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SEC Penalties: Getting Tougher, and Remembering Some History

In a recent speech, Andrew Ceresney, the co-director of the SEC's Division of Enforcement, suggested that the monetary penalties imposed by the SEC should grow to reflect the size of the relevant companies and transactions. According to press reports, he observed that "Ten years ago we would not have been speaking about $10 billion transactions or billions in income in a quarter and now we are. . . . I sometimes worry that, given the profits of companies and banks, penalties cannot be at a level that would meaningfully impact their bottom line in a way that will deter misconduct."

Director Ceresney's comments are without question in tune with the times, as we hear almost on a daily basis a drumbeat of demands that the SEC get tougher on companies, and particularly on financial services firms. The reality, however, is that the SEC does not have unlimited power to fix the level of monetary penalties. The SEC's penalty power is defined under the federal securities laws, and it is circumscribed by statutory criteria. Most SEC enforcement cases end in settlements, rather than litigation. As a result, the SEC's proclivity to deploy its penalty power aggressively is seldom tested. Companies sometimes are willing – albeit reluctantly – to pay penalties that are higher than a court would likely impose as part of the price of achieving closure of an enforcement investigation.

In litigated cases, however, the SEC's penalty calculations are subject to determinations made by a federal judge, who will assess a proposed penalty based on all of the facts and circumstances of the particular case. An instructive recent example is *SEC* v. *Reserve Management Co.*, 09 Civ. 4346 (PGG) (S.D.N.Y. Sept. 30, 2013). This case arose from the collapse of the Reserve Primary Fund, a money market fund that held commercial paper issued by Lehman Brothers at the time of Lehman's bankruptcy filing. Concerns over the Lehman-related assets led to a run on the Fund, which ultimately resulted in the Fund's NAV falling below $1.00 per share – popularly known as "breaking the buck."

After an investigation, the SEC concluded that certain persons associated with the Fund made misrepresentations concerning the impact of the Lehman bankruptcy on the Fund. The SEC commenced an enforcement action alleging securities fraud and other violations against two corporate entities (the investment manager to the Fund and an affiliated broker-dealer) and two individuals. After trial, the jury returned a verdict rejecting all of the SEC's claims that required proof of fraudulent intent. The jury did find liability on the part of the two entities and one of the individuals on several charges that involved lesser intent requirements.

In post-trial motions, the SEC, among other things, asked the court to impose monetary penalties against the three defendants who had been found liable. The SEC argued that the court should impose penalties totaling $130 million against the two entities and $1.3 million against the individual. The court rejected the SEC's calculations, and determined instead to impose penalties of $325,000 on each of the two entities and $100,000 against the individual.

The court reached these conclusions after a detailed analysis of the statutory criteria governing penalty calculations, and after noting that the purpose of the penalty power is deterrence of future violations. The court's opinion was a thoughtful effort to consider all of the circumstances in context to arrive at penalty amounts that fairly reflected all of the relevant evidence, including mitigating facts. Along the way, and based on the full record, the court rejected the SEC's argument that in this case the transmission of the same disclosure document to 200 investors constituted 200 "violations" for penalty purposes, which the SEC asserted should result in a mechanical multiplication of the statutory penalty amounts by a factor of 200.

The *Reserve* case illustrates that, no matter how heated the rhetoric may be, the SEC's penalty authority has constraints. The SEC often seeks to be aggressive, and frequently succeeds when the party on the other side of the table is sufficiently motivated to settle. But the penalty calculations that the SEC obtains in the settlement context might not always pass muster in a contested proceeding before a federal judge.

The debate over penalty amounts is based in part on the misconception that the current levels are a mere "cost of doing business." This belief sells short the real financial impact that penalties have and, more importantly, overlooks what has always been the "toughest" aspect of SEC settlements with corporate entities – the reputational impact that results from the opprobrium of an SEC enforcement action and the SEC's recitation of its view of the evidence in a publicly filed charging document. The debate also illustrates how SEC enforcement mechanisms tend to take on a life of their own and depart from their original intent. Congress gave the SEC its penalty power in 1990. Admittedly, it is a power that can be viewed as punitive, though its purpose is to be a deterrent. But the thinking at the time of enactment – including at the SEC – was *not* that all violations warrant exercise of this power. In congressional testimony supporting the legislation in 1990, senior SEC officials explained that the SEC did not intend to use the penalty authority in all cases. They further noted the inequity of assessing a substantial penalty against a corporation in circumstances where shareholders have already been injured by the subject misconduct.

The SEC imposes penalties in virtually all cases, and, as we have noted above, it sometimes does so based on highly aggressive math. The historical evolution of the penalty power is one more reason to watch carefully as the SEC implements its new policy of requiring admissions in settlements, another mechanism that is now being described as intended for use selectively, and not in most cases.

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