 413, 415 (6th Cir. 1984); *SEC v. Lorin*, 76 F.3d 458, 461 (2d Cir. 1996); see generally Daniel J. Morrissey, *SEC Injunctions*, Tenn. L. Rev. 427, 473-75 (2001).

²⁷ See, e.g., *SEC v. Gruenberg*, 989 F.2d 977, 977-78 (8th Cir. 1993); *SEC v. Fehn*, 97 F.3d 1276, 1295-96 (9th Cir. 1996).

Note to Readers

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On a more practical level, increased SEC flexibility on injunctions would improve the likelihood of early settlement in many cases that now result in prolonged contested litigation. For some defendants, such as securities professionals and public accountants, an injunction is simply unacceptable due to the devastating collateral consequences it can have on their licenses and livelihoods. Such defendants may be willing to pay civil penalties and disgorgement to settle an enforcement action, but settlement is impossible because the Commission and its staff treat their injunction demand as non-negotiable. Unless such cases involve ongoing or imminent violations—or at least a history of recidivism demonstrating a real and present danger of future misconduct—the SEC's deployment of litigation staff and resources to obtain the marginal benefit of an injunction makes little sense, and often proves unsuccessful in any event.

Conclusion. The injunction has served the SEC well as a basic prophylactic weapon in the fight against securities fraud, but in many cases it is simply an anachronistic carry-over from a bygone era in which the Commission had no practical choice but to seek one in every case. The *Smyth* footnote provides the Commission with an excellent opportunity to acknowledge that injunctions are no longer essential in every case, and indeed are inappropriate in many. Given the wide array of harsh alternative remedies now available to the Commission from the federal courts, including monetary penalties, disgorgement, and ancillary equitable remedies—most of which send a far more comprehensible deterrent message anyway—the agency should strongly consider seeking injunctions only in cases that involve ongoing or imminent misconduct, or at least recidivism strongly portending future misconduct. Even then, to remove any doubt about the utility or enforceability of its injunctions, the SEC should ask courts to enjoin particularized future conduct rather than continue seeking broad, obey-the-law injunctions like the ones criticized by the Eleventh Circuit in *Smyth*.