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LOOKING FOR THE PERFECT ENFORCEMENT REMEDY: OLD WINE IN NEW BOTTLES OR: HAVE I SEEN THIS MOVIE BEFORE?

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"This man should be left naked, homeless, and without wheels." About a year ago, the press reported that Securities and Exchange Commission (Commission or SEC) Chairman Richard Breeden made this comment in connection with the Commission's consideration of a widely reported insider trading case.[1] A senior partner in a nationally prominent law firm allegedly obtained inside information about a corporate client's planned bid for another company and purchased call options and stock of the target company before any public announcement of the acquisition. The Commission sought an injunction against future violations of the securities laws, disgorgement of the defendant's ill-derived gain of $4.3 million, and the payment of a fine under the Insider Trading Sanctions Act ("ITSA").[2] To my knowledge, this litigation is still pending. In other, non-SEC proceedings, the attorney, Mr. O'Hagan, was convicted of stealing from trust accounts established by some of his clients—he has argued that his insider trading was not really his fault—he did it to repay the money stolen from the trust accounts—and has been disbarred.

You can decide whether Mr. O'Hagan was left, or ultimately will end up, "naked, homeless and without wheels," but Chairman Breeden's comment echoes a familiar frustration—frustration that the Commission's remedies, principally the traditional "don't do it again" injunction, do not sufficiently deter violations—that they are inadequately feared—that, in a given case, sufficient harshness is not being visited upon the wrongdoer.

One day those of you who become distinguished members of the securities bar—a most honorable calling—will sit in a small room—probably windowless—at the Commission's Enforcement Division. In your secret thoughts, you will know that your client "did it"—he violated the securities laws—or that your chances of prevailing in a contested proceeding are not great—and that you're really there to "cut the best deal you can." After the perfunctory introductions and required handshakes, a

* Executive Vice President, PaineWebber Incorporated; Commissioner, United States Securities and Exchange Commission, 1982-85. Washington and Lee University School of Law Annual Securities Law Lecture, March 22, 1991.

1. *See* Chi. Tribune, May 18, 1990, at 23, zone C.

2. Pub. L. No. 98-376, 98 Stat. 1264 (1984).

grim-faced senior enforcement attorney, flanked by three or four equally grim-faced, more junior enforcement attorneys, will level his gaze at you and say:

> Your client should be left naked, homeless, and without wheels.

Followed by:

> It's open and shut—we can get an injunction, disgorgement, an ITSA fine, and cancel his ticket for life. What are you here to offer us that we can't already get standing on our head?

This is when your finest skills as an advocate are tested. What sanctions do you offer to reach a negotiated settlement? What sanctions do you absolutely refuse to put on the table, even at the risk of horrendously expensive litigation which, in all probability, your client can't afford, which means also you won't get paid. Remember, even run-of-the-mill, simple SEC litigation can cost six figures and then some. Both as an advocate and as an objective observer of the scene, what is a fair and balanced sanction? What will strike the staff—despite their litigation posture—as fair and balanced? And even if you persuade the staff, what will strike the Commission as fair and balanced when the staff presents the proposed settlement to the full Commission? Will the staff be able to "sell" your settlement to the Commissioners, who sometimes have minds of their own?

A 1985 *Wall Street Journal* article, entitled "Some on SEC Seeking Harsher Penalties for Flagrant Violators of Securities Laws," commented:

> Sentiment is growing at the . . . Commission for barring flagrant violators of securities laws from serving as officers or directors of publicly held companies. Several SEC Commissioners and senior officials say they are fed up with corporate officials who repeatedly violate securities laws. And in speeches, some of them have begun venting their exasperation, contending that the SEC should do more than simply ask the courts to enjoin corporate miscreants from breaking the law again.

In November, 1990, Judge Kimba Wood, United States District Court Judge for the Southern District of New York, sentenced Michael Milken to ten years in prison following his six count guilty plea. As you may recall, Milken had been indicted on 99 counts, had previously paid a $600 million fine and consented to an SEC injunction against future violations, and recently had agreed to a lifetime bar from the securities industry. As you also may recall, Milken's sentence generated the full range of public reactions from "the sentence is an outrage—the guy should have been shot" to "the sentence is an outrage—Mike Milken is a genius—this is nothing but a government vendetta."

As these two loosely connected cases and bit of journalistic history suggest, the appropriate sanction frequently seems most difficult to pinpoint. And to test whether that's a correct statement, what do you think about Milken's sentence?

You have three choices: (a) ten years was about right; (b) it was far too light; or (c) it was far too heavy. But before you vote, remember that:

* Before Milken's sentence, the harshest sentence imposed in any of the high visibility, criminal securities law cases coming out of the high-flying '80's was four years on Paul Bilzerian. Ivan Boesky, Dennis Levine and Marty Siegel each received a lighter sentence.
* When finally convicted, Al Capone was sentenced to eleven years in prison.
* Robert Chambers, convicted of killing Jennifer Levin in the "Preppie Murder" case, was sentenced to five to fifteen years in prison.
* Antron MacCray, convicted in the Central Park jogger case, received five to ten years.

Based on the show of hands I have just seen, it appears as if the people in this room are far from unanimous on the perfect sanction for Mike Milken. In fact, it looks like an approximate one-third, one-third, one-third division of views.

My comments are entitled "Looking For The Perfect Enforcement Remedy," so let me propose one definition of the "perfect enforcement remedy." It is that remedy which effectively deals with the violation, deters future violations, does not overreach or unnecessarily interfere with personal freedoms, internal corporate affairs, or matters traditionally left to state law, is fully consistent with the general intent of the federal securities laws but goes not one step further, does not deter the legitimate capital formation process, and protects public investors and the integrity of the marketplace without being punitive, except when expressly intended to be punitive. That's my definition of "the perfect enforcement remedy."

You may or may not agree with my definition—which I admit is not particularly concise—but I think most observers would agree that the long-running debate about appropriate sanctions usually involves the following questions:

* Is an injunction—the Commission's traditional, principal enforcement remedy—the "don't do it again" decree—really effective? If so, when and why?
* Is such an injunction merely a slap on the wrist, or even less? As many critics allege, it only orders you to obey the law, which you're already bound to do—so what kind of penalty is that?
* Should the Commission have cease and desist authority? If so, how should that power be exercised?
* Should the Commission have the authority to levy fines? If so, how should that power be exercised?

* Should the Commission have additional enforcement remedies, such as the authority to bar certain persons from acting as officers or directors of publicly-owned companies?
* Would not expanded remedies allow the Commission the flexibility to tailor the remedy to fit the crime and thus allow the Commission to avoid being forced to choose between enforcement remedies that are either draconian—too harsh for a non-intentional violation—or ineffectual—far too light for the violator who is really a bad actor?
* Is there a downside—a dark side—to expanded Commission enforcement powers?

The Remedies Act

To an extent, at least part of this debate ended last October when the Securities Enforcement Remedies and Penny Stock Reform Act of 1990[3] (Remedies Act) became law. In a nutshell, for the first time the Remedies Act (1) grants the SEC broad cease-and-desist authority, (2) allows the imposition of fines in both civil cases and administrative proceedings, and (3) empowers federal courts to bar certain securities law violators from serving as officers or directors of public corporations.

Cease and Desist Authority. The Remedies Act empowers the Commission to enter administrative cease-and-desist orders upon a finding that any person is violating, has violated or is about to violate the securities laws or any Commission rule. The Commission can enter such orders not only against the principal violator, but also against "any other person that is, was, or would be a cause of the violation, due to an act or omission the person knew, or should have known, would contribute to such violation. . . ." Under cease-and-desist orders, the Commission can require a respondent not only to refrain from future violations, but also to take steps to effect future compliance with the securities laws regarding any security, any issuer, or any other person. Finally, the Commission can order accountings and disgorgement.[4]

The Remedies Act also grants the Commission temporary cease-and-desist authority—some view this as the single most revolutionary aspect

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3. Pub. L. No. 101-429, 104 Stat. 931 (1990). The civil penalty provisions of the Act apply to conduct occurring after October 15, 1990. The enforcement provisions of the Act were effectuated through parallel amendments to the Securities Act of 1933 (Securities Act), the Securities Exchange Act of 1934 (Exchange Act), and the Investment Company Act of 1940 (Investment Advisors Act of 1940). (These statutes collectively are known as the "Federal Securities Acts.") The Penny Stock Reform Act of 1990 (Penny Stock Act) is contained in amendments to the Securities Act and the Exchange Act and will be implemented through additional regulations to be promulgated by the Commission.

4. A cease-and-desist proceeding contemplates formal notice and opportunity for hearing. A hearing before an administrative law judge must be scheduled not earlier than 30 days nor later than 60 days after issuance of the order instituting the proceedings, although these time periods may be waived by mutual agreement.

of the Act—which authorizes the Commission to issue immediate administrative restraining orders on an ex parte basis without notice or hearing.[5] Such orders are permitted, however, only when "significant harm to the public interest" is likely to occur prior to the completion of proceedings and the Commission determines that notice and hearing before the issuance of such an order are not practical or are contrary to the public interest. Such situations logically would include those in which substantial assets are likely to be converted or dissipated or investors otherwise might be substantially harmed. Temporary orders are subject to review by the Commission or the courts under special procedures provided by the Act.

On its face, temporary cease-and-desist orders are limited to the activities of regulated entities—broker-dealers, investment advisers, and investment companies—but the application could be broader. For example, investment bankers are essential participants in tender offers and other extraordinary transactions; thus, the Commission arguably could effectively halt such transactions by directing its orders at the registered persons who "contributed" to the violation. If the Commission chooses this course of action, controversy assuredly will follow.

Fines. The Remedies Act provides for civil fines which may be imposed by the federal district courts and, in certain cases, by the Commission in administrative proceedings (other than for violations of ITSA, which already provides for civil monetary penalties for insider trading of up to three times the profit earned or loss avoided as a result of the misuse of inside information).[6]

The fine system is three-tiered and is designed to match the fine to the severity of the violation. The maximum penalty is the greater of $100,000 for a defendant who is a natural person or $500,000 for any other defendant, or the gross pecuniary gain the defendant realized as a result of the violation. The maximum penalty may be imposed if the violation involved fraud, deceit, manipulation, or deliberate or reckless disregard of a regulatory requirement, and directly or indirectly resulted in substantial losses or created a significant risk of such losses.

For violations satisfying only the first condition, the maximum is the greater of $50,000 for a defendant who is a natural person or $250,000 for any other defendants, or the defendant's gross pecuniary gain realized as a result of the violation.

In addition to the court-imposed penalties, the Remedies Act establishes a similar system of fines which the Commission or other appropriate regulatory agencies may impose "in the public interest." These administratively imposed fines are limited to proceedings against regulated enti-

5. The Act requires the Commission to establish regulations governing the conduct of such hearings within one year of the effective date of the Act.

6. The new penalties also apply in cases alleging violation of a cease-and-desist order. Each violation of a cease-and-desist order, and each day of a continuing violation of such an order, is deemed a separate offense for purposes of the penalty provisions.

ties—brokers, dealers, municipal securities dealers, government securities brokers or dealers, clearing agencies or transfer agents—and are available only in cases of willful violations (or failure reasonably to supervise another person who commits such a violation) of the Federal Securities Acts or regulations thereunder, including regulations of the Municipal Securities Rulemaking Board. The three levels of administrative fines essentially parallel those applied by the district courts, which are described above.[7]

In administrative proceedings, the Commission must find that the imposition of a monetary penalty is "in the public interest." In making that decision, the Commission may consider the following factors:

1. whether the act or omission involved fraud, deceit, manipulation or deliberate or reckless disregard of a regulatory requirement;
2. the harm resulting to others;
3. the extent of unjust enrichment (taking into account any restitution);
4. prior violations of federal or state securities laws or the rules of a self-regulatory organization by the defendant;
5. the need to deter the defendant or other persons from committing such acts or omissions; and
6. such other matters as justice may require—the great catch-all.

In addition, the defendant may present evidence concerning the defendant's ability to pay any proposed penalties. The Commission, in its discretion, may consider such evidence in its determination of the public interest and may require an accounting and disgorgement.

Bars. The Remedies Act authorizes federal district courts to temporarily or permanently bar an individual from serving as an officer or director of a public company upon a showing by the Commission that "the person's conduct demonstrates substantial unfitness to serve as an officer or director." This sanction is available only in the case of violations of Sections 17(a)(1) of the Securities Act and 10(b) of the Exchange Act—the scienter-based, anti-fraud provisions. The statute does not define substantial unfitness, although the legislative history states that this remedy is reserved for "egregious" cases or "recidivists" and is "not intended to establish federal standards governing the qualifications of corporate officers and directors." On this last point there is and will continue to be much fierce debate as the Commission begins to pursue this statutory remedy.

THE PROGNOSTICATIONS

The Remedies Act has led to the usual round of prognostications by Commission-watchers, most predicting that the Remedies Act will have a

7. However, in the administrative context, the defendant's pecuniary gain is not considered in calculating the dollar amount of the penalty within any particular tier. Rather, "substantial pecuniary gain" to the party committing the act or omission will permit the agency to apply the highest tier of fines (*i.e.*, up to $100,000 for natural person defendants or up to $500,000 for other defendants), even if such act or omission did not create a significant risk of substantial losses to other persons.

two-fold general impact: (1) the civil administrative process will become more significant, with the Commission exercising much greater power at the administrative level than it presently exercises; and (2) civil enforcement penalties in both judicial and administrative proceedings will become much stiffer.

Specific predictions about the impact of the Remedies Act tend to break up into six areas.

The first is that enforcement proceedings will become punitive rather than remedial. This may strike you as semantics, but this distinction is traditionally accepted and sometimes is argued with a vengeance. Under current laws, civil monetary penalties—or fines—may be imposed only under ITSA and the Insider Trading and Securities Fraud Enforcement Act (ITSFEA).[8] The Remedies Act, however, theoretically empowers the SEC to seek a monetary penalty in every case it brings.

Most veteran Commission-watchers nonetheless tend to doubt that penalties will become the rule, a view supported by the legislative history, which notes that penalties should not be sought for cases of isolated or unintentional conduct. But I wonder if that may not be a simplistic view—remember that the Commission campaigned long and hard for expanded remedies on the ground that it needed greater deterrents. That means the Commission will be under political pressure to use the new remedies, and that Congress will ask questions about the Commission's use or non-use of its new powers in Congress's annual oversight hearings. Furthermore, most Commission enforcement cases allege willful or fraudulent conduct, and that sounds decidedly different from "isolated or unintentional conduct." One additional thought: if history indeed is precedent, remember that the Commission has demanded a civil penalty of at least 100 percent of the defendant's profit (or loss avoided) in almost every case brought since ITSA became law.

A second widely predicted consequence is a pronounced increase in the Commission's administrative enforcement activities and orders. Previously, the Commission's principal administrative remedies—those that the Commission could directly impose—were bars, suspensions, and limitations on the activities of brokers, investment advisers, and investment companies—the regulated entities. The Remedies Act expanded these remedies substantially in the case of professionals. Without ever going to court, the Commission now can obtain fines, disgorgement, and cease-and-desist orders, as well as bars, suspensions, and limitations from brokers, investment advisers, and investment companies.

With respect to all other persons—principally commercial and industrial public companies and their officers and directors—the Remedies Act makes available administrative cease-and-desist orders, disgorgement, and ancillary relief; and most observers predict that commercial and industrial public companies and their officers and directors will become respondents

8. Pub. L. No. 100-704, 102 Stat. 4677 (1988).

in an increasing number of administrative actions. In fact, some experienced Commission-watchers believe that such an increase is virtually foreordained since some federal district court judges in recent years have demonstrated a degree of hostility to Commission enforcement cases, particularly when the alleged violation is several years old or is a relatively technical violation rather than obvious fraud. Furthermore, they reason, the Commission may elect to seek cease-and-desist orders since the Commission in an administrative proceeding will not have to prove a reasonable likelihood of future violations (sometimes a difficult standard to meet) as it does in a federal court injunctive case, thereby perhaps offering some "home court" advantage.

A third widely-predicted effect is a reformation of the Commission's administrative processes. Fairly or unfairly, the Commission's administrative process is perceived by some as biased against respondents. For example, the Commission's Rules of Practice permit the staff to conduct a full investigation with the benefit of subpoena power before proceedings begin, while the respondent has no pre-hearing third-party discovery rights at all.[9] To address at least some of these issues, Commissioner Mary Schapiro is now leading a review of the Commission's Rules of Practice, an effort expected to lead to major changes. Commissioner Philip Lochner also has recently expressed his view that the Commission will have to adopt and publish guidelines for sanctions in administrative proceedings as a matter of fairness.

Fourth, the Remedies Act is expected to cause an increase in contested Commission proceedings. Even before the Act was proposed, the Commission had begun to seek monetary recoveries whenever possible and, in general, significantly stiffer sanctions against brokers and investment advisers. As a result, the number of litigated enforcement actions has increased dramatically—probably more than doubling—in the past five years. The general availability of civil monetary penalties and disgorgement simply means higher stakes—money will be a potential issue in every case, and matters not previously the subject of financial liability—such as defective financial disclosure—may give rise to huge monetary penalties.

A fifth predicted consequence of the Remedies Act is greater Commission involvement in corporate governance, an area traditionally left to state law. In the eyes of some, the authority to bar individuals from positions in public companies amounts to a form of federal negative licensing authority over officers and directors and is nothing short of blatant federal preemption of state law.

Finally, organized securities law compliance programs will become a necessity for public companies. The Remedies Act lists several factors for the Commission to consider in determining whether a fine should be imposed in an administrative proceeding, including intent (including whether

9. On the other hand, the ALJ's decisions are subject to *de novo* review by the full Commission and do not take effect until after a final decision by the full panel.

the defendant acted in reckless disregard of a regulatory requirement), recidivism, and the need for general or specific deterrence. Courts may well follow this statement of Congressional intent in ruling on Commission requests for bars of officers and directors, making proof of good faith an issue in every case. The presence or absence of established compliance procedures and the degree to which they were followed will be important in establishing that good faith.

SOME HISTORY AND PERSPECTIVE

There it is—new powers, new procedures, a new study, and article upon article analyzing these "extraordinary and brand new powers and developments." I do not suggest that the Remedies Act is not significant, or that it does not represent change. And while I suppose I do not take violent exception to some who rail against this radical new Remedies Act, let's preserve some perspective. The fact is that many of the so-called "new remedies" arguably have been around for a long time—disguised perhaps, but nonetheless around. Furthermore, some careful analysis of, and thoughtful reflection upon, Commission history may well provide some insight into the ways the Commission may seek to exercise its powers under the Remedies Act.

So, a little history, starting with cease and desist orders. Daniel Goelzer, a former Commission General Counsel, has long suggested that Section 15(c)(4) of the Exchange Act (as amended by ITSA in 1984) may well empower the Commission to issue administrative orders barring individuals who "cause" issuers to violate reporting, proxy, and record-keeping requirements from holding corporate office. Section 15(c)(4) has always authorized the Commission to require compliance *"upon such terms and conditions as the Commission may specify,"* and Goelzer reasoned that a wide range of remedies therefore already were potentially available, including orders barring individuals from association with a public company. In support of his analysis, Goelzer noted that as long ago as 1976 in a Section 15(c)(4) proceeding, the Commission accepted two individuals' undertakings to refrain from serving as an officer and director of any public company for three years.[10]

Also, the idea that an administrative agency should have cease and desist authority is hardly novel. The Federal Trade Commission, Commodity Futures Trading Commission, National Labor Relations Board, Federal Communications Commission, and the bank regulatory authorities all have this authority. Even the Secretary of Agriculture has had cease and desist authority since the 1920's. I simply find it almost impossible to envision a federal regulatory agency being created in 1991 without having cease and desist authority.

10. *In re* Gov't Employees Ins. Co., Exchange Act Release No. 12,930 (Oct. 27, 1976); *see also In re* Hycel, Inc., Exchange Act Release No. 14,981 (July 20, 1978).

Furthermore—to argue a point in favor of cease-and-desist authority—it provides flexibility to address violations that do not require injunctions or carry certain of the collateral consequences of injunctions—such as the automatic bars under Section 9 of the Investment Company Act. From the defendant's perspective, this may become a powerful negotiating tool in settling the appropriate case for a light sanction. From the Commission's perspective, the temporary cease-and-desist procedure allows the Commission to obtain emergency relief administratively rather than coping with the problems of obtaining a temporary restraining order in federal court.

In the long run, perhaps the real debate will not be whether the Commission should have cease and desist authority, but about adequate protections to assure procedural fairness.

In terms of fines, ITSA, of course, has been around since 1984, and disgorgement of the ill-gotten gains from insider trading—arguably a form of fine—has long been approved by the courts as a form of ancillary relief. And whether the Remedies Act has changed the Commission's enforcement focus from remedial to punitive by introducing express fining authority—well, I challenge anyone to find an SEC defendant who ever thought the Commission's processes and sanctions were merely remedial and not punitive.

In thinking about the so-called new bar authority, let's look at some cases pre-dating the Remedies Act which involved some form of ancillary relief not expressly authorized by statute, but which arguably amounted to some form of bar. For example, in one 1990, pre-Remedies Act case, *SEC v. Kolokouris*,[11] the Commission charged that a Chief Executive Officer misappropriated funds from his company's initial public offering, thereby violating the anti-fraud, reporting, recordkeeping, internal controls, and a few other provisions of the securities laws. None of the alleged diversions, totalling at least $1.29 million, were disclosed. Moreover, the defendant allegedly engaged in a kickback scheme with the brokerage firm that underwrote his corporation's initial public offering.

Under the settlement, the defendant agreed (1) to a permanent injunction against future violations of the securities laws, (2) to be barred for five years from purchasing more than 5% of any public company, a remedy nowhere expressly found in the securities laws, (3) to disgorge $2.13 million, representing the $1.47 million he obtained illegally plus $660,000 in prejudgment interest, again, a remedy nowhere expressly authorized in the securities laws, particularly the prejudgment interest,[12] (4) to release all claims against his company, its temporary receiver, and three related companies, a remedy nowhere expressly found in the securities

11. No. CIV-89-0682-T (W.D.N.Y. June 28, 1990).

12. To meet his disgorgement obligation, Kolokouris will transfer shares of stock in three separate controlled corporations to NAF's temporary receiver, who will hold the various shares for the benefit of public shareholders who acquired the shares in each such corporation in bona fide transactions.

laws, and (5) that shareholders of his company would retain the right to sue Kolokouris, which was, again, a remedy not expressly found in the securities laws.

Look at another pre-Remedies Act bar case—the 1984 *SEC v. Florafax International, Inc.* case.[13] The Commission alleged that Florafax, aided and abetted by its Chief Executive Officer, Joseph Hale,[14] published financial statements which materially overstated revenue and income and materially understated required reserves over a two year period. Florafax was alleged to have:

* improperly recognized revenue by recording as sales unauthorized "for approval" and consignment shipments;
* conducted a multi-year campaign of shipping unordered products to boost sales, with returns associated with such "sales" ranging from 28% to 69% of purported sales;
* sold its products through the use of telephone sales scripts which emphasized an unconditional right to return products for any reason and the absence of any obligation to pay for products shipped when, in reality, these were consignment shipments improperly recorded as completed sales.

Florafax consented to an injunction against further violations of various provisions of the Exchange Act. Florafax was required:

* to correct and amend its quarterly and annual reports and to restate financial statements;
* to engage, in addition to its own accountants, a special auditor to review and report on the restatements, with the special auditor to file with the restatements a special report setting forth the results of its review;
* to recalculate Hale's compensation, which was based on a percentage of pre-tax profits during the years in question;
* to maintain, for at least three years, an audit committee comprised of three independent directors.

Hale also consented to a permanent injunction against future violations of the Exchange Act and was ordered to resign as Chairman and Chief Executive Officer and to refrain from serving directly or through any nominee as an officer or Chairman of the Board of Florafax for three years, although he was allowed to remain as a director of Florafax.[15]

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13. SEC v. Florafax Int'l, Inc., Civil Action No. 84-C-937-B, Lit. Release No. 10,617, Acctg. and Aud. Enf. Release No. 44, Fed. Sec. L. Rep. (CCH) ¶ 73,444 (N.D. Okla. Nov. 27, 1984) (LEXIS, Fedsec, Cases).

14. Hale was Chairman, Chief Executive Officer, and owns 28% of Florafax's stock. Hale was Florafax's President and Chief Operating Officer from 1981 to 1983.

15. Obviously, certain of these remedies—*e.g.*, the bar against Hale—are not expressly authorized by the securities laws. Yet, the Commission seemingly was convinced that nothing short of a bar and the other prohibitions would ensure Florafax's future compliance with

In another relatively recent bar case pre-dating the Remedies Act, *SEC v. San Saba Nu-Tech, Inc.*,[16] the Commission alleged that Messrs. Tripple and Thouvenelle, the principal officers and directors of San Saba Energy, caused that company to issue a series of grossly misleading letters which effectively conditioned the market for its planned public offering.[17] This offering was abandoned because of San Saba Energy's accounting problems.[18]

But Tripple and Thouvenelle were men of persistence and ingenuity—if you can't do it directly, there's always the indirect route. So they incorporated San Saba Nu-Tech, which had no assets and no operations, and moved it forward toward a public offering. Nu-Tech disclosed that it intended to manufacture and market a device absolutely essential to the well-being of each of us—a water conservation toilet labelled the "Meditator Toilet." The Meditator Toilet—think about that image—and to manufacture certain electronic control devices.

But Nu-Tech's registration statement

* failed to disclose that the purported assignments of rights to manufacture the electronic devices were invalid because the purported assignors had no rights to assign;

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the securities laws. That conclusion perhaps was influenced by Hale's involvement in a 1983 litigated Commission case, *SEC v. World-Wide Coin Investment, Ltd.*, 567 F. Supp. 724 (N.D. Ga. 1983), the first case litigated under the Foreign Corrupt Practices Act. In that case, Hale was found to have committed numerous violations of the FCPA by systematically and intentionally dismembering World-Wide's internal accounting controls. Along the way, he also violated the Williams Act, the proxy rules, periodic reporting requirements, and the anti-fraud provisions. Hale was a recidivist and the deterrent impact of the first injunction was clearly negligible—in short, Hale was the egregious violator envisioned by the Remedies Act.

In 1979, Hale became the controlling shareholder, Chairman of the Board, Chief Executive Officer and President of World-Wide. According to the District Court opinion, Hale aided and abetted numerous violations of the accounting provisions of the Foreign Corrupt Practices Act, literally by dismembering World-Wide's system of internal auditing controls. The complete breakdown of internal accounting controls at World-Wide rendered the financial statements included in its quarterly and annual reports totally lacking in reliability. The court found that Hale also violated the anti-fraud provisions of the Exchange Act by acquiring World-Wide stock in exchange for worthless property, which he overvalued, and by falsely entering in the corporate minute books that the directors approved the exchange. In addition, an offering circular sent to shareholders in connection with a tender offer by Hale to purchase additional common stock contained numerous misrepresentations, as did the proxy statements. During Hale's management of World-Wide Coin, he caused that company to purchase a sizeable interest in Florafax, without disclosing that he was attempting to obtain control of Florafax.

16. Civil Action No. 84-2921, Lit. Release No. 10531 (D.D.C. Sept. 19, 1984) (LEXIS, Fedsec, Cases).

17. The letters stated that, as a result of a San Saba Energy acquisition of an Amex-listed company and the planned merger with an OTC company, San Saba Energy stock and the stock of a subsidiary which would be issued at 25 cents and 10 cents per share, respectively, would trade after one month at $2.00 and 50 cents per share, and that the planned underwriting was oversubscribed.

18. *I.e.*, Energy's inability to obtain an unqualified auditors' opinion.

* falsely stated that the Meditator Toilet was patented;
* failed to disclose that a required consent of the inventor of the Meditator Toilet—yes, there really was such a thing—had not been given; and
* failed to disclose that, even if Nu-Tech's offering had occurred, sadly the world would still lack the Meditator Toilet, for all along, Tripple and Thouvenelle intended to cause Nu-Tech to lend the offering proceeds to San Saba Energy—remember Energy, that's where we started—which Energy would use to repay money it owed to Tripple and Thouvenelle and to pay an unsatisfied judgment against Energy, Tripple and Thouvenelle. These were not nice guys!

In addition to the standard "don't do it again" injunction, Tripple (who had been enjoined in 1971 from violations of the securities laws) and Thouvenelle were barred from selling, offering to sell or participating in the offer or sale of any security by or for any issuer for several years. They also were barred for five years from holding the positions or performing the duties of officers or directors of any company with publicly traded securities. Note, here, that the bar in Florafax related only to positions at Florafax, whereas the bars of Tripple and Thouvenelle run to any public company.

These three cases almost make it sound as if the Remedies Act has been around for quite some time. But that conclusion might be a bit skewed, for these cases involved consent decrees, and litigated cases dealing with ancillary relief are relatively few. But one tangential thought—do not underestimate the significance of Commission consent decrees in terms of their value as precedent. In *E. I. Dupont de Nemours & Co. v. Collins*,[19] an action seeking review of a Commission order entered under the Investment Company Act, the Court noted with respect to SEC consent decrees that the

> [Contemporaneous] construction [of a regulatory statute by the agency charged with its administration] is entitled to great weight . . . even though it was applied in cases settled rather than by litigation.

And likewise, in *United States v. Chiarella*,[20]—a criminal insider trading case—the Second Circuit cited four Commission consent decrees, suggesting that the defendant should have been on notice of the gist of each, especially one that was well publicized and aroused widespread concern in the defendants' financial printing industry. The Second Circuit stated that all that is required to satisfy due process, by providing fair notice of the elements of a crime, is "a clear and definite statement of the conduct

19. 432 U.S. 46, 54 (1977).
20. 588 F.2d 1358, 1369 n.17 (2d Cir. 1979), *rev'd*, 445 U.S. 22 (1980).

proscribed'' predating the actions alleged to be criminal, and that consent decrees can provide adequate notice.

But back to bars. To my knowledge only one litigated case has considered the subject of bars—at least expressly going by that name—more on that in a moment—and the Supreme Court has considered the general issue of the legitimate scope of ancillary relief only once. *Deckert v. Independent Shares Corp.*[21] was a 1940 private action under Section 12(2) of the 1933 Act, seeking rescission, restitution, a receiver to wind up the affairs of the issuer, and an injunction restraining a trustee from disposing of assets. In *dictum* the Court stated:

> The power to enforce implies the power to make effective the right of recovery afforded by the Act. And the power to make the right of recovery effective implies the power to utilize any of the procedures or actions normally available to the litigant according to the exigencies of the particular case.[22]

Don't you love that quote? It's one of those great proclamations that can be cited for almost any proposition you pick.

The one litigated case involving bars expressly denominated as such is *SEC v. Techni-Culture*,[23] a 1974 Arizona federal district court case. In that case, the Court ultimately barred one of the individual defendants from serving as an officer or director of any public company ''except upon a showing to the Court that measures have been taken to prevent repetition of the conduct alleged . . . or conduct of similar object or purport.'' It's hard to find a whole lot of specific guidance there.

Fortunately, a few litigated District Court and appellate cases involving ancillary relief do provide slightly more concrete guidance. In one 1977 case, *SEC v. Beisinger Industries Corp.*[24]—essentially a looting case—valuable corporate assets were secretly sold to insiders for nominal consideration. Virtually no disclosure of this activity was made in various Commission filings and public reports, and the transactions resulted in false financial statements. The District Court appointed a special agent—

21. 311 U.S. 282 (1940).

22. *Id.* at 288.

23. No. C-73-473, Fed. Sec. L. Rep. (CCH) ¶ 94,501 (D. Ariz. April 2, 1974) (LEXIS, Fedsec, Cases).

24. 552 F.2d 15 (1st Cir. 1977), *aff'g* 421 F. Supp. 691 (D. Mass. 1976). Beisinger Industries transferred over half of its corporate assets (over $1 million in cash and receivables) to a wholly owned subsidiary. That subsidiary then acquired an on-going operating corporation. Later that year, Beisinger sold all of the outstanding stock of the subsidiary for $9,500 to a corporation which was wholly owned by Beisinger management. The first disclosure of the transfer of assets or the sale of stock came in Beisinger's 1973 Form 10-K, filed 8 months after its due date. Beisinger's auditors revealed that Beisinger had precluded an examination of advances to the subsidiary, so they could not express an opinion on Beisinger's financial statements. Subsequent secret transfers of corporate assets were discovered, and the accountants issued a similar disclaimer in connection with the 1975 Form 10-K.

a neutral party—and instructed him to retain an independent accounting firm to perform a special audit for three years, to supervise and file reports with the Commission, and to supervise and secure the dissemination of information to the public. The First Circuit affirmed.

Beisinger involved a special agent, not a bar. But is that distinction meaningful? This special agent assumed control of significant duties normally performed by officers and directors—including control of the audit and accounting function, the preparation and filing of periodic reports, and the dissemination of critically important information to the public. Yes, there is a logical connection between those duties and the disclosure process, but this relief also effectively barred duly elected management from performing functions which state law authorized them—and only them—to perform. And those functions were, at this time in the corporation's life, of a most critical and sensitive nature. Is this relief any different from a *de facto* partial bar?

Consider another litigated ancillary relief case, *SEC v. Koenig*,[25] a 1972 case relied upon by *Beisinger*. In *Koenig*, the Commission brought two Rule 10b-5 enforcement actions against a publicly held corporation and its president within a short period of time.[26] The first resulted in the standard "don't do it again" injunction. The second time the Commission also sought the appointment of a "limited receiver," with the power to investigate and report upon the state of corporate affairs and to convene a stockholders' meeting.

Emphasizing that the defendants had engaged in a "complex set of secret securities transactions" which left the Court in the position of being unable to determine the nature and extent of the injury to stockholders, had committed numerous disclosure related violations, and had frustrated all attempts of dissident shareholders to change management, the Court ruled:

> In view of these past activities, the Court concludes that it cannot rely on the defendants to implement the directions of the Court . . . A receiver therefore will be appointed and will be directed to (1) investigate the recapitalization of the European subsidiaries of ECO; (2) make full, complete and accurate public disclosure of all material events and facts concerning the defendants, their officers, agents, servants, employees, directors, subsidiaries and affiliates; (3) make timely and accurate filing of reports with the commission in conformity with Section 13(a) of the Securities Exchange Act and the Rules promulgated thereunder and to make those amended filings necessary to correct those reports presently filed; (4) issue a report to ECO stockholders for the years 1970 and 1971; (5) hold a 1972 annual ECO stockholders' meeting and

25. 469 F.2d 198 (2d Cir. 1972).

26. Both actions generally arose from allegedly misleading or inaccurate press releases and failures to disclose the true state of corporate affairs and transactions.

> (6) make ECO's books and records and stockholder list available to any ECO stockholder who is legally entitled to access to these documents.

I pose the same question. Did this relief differ substantively from a *de facto* partial bar of officers and directors? Did the Court not bar management from performing functions and exercising powers contemplated by state law as effectively as if the Court's decree were labelled a partial bar?

Pursuing this notion further—that bars by another name have been around for quite a while—let's go back to a 1960 Ninth Circuit decision. In *Los Angeles Trust Deed & Mortgage Exchange v. SEC*,[27] the Commission sought a receiver to take over the assets of a company that had committed extensive violations of the registration and anti-fraud provisions of the Securities Act and the anti-fraud provisions of the Exchange Act. The Commission ultimately prevailed, with the Ninth Circuit holding:

> Nor are we convinced that because the SEC has asked for authority from the Congress to broaden its statutory powers, and that Congress has not seen it proper to do so, means that the broad equitable powers of the federal courts cannot encompass "necessary ancillary" relief, such as the appointment of a receiver.

If a 1960 case fails to persuade you that *de facto* bars are not novel, let's go back to the Book of Genesis, at least insofar as the Commission is concerned. If you read together the Commission's brief in the *Los Angeles Trust* case and the Commission's 1935 Annual Report, you will find an unreported, but litigated, 1935 Nevada District Court case, *SEC v. Colonial Trading Co.*,[28] which resulted in the appointment of a receiver to remedy violations of the 1933 Act.

I would readily concede that this walk through some litigated ancillary relief cases proves that bars of corporate officers and directors are not novel only if you accept my basic thesis—that many forms of ancillary relief amount to *de facto* bars by another name. But since a receiver—even a limited receiver—effectively deprives management of power and authority it otherwise has, it certainly seems to operate as effectively as a bar.

Moving from ancient history, let's consider two relatively recent accounting cases, *SEC v. A.M. International, Inc.*[29] and *SEC v. United*

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27. 295 F.2d 162 (9th Cir. 1960).

28. D. Nev. 1935. The Commission's 1935 Annual Report discussed Colonial Trading as follows: "On April 11, 1935, the Commission filed in the United States District Court for the District of Nevada a suit against Colonial Trading Co. and 36 Affiliated persons, alleging fraudulent activities in violation of the Securities Act. A preliminary injunction (which included the appointment of a receiver) was obtained on April 19, 1935 against such defendants as had been served with process.

29. 606 F. Supp. 600 (S.D.N.Y. 1985).

States Surgical Corp.,[30] focusing principally on the relief rather than the alleged violations. In neither case is the relief denominated a bar, but is the practical effect any different, at least from a partial bar? In *A.M. International* the Company was ordered to:

* maintain an Audit Committee of non-management directors for a period of three years;
* appoint, after confirmation of its plan of reorganization, two qualified, independent persons to serve as additional directors and on the Audit Committee; and
* to retain its independent auditors for a three-year period to report on A.M.'s accounting systems and procedures and to assess the adequacy of its system of internal accounting controls, in addition to any review which was part of the annual audit, with such special review being sufficient in scope, when coupled with the annual audit, to provide reasonable assurances that all material weaknesses had been discovered.

Among other areas, the independent accountants were directed to review A.M.'s accounting system and procedures with respect to revenue recognition, intercompany transactions, accounting for and pricing of inventories, and the establishment of and periodic adjustment to asset valuation allowances. The independent accountants were to provide a written report of the review, and A.M. was required to take "any and all necessary and appropriate steps to correct or eliminate all material weaknesses noted."

In *U.S. Surgical* the Commission alleged that U.S. Surgical had engaged in a massive, multi-year "cooked books" campaign.[31] Without

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30. Civil Action No. 84-0589, Lit. Release No. 10293, Acctg. and Aud. Enf. Release No. 22 (D.D.C. Feb. 27, 1984) (LEXIS, Fedsec, Cases).

31. The Commission alleged that, beginning at least in 1979 and continuing through 1983, the defendants materially overstated Surgical's earnings and financial condition as follows: (a) in 1979, Surgical reported pre-tax earnings of $7.9 million, when Surgical earned less than $6.3 million; (b) in 1980, Surgical reported pre-tax earnings of $12.1 million, when Surgical earned less than $8 million; and (c) in 1981, Surgical reported pre-tax earnings of $12.9 million, when Surgical earned approximately $200,000. The Commission alleged that Surgical issued falsified purchase orders to vendors, who in turn submitted untrue invoices so that Surgical's reported cost of parts was decreased and its reported cost of materials was improperly over-capitalized by over $4 million; shipped significant quantities of unordered products to customers and recorded them as sales; improperly treated shipments on consignment to dealers, salesmen, and certain foreign entities as sales, resulting in a cumulative overstatement of income of over $2 million; improperly failed to write off assets which could not be located or had been scrapped, and capitalized certain operating costs as overhead, increasing earnings by millions of dollars; improperly capitalized approximately $4 million dollars of legal costs, purportedly for the defense of certain patents, when those costs did not relate to the defense of patents and should have been charged to operations as incurred; and beginning in 1981, improperly capitalized the costs of 10,000 parts each time Surgical purchased a new or modified mold or die, with such improperly capitalized costs alone amounting to approximately $5.7 million in 1981.

admitting or denying the allegations, Surgical consented to an injunction against further violations of various provisions of the securities laws. The decree also embodied broad, ancillary relief designed to strengthen the accounting and auditing functions, the Audit Committee, and the independent auditor. Surgical was ordered, among other things, to:

* appoint two new unaffiliated directors, acceptable to the Commission, for a period of at least 5 years, to serve on the Audit Committee;
* maintain and strengthen the position of chief internal auditor;
* review certain past and present accounting practices, retaining independent auditors to aid in the review and take whatever action was necessary, including restatement, amendment or adjustment of its financial statements;
* retain independent auditors to review and report to the Audit Committee on Surgical's current accounting policies, practices, procedures, and controls, their propriety and effectiveness, and the conduct (scope, timing, and effectiveness) of the audit function;
* have the Audit Committee review Surgical's financial statements, filings with the Commission, written reports of earnings or financial condition, and accounting practices, procedures, and controls; and
* have the Audit Committee engage a separate accounting firm to advise it for at least three years, and to assist it in fulfilling its independent responsibilities.

The term "bar" or "partial bar" nowhere appears, in either case, but what is the *A.M. International* and *U.S. Surgical* relief? New board members, new and independent audit committee members, restructured internal accounting procedures, the involvement of a second independent accounting firm, and a significant dilution of the authority of incumbent management. Does such relief not effectively bar duly elected officers and directors from managing the business affairs of these issuers?

That's enough about partial bars going under another name. In addition, outright bars—denominated as such—were obtained by the Commission at least as early as 1976 in settled cases. For example, in *SEC v. Giant Stores Corp.*[32] the court barred four individuals from serving as officers or directors of any public company, or in a like capacity, or in any position with any responsibility for financial statements of a public company.

CONCLUSION

So where does the Remedies Act leave us? Perhaps to a large extent it leaves us asking many of the same questions always asked as Commis-

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32. Civil Action No. 76-1641, Lit. Release No. 7546 (D.D.C. Sept. 2, 1976) (LEXIS, Fedsec, Cases). The case involved allegations of falsified corporate expense accounts, manipulation, and self-dealing.

sion-watchers have monitored the Commission's enforcement process, such as:

What are the outer limits of ancillary relief and bars—both pre-and post-Remedies Act? Is all of this really a disguised preemption of state law? Do certain types of violations of the securities laws—looting or egregious accounting cases, for example—justify bars or other expanded sanctions more readily than others? If so, why? And the ultimate question—is the Commission fashioning a federal law of corporations, and has Congress—intentionally or not—now given the Commission the authority to do so?

Those questions are not without substance, and each one provides ample material for a separate lecture, which I will leave for the law faculty.

I began by noting my title: "Looking For The Perfect Enforcement Remedy." I now ask: "What is the Commission really after?" Again, I suggest that, both pre- and post- the Remedies Act, the Commission is seeking that remedy which effectively deals with the violation, deters future violations, does not overreach or unnecessarily interfere with personal freedoms, internal corporate affairs, or matters traditionally left to state law, is fully consistent with the general intent of the federal securities laws but goes not one step further, does not deter the legitimate capital formation process, and protects public investors and the integrity of the marketplace without being punitive, except when expressly intended to be punitive. That's a bit long-winded and somewhat philosophical, but I believe it's what the Commission is after. And if that definition and the history we have walked through today are kept in focus, perhaps the Remedies Act becomes a little less mysterious.

My aim today, in part, also was to suggest that the Remedies Act and its so-called unheard of, extraordinary remedies are not completely and totally novel, despite the current verbal sparks. If we are truly honest intellectually, it's partly a continuation of an evolution that began long ago in that Nevada district court in 1935 with the appointment of a receiver to remedy violations of the 1933 Act. And, to some extent, it is the classic example of old wine in new bottles or a bit like a movie I think I may have seen before.