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Ancillary Relief and Remedies: Exotic, Extraordinary or Just Plain Effective?

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ANCILLARY RELIEF AND REMEDIES:
EXOTIC, EXTRAORDINARY OR JUST PLAIN EFFECTIVE?

I thank Jack Bookey and Steven Graham very much for inviting me to speak to this distinguished group today. I am pleased that there is such diverse representation here, because it is only through the cooperation, at all levels, state and federal, public and private, of various groups and professions that we are able to maintain such high standards in our securities markets.

You may be aware that recently I cautioned various segments of the securities industry to be alert for increased sales practice abuses which could develop as a by-product of the decrease in profits after the boom periods of yesteryear. I want to emphasize that my concerns are not limited to broker-dealers pressuring their account executives to produce more while ignoring their obligation to supervise these people carefully and closely. My warnings should also be heeded by reporting companies that are caught in the financial wringer that demands ever improving balance sheets and who are, thus, tempted to "cook their books". That is to say, they manipulate the numbers in their financial statements so that the bottom line appears rosier than it is. Likewise, my admonitions should be ringing in the ears of each and every accountant out there practicing before the Commission who may be contemplating engaging in what some of my colleagues have dubbed "cute accounting". Am I beginning to sound like the "Enforcer"?

Since my appointment to the Commission in June of last year, I have been asked frequently about my goals during my tenure at the SEC. After nearly nine months of deliberating on proposed enforcement actions, I have made one of the priority items on my personal agenda the strengthening and enhancement of the SEC's enforcement capabilities. In light of my background as a litigator, this focus should come as a surprise to none. Believe me, it is better than letting me run amuck in the Division of Corporation Finance -- were I to do that, Edgar would never get off the ground. One mechanism for achieving stronger enforcement capability would be for the SEC Regional Offices and Enforcement Division to be omnipresent. But we are only flesh and blood, and that would be very difficult to achieve. Consequently, we are left with the aggressive imposition of remedies and ancillary relief, both traditional and innovative. I believe that the Commission must read its statutory mandate broadly, and with a creative eye, in order to enforce effectively the federal securities laws. So, that is what I would like to talk about today -- ancillary relief and remedies.

Perhaps the best place to start is at the beginning. For a securities lawyer, that's the 1930's. Those of you who have drawn a sharp breath may exhale -- I am not going to treat you to a summary of the last 50 years. But I do wish to point out that the creation of the federal securities laws was aimed at insuring the integrity of the American financial markets and the maintenance of investor confidence. To that end, both the Securities Act of 1933 ("1933 Act") and the Securities Exchange Act of

1934 ("1934 Act") empower the Commission to seek injunctive relief in the federal courts against persons who violate those statutes. In addition, the Commission has administrative jurisdiction to "censure, place limits on the activities, functions or operations, suspend . . . or revoke the registration of certain securities professions . . . ." The Investment Company Act of 1940 ("1940 Act") goes just a slight bit further. It provides expressly for the appointment of a receiver to manage the affairs of an investment company upon a showing of a material violation of the Act.

Thus, as you can see, although the statutes could be broader, there is statutory authority expressly providing for ancillary relief. Moreover, the Commission has obtained such relief through the general equitable powers of the federal courts. As the Second Circuit noted in its opinion in Chris Craft v. Piper, "Ancillary relief contributes to the effective enforcement of the securities laws . . ." and it is in large part through courts of equity that the SEC has been able to carry out effectively its mandate.

The Commission has, of late, been actively shaping remedies that some have called exotic, others call them extraordinary, but I call them effective! The more interesting of these remedies have taken the form of ancillary relief -- by that I mean a remedy/sanction other than and imposed in addition to a traditional injunction, censure, suspension, or bar. It is interesting that much of this innovative ancillary relief is not a by-product of litigated cases. By and large, such relief has been imposed pursuant to consent decrees, negotiated by the

Commission and the proposed defendants. (While settlements are an efficient use of resources, I believe that they are not always the best solution under all circumstances. The Commission is, and must be, willing to litigate any and all cases it pursues. But that is a topic for another day.) Back to where I was before I digressed -- though not judicially sanctioned, much of the ancillary relief remains unchallenged in court, enabling the Commission and its staff to continue to weave meaningful relief from the thin cloth of the federal statutes. I applaud the innovative approach to remedies and sanctions that the staff of the SEC has taken, and I encourage them to continue down that road.

Generally, the ancillary relief meted out by my colleagues in Washington, both past and present, falls roughly into three broad categories. First, and perhaps the oldest type of equitable relief imposed in the context of the securities laws, is the appointment of a third party, either a receiver, or special counsel or other expert to manage and/or monitor the affairs of a regulated entity. Second, the imposition of monetary relief, most frequently in the form of disgorgement of profits gained from one's illegal activity. Finally, many cases have rectified past financial statement inaccuracies and violative practices through the adoption of procedural undertakings and/or public disclosure of past transgressions (e.g. restatement of financials).

Before delving into some of the newer and, perhaps, more innovative approaches, let me just take the next few minutes to discuss a few situations in which the remedies I have mentioned have been applied.

Third Party Watchdogs: In a variety of situations, the Commission has effectively remedied various types of unlawful conduct by using variations on this theme. Receivers have been appointed when there was a fear that corporate assets may be wasted or when it appears that the positions of corporate shareholders are in jeopardy due to mismanagement or fraud. Similarly, the Commission has stepped into the world of corporate management, and, in egregious cases, replaced elected management with impartial third parties. It has required the appointment of independent directors to a company's board. The individuals are usually subject to prior court and Commission approval.

Let me give you an example -- the often-cited Mattel case. Independent directors were brought into the toy company's management structure to oversee accounting procedures and the preparation of financial statements. This imaginative approach allowed Mattel to continue its operations, but assured the SEC that Mattel would not continue to inflate its profits and make fraudulent disclosures.

A similar consent decree was entered into in connection with the settlement last year of the U.S. Surgical matter. Surgical was required to appoint two non-affiliated directors to its Board. The two were to serve on the audit committee that was charged with reviewing the company's SEC filings and financial statements. Also of interest -- Surgical was required to secure the services of an independent accounting firm to report directly to the audit committee with respect to all of the company's accounting practices and procedures.

Another ancillary remedy that has been successfully used in the past is the appointment of a special counsel to review and investigate corporate procedures and then report the findings to the court. They also have been used to ensure specific compliance with undertakings assumed in connection with settlement of a case. You are probably aware of the Commission's much publicized recent settlement with First Jersey Securities, Inc. and its president, Robert Brennan. First Jersey and Mr. Brennan consented to the entry of an injunction against future violations of the law. However, the consent further provided for a court-appointed independent consultant, with complete access to First Jersey's books and records, whose task is to review First Jersey's procedures and policies to insure its compliance with the appropriate statutory and self-regulatory guidelines. Upon completing his examination, the consultant will make recommendations for improving procedures, etc. to First Jersey's Board of Directors in the form of a report, a copy of which will be filed with both the SEC and the court.

Monetary relief. Justification of the imposition of monetary relief by the SEC can be made on the theory that violators of the law should not benefit by their illegal activity. Today, it is fairly well settled that a court of equity, at the request of the Commission, can order disgorgement, or order rescission and restitution. Therefore, disgorgement is now a regular weapon in the enforcement arsenal and it is used, since the landmark decision in Texas Gulf Sulphur, to deprive those who illegally trade while in possession of inside information of their

ill-gotten gains. Congress has recently added to remedies available to the Commission by enacting the Insider Trading Sanctions Act. This statute permits the Commission to seek up to three times the amount of profits obtained or losses avoided by those who trade on inside information. The statute was signed into law in August 1984. Last week, the Commission for the first time considered its application in an enforcement context. I hope that the very existence of this statute and our demonstrated willingness to use it will act as a deterrent to "insider" trading.

Undertakings and Restatements: The final type of ancillary relief which is no longer considered "exotic" is the required filing with the Commission 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. The Commission seeks, when requiring such corrected disclosure, to prevent future violations. Other ancillary relief is often coupled with the restatement. For example, the temporary appointment of a special master or auditor to review corporate books and documents to insure compliance with negotiated undertakings and the accuracy of the new filings. One example of this kind of relief and how it works is found in the American Shipbuilding Company case. Back in the 1970's, the Commission was concerned with fraudulent financial reports used to disguise illegal political campaign contributions. In that vein, the Commission entered into a consent settlement with the American Shipbuilding Company after it was discovered that [illegible]aign contributions were

being made with corporate funds. In addition to securing an injunction against future violations, the Commission required the company's president to repay the contribution and required that the American Shipbuilding Company's books and records be reviewd by a special independent master with an eye towards uncovering any other illegality that would have an impact on the corporation's financial position. Upon completion of his examination, the master was required to disclose to the Commission and the American Shipbuilding Company's shareholders his findings.

There is no doubt that the Commission has been imaginative in the past in tailoring remedies that effectively implement its Congressionally-mandated goals. We would like to think that this is part of the reason that the American financial markets are secure, and that there is a favorable public perception of the integrity of those markets. Administrative sanctions and injunctive relief, along with the ancillary remedies I've mentioned, serve as meaningful deterrents, as well as powerful remedial tools. But, the SEC's mission is far from complete, as was recognized in recent speeches by Daniel Goelzer, the Commission's General Counsel, and James Treadway, a fellow Commissioner. Their remarks reflect my own growing concern that our enforcement tools could, perhaps, be more effective when we are dealing with those who violate the securities laws, particularly repeat offenders. I do not want the securities industry to be viewed as a revolving door for recidivists. Consequently, it appears that we may have to modify our approach in order to deter such violators. Perhaps we'll have to go to Capitol Hill to request increased clout. The

question has been raised as to whether the SEC should be given express authority to impose various forms of monetary relief -- an idea worthy of serious consideration.

In addition, I believe that there is one sometimes overlooked avenue which we could pursue. That is, to work within the statutory framework we now have to the fullest extent, and to be inventive. We should not ignore or shy away from any of the tools Congress has laid at our doorstep.

Let me give you some examples of what I mean. The first is not a remedy, but it's certainly a way to get there. I would urge increased use of Section 20(a) of the 1934 Act to impose direct liability on individuals responsible for violations of the securities laws. Section 20 provides that "every person . . . who directly or indirectly, controls any person liable . . . shall also be liable . . ." In my view, this section clearly grants authority to the Commission to bring an action against individuals who are control persons of entities which report to the SEC.

It is interesting that the Insider Trading Sanctions Act also amends Section 15(c)(4) to permit the Commission to name individuals, other than securities professionals, as defendants in administrative proceedings. Another tool infrequently used is that provided in Section 12(j) authorizing an administrative proceeding to revoke the registration of a security. This can be an effective remedy against the promoters of thinly traded shell corporations who use the badge of registration to palm worthless stock off onto the public.

Lately, an idea for ancillary relief has surfaced at the Commission that allows the Commission greater flexibility in administering the federal securities laws -- that idea is to remedy egregious violations of the law, particularly by repeat offenders, by a bar of certain violators from acting as corporate officers or directors. I have no doubt that a court, in the exercise of its equitable powers, could order such a remedy.

Dan Goelzer suggests corporate bars, as well as other innovative remedies, are now also possible in an administrative context as a result of amendments to Section 15(c)(4), which were adopted by Congress last year as part of the Insider Trading Sanctions Act ("ITSA") package. In its present formulation, Section 15(c)(4) enables the SEC to institute public administrative proceedings against _any_ person for violations of Sections 12, 13, 14 and 15(d). Clearly, individuals who cause a violation of those sections are within the purview of the section. The section expressly states that the Commission may order "any person who was a cause of [a] failure to comply due to an act or omission the person knew, or should have known, would contribute to the failure" . . . to comply with the Act. Even more important than _who_ falls within Section 15(c)(4)'s scope, is the flexibility that Section 15(c)(4) now gives the SEC in meting out meaningful sanctions. The Commission is empowered, pursuant to the section, to order violators to comply "upon such terms and conditions that the Commission may specify." This language should provide considerable latitude in fashioning relief.

I like Mr. Goelzer's rationale and agree with his conclusions. I applaud the insight Congress had when it granted us the much needy flexibility to promote compliance with the laws we administer. Let's hope that this is just the beginning of a trend. There are many instances where it would be appropriate to forbid a violator from acting in a specified capacity for a limited but defined period of time. Or, perhaps, to curtail the activities of the individual within a specified realm.

While this type of remedy has not been used with any great degreee of frequency so far, it is certainly not without precedent. The Commission has express statutory authority to censure, suspend or bar securities professionals such as registered representatives and investment advisers. Significantly, the Commission has successfully extended this authority to barring accountants and attorneys who practice before the Commission from that practice.

Recently, the Commission has used the bar device in a couple of consent decree situations, one of which involved a settlement with Florafax International, a nationwide floral delivery firm. A Commission investigation revealed that Florafax had employed improper accounting practices which resulted in the material overstatment of financial statements. In addition, it was discovered that Florafax's Chief Executive Officer and Chairman knowingly engaged in the improper accounting practices and actively concealed the fraud from Florafax's independent auditors. Rather than litigating the case, the defendants offered to settle for an injunction against future violations and for a restatement of the

prior financials. Moreover, the company's Chairman and Chief Executive Officer was enjoined and was required to resign from his position, as well as refrain from serving in the capacity of any corporate officer of Florafax for a period of three years. The bar on Joseph Hale was viewed as a novel twist, and the question has been asked whether such extraordinary relief was justified. As Commissioner Treadway explained in a recent speech:

> "Given Hale's controlling interest in Florafax, the extent of his involvement in the activities, and the multi-year nature of the violations, the Commission was convinced that nothing short of a bar would ensure Florafax's future compliance with the securities laws. That conclusion was buttressed by Hale's involvement in a 1983 litigated Commission case, SEC v. World-Wide Coin Investment, Ltd., et al. This was the first case litigated under the Foreign Corrupt Practices Act. Hale was found to have committed numerous violations of the FCPA, by systematically and intentionally dismembering World-Wide's internal auditing controls. Along the way, he also violated the Williams Act, the proxy rules, periodic reporting requirements, and the antifraud provisions. Hale was a repeat violator, and the deterrent impact of the first injunction was clearly negligible."

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 future violations are likely. 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. I haven't even been at the Commission a year yet, but I'm awfully tired of recidivists, and if we have a tool effective at curtailing the activities of repeat offenders, it should be used.

There have even been developments in the area of monetary relief. Very recently, the Commission took a new approach to the concept of what constitutes appropriate monetary relief when it voted to accept an offer of settlement from the broker-dealer firm of Thompson McKinnon. A Commission investigation determined that Thompson McKinnon 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. In trying to fashion an appropriate remedy for Thompson McKinnon, the Commission was somewhat constrained, not only by the language of Section 15(b)(4), but also by the size of Thompson McKinnon. You will recall that under Section 15(b)(4), the Commission could censure, suspend, or bar a broker-dealer for unlawful conduct. But in my view, censuring Thompson McKinnon would have been a mere slap on the wrist for relatively egregious conduct. However, barring or suspending it from operating as a broker-dealer, or from carrying on its stock loan business, would have had far-reaching draconian effects for not only the firm, but also its hundreds of employees and tens of thousands of customers and their participants in the stock loan business. Focusing on the language of Section 15(b)(4), which permits the Commission to impose conditions and/or limitations on the operations or activities of a broker-dealer, the staff negotiated an innovative

settlement with Thompson McKinnon. Pursuant to that settlement, Thompson McKinnon would tender to the Securities Investor Protection Corporation ("SIPC") the profits it earned from its stock loan business over a predetermined 10-day period. This remedy was obtained by settlement in the context of an administrative proceeding, but I see no reason why it should not be available in a civil injunctive action.

Some might question the SEC's authority to secure this type of relief -- some might call it a fine or a penalty. I, on the other hand, am 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 is just a limitation, novel perhaps, but certainly not _ultra vires_! When one thinks about limited ways in which the SEC can sanction large brokerage houses and others, it suggests we might need legislation granting it the authority to fashion monetary relief in any circumstance -- remedial, but not disruptive is the proper approach.

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 innovative, indeed. I look forward, during my tenure at the Commission, to helping mold the clay that Congress has given us to insure that we meet our goals. I hope, too, that we will be so successful in shaping creative remedies that they will no longer be deemed to be "exotic" or "extraordinary" -- but just effective!

Thank you.