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ANCILLARY RELIEF AND REMEDIES: DOES THE SEC NEED MORE CLOUT?

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The views expressed herein are those of Commissioner Peters and do not necessarily represent those of the Commission, other Commissioners, or the staff.

Good morning ladies and gentlemen. My remarks, which I am bound to warn you reflect my own opinions and not necessarily those of the Commission or its staff, concern one of the priorities on my personal agenda -- the enhancement and strengthening of the Commission's enforcement capabilities. In light of my background as a litigator, this focus should come as a surprise to no one. However, being pro-enforcement does not necessarily mean I advocate more rules and regulations. A recent magazine article characterized me as believing the more regulation the better. That characterization is inaccurate. But for a few notable exceptions, I have agreed with most of the deregulatory initatives undertaken by the Commission during the past two years. In my view, the need for more regulation is a different issue from whether we need more or better enforcement of the rules we already have. I do believe that effective enforcement is particularly critical today in light of the deregulatory mode we are in. With effective enforcement of the securities laws as my theme, I would like to talk about the remedies presently available to the Commission and a few that are not available but which I believe we should have.

The statutes the Commission enforces provide it a range of remedies. Both the Securities Act of 1933 ("1933 Act") and the Securities Exchange Act of 1934 ("1934 Act") authorize the Commission to seek injunctive relief in the federal courts against persons who violate those statutes. Frequently, the Commission

has obtained ancillary relief in connection with those injunctive actions. In addition, the Commission has the power to censure, suspend (for a period not to exceed 12 months) or limit the activities of persons registered with it and their associated persons. The Commission may also bar certain securities professionals from the industry. 1/ Notwithstanding the remedies at our disposal, the question I am asking today is, are the present statutory remedies enough or should they be modified or added to in order to enhance and strengthen the Commission's enforcement capabilities?

Working within the present statutory framework, the Commission, or more accurately the Commission's staff, has been very creative in shaping remedies designed to deter a repetition of unlawful conduct. The more interesting of these remedies have been developed in injunctive actions and have taken the form of ancillary relief. Generally, the ancillary relief sought by the Commission falls roughly into three broad categories. First, there are the devices I call third party watchdogs; second, there is monetary relief; and, third, there are undertakings. Let me take just a few minutes to discuss recent examples of these three types of ancillary relief.

Third Party Watchdogs. In a number of situations, the Commission has effectively remedied different types of unlawful conduct by using variations on this theme. Receivers have been

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1/ Securities Exchange Act of 1934, § 15(b)(4), (6), 15 U.S.C. 78o (b)(4), (6).

appointed when there was a fear that corporate assets may be wasted or misappropriated. Similarly, the Commission has on occasion required the appointment of independent directors to a company's board. 2/

The Commission has also required the appointment of a special consultant to investigate a registrant's internal procedures and report his findings to it and the court. You may be aware of the Commission's much publicized settlement with First Jersey Securities, Inc. 3/ two years ago. Among other things, that settlement provided for a court-appointed independent consultant to review First Jersey's procedures and policies to determine its compliance with the appropriate statutory and self-regulatory guidelines. The consultant was also required to file with First Jersey's board of directors a report containing any recommendations for improving procedures. A very similar approach was followed in the Commission's recent enforcement action against E.F. Hutton. 4/ Two special consultants were used in that case, one to review E.F. Hutton's brokerage activities and another to review its mutual fund operations.

2/ SEC v. U.S. Surgical Corporation, No. 84-0589 (D.D.C. Feb. 27, 1984), Litigation Release No. 10293 (Feb. 27, 1984), 29 SEC Docket 1523.

3/ SEC v. First Jersey Securities, Inc., No. 83 Civ. 0483 (MP) (S.D.N.Y. Nov. 26, 1984), Litigation Release No. 10616 (Nov. 26, 1984), 31 SEC Docket 1423.

4/ In re E.F. Hutton & Company, Inc., Securities Exchange Act Release No. 22579 (Oct. 29, 1985), 34 SEC Docket 619; Investment Advisers Act Release No. 993 (Oct. 29, 1985), 34 SEC Docket 700.

Monetary relief. The imposition of monetary relief by the SEC is founded on the proposition that violators of the law should not benefit in any respect from their illegal activity. There is no doubt that a court, at the request of the Commission, can order disgorgement or restitution in the appropriate circumstances. 5/ Disgorgement is now a regularly used weapon in the SEC's enforcement arsenal. Although this remedy is most frequently used in insider trading cases, 6/ it is also applied to recoup monies generated in fradulent securities offering. 7/

Congress has recently added to the monetary remedies available to the Commission by enacting the Insider Trading Sanctions Act ("ITSA"). 8/ This statute permits the Commission to seek up to three times the amount of profits obtained or losses avoided by those who trade while in possession of material non-public information. To date, the Commission has recovered penalties up to an amount twice the profit gained. 9/ It has

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5/ SEC v. Texas Gulf Sulphur Co., 446 F.2d 1301, 1307-08 (2d Cir. 1971).

6/ See, e.g., SEC v. Thayer, No. 84-0066 (S.D.N.Y. filed Jan. 5, 1984), Litigation Release No. 10251 (Jan. 5, 1984), 29 SEC Docket 887; SEC v. Brant, No. 84 Civ. 3470 (CBM) (S.D.N.Y. Oct. 21, 1985), Litigation Release No. 10908 (Oct. 21, 1985), 34 SEC Docket 592.

7/ See, e.g., SEC v. Stines, No. 3-84-1277-R (N.D. Tex. May 6, 1985), Litigation Release No. 10762 (May 22, 1985), 33 SEC Docket 259.

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

9/ See SEC v. Katz, No. 86 Civ. 6088 RJW (S.D.N.Y. Aug. 7, 1986), Litigation Release No. 11185 (Aug. 7, 1986); SEC v. The First Boston Corporation, No. 86 Civ. 3524 PNL (S.D.N.Y. May 5, 1986), 35 SEC Docket 1157.

also obtained penalties from tippers who did not trade, thereby imposing a monetary sanction on those who did not profit directly from their unlawful conduct. 10/

Speaking of the Insider Trading Sanctions Act brings to mind the spate of insider trading cases recently filed by the SEC and the widespread interest and comment that activity has spawned. It would be difficult to resist taking this opportunity to respond to the criticism leveled at the SEC because of its enforcement efforts in this area, and I have decided not to resist the temptation. The critics whom I have in mind are those who suggest, indeed insist, that the Commission is stretching the current parameters of the law on insider trading and that it is using novel and untested legal theories to remedy wrongs which could be better addressed outside of the ambit of the securities laws. 11/

I believe these critics have failed to understand the thrust of the allegations made in SEC v. Levine 12/ and even SEC v. Winans. 13/ For example, the concern that the Commission was stretching the law by charging that Levine acted unlawfully

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10/ See, e.g., SEC v. Katz, supra note 9.

11/ Cohen, SEC Crackdown Cools Trading, Heats Debate, Chicago Tribune, June 17, 1986, at 10; Bleiberg, Those Hobnailed Boots, Barron's, June 2, 1986, at 11; Lewin, The Dilemma of Insider Trading, N.Y. Times, July 21, 1986, at D1.

12/ No. 86 Civ. 3726 RO (S.D.N.Y. filed May 12, 1986), Litigation Release No. 11095 (May 12, 1986), 35 SEC Docket 1212.

13/ SEC v. Brant, supra note 6.

when he traded on information misappropriated from sources other than his employer ignores the full import of the misappropriation theory. If one accepts the misappropriation theory in the first place, it should not require any great leap of logic to conclude that the theory prohibits knowingly trading on misappropriated non-public material information whatever its source, particularly if one has set up a network of people whose purpose is to obtain and share the misappropriated data.

Some commentators protest that the theories underlying the charges against Levine, while perhaps justifiable on a moral ground, are based on theories which are novel and untested. Those critics suggest that the misappropriation theory is a strange approach to enforcement of the securities laws in that it does not protect people who buy or sell securities, but rather protects employers whose reputations might suffer as a result of the investment activities of their employees. These critics question whether such conduct should be covered by Section 10(b) and Rule 10b-5. 14/

I agree that the misappropriation theory is an interesting and perhaps even convoluted approach to enforcement of the securities laws; nevertheless, it is one that has been imposed upon the Commission by the U.S. Supreme Court, not vice versa. In my view, the misappropriation theory was not conceived to protect the owners of information, but rather is used as a basis upon which

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14/ Herzel & Katz, Insider Trading Cases: Right Result, Wrong Rules, Legal Times, June 23, 1986, at 15; Macey, SEC Vigilant on Insider Trading, But Is It Within the Law?, Wall St. J., May 28, 1986, at 34.

to posit a "duty" not to use the confidential information for the trader's personal gain and benefit. The Supreme Court developed this concept of "duty" to limit the reach of the securities laws. Unfortunately, the concept also complicates their enforcement.

This problem was highlighted in a recent article by Michael Klein. 15/ In discussing the Supreme Court's campaign to construe narrowly statutes that previously had been interpreted expansively, Mr. Klein correctly noted that "inevitably, such a dramatic shift in doctrinal direction produces analytic anomalies." By focusing on the concept of "duty" and receipt of a "benefit" rather than the plain language of Section 10(b), the Supreme Court has indeed created an analytic anomaly resulting in uncertainty. The uncertainty is clearly apparent in public reaction to cases like *Winans*. In explaining his view of the *Winans* case, a view with which I agree, Mr. Klein stated:

> Many lawyers . . . contend that [there are] inconsistencies and illogic in the majority opinion. . . . But these lawyers may well have missed the point. The majority was not motivated to find consistency with the thrust of the Supreme Court's latest rulings.
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> The majority simply was unwilling to accept the notion that what Winans and his cohorts had done was beyond the intended reach of the securities laws. *After all, the defendants had devised and executed a scheme whose sole and clear purpose was to profit from securities trading in anticipation of undisclosed events they correctly believed might be material to investors.* 16/

15/ Klein, *Winans Decision Defies Doctrinal Shift*, Legal Times, June 23, 1986, at 15.

16/ *Id.* (emphasis added).

In my opinion, the conduct challenged in the Levine and Winans cases is covered by Section 10(b) of the 1934 Act. Five minutes is long enough for any digression. Therefore, I will turn from the heady topic of legal theories back to the mundane world of legal remedies.

Undertakings and Restatements. The final type of ancillary relief frequently used by the Commission is to require the filing of corrected documents. Most frequently, this type of remedy is employed to rectify material omissions or misstatements made in connection with proxy statements or financial statements filed with the Commission. Other ancillary relief, such as undertakings, is often coupled with the restatement. Undertakings, designed to avoid a recurrence of specific conduct, are also frequently used in settlements of administrative proceedings.

Administrative sanctions and injunctive relief, along with the ancillary remedies I've discussed, serve as meaningful deterrents, as well as powerful remedial tools. Nevertheless, I have a growing concern that our enforcement tools are not as effective as they could be when we are dealing with: (1) particularly egregious violations of the securities laws, (2) situations where traditional remedies would have an overly broad effect, and (3) repeated violations by recidivists. In my view, we need new approaches and perhaps even new legislation to deal with these situations. Several new approaches come to mind.

The Commission, of course, has the statutory authority to bar registered representatives, broker-dealers and investment advisers from the securities industry. Moreover, through Rule

2(e), it has some measure of control over who may practice law and accountancy before it. However, the problem remains of what to do about the irrepressible entrepreneur who consistently and repeatedly misleads the investing public through false prospectuses, registration statements and periodic reports.

In several recent cases, the staff has proposed and the Commission has accepted a new type of ancillary relief, which I personally find appealing and very useful. The idea is to remedy egregious violations of the law, particularly by repeat offenders, by barring these persons from acting as corporate officers or directors or being associated in any manner with publicly-held companies. What makes the idea novel is that the bar could be and has been applied to non-securities industry professionals.

It is fair to say that not everyone at the Commission is as enthusiastic about this remedy as I. Although it has been applied in several cases, the Commission and the staff have proceeded with caution, mindful that some might question whether it is good policy for the Commission, in the absence of express statutory authority, to bar persons from holding corporate office. For my part, I have no doubt that such relief could be granted by a court in an injunctive action. Therefore, such a bar is a legitimate and appropriate demand to make in the context of a judicial proceeding, settled or litigated. 17/

17/ As a result of amendments to Section 15(c)(4) of the Securities Exchange Act of 1934, 15 U.S.C. 78o(c)(4), corporate bars against individuals who are not securities professionals may be possible in an administrative context.

I believe that it is appropriate to resort to this type of specialized ancillary relief where the facts of the case are sufficiently egregious and there is a well-founded concern on the part of the Commission (or the court, if the matter is litigated) that an injunction would be inadequate to deter future violations. 18/ This is not to say that I think a bar from corporate office is appropriate in every case. Indeed, it should not be applied routinely, without regard for the circumstances. On the other hand, I am reluctant to label the remedy as "extraordinary and thereby imply that it should rarely be invoked.

Incidently, I would not recommend legislation in this area. First, I am not persuaded it is necessary, and, second, I am not certain how such legislation could be drafted to avoid preemption of state law in the corporate governance area.

18/ See SEC v. Florafax International, Inc., No. 84-C-937-B (N.D. Okla. Nov. 27, 1984), Litigation Release No. 10617 (Nov. 27, 1984), 31 SEC Docket 1425 (the SEC barred a repeat violator who was a key officer and majority shareholder of the corporation; in the absence of a bar, this individual would have had the opportunity and the incentive to cause the corporation to violate the law again). See also SEC v. San Saba Nu-Tech, Inc., No. 84-2921 (D.D.C. Sept. 19, 1984), Litigation Release No. 10531 (Sept. 19, 1984), 31 SEC Docket 625 (the two key officers were barred for five years because of their egregious conduct in connection with an attempted public offering of common stock); SEC v. Oak Industries, Inc., No. 85-1507 (KI) (S.D. Cal. June 25, 1985), Litigation Release No. 10801 (June 25, 1985), 33 SEC Docket 740 (the former Chairman of the Board and Chief Executive Officer of Oak Industries, Inc. was barred as a result of his participation in an extensive accounting fraud).

Speaking of bars reminds me of an legislative amendment to an existing statutory remedy I would recommend -- that is changing the securities laws to permit the Commission to suspend registered persons for a period of more than 12 months. This would give the Commission much needed flexibility in the sanctioning process and preserve the impact of the bar as the ultimate sanction.

Finally, the Commission needs more flexibility to fashion monetary relief. Recently, the Commission tried a new approach when it voted to accept an offer of settlement from a major broker-dealer firm involving the payment of cash that was neither disgorgement nor restitution. A Commission investigation determined that the broker-dealer was using customers' fully-paid securities in its stock loan program in contravention of Commission rules on customer protection -- in our view, a serious violation.

Focusing on the language of Section 15(b)(4) of the 1934 Act, which permits the Commission to impose conditions or limitations on the operations or activities of a broker-dealer, the staff negotiated an innovative settlement. The terms of the settlement required the broker-dealer to tender to the Securities Investor Protection Corporation ("SIPC") the profits it earned from its stock loan business over a predetermined 10-day period.

Some might, and indeed did, question the SEC's authority to secure this type of relief on the grounds that it constitutes a fine or a penalty. I, on the other hand, was not the slightest

bit uneasy about this settlement. Section 15 of the 1934 Act clearly states that the SEC has the authority to impose limitations on the activities of registered broker-dealers. The payment to SIPC was merely a limitation, novel perhaps, but not ultra vires. If there is any serious doubt about whether the Commission has the power to obtain such remedies, then the 1934 Act should be amended to grant it.

In my view, legislation should be enacted granting the SEC express authority to impose civil money penalties. The ability to impose fines would give the Commission much needed flexibility and clout in the sanctioning process. When one mentions the possibility of fines, many securities lawyers start to squirm, but the idea of a fine is far from new and certainly should not be especially discomforting. Many regulatory agencies are already empowered by Congress to fine violators of the statutes they administer. For example, the Commission's sister agency, the CFTC, has been fining commodities/futures law violators for a wide range of infractions since its inception. Moreover, it is hard for me to believe that the Commission, if given such authority, would abuse its decretion and impose arbitrary or capricious fines. After all, you do not see us running amuck and wantonly putting persons out of business pursuant to our current powers. The Commission has also enforced the treble damage provisions of ITSA with restraint. There is no reason to expect it to operate differently when it comes to imposing fines.

There are many advantages that could be derived from the imposition of civil money penalties in SEC enforcement actions. First, the imposition of fines could be used to call attention to the egregiousness of a particular violation. A fine, coupled with an injunction or an administrative remedy, would signal the seriousness with which the Commission views the violative conduct. Similarly, the imposition of fines would be meaningful in distinguishing between different levels of culpability. Furthermore, in the appropriate situations a civil money penalty may be imposed instead of what would otherwise be a draconian or overly broad sanction such as the revocation of registration or a suspension or bar. For example, with respect to large broker-dealer firms, the use of civil money penalties may help us get around the "all-or-nothing" dilemma of sanctioning.

Another benefit of fines is the deterrent effect they may have on repeat offenders who are not the least bit fazed by the threat of an injunction. A recent letter to the editor of the Los Angeles Times 19/ questioned the meaningfulness of Commission injunctions as a deterrent to future violators and suggested that their impact is limited to saying "go, my child, and sin no more." If that is the case, fines would increase the downside risk of violating the securities laws. One other benefit comes to mind -- they might help to reduce the deficit.

19/ William K. Bachelder, "Letters to the Editor," Los Angeles Times, Aug. 4, 1985, § 5, at 3.

Recent articles in the Washington Post reporting on the activities of the U.S. Sentencing Commission suggest that the time is ripe to consider legislation allowing fines to be assessed against corporate law breakers in the securities industry. In those articles, fines are discussed as a viable and legitimate means to deter companies from violating the law and to punish those who do. 20/ Since the Administration and other agencies are currently focusing on the problems of the corporate recidivist, the SEC should take advantage of the moment to request Congress for legislation enabling the Commission to impose fines.

Conclusion. The Commission is charged with protecting our financial markets and with administering the federal securities laws. Innovation is the name of the game -- we must be at least as innovative as the lawbreakers, and they are clever, indeed. The Commission has been quite successful in shaping creative and effective remedies. Nevertheless, we should not hesitate to ask Congress for additional tools, and the ability to fine should be at the top of the list.

20/ Moskowitz, New Book to Be Thrown at Corporate Lawbreakers, Wash. Post, July 28, 1986, Washington Business, at 9; Moskowitz, Judges May Get Wider Role in Reforming Errant Companies, Wash. Post, Aug. 8, 1986, Washington Business, at 10.