Report Pursuant to Section 308(c) of the Sarbanes Oxley Act of 2002

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I. Executive Summary

As part of the Sarbanes-Oxley Act of 2002 ("Sarbanes-Oxley Act"), Congress provided an innovative legislative response to some of the financial and legal obstacles that have hampered the Commission's ability to obtain compensation for defrauded investors. Section 308(a) of the Sarbanes-Oxley Act ("Fair Fund" provision) authorizes the Commission to take civil penalties collected in enforcement cases and add them to disgorgement funds for the benefit of victims of securities law violations. Accordingly, the Fair Fund provision should increase the funds available to investors injured as a result of violations of the federal securities laws. Within the first six months of its enactment, the Commission has already authorized the Division of Enforcement to seek federal court approval of Fair Fund distributions. During that period, the Commission also has been implementing other measures to improve its collection of disgorgement and penalties.

As required by Section 308(c) of the Sarbanes-Oxley Act, the staff of the Commission has conducted a review and analysis of its enforcement actions over the five years preceding the enactment of the Sarbanes-Oxley Act to identify how such proceedings may best be utilized to provide restitution for injured investors. This report summarizes the findings and conclusions of that review. The report shows that:

- Significant payments, or the failure to make such payments, by a small number of defendants has a disproportionate impact on the Commission's overall collection success;
- Emergency enforcement actions (seeking temporary restraining orders and asset freezes), where appropriate, can limit investor losses and increase the chances of returning funds to investors in almost all types of cases, particularly when the Commission receives early notice of the misconduct;
- The appointment of a receiver, where appropriate, enhances the Commission's ability to maximize investor recovery; and
- The Commission's historic practice of allocating defendants' payments first to disgorgement and last to penalties has produced results, within prior statutory restrictions, consistent with the principle on which the Fair Fund provision is based – that all monies recovered in Commission actions be made available first to compensate the victims of securities fraud.

Nevertheless, there continue to exist several practical and legal obstacles to providing compensation to injured investors. These obstacles include disgorgement collection difficulties, evidentiary burdens in enforcement actions, and costs to create and administer distribution plans. Compensating injured investors is especially difficult with issuer financial fraud violations because they may cause huge investor losses that dwarf, by several orders of magnitude, any profit that the violators may have made. To address these concerns, and to improve its record of compensating investors, the Commission has

already undertaken some important initiatives. These include enhanced efforts at "real time" enforcement, and current and planned improvements in collection efforts.

Ultimately, the Commission concludes that several additional legislative amendments may help fulfill the investor compensation goals of the Fair Fund provision, and enhance the Commission's ability to collect disgorgement and penalty monies owed by securities violators.

- First, we recommend amending the Fair Fund provision to permit the Commission to use penalty monies ordered in a particular matter for distribution to injured investors in that matter regardless of whether disgorgement was ordered;

- Second, we recommend new legislation granting express authority to the Commission to contract with private collection attorneys; and

- Third, we recommend new legislation to exclude securities cases from state law property exemptions, such as homestead exemptions.

II. Introduction

In Section 308(c) of the Sarbanes-Oxley Act, Congress required the Commission to "review and analyze enforcement actions by the Commission over the five years preceding the enactment of this Act that have included proceedings to obtain civil penalties or disgorgements to identify areas where such proceedings may be utilized to efficiently, effectively, and fairly provide restitution for injured investors; and other methods to more efficiently, effectively, and fairly provide restitution to injured investors, including methods to improve the collection rates for civil penalties and disgorgements." This provision further required the Commission to report its findings to the Committee on Financial Services of the House of Representative and the Committee on Banking, Housing, and Urban Affairs of the Senate within 180 days of enactment. Congress further instructed the Commission to use its findings "to revise its rules and regulations as necessary," and to include in its report "a discussion of regulatory or legislative actions that are recommended or that may be necessary to address concerns identified in the study." The Commission has reviewed and analyzed the relevant enforcement actions, and is reporting its findings, including recommendations for Commission and legislative actions, in this report.

III. Background on Monetary Remedies

A. Disgorgement

The Commission obtains disgorgement orders in a wide variety of its enforcement actions. Disgorgement is a well-established, equitable remedy applied by federal district

courts and is designed to deprive defendants of "ill-gotten gains."[1] In contrast to actions for restitution or damages in private actions, which are brought to compensate fraud victims for losses, disgorgement orders require defendants to give up the amount by which they were unjustly enriched.[2] Before exercising their discretion to order defendants to pay disgorgement, courts have required findings that a causal connection exists between the defendants' wrongdoing and amounts to be disgorged.[3] "[D]isgorgement extends only to the amount with interest by which the defendant profited from his wrongdoing."[4] To assist in determining the amount of disgorgement, the Commission often seeks, and courts require, that defendants provide an accounting of the funds and other assets they received in the course of their wrongdoing.[5]

In ordering disgorgement, courts have not required the Commission to determine the exact amount of the defendant's ill-gotten gains. The Commission has the burden, though, of showing that the amount sought is a "reasonable approximation of profits causally connected to the violation."[6] Once the Commission has satisfied its burden, a defendant who asserts that the amount should be less has the burden of demonstrating that the amount should be reduced.[7] As long as the measure of disgorgement is reasonable, courts have held that the wrongdoer should bear the risk of uncertainty regarding the precise amount.[8]

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[1] With the enactment of the Securities Enforcement Remedies and Penny Stock Reform Act of 1990, 104 Stat. 931 (1990), the Commission has the authority to seek and impose disgorgement orders in administrative proceedings as well.

[2] *See* SEC v. Blavin, 760 F.2d 706, 713 (6th Cir. 1985). Restitution is the repayment by a defendant of funds, or their equivalent, to an injured person. When the Commission requests courts to order disgorgement and approve plans to distribute those funds to investors, some courts describe this as restitution. *See* SEC v. First Pacific Bancorp, et al., No. CV-93-07510 (C.D. Cal. 1995), *aff'd*, 142 F.3d 1186 (9th Cir. 1998). Courts may at times use the terms disgorgement and restitution interchangeably and may on occasions equate them. *See* Tull v. United States 481 U.S. 412, 424 (1987); SEC v. Blatt, 583 F.2d 1325 (5th Cir. 1978). However, the concepts are distinct. Restitution is intended to make investors whole, and disgorgement is meant to deprive the wrongdoer of their ill-gotten gain. Defendants in Commission enforcement actions, especially in issuer financial fraud and offering fraud cases, may cause investor losses that are larger than any profit disgorgeable by them.

[3] *See, e.g.,* SEC v. Banner Fund Int'l, 211 F.3d 602, 617 (D.C. Cir. 2000); SEC v. First City Financial Corp., Ltd., 890 F.2d 1215, 1231 (D.C. Cir. 1989); SEC v. Blatt, 583 F.2d 1325, 1335 (5th Cir. 1978).

[4] Blatt, 583 F.2d at 1335.

[5] *See, e.g.,* SEC v. American Bd. of Trade, 830 F.2d 431 (2d Cir. 1987) (with respect to federal district court actions); Section 21C(e) of the Securities Exchange Act of 1934 ("Exchange Act") (with respect to certain administrative proceedings).

[6] SEC v. First City Financial Corp., Ltd, 890 F.2d 1215, 1231 (D.C. Cir. 1989).

[7] SEC v. Great Lakes Equities Co, et al., 775 F. Supp. 211, 214 (E.D. Mich. 1991) (citing SEC v. First City Financial Corp., Ltd., 890 F.2d at 1232).

[8] SEC v. Warde, 151 F.3d 42, 50 (2d Cir. 1998); SEC v. Patel, 61 F.3d 137, 140 (2d Cir. 1995); SEC v. First City Financial Corp., Ltd., 890 F.2d at 1232.

When the Commission receives payment of disgorgement, it may distribute such money to injured investors if appropriate. The Commission transmits disgorgement sums collected to the U.S. Treasury if the Commission does not distribute disgorgement to injured investors.

B. Civil Penalties

The Commission obtains orders imposing civil monetary penalties against defendants in a wide variety of its enforcement actions, and its authority to seek penalties is exclusively governed by statutes.[9] Though the Commission has authority to seek penalties in all federal district court actions, the Commission does not have authority to penalize respondents in certain agency proceedings, including stop order proceedings, cease-and-desist proceedings, and administrative proceedings under the Commission's Rules of Practice and Investigations ("Rules of Practice") against professionals such as attorneys and accountants. In fact, in an administrative forum, the only persons from whom the Commission may obtain penalties are regulated entities and securities industry professionals, such as stockbrokers, investment advisers and transfer agents,[10] except the Commission may, in some circumstances, seek a penalty in a cease and desist proceeding against anyone who was a cause of a violation of Section 10A of the Exchange Act.[11]

In civil actions, the decision whether to impose a penalty, and the determination of the amount of penalty to be imposed, are subjects left to the courts' discretion, within statutory limits. In insider trading cases, the Commission is authorized to seek up to three times the amount of profit gained or loss avoided from insider trading.[12] In non-insider trading cases, the amount of penalty that can be sought depends on the nature of the wrongful conduct, whether the penalty is sought against a natural person or entity, and whether the conduct involved substantial loss or risk of substantial loss. Available penalties are structured in tiers. As conduct becomes more egregious, the maximum penalty increases.[13] Courts consider a wide variety of case-specific factors in

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[9] *See* Section 20(d) of the Securities Act of 1933 ("Securities Act"), Sections 21(d) and 21B of the Exchange Act, Sections 203(i) and 209(e) of the Investment Advisers Act of 1940 ("Advisers Act"), and Sections 9(d) and 42(e) of the Investment Company Act of 1940 ("Investment Company Act").

[10] *Compare, e.g.*, Section 21C of the Exchange Act (which applies to any person, but does not contain a penalty provision) *with* Sections 15(b) and 21B of the Exchange Act (which apply to brokers and persons associated with brokers, and contain a penalty provision).

[11] Section 10A(d) of the Exchange Act. In addition, Section 105(c)(4)(d) of the Sarbanes-Oxley Act authorizes the Public Company Accounting Oversight Board ("Board") to impose penalties against registered public accounting firms, and their associated persons, for certain violations. Section 107 provides for Commission oversight of the Board, including review of Board disciplinary action.

[12] Section 21A of the Exchange Act.

[13] *See, e.g.,* Section 21(3)(B) of the Exchange Act.

determining the amount of penalty, including the egregiousness of violations, the defendant's mental state in committing the violations, whether the misconduct was repeated or isolated, and the amount of "gross pecuniary gain."[14]

The penalty statutes applicable to administrative proceedings against regulated entities and securities industry professionals are also structured in tiers, and as conduct becomes more egregious, the maximum penalty increases.[15] The statutes applicable to these cases expressly delineate the factors that the Commission may consider in determining whether a penalty is in the public interest. These factors include the mental state of the respondent in committing the violation, the harm done to other persons, the extent of unjust enrichment, and the respondent's financial ability to pay a penalty.[16]

Prior to the Sarbanes-Oxley Act, when the Commission received payment of a penalty, it was required to transmit such money to the U.S. Treasury. Section 308(c) changed the law to permit penalty sums collected to be added to disgorgement funds in certain circumstances.

IV. Results of the Study

A. Disgorgement and Penalty Cases Studied

To conduct the review and analysis required by Section 308(c)(1) of the Sarbanes-Oxley Act, the Commission's Office of Economic Analysis ("OEA") created a representative sample of the appropriate enforcement cases, i.e., enforcement actions in which the Commission sought and obtained disgorgement or penalties within the five years preceding July 31, 2002. In brief, OEA determined the optimal size of the sample and then randomly selected the sample cases. (The details of OEA's methodologies are provided in Appendix A.) The sample cases OEA selected covered eight types of cases, including six of the most important Enforcement program areas: offering fraud, issuer financial fraud and reporting, broker-dealer, insider trading, non-broker-dealer regulated entities, and market manipulation.[17] The studied cases involve 513 defendants.

Next, staff from the Commission's Division of Enforcement ("Enforcement") reviewed and analyzed the sample cases selected by OEA. As part of that review, Enforcement staff sought to identify key issues and themes raised in these cases. The following section describes the most significant issues identified by the staff's review.

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[14] *See, e.g.,* SEC v. Ellis Deyon, et al., 977 F. Supp. 510 (D. Me. 1997), aff'd, 201 F.3d 428 (1st Cir. 1998) (greater penalties against the defendant who acted knowingly as opposed to recklessly).

[15] *See, e.g.,* Section 21B(b) of the Exchange Act.

[16] *See, e.g.*, Section 21B(c) of the Exchange Act.

[17] Four defendants identified by OEA were charged with violations relating to newsletter/touting or related party transactions. The Commission did not include these defendants in the study.

1. Collection of Large Individual Payments

An issue common to the collection of monetary payments in all types of enforcement cases is the great impact that large individual payments have on the Commission's overall collection success. In the study, payments by just a handful of defendants account for a disproportionate share of all amounts collected.

For example, in the issuer financial fraud and reporting cases studied, involving 35 defendants, two defendants in two separate enforcement actions account for over 70 percent of the disgorgement ordered and 95 percent of the disgorgement paid. One of those defendants, Michael Saylor, the chief executive officer of MicroStrategy, Inc., was alleged to have sold a significant amount of stock and was ordered to disgorge over $8 million and pay a $350,000 penalty.[18] Saylor paid the disgorgement into a class action fund, and paid the penalties to the U. S. Treasury. In the other matter, SEC v. Bond Dellapp Fletcher, et al.,[19] Fletcher, the president of a customer of the issuer (Centennial Technologies, Inc.), was alleged to have aided and abetted the issuer's fraud by fabricating purchase orders. Fletcher received Centennial stock and other compensation valued at over $6 million. The court-appointed receiver was able to collect and liquidate approximately $3.6 million of Fletcher's assets, and payment of the remainder was waived due to his financial condition. Recently, the court authorized the receiver to turn over those funds to an escrow agent in a parallel class action brought by the Centennial investors for distribution to those investors.

The broker-dealer and insider trading cases studied also bear out these findings. There were 65 defendants in the broker-dealer cases studied and three of them paid nearly all of the $50 million in disgorgement collected from these cases. One such defendant, Michael Milken, was alleged to have violated a Commission order barring him from associating with a broker, and paid $47 million in disgorgement. The other defendants were brokerage firms, Lazard Freres & Co. and BT Alex Brown Inc., who paid approximately $450,000 and $600,000 respectively. Prominent brokerage firms may have the resources to pay large amounts of disgorgement and penalties, and have business and regulatory reputations that they want to protect by fulfilling their financial obligations to the Commission. As to insider trading, though the study covered 118 defendants, 11 of these defendants account for approximately 80 percent of all disgorgement collected. For the most part, these 11 defendants were executives, such as vice presidents of companies, directors, financiers, and business advisors. The significant earning power of these executives may be a factor in the payment of these disgorgement orders.[20]

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[18] SEC v. Michael Jerry Saylor, et al., Lit. Rel. 16829 (December 14, 2000).

[19] Lit. Rel. 15818 (July 21, 1998).

[20] The study of payments of penalties by defendants in issuer financial fraud and reporting cases also supports this conclusion. The study shows that penalties ordered in these cases ranged from $5,000 to $350,000. The Commission collected nearly 90 percent of these penalties. Defendants in these cases often are former chief executive officers, chief financial officers, accountants, and other high-level managers

2. Negative Effect of a Few Delinquent Defendants

Similarly, on the other side of the ledger, a few defendants account for a disproportionate amount of disgorgement ordered and not paid. In the offering fraud cases studied, of the 207 defendants, four were ordered to pay a total of $529 million in disgorgement – just under half of all disgorgement ordered – and have paid none of what they owed. One of these defendants, ETS Payphones, Inc., was ordered to pay $190 million, and approximately $5 million in assets belonging to Charles E. Edwards, its control person, were frozen after the Commission sued ETS and Edwards alleging that they fraudulently sold securities to over 10,000 mostly elderly investors.[21] ETS Payphones sought and received a waiver of payment due to its demonstrated financial inability to pay. In another case, Richard Goettlich was jointly prosecuted by the U.S. Attorney's Office for the District of New Jersey and the Commission for the $295 million Ponzi scheme he and some of his family members were alleged to have operated through First Interregional Equity Corporation ("FIEC"), a registered broker-dealer now in liquidation, and First Interregional Advisors Corporation ("FIAC"), formerly an equipment lease finance company that is now a debtor in bankruptcy.[22] Goettlich defaulted in the Commission action, was ordered to pay over $123 million in disgorgement, and pled guilty to an eight-count criminal indictment and is awaiting sentencing. All of Goettlich's known assets have been seized and liquidated and are part of the approximately $33.4 million in assets obtained from all defendants.[23]

Analysis of the other types of enforcement cases, except for issuer fraud and reporting violations, also supports the finding that a handful of delinquent defendants account for a disproportionate share of money not collected. In the broker-dealer cases studied, four defendants were ordered to pay nearly $172 million in disgorgement, which means that approximately six percent of the defendants were ordered to pay approximately 84 percent of all disgorgement. Only one of these four defendants has paid disgorgement in full; one of the remaining defendants received a partial waiver and the other two defendants are delinquent. Similarly, a small number of the defendants in the market manipulation cases account for a disproportionate share of the disgorgement ordered. In the cases studied, courts ordered six defendants to pay a total of $52 million, which is approximately two thirds of all disgorgement ordered in these cases. These defendants have paid a total of just over $2 million to date.

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who have earned significant income. These defendants may therefore be more likely to have the financial resources to pay penalties than defendants in other types of cases.

[21] SEC v. ETS Payphones, Inc., et al., Lit. Rels. 16813 (November 30, 2000) and 17436 (March 26, 2002). Edwards appealed the granting of a preliminary injunction, and the court of appeals reversed the district court. SEC v. ETS Payphones, Inc. et al., 300 F.3d 1281 (11th Cir. 2002), *reh'g denied per curiam* (November 15, 2002).

[22] SEC v. Richard Goettlich, et al., Lit. Rel. 16160 (May 25, 1999).

[23] The bankruptcy and Securities Investor Protection Act of 1970 trustees collected the assets of FIAC and FIEC.

The findings in the investment adviser and insider trading cases studied also demonstrate the effect of nonpayment of large disgorgement orders by a small number of defendants. Disgorgement orders against two insider trading defendants account for approximately 45 percent of the disgorgement ordered in those cases. The first defendant, Sam M. Antar, the father of "Crazy" Eddie Antar, was alleged to have sold approximately $15 million of Crazy Eddie, Inc. stock while in possession of non-public information about a financial fraud at the company.[24] The Commission has vigorously pursued Antar and others to make the "Crazy Eddie" defendants disgorge their illicit profit. For example, in December 2000, a court found that Sam M. Antar had fraudulently conveyed assets to three transferees, and that the transferees held the assets in constructive trust for the benefit of the Commission.[25] The second defendant, Miko Leung, was ordered to pay approximately $16 million in disgorgement.[26] Leung eluded service of process for three years before service was accomplished by publication overseas. Neither of these defendants has paid any money to the Commission.

3. Disgorgement of all Compensation for Corporate Malfeasors

In the area of issuer financial fraud and reporting violations, the Commission seeks and obtains disgorgement and penalties from individuals who receive bonuses based on the misleading results of operations, sell the issuer's stock during the relevant period, or otherwise profit from their violations.

Recently, in the more egregious issuer financial fraud and reporting cases, the Commission has sought the salaries defendants earned while committing fraud. In SEC v. Adelphia Communications Corp., et al., John Rigas, the former chief executive officer and chairman of the board of Adelphia, and his sons and other executives were charged with making materially misleading statements to cover up their use of corporate funds to purchase luxury homes, acquire other personal assets, and pay margin calls.[27] The Commission is seeking injunctions, officer and director bars, accountings, disgorgement of all compensation received after the fraud began, disgorgement of all property unlawfully taken through undisclosed third party transactions, and disgorgement of severance payments; and penalties. Similarly, in SEC v. L. Dennis Kozlowski, et al., several high level executives of Tyco were charged with failing to disclose to shareholders that the company had loaned them millions of dollars to fund their extravagant lifestyles, including their purchases of yachts, luxury apartments, vacation estates, fine art, and various investments.[28] The Commission is seeking injunctions,

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[24] SEC v. Sam M. Antar, et al., Lit. Rel. 16817 (December 5, 2000).

[25] Id.

[26] SEC v. Miko Leung, et al., Lit. Rel. 17458 (April 4, 2002).

[27] Lit. Rel. 17627 (July 24, 2002).

[28] Lit. Rel. 17722 (September 12, 2002).

officer and director bars, disgorgement of all salaries and other compensation they received after the fraud began, disgorgement of all loan amounts not repaid by them to Tyco, disgorgement of interest imputed at market rates on low interest or interest-free loans, disgorgement of losses avoided from their sale of Tyco stock, and penalties.

Though these cases have not yet gone to trial, or settled prior to a trial, the Commission believes that seeking disgorgement of corporate officer compensation is well founded in these circumstances. Court orders requiring such disgorgment are necessary to deter would-be corporate malfeasors from abusing the public trust and help recompense injured investors.

4. Contribution of Emergency Action

Emergency action, in the form of a temporary restraining order and an asset freeze, tends to have a positive impact on the Commission's ability to obtain money from defendants where the Commission is able to meet the legal threshold for obtaining such relief. Asset freezes against corporate defendants restrict their payments to suspected wrongdoers and preserve assets in the corporation for the benefit of investors. The positive impact of emergency action is particularly evident when the Commission learns of, and is able to halt, ongoing illegal conduct before the defendant has had a chance to dissipate the ill-gotten funds. For example, in the offering fraud cases studied, on a per defendant basis, the largest amounts of disgorgement paid ranged from $1.7 million to $6.5 million, for a total of approximately $33 million paid by eight defendants. Thus, these eight defendants, who comprise less than 4 percent of the offering fraud defendants studied, account for nearly 75 percent of the disgorgement collected to date. Seven of these defendants were the subject of emergency actions – during or immediately after the fraud -- seeking temporary restraining orders. The Commission also obtained asset freezes with respect to six of the defendants. Accordingly, we conclude that, where appropriate, temporary restraining orders and asset freezes may stop ongoing investor losses and increase the amount of money available to compensate injured investors.

This conclusion is also borne out by the review of insider trading and market manipulation cases. With respect to one insider-trading defendant, Shahryar Soroosh,[29] the fact that the court granted an asset freeze was an important factor in being able to collect all of the $505,000 disgorgement ordered. As to market manipulation cases studied, three cases, involving a total of 49 defendants, account for over $10 million collected. In two of these cases, the Commission sought and obtained temporary restraining orders and asset freezes. In the other case, after the Commission filed the action, two of the defendants died and their estates were ordered to pay disgorgement. One of these estates disgorged over $1 million. Thus, asset freezes have been a device that facilitates the collection of disgorgement.

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[29] SEC v. Shahryar Soroosh, Lit. Rels. 15143 (November 1, 1996) and 15553 (November 5, 1997).

B. Distribution Plans Studied

The focus of the second segment of this study is distributions to investors as a result of Commission civil actions and administrative proceedings. This segment covers cases in the past five years in which disgorged funds have been distributed, or proposed to be distributed, to injured investors. The purpose of this segment is to analyze what aspects of cases make it more likely there will be a distribution to injured investors, how implementing the Fair Fund provision may impact distributions, and to find ways to increase the incidence of distributions.

In a federal district court action, the court reviews the proposed plan of distribution and holds a hearing to determine whether it is "fair and reasonable."[30] For administrative proceedings, the Commission has special rules regarding a notice and comment period before the hearing officer or the Commission may approve a distribution plan and the administrator may implement the plan.[31]

In federal district court, the typical distribution plan requires a claims administrator to review and process the claims, though if the court already has appointed a receiver, the receiver may fulfill the function of a claims administrator or supervise the claims process. The claims administrator's fees and expenses, if approved by the court, are deducted from the distribution fund. In contrast, all of the costs associated with distribution plans in administrative proceeding are borne exclusively by the Commission.

1. Distributions in Federal District Court Actions

Most of the money returned to investors comes from the successful conclusion of actions filed in federal district court. Eighty-seven district court actions involving 358 defendants were reviewed in which, at the outset of the litigation, there was reason to believe that a payment to investors might result.[32] In 34 of these cases, payments totaling a little over one billion dollars were made directly to approximately 125,000 investors. The cases reviewed also included 14 where a payment to investors is expected, but has not yet been made.[33] In four cases, payment of disgorgement was made to investors through an alternative method, e.g., payment into an investor fund established in a private shareholder lawsuit, or payment to a bankruptcy trustee for distribution to creditors,

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[30] SEC v. Stephen Sui-Kuan Wang, et al., 944 F.2d 80, 85 (2d Cir. 1991) (court approved plan that treats some options traders differently than traders of the common stock).

[31] *See* Rules of Practice 610 through 614.

[32] In certain cases, a distribution to investors will not be feasible. The Commission may sue defendants it believes to be indigent for the purpose of preventing future harm to investors and holding wrongdoers accountable for their misconduct.

[33] These 14 cases included situations where a distribution plan has been filed, but has not yet received final approval by the court. Also included in this group are cases where the receiver is in the process of completing a distribution plan to be filed with the court.

including investors. In the remaining 35 cases, payment was generally made to the Department of the Treasury, or no payment has yet been made.

a. Payments by Receivers

In some cases, the Commission may ask a court to place an entity in receivership, to continue operating a business until the receivership estate can be wound up and a distribution of assets made to investors. Similarly, the Commission may seek the appointment of a trustee or distribution agent (or claims administrator) to take control of assets, or otherwise collect and liquidate assets from the defendants and their agents and assigns, and distribute the money collected to investors. For purposes of this report, a receiver, distribution agent or trustee will each be referred to as a "receiver." As an agent of the court, a receiver acts independently of both the Commission and the defendant in carrying out its prescribed duties. Generally, the appointment of a receiver, where appropriate, facilitates investor recovery.

The decision to seek a receiver in a case may be made at any stage of the litigation. In cases involving large amounts of illiquid assets (e.g., automobiles, real property, livestock, limited partnerships, etc.) or known or suspected overseas or hidden assets, collection and disposition of the assets is a difficult, time-consuming task, sometimes beyond the limited resources of the Commission. Depending on the order appointing the receiver, he or she may also have the power to file his or her own related lawsuits to recover assets or take other actions deemed necessary to return money to investors. In determining whether to ask a court to appoint a receiver, the Commission must consider whether it is reasonable to expect that the money and other assets collected by a receiver will be sufficient to justify the expense of hiring the receiver.[34]

A receiver hired solely for the purpose of distributing assets must identify harmed parties, provide notice and invite claims, review and categorize claims, and distribute the collected funds based on the amounts of the claimed losses. The receiver also withholds appropriate amounts for future claims, tax liability, his or her own fees and expenses, and the fees and expenses of accountants, lawyers and other professionals retained by the receiver to carry out the receiver's duties. This type of receiver is typically selected after disgorgement has been collected.

Twenty-eight of the cases reviewed involved collection and/or distribution by a receiver. A receiver often makes the process of returning money to investors more efficient. In 20 of the 28 cases involving a receiver, investors have received or are expected to receive a total distribution in excess of $119,406,360. Only five of the 28 receiver cases did not result in a distribution or proposed distribution of assets to investors. The results of each of those cases turn on particular facts and circumstances. For example, in <u>SEC v. First American Reliance, Inc., et al.</u>,[35] no disgorgement was

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[34] For the most part, receivers are paid a fee for their services, plus reimbursement for actual costs incurred. They are paid out of the proceeds of the money collected.

[35] Lit. Rel. 15931 (October 6, 1998).

ordered by the court after the individual defendant being sued committed suicide, and the receiver placed the entity defendant in bankruptcy. In another case, SEC v. Sidney W. Sers, et al.,[36] investors opted to take control of the defendant company and, rather than receive a distribution, turn over the approximately $4,000,000 collected to the company in exchange for shares of stock of the "new" entity.

By using receivers where appropriate, the Commission is able to leverage its resources to maximize investor recovery. For example, in SEC v. Friendly Power Co., Inc., et al.,[37] the receiver was able to return $2,341,423 to 350 investors, even though only $1,645,674 was collected from the defendant in disgorgement. The receiver accomplished this result by bringing a separate lawsuit against outside counsel for the entity defendants even though the money the attorney received was compensation for a service provided, and the attorney was not alleged to have committed a securities law violation. The proceeds of that lawsuit were included in the distribution amount. A receiver may also bring to bear his or her experience and expertise to enhance investor recovery. In SEC v. John Aptt, et al.,[38] approximately 200 investors recovered an estimated $4,500,000 based in large part on the efforts of the receiver. Applying his international business, international law and real estate expertise, the receiver took over the defendants' primary asset (a real estate development in Costa Rica), finished the real estate projects in process and sold them for the investors' benefit. He also forced the entity into bankruptcy for the investors' protection.

b. Payments By Alternative Methods

The fact that a distribution in a Commission action has not been made does not necessarily mean that investors have not been compensated. During the course of some civil actions, assets that would have ordinarily been distributed through a receiver may be turned over to a bankruptcy trustee for disposition through a bankruptcy proceeding. For example, in John F. Aptt, *supra*,[39] the Commission first obtained an asset freeze against the defendant corporation, securing approximately $5,000,000. When the company filed for liquidation in bankruptcy, the frozen amount was transferred to the bankruptcy estate. After receiver and bankruptcy trustee fees, 200 investors received a net payment of $4,500,000.

In addition, the Commission will often offset its own claims for disgorgement against orders to pay criminal restitution. In SEC v. First Americans Bank Ltd., et al.,[40]

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[36] Lit. Rel. 16386 (December 10, 1999).

[37] Lit. Rel. 16874 (January 29, 2001).

[38] Lit. Rel. 15361 (May 8, 1997).

[39] Id.

[40] Lit. Rel. 15734 (May 7, 1998).

the court ordered disgorgement of $2,000,000, which was satisfied by amounts secured in an asset freeze. However, as the criminal restitution amount of $6,800,000 was much larger than the amount of the defendants' ill-gotten gain, the frozen assets were transferred to the restitution fund established in the criminal action for distribution to 260 investors.

Further, in SEC v. William Goren, et al.,[41] the individual defendant's disgorgement and interest obligations were waived after he demonstrated an inability to pay the amounts ordered. The entity was placed in receivership, and is currently in the process of liquidation through the Securities Investor Protection Corporation (SIPC). To date, investors have received more than $20,000,000 through the SIPC liquidation process.

c. Interim Distributions

The Commission makes every effort to return promptly to investors disgorged and other funds collected that are available for distribution. In some cases, through an early settlement, the Commission is able to collect and quickly distribute the entire amount of disgorgement owed shortly after litigation is commenced. More often, the Commission may obtain some, but not all, of the money owed early in the course of litigation, and additional amounts are collected as litigation progresses.

Because the process of litigating a civil injunctive action may take years, court-appointed receivers may make interim distributions to investors as money is collected. For example, in SEC v. Continental Wireless Cable Television, Inc., et al.,[42] a securities offering fraud matter, an initial distribution to a little more than 1,000 investors of approximately $9,551,951 was followed by a later distribution of $5,493,142.73 to another 1,000 investors. Similarly, in SEC v. Pacific Waste Management, et al.,[43] approximately $363,439 was paid to 350 investors in a series of distributions from July through December 1997, after the Royal Court of Guernsey ordered that $195,305 be repatriated to the United States from Guernsey. The goal of an interim distribution is to recompense investors, at least in part, while they await any additional compensation that may be obtained in the litigation.

In some cases, it makes sense to defer distribution until the conclusion of the case. If, for example, the Commission obtains funds early in the litigation from some, but not all defendants, the collected funds may be insufficient to justify immediate distribution. In such a case, since the feasibility of a distribution plan would depend on the receipt of additional funds that may prove collectible, the distribution may be deferred until the ultimate recovery amount becomes more certain. In addition, economies of scale may

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[41] Lit. Rel. 16442 (Februrary 17, 2000).

[42] Lit. Rel. 14800 (January 29, 1996).

[43] Lit. Rels. 13617 (April 21, 1993), 15300 (March 18, 1997).

justify carrying out a single distribution at the conclusion of the litigation, rather than making interim payments to investors. For example, in SEC v. J&K Global Marketing Corp., et al.,[44] approximately $4,200,000 of the nearly $7,000,000 owed in disgorgement has been frozen in accounts in Luxembourg and Grenada. Once the money there has been repatriated, a single distribution will be made to the approximately 13,000 investors who were harmed. Given the large number of harmed investors, and the ratio of investors to money to be distributed, more than one distribution would be impracticable and would decrease the amount ultimately received by investors.

d. Payments to Treasury or no Payment at All

Unfortunately, payment to investors is not always economically feasible. In some circumstances, the amount of money collected is too small, or the number of identifiable investors too large (in comparison to the amount collected) to justify a distribution to investors. In those circumstances, the Commission routinely asks the court to direct that disgorgement amounts collected be paid to the Department of the Treasury. SEC v. Club Atlanta Travel, et al.[45] and SEC v. Jeffrey L. Fuller, et al. [46] are two such cases.

In Club Atlanta Travel, a securities offering fraud case, the defendants paid a total disgorgement amount of $76,698, representing their personal ill-gotten gain. However, because the matter involved a massive fraud in which $32,000,000 was raised from approximately 24,000 investors across the United States and Canada, it was not possible to make a meaningful distribution of the disgorgement amount to the harmed investors. The money collected was paid to the Treasury.

In Fuller, a financial reporting fraud matter, two defendants paid the full disgorgement amount ordered ($149,120), and a third paid a penalty of $25,000. However, the disgorgement amounts, which approximated the defendants' ill-gotten gains in the form of profits from stock trading at the time of the false information were small compared to the number of harmed investors. This made a distribution to investors infeasible.[47] Again, the money collected was paid to the Treasury.

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[44] Lit. Rels. 16961 (April 13, 2001), 17811 (October 29, 2002).

[45] Lit. Rel. 17008A (May 17, 2001).

[46] Lit Rel. 16887 (February 5, 2001).

[47] Even if this matter had occurred after the enactment of Section 308(a) of the Sarbanes-Oxley Act, it would not have been possible to add the penalty amount to the disgorgement sum, since the penalty was ordered against a party who was not ordered to pay disgorgement, and the parties paying disgorgement were not assessed penalties. If the provision were revised as the Commission recommends in Section VII.A., *infra*, it may be possible to invoke the Fair Fund provision in future cases with similar issues.

e. Penalty or Other Payments Where Disgorgement Not Formally Ordered

On the other side of the spectrum, in some cases, distributions are made to investors even though the payment ordered is not referred to as disgorgement. In SEC v. Brycar Financial Corporation,[48] the court granted the Commission's request for an asset freeze and appointed a receiver to collect and distribute the assets of the defendants. To date, the receiver has collected and distributed $618,838 of receivership assets to 387 investors. In a related criminal action, Bryan Egan, the president of Brycar Financial Corporation, was ordered to pay $4,800,000 in restitution. In SEC v. Michael T. Higgins,[49] a hedge fund adviser and the fund itself were ordered to surrender all assets to a receiver. Ultimately, the hedge fund turned over $2,146,000 in disgorgement-like payments to the receiver, which was subsequently distributed to 11 investors (less fees and taxes). In Prudential Securities, Inc.,[50] the court required the defendant to establish a claims fund, and place in it an initial amount of $330,000,000. The court further ordered that the defendant satisfy any claims made exceeding the initial amount. The 105,000 investors affected ultimately received approximately $940,000,000 in payment through the fund. In addition, the defendant settled a separate administrative proceeding with the SEC, paying $10,000,000 in penalties.

f. Other Circumstances

A federal district court sitting in equity has wide latitude in determining what remedies to apply. On occasion, a court may decide to impose an unusual remedy based on the facts and circumstances of an individual case. For example, in SEC v. First Zurich National USA, LLC, et al.,[51] an asset freeze ordered at the outset of the litigation secured $50,000 in cash and office equipment for distribution to investors. Later in the case, the court ordered disgorgement of $4,370,425 and $100,000 in penalties against the defendants. Because the amount secured was insufficient to make a distribution to the approximately 1,000 investors cost-effective, the court ordered that the assets (minus costs of securing premises and cataloguing property) be given to charities and local public schools.

2. Distributions in Administrative Proceedings

During the past five years the Commission has distributed or proposed to distribute funds to injured investors in 16 administrative proceedings in which the defendants were ordered to pay disgorgement. These cases do not include administrative proceedings in which the respondents paid only penalties or paid money directly to third

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[48] Lit Rel. 16713 (September 20, 2000).

[49] Lit. Rel. 16547 (May 10, 2000).

[50] Lit. Rel. 13840 (October 21, 1993). Distributions in this case were completed as of June 22, 1998.

[51] Lit Rel. 16011 (December 29, 1998).

parties as a result of an undertaking instead of through a payment to the Commission and distribution by the administrator. For example, in April 2000, the Commission brought fraud charges against ten Wall Street and regional brokerage firms stemming from conduct commonly known as "yield burning."[52] The resolution of these actions, with the cooperation of NASD Regulation, Inc. and various federal agencies, resulted in the brokerage firms paying, to various alleged victims, including municipalities and the U.S. Treasury, more than $172 million of funds that were not specifically denominated as disgorgement. The brokerage firms made these payments pursuant to undertakings rather than direct Commission orders. Payments of this kind are beyond the scope of this study because the payments are not disgorgement or penalties.

The disgorgement distributions in administrative proceedings primarily relate to frauds committed by securities industry professionals. Of the 16 cases in this study, six primarily involve broker-dealer violations and seven primarily involve investment adviser violations. One offering fraud and two market manipulation cases make up the rest.

For the most part, the amounts collected in these 16 cases were distributed to defrauded customers of brokers and clients of investment advisers -- on a pro rata basis if the disgorgement paid by defendants was insufficient to satisfy all claims. In two of the cases, the funds were to be distributed to bankruptcy claimants, which include injured investors.

a. Small Number of Claimants

Of the 14 non-bankruptcy distributions, approximately 65 percent of the distributions involved a relatively small number of injured customers, clients, and investors. Specifically, nine of these cases involved distributions of funds to between three and 40 account holders. Cases involving a small number of injured investors may constitute a greater relative percentage of distributions made because administration costs on a per recipient basis are relatively small.

b. Moderate Number of Claimants

In each of the remaining five non-bankruptcy distributions – accounting for approximately 35 percent of the distributions made -- the number of account holders who received funds ranged between 80 and 300, with an average of 161 account holders. Though these numbers are relatively high for administrative proceedings, because the violations involve brokerage and investment adviser firms, who kept good records, the ease of identifying injured investors and their losses makes it relatively efficient to distribute funds to them.

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[52] SEC Press Release 2000-45 (April 6, 2000)

c. Partial Payment of Disgorgement

In eight administrative proceedings the Commission made or proposed distributions despite the defendants' failure to pay full disgorgement and make any penalty payment. The amount of disgorgement collected in each of these cases ranged from a low of $10,000 to a high of $1 million. Because the Commission has a policy of applying all payments received from a defendant to any outstanding disgorgement order before applying payments to satisfy outstanding penalty orders, the Fair Fund provision would not have provided more compensation for injured investors in these eight cases.

d. Full Payment of Disgorgement

There were five administrative proceedings in the study in which all of the disgorgement and penalties ordered were paid by the defendants. In these cases, a total of just over $1 million in disgorgement was ordered and paid, and just over $700,000 in penalties were ordered and paid. In addition, there were three cases in which the defendants paid all of their disgorgement, for a total of $1.3 million, but none of the $575,000 penalties ordered. In one such case, In the Matter of Eugene Bilotti,[53] the Commission alleged that Bilotti, the chairman and 50 percent owner of a registered investment adviser, recommended that his clients buy shares of Eva-Health USA, Inc., which was a fraudulent enterprise, for which Billotti received approximately $25,000 in fees. The Commission ordered Billotti to pay disgorgement and penalties, which Bilotti paid. While Bilotti's victims received compensation for the fees they paid Bilotti, they did not obtain compensation for the loss of their principal, at least through the Commission action. The Commission could not use money Bilotti paid in the form of penalties to compensate his victims, or other Eva-Health victims, because at the time of this distribution, the U.S. Treasury was the only lawful recipient of penalty money.

Similarly, and because disgorgement is often a different measure than restitution, injured investors in some of the other administrative proceedings may not have been fully compensated even though the defendants paid full disgorgement. Included among these cases are those relating to excessive fees, improper referral practices, and biased allocation practices. For example, in In the Matter of McKenzie Walker Investment Management, Inc. et al.,[54] the Commission alleged that an investment adviser had an undisclosed practice of favoring clients who paid a fee based on their accounts' performance with profitable equity trades while disfavoring clients who paid a fee based on their assets under management. In settlement with the Commission, the investment adviser paid nearly $225,000 in disgorgement, which represented the extra fees it received, and $100,000 in penalties. Although the asset-based fee clients received the disgorged funds,[55] it is unknown whether disgorgement fully compensated them. Again,

[53] Advisers Act Rel. 1689 (December 23, 1997) (order instituting proceedings).

[54] Advisers Act Rel. 1571 (July 16, 1996) (order instituting proceedings).

[55] Advisers Act Rel. 1635 (June 6, 1997) (order approving plan).

because these funds were distributed prior to the enactment of the Fair Fund provision, the Commission could not add penalty sums to the distribution to injured clients.

V. Difficulties Faced in Trying to Compensate Investors

A. Evidentiary Difficulties

The Commission also faces a variety of burdens when it seeks to obtain monetary judgments. These include limitations created by case law, incomplete, inaccurate, or false books and records, resource considerations, and defendants' transfer of assets to off-shore accounts and jurisdictions.

In litigation, the Commission must satisfy various evidentiary burdens and rebut defense arguments. For example, in obtaining disgorgement orders against insider trading defendants, courts usually measure illegal profits as the increase in the stock price from the date of purchase to "a reasonable time after the undisclosed information has become public."[56] In insider trading cases, the Commission may need to litigate what is the particular "reasonable time" after disclosure for purposes of calculating disgorgement. In addition, the Commission's calculations of disgorgement are occasionally limited due to insufficient evidence. For example, in In the Matter of Laurie Jones Canady,[57] evidence of fraud relating to four customer accounts could not be used to extrapolate fraud or disgorgement with respect to other customer accounts, and thus the disgorgement order was smaller than Enforcement had requested. By streamlining litigation to present evidence of only a few of the possible violations committed by each defendant, the Commission is able to effectively address securities violations by as many wrongdoers as possible.

Case law concerning offsetting defendants' expenses against defendants' profits presents another difficulty. A defendant may assert that expenses incurred in the course of the fraud should be deducted from unjust profits to reduce the amount of appropriate disgorgement. Although the Commission has asserted otherwise, and courts have generally agreed with it, in some cases, courts have held that a defendant is entitled to an offset of these expenses.[58]

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[56] SEC v. MacDonald, Jr., 699 F.2d 47 (1st Cir. 1983). *See also* SEC v. Shapiro, et al., 494 F.2d 1301 (2d Cir. 1973) (once public disclosure is made, defendant who does not sell should bear the market risks).

[57] Exchange Act Release No. 41250 (April 5, 1999).

[58] *Compare,* SEC v. Hughes Capital Corp., et al., 917 F. Supp. 1080 (D.N.J. 1996) (defendants not entitled to deduct unspecified business expenses); SEC v. Great Lakes Equities Co., et al., 775 F. Supp. 211 (E.D. Mich. 1991) (overhead, commissions and other expenses may not be deducted) with SEC v. Dilip Shah, U.S. Dist LEXIS 10347 (S.D.N.Y. July 28, 1993) (defendant may deduct commissions paid to broker to trade on inside information); SEC v. Thomas James Assocs., 738 F. Supp. 88 (W.D.N.Y. 1990) (deduction for cost of covering short positions allowed).

An additional impediment to the Commission's ability to effectively recover ill-gotten gains is locating assets and evidence relating to assets. Defendants may hide assets in off-shore trusts or other accounts to prevent discovery of the assets. Further, finding evidence of off-shore or hidden assets is exceedingly difficult and is often compounded by defendants' refusals to comply with disclosure and production orders.[59] In the appropriate circumstances, the Commission expends significant resources tracking down assets and compelling defendants to satisfy monetary judgments. For example, to enforce a $73 million judgment against Eddie Antar obtained in the "Crazy Eddie" litigation, the Commission conducted a worldwide search for assets.[60] Using information sharing mechanisms and relationships with foreign securities authorities, the Commission and Crazy Eddie's trustee brought actions in six countries to recover Antar's unjust profits. These efforts were critical to the recovery of approximately $64 million. Even after these extraordinary efforts, millions of dollars remain unaccounted for.

Though the Commission is entitled to discovery in federal district court, defendants may have either not kept records, or may have maintained poor records, of investors' names and addresses, amounts each investor contributed, and amounts that may have been returned to investors. Thus, it is often difficult for the Commission or court-appointed receivers or distribution agents to identify potential claimants and verify amounts owed. Receivers, distribution agents, and Commission staff need to expend resources to verify claims and reject inappropriate or fraudulent claims.[61]

B. Disgorgement Isn't Restitution

The aim of restitution is to make investors whole and the aim of disgorgement is to deprive defendants of their ill-gotten gains in order to deter future violations. Many defendants in Commission enforcement actions cause investor losses in excess of profits disgorgeable by the defendants, as in the Bilotti matter, discussed in Section III.B.2.d., above. Similarly, defendants who sell securities typically earn far less in commissions, which are disgorgeable, than the total proceeds from a fraud.

In addition to seeking to protect investors, Commission enforcement actions promote other economic and social policies.[62] Effective enforcement of the federal securities laws maintains investor confidence in the fairness and transparency of our

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[59] *See, e.g.,* SEC v. Elfindepan, et al., 169 F. Supp. 2d 420 (M.D. NC 2001) (granting receiver's motion to compel production after defendant's pervasive evasion of orders to produce resulted in a contempt order).

[60] SEC v. Eddie Antar, et al., Lit. Rel. 15251 (February 10, 1997).

[61] See SEC v. Marcus Schloss & Co., Inc., 714 F. Supp. 100 (S.D.N.Y. 1989) (Court held that claimant was not entitled to portion of distribution fund because causal connection between defendant's trading and claimant's damage too tenuous); SEC v. Mal Yerasi, Lit. Rel. 14514 (May 30, 1995) (Defendant allegedly filed over $4 million in fraudulent proofs of claim in Commission and class action cases).

[62] *See* SEC v. Rind, 991 F.2d 1486, 1490 (9th Cir 1993).

securities markets, and deters future violations. While the Commission may seek to return disgorged funds to injured investors, the main objective of disgorgement is to take the profits away from wrongdoers and thereby make violations unprofitable.

Private litigation, however, offers the dual benefit of complementing Commission enforcement action[63] and providing a mechanism to compensate investors through the award of restitution or damages. In contrast to Commission enforcement actions which have several aims, the aim of private litigation is solely to compensate injured investors. The ability of investors to fully recover their losses, indeed, may largely depend on the use of private actions.[64] Further, courts have recognized that the Commission's limited resources[65] may oblige it to prosecute only the most 'flagrant abuses,'[66] and that private actions complement Commission enforcement action and allow for the fullest investor recovery.[67] Thus, while the Fair Fund provision may facilitate investor compensation in some cases, in other cases private litigation remains the best mechanism for investor recovery of losses.

C. Collection Problems

There are a variety of factors beyond the Commission's control that negatively affect its ability to collect monetary judgments so that those funds can be returned to shareholders. A report by the General Accounting Office ("GAO") cited these factors as reasons why the Commission's collection rate is not a good gauge of the effectiveness of its collection efforts.[68] Spendthrift defendants, defendants who lack current or future prospects for earning money, and defendants who have declared bankruptcy or are incarcerated contribute to collection problems.

Collecting sufficient funds to compensate investors is especially problematic, if not impossible, with issuer fraud and reporting cases. People who commit issuer financial fraud violations create huge investor losses when the artificially high price of an issuer's stock plummets with the public dissemination of information about the issuer's actual financial condition. In fact, these securities law violations may cause investor losses that dwarf, by several orders of magnitude, any profit that the violators may have

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[63] *See* J.I. Case Co. v. Borak, 377 U.S. 426 (1964); Bateman Eichler, Hill Richards, Inc, v. Berner, 472 US 299 (1985).

[64] *See* 3 L. Loss, SECURITIES REGULATION 1819 (2d. ed. 1961).

[65] *See* Bateman Eichler, Hill Richards, Inc, v. Berner, 472 U.S. 299, 310, 315 (1985).

[66] Berner v. Lazzaro, 730 F.2d 1319, 1321-23 (9th Cir. 1984), *aff'd*, Bateman*, supra*.

[67] *See* In re M.D.C. Holdings Securities Litigation, 1990 WL 454747 (S.D. Cal. 1990) (commenting on the usefulness of private securities litigation as a supplement to Commission action and the need for private civil litigants to have adequate access to counsel to pursue such actions).

[68] SEC ENFORCEMENT: More Actions Needed to Improve Oversight of Disgorgement Collections, p. 7, GAO-02-771 (July 2002).

made. Thus, when the Commission sues these wrongdoers, they may have insufficient funds with which to compensate investors.

In offering fraud cases, collecting disgorgement from defendants is particularly difficult because these defendants tend to spend money to bring in investor money. Defendants spend money on a wide variety of business expenses, ranging from general office supplies, printing fees, electricity, rent, mock business operations, entertainment expenses and commissions. Furthermore, once defendants in all kinds of enforcement cases have taken profits from their fraud, they tend to spend it. The GAO noted in its report that in a high percentage of the cases in which violators did not pay all the disgorgement ordered, disgorgement was not collected because the violators had already spent the money on expenses that the Commission could not recover.[69] The GAO described a case in which "the violator had spent $175,000 on custom-made furniture, which the case's court-appointed receiver was able to sell for only about 10 percent of its original cost."[70] Defendants may have also spent their profits by paying off credit card debt or other judgments, or may have accumulated assets, such as primary residences and certain retirement assets, which are protected by state homestead exemptions or other state or federal anti-alienation laws. Defendants may also declare bankruptcy and use the automatic stay provisions of the bankruptcy code[71] to impede the Commission's collection of penalties or other remuneration.[72]

Finally, as a result of Commission action, some defendants may have a reduced or limited earnings capacity from which to pay judgments. Bars from the securities industry, officer or director bars, and bars from appearing or practicing before the Commission, limit employment opportunities. State or federal criminal authorities may also prosecute defendants, and as a result they may be incarcerated.

VI. Commission Initiatives to Improve Investor Compensation

The Commission has considered a number of ways to reach the objective of returning more funds to harmed investors. These range from case-specific improvements, such as asserting aggressive disgorgement theories, to improvements of broader application, such as using the Fair Fund provision whenever applicable.

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[69] Id., p. 14.

[70] Id.

[71] 11 USCA §362(a) (providing for a stay upon the filing of a bankruptcy petition from enforcement against the debtor estate of judgments or any other acts to obtain possession of the bankruptcy estate).

[72] *See, e.g.,* SEC v. Brennan, 230 F.3d 65 (2d Cir. 2000) (holding that the SEC's order to repatriate assets moved to an offshore asset protection trust, immediately prior to the entry of judgment, violated the automatic stay).

A. Apply the Fair Fund Provision

The Fair Fund provision is an innovative legislative response to some of the financial obstacles that prevent the Commission from providing funds to injured investors. Making appropriate distributions to investors, by applying the Fair Fund provision, is a desirable and important objective. The Commission intends to use the provision whenever reasonably possible, consistent with its mission to protect investors.

The Fair Fund provision is the only exception to the statutes which require that penalties paid in Commission enforcement actions must be turned over to the U.S. Treasury. Under the Fair Fund provision, the Commission may make a motion to the court to add penalties paid by a defendant to a distribution fund if that defendant also has been ordered to pay disgorgement. The fact that another defendant in the same case or investigation has been ordered to pay disgorgement is not sufficient to trigger the Fair Fund provision with respect to another defendant's payment of a penalty.

The Commission has already approved the filing of motions to apply the Fair Fund provision in a number of enforcement actions: an offering fraud,[73] issuer financial fraud and reporting cases;[74] a fraudulent touting case;[75] "pump and dump" and classic manipulation cases;[76] a Ponzi scheme;[77] and an insider trading case.[78]

B. Swift Enforcement Action and Asset Freezes

Last year, the Commission implemented the "real-time" enforcement initiative, and it is helping to achieve enforcement goals. The goal of the Commission is to learn of securities law violations quickly, take prompt action to halt fraud, and compensate injured investors. As a result, the Commission has more frequently sought temporary restraining orders, asset freezes, and the appointment of receivers. Currently, courts are ordering asset freezes to preserve funds in Commission enforcement actions at an accelerated rate: the Commission sought 55 percent more asset freezes in fiscal year 2002 than it did in fiscal year 2001. In addition, the Commission has increased its requests for temporary restraining orders by approximately 50 percent during that same period of time. Though the "real-time" enforcement initiative has resulted in some stiffer penalties, the initiative also provides incentives to would-be defendants who report

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73 SEC v. Starcash, Inc., et al., Lit Rel. 17526 (May 21, 2002).

74 SEC v. John Giesecke, Jr., et al., Lit. Rel. 17745 (September 25, 2002); SEC v. System Software Associates, Inc., et al., Lit Rel. No. 17770 (October 7, 2002).

75 SEC v. Wayne F. Gorsek, et al., Lit. Rel. 17010 (May 18, 2001).

76 SEC v. Tel-One, Inc., et al., Lit. Rel. 17337 (January 24, 2002); SEC v. Peter C. Lybrand, et al., Lit. Rel. 16448 (February 24, 2000).

77 SEC v. Terry L. Dowdell, et al., Lit. Rel. 17780 (October 10, 2002).

78 SEC v. Harvey R. Dobrow, et al., Lit. Rel. 17733 (September 18, 2002).

violations as soon as they become aware of them, self-correct those problems, and compensate injured investors. The Commission considers the extent of a defendant's cooperation when it determines the sanctions to seek.

Asset freezes aid in the collection of funds from defendants by preventing assets from being dissipated before or after a court renders a judgment. The Commission seeks asset freezes in appropriate cases. Typically, the Commission stands the best chance of success when it can show to the court that the defendant is likely to dissipate, or transfer or secret assets beyond the jurisdiction of the United States. The Commission generally must also establish a likelihood of success on the merits of its claims. *See, e.g*., SEC v. Cavanagh, 155 F.2d 129 (2d Cir. 1998); SEC v. Unifund SAL, 910 F.2d 1028 (2d Cir. 1990).

The results of the study of cases supports our conclusion that faster enforcement action and more asset freezes are primary tools for returning money to defrauded investors. Across almost every enforcement program area, there are significant benefits from temporary restraining orders and asset freezes.

In an enforcement action against an issuer with real business operations and legitimate expenses, courts may not grant an asset freeze because of the severe economic consequences to the issuer, its creditors and its employees. In cases in which an asset freeze is not appropriate, the Commission intends to be more aggressive in preserving assets by obtaining court orders forbidding defendants from making certain extraordinary payments. In June 2002, in SEC v. WorldCom, Inc., the court temporarily prohibited WorldCom from paying more than $100,000 to any current or former officer, director, employee, or affiliate, and forbade WorldCom to make any extraordinary payment to various persons.[79] Furthermore, the Commission intends to use Section 1103 of the Sarbanes-Oxley Act as an adjunct to its historical basis for seeking emergency relief to preserve assets that will be used to compensate injured investors. Section 1103 provides that the Commission may, during an investigation into securities laws violations by a public company or an officer, director or other affiliate of a public company, seek a temporary order from a federal district court requiring the company to escrow "extraordinary payments" likely to be made to such person up to 90 days or, if such person is charged with a violation of the securities laws, until the expiration of the proceedings.

C. Vigorous Assertion of Disgorgement and Penalty Claims

It is essential that the Commission vigorously assert claims for monetary sanctions to deter wrongdoing by individuals who hold positions within publicly held corporations. When those individuals disgorge their improperly obtained profits, and those profits are used to compensate victims, the Commission accomplishes two objectives: (1) deterring securities law violations; and (2) compensating defrauded investors. It is more important than ever that the Commission seek disgorgement because

[79] SEC v. WorldCom, Inc., Lit. Rel. 17594 (June 28, 2002).

the Fair Fund provision hinges on whether disgorgement was ordered against a particular defendant.

The Commission intends to continue to seek effective recompense for defrauded investors by aggressively asserting legal arguments for disgorgement in appropriate cases. While many general principles of disgorgement law are well-established, defendants can challenge the application of these general principles in particular cases, and the decision whether or not to require disgorgement is within the equitable discretion of the court hearing the case. Though some courts have ordered disgorgement of all profits gained while a defendant was in violation of the law because it is often difficult to separate legal from illegal profit,[80] many courts require a more strict causal connection, as described above in Section II.A. With the right cases, where the facts and circumstances favor an expansive measure of unjust profits, the Commission pursues disgorgement of all compensation, including salaries. The Commission will continue to try to develop the law of disgorgement in a manner favoring compensation of investors by pursuing all appropriate theories of disgorgement by wrongdoers.

D. Continuing To Seek An Improved Collections Rate

The Commission recognizes that continuing to seek an improved collections rate is important in returning funds to defrauded investors.

1. Post-Judgment Enforcement

The Commission employs various mechanisms to collect penalties and disgorgement after courts enter a judgment. After a judgment is obtained, the Commission most commonly pursues collection either "in-house" or through referral to the Department of the Treasury. Because the Commission's independent litigation authority extends to the collection of its enforcement judgments, Commission attorneys can collect the money through contempt proceedings and other litigation or non-litigation means (e.g., negotiated payment plans). The Commission also has an interagency agreement with Treasury, so that the Commission can refer debt for administrative offset and for non-litigation collection services. Treasury can in turn recommend to the Commission that a matter be referred to the Department of Justice ("DOJ") for collection through litigation.[81]

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[80] *See* SEC v. Drexel Burnham Lambert, Inc., 837 F. Supp. 587, 612 (S.D.N.Y. 1993), *aff'd*, 16 F.3d 520 (2d Cir. 1994), *cert. denied*, 513 U.S. 1077 (1995).

[81] The Commission also may, in its discretion, directly refer the collection of penalties to DOJ. *See* Section 20(d)(3)(B) of the Securities Act, Sections 21(d)(3)(C)(ii) and 21A(d)(2) of the Exchange Act, and Section 209(e)(3)(B) of the Advisers Act.

a. In-House Collection

In-house collection may entail litigation or non-litigation efforts, such as the negotiation of a payment plan. The litigation may involve filing a civil contempt motion (requesting the court to hold the defendant in contempt for failure to pay a judgment for disgorgement) or pursuing remedies such as levying on and liquidating real and personal property, or filing various writs, such as writs of garnishment.

Employing litigation to enforce judgments is generally one of the most persuasive means to convince a debtor to pay a debt. Collection actions pursued through litigation provide the means to take assets involuntarily from an uncooperative debtor. Enforcing Commission judgments through litigation, however, is often complicated; and the time commitment necessary to pursue such enforcement competes with the priorities of the staff to work on stopping new and ongoing frauds. As detailed below, the legal procedures that are required to be employed to enforce disgorgement judgments are different from those used to enforce penalty judgments. Consequently, collection litigation against a single debtor can become bifurcated into one proceeding to enforce a disgorgement judgment and another proceeding to enforce a penalty judgment. Additionally, procedures may vary from state to state.

i. Collection Litigation To Enforce Disgorgement Judgments

To pursue judgments for disgorgement the Commission may use one or a combination of the following remedies. First, the Commission can request the federal court to hold a defendant in civil contempt for failure to pay the judgment under Fed. R. Civ. P. 70. The Commission can also request the federal courts to issue "writs of execution" allowing it to "execute on" real or personal property.[82] An execution is the physical seizure or forced sale of a defendant's real or personal property. Finally, the Commission can utilize its administrative wage garnishment process.[83]

Contempt is an important collection tool for the Commission. In many jurisdictions where the Commission pursues civil contempt, the debtor is unable to shelter assets under state law exemptions due to the equitable nature of disgorgement.[84] Contempt therefore can increase the potential pool of assets available for recovery.

Executions on disgorgement judgments are commenced in federal court using the substantive and procedural law of the state where the federal court sits.[85] Executions on

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[82] *See* Fed. R. Civ. P. 69(a).

[83] *See* 17 C.F.R. Sections 204.61-65.

[84] *See* SEC v. AMX International, Inc., 7 F.3d 71 (5th Cir. 1993); SEC v. Huffman, 996 F.2d 800 (5th Cir. 1993).

[85] *See* Fed. R. Civ. P. 69(a).

property to enforce disgorgement judgments are complicated by the primacy of state law in this area. Proficiency is required in various state law procedures. Further, although a case may have been initially litigated in one jurisdiction, a debtor may own property in several jurisdictions. Typically, execution proceedings are commenced in the jurisdiction where the property is physically located. Should the debtor own assets in several states, the enforcement of one judgment may require proficiency in multiple state procedures.

The administrative wage garnishment procedure allows the Commission to take 15 percent of the defendant's wages without having to avail itself of the federal court system. In some cases, obviating the need for court intervention may prove more expeditious.[86]

ii. Collection Litigation To Enforce Penalty Judgments

To collect penalties, the Commission is limited to the remedies provided by the Federal Debt Collection Procedures Act ("FDCPA")[87] to pursue judgments for penalties. These include: execution on real property and personalty; writs of garnishment;[88] installment payment orders;[89] and, in certain circumstances, fraudulent transfer actions, which can be initiated against debtors who transfer their assets, thereby keeping them out of the creditor's reach. Because the FDCPA is a federal statutory scheme, the execution procedures on property to enforce penalty judgments are the same nationwide.

The FDCPA cannot be used to seek recovery of disgorgement debt. Conversely, contempt and the state execution procedures described above to collect disgorgement judgments cannot be used to collect penalty judgments. Thus, the Commission may have to pursue multiple remedies to collect against one debtor.[90]

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[86] However, state law may allow the Commission to take a greater percentage. Under the Debt Collection Act as amended by the Debt Collection Improvement Act of 1996 (collectively, "DCIA"), 31 U.S.C. Sections 3701 - 3720E, all federal agencies are limited to a 15 percent administrative wage garnishment. To pursue the state law remedy, the Commission would need to initiate proceedings in federal court.

[87] 28 U.S.C. Sections 3201-3308.

[88] The Commission also may pursue wage garnishment pursuant to the Commission's administrative wage garnishment regulations noted above. However, using the federal court process under FDCPA, federal agencies can request 25 percent of the defendant's wages.

[89] These orders are similar to wage garnishments. The orders are used to capture income of non-salaried individuals who receive commissions or other periodic payments.

[90] For example, assume the Commission has a $200,000 judgment against the debtor, comprised of $100,000 in disgorgement and a $100,000 penalty. Further, assume the debtor has $200,000 in available equity in his home. If the Commission filed and prevailed in a contempt proceeding, the court could only order the payment of the $100,000 disgorgement judgment. To enforce the penalty judgment the Commission would need to employ FDCPA execution remedies to pursue the remaining $100,000. Under FDCPA, the debtor can elect protection of federal or state law exemptions, making only a portion of the remaining $100,000 available for recovery.

It is often the case that the Commission obtains a disgorgement and penalty judgment against a defendant, but the defendant's available assets would only satisfy the disgorgement amount. Prior to the Fair Fund provision, the Commission pursued the collection of disgorgement before penalties in order to maximize the amount that could be returned to defrauded investors. Because, as noted above, penalties and disgorgement are pursued differently, the collection of judgments can result in a two-step collections process: first, one proceeding to collect disgorgement, then if any assets remained, a second proceeding to collect penalties. The Commission believes that Fair Fund provision will allow the Commission to pursue the collection of disgorgement and penalties more efficiently. Although different types of proceedings to collect penalties and disgorgement are still necessary, those proceedings can now be initiated simultaneously, or an action to recover penalties could be initiated first. Because under the Fair Fund provision, all monies recovered from either the disgorgement or penalty proceeding can be returned to investors, the Commission has greater flexibility to choose the most advantageous remedy. For example, an action to recover penalties in some cases could provide a quicker means to capture limited assets held by the defendant. Under the Fair Fund provision, the Commission would be free to seek collection of penalties first and still return the monies collected to investors.

iii. Non-Litigation Collection

Commission staff can also pursue the collection of debt by employing non-litigation methods, such as negotiated payment plans. The Commission may also discharge the debt and issue the debtor an Internal Revenue Service ("IRS") Form 1099C. The Commission first refers the debt to the Treasury collection program discussed below, and once Treasury returns the debt to the Commission as uncollectible, the Commission considers whether the debt should be discharged. Under this alternative, even if the Commission cannot collect the debt, the debtor is still burdened with a nondischargeable tax liability. In addition, we are familiar with other federal agencies' initiatives in debt collection. We will explore the possibility of coordinating with, and utilizing the information gained, and the systems developed by, other agencies to maximize the Commission's collection efforts.

b. U.S. Treasury Referral Programs

The Department of Treasury has two debt collection programs that are available to all agencies. The first program, the Treasury Offset Program ("TOP"), is a centralized process that matches certain Federal payments against debts owed to the government. When a match occurs, the payment is offset to collect the debt.[91] The Commission has promulgated regulations to participate in this program. To enter a judgment in TOP, the Commission staff sends the debtor a demand for payment. If the debtor fails to pay the

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[91] Current federal payment types that are offset include: IRS tax refund payments; vendor payments made to government contractors; travel advances and reimbursements; federal employee monthly retirement benefits; Social Security benefits; and some federal salary payments.

debt in response to this notice, the Commission may refer the debtor to the Treasury for offset while the Commission continues to pursue the collection of the debt by other means.

Under the DCIA, if a debt has been delinquent for 180 days and an agency has been unsuccessful in collecting the debt, generally the agency is required to refer the debt to Treasury's collection services program. Delinquent debts are exempt from this general rule if the debt: is in litigation; has been referred to a private collection agency on contract with the government; or has been referred to private collection counsel under contract with DOJ. Under this program, Treasury and its contractors serve as collection agencies. Treasury's services are limited to traditional collection agency services such as skip tracing, sending demand letters, and making phone calls to the debtor. Treasury cannot conduct litigation to enforce the debt. Treasury may, however, refer the case to a local U.S. Attorney's Office for litigation. When Treasury receives a referral, it first services the debt in-house. Treasury reports the debt to the credit bureau reporting agencies. Treasury then attempts to collect the debt by sending demand letters, calling the debtor, etc. If Treasury is successful, it takes 18 percent of the recovery and sends the balance to the Commission. If Treasury is unsuccessful after 120 days, it sends the judgment to one of its private collection agencies. The private collection agency works the matter for six months. If it is unsuccessful, Treasury refers the matter to a second private collection agency for another six months. Treasury will refer the matter to up to three private collection agencies in this fashion. If the debt is still uncollectible, Treasury will return it to the Commission.

If a private collection agency recovers the debt, it is paid 25 percent of the recovery plus any additional percentage from Treasury's monthly bonus pool, which is paid to its best performing collections agency for the month. In addition, Treasury takes 3 percent. The remainder is sent to the Commission.

Since November 1996, the Commission has referred 413 debtors to Treasury's collection services program. Treasury has returned 123 referrals as uncollectible and returned 11 due to bankruptcy or for other agency action. Eleven referrals were fully collected. The remaining 269 referrals are currently pending with Treasury, including 12 matters with negotiated payment plans, and 16 referrals to DOJ for judgment enforcement litigation.

Because the Commission receives low returns through the Treasury programs, the staff has been examining the issue of contracting directly with private collection agencies. *See* Section VI.D.3.a., below.

2. Recent Improvements to the Commission's Collection Program

a. Collections Guidelines and Collections Database

In July 2002, the Commission took several steps to enhance its collections program: it developed written guidelines for staff on how to pursue collections;

established a collections tracking system; and designated personnel to oversee the program in each regional and district office. Additionally, it created a position for an attorney dedicated solely to collections.

The guidelines require that the staff adhere to certain deadlines to ensure that the Commission meets statutory requirements and that the collection of judgments is pursued promptly and efficiently.

The tracking system for collections and disgorgement/Fair Fund distributions monitors the staff's adherence to the collections guidelines, and tracks when courts enter distribution plans and when receivers (or other distribution agents) distribute funds.

Collections monitors have been appointed in each of the Commission's offices nationwide. The monitors are responsible for keeping the staff apprised of upcoming deadlines, assisting the staff in making referrals to the Treasury programs, and maintaining a collections database for their office.

The Commission's collections attorney provides advice and counsel to the staff nationwide on their collection cases. The advice involves resolving legal issues as well as strategy on how to best pursue judgment enforcement litigation. The assistance allows the staff to more quickly resolve collections issues and thereby preserve limited staff resources. The collections attorney also oversees the collections program and its monitors to ensure consistency nationwide.

We believe that these measures are improving our ability to collect and to monitor the effectiveness of our collections program. However, further improvement of our collections program cannot be accomplished without increased resources and overall staffing. Collection monitor duties are collateral to already heavy enforcement workloads. While the staff is diligently meeting the collections deadlines, judgment enforcement diverts staff resources from investigating and stopping on-going fraud. Further, the current collections database technology makes it difficult to fully assess program objectives. For example, due to limited technological resources, collections databases in the home, district, and regional offices are not linked to each other.

b. Improved Status in Bankruptcy Proceedings

Since the enactment of the Sarbanes-Oxley Act, the Commission is no longer required to file adversary actions in bankruptcy court to establish that most of its judgments are nondischargeable. The new bankruptcy provision in the Sarbanes-Oxley Act prohibits individuals from obtaining discharge of the Commission's disgorgement claims; previously, only penalties were automatically nondischargeable. Section 803 of the Act amends the Bankruptcy Code to provide that a bankruptcy discharge will not discharge an individual debtor from any debt that is for the violation of the provisions of the federal securities laws and results from any judgment or order (including consent orders) entered in any federal or state judicial or administrative proceeding. The new provision enables the Commission to preserve its claims for both disgorgement and

penalties, and thereby increases potential assets for collection. The provision also conserves Commission resources because it is no longer necessary to file adversary proceedings against many individual defendants who file for bankruptcy.

The new nondischargeability provision, however, is limited to individual debtors, not corporations or other legal entities.

c. Using TOP Routinely And More Effectively

The Commission recently promulgated regulations to participate in the TOP.[92] This has allowed the Commission routinely to refer its debt for administrative offset. Under the new collections guidelines, discussed above in Section VI.D.2.a., the Commission now combines its initial demand letter with a notice of intent to refer the debtor for administrative offset through TOP. Under Treasury's rules and regulations, agencies may refer their debts for Treasury offset while continuing to pursue the collection of the debt at the agency level. Such a referral requires the two agencies to closely monitor monies as they are collected. The Commission is currently working with Treasury to implement the necessary technology. This "in tandem" collection alternative allows the Commission to take advantage of all available collection tools simultaneously.

3. Current Initiatives: Improve Collections Using Outside Contractors

The Commission is examining whether it would be beneficial to contract directly with private collection agencies to perform non-litigation collections services and with private law firms to conduct collections litigation on its behalf on a contingency fee basis.

The Federal Acquisition Regulations ("FAR") do not allow the federal government to contract-out "inherently governmental functions."[93] Under FAR, the "collection, control, or disbursement of Federal funds," or "public funds," are considered inherently governmental functions.[94] Treasury statute 31 U.S.C. Section 3302 also prohibits deductions from monies received "for the Government." The DCIA, however, provides exceptions to the FAR rules and the Treasury statute. The DCIA allows all agencies, including the Commission, to contract directly with private collection agencies for non-litigation collection services and to pay the contractors on a contingency fee basis (i.e., from collection monies received "for the Government").[95] DCIA also grants express authority to DOJ, but not the Commission, to contract for, on a contingency fee basis, litigation services to collect debt by private law firms.[96]

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[92] 17 C.F.R. Sections 204.1 – 204.60.

[93] *See* 48 C.F.R. Section 37.102(c).

[94] 48 C.F.R. Section 2.101 and Section 7.503(a) (respectively).

[95] 31 U.S.C. Section 3718(a).

[96] 31 U.S.C. Section 3718(b).

a. Private Collection Agencies

As noted above, the Commission, like any other federal agency, has express authority granted to it under DCIA to contract directly with private collection agencies for non-litigation collection services on a contingency fee basis. The Commission has promulgated regulations to take advantage of this authority.[97] Also noted above, Treasury currently provides the Commission with the services of private collection agencies, but the Commission's recoveries have been marginal. Thus, the Commission is studying direct contracting as an alternative.

There are several advantages to contracting directly with collection agencies. With direct contracts, the Commission can establish the incentives geared toward improving the collection of Commission debt. Commission debt would no longer be part of the larger Treasury pool of debts. Treasury motivates its contractors by paying a bonus to the firm with the highest recoveries. While this is a good incentive for the collection of the overall pool of government debt, it has a negative effect on Commission debt because it motivates the private contractors to avoid working Commission debt, which is typically more difficult to collect. The Treasury program has many types of debt to collect. The contractor can focus on smaller, more easily collectable, debts such as student loans. In contrast, the debts that the Commission seeks to recover may involve millions of dollars, and debtors with a track record of fraud. In addition, the Treasury program contractors are only getting sporadic volume of Commission debts. A direct contract could provide a level of critical mass that would make the contractor more experienced in collecting on Commission debt. Increased volume may increase returns.

Under direct contracts, the Commission might also be able to require that the contractor dedicate a project team to collect solely Commission debt. This would allow the team to become specialized in the types of debt the Commission has, and should subsequently enhance returns. The Commission might also benefit from a contractor providing more in-depth services for collection of debts incurred by foreign nationals. Treasury services are limited to calling a foreign debtor, provided a phone number is available.

The collection matter will be referred more quickly to direct contractors. With some exception, agencies working under the Treasury program cannot refer the matter until the debt is 180 days delinquent. Under the direct program, the debt must be referred before the debt is 180 days old.[98] In many cases, the staff needs the assistance of a collection agency to trace assets being intentionally hidden by debtors. Early referral

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[97] 17 C.F.R. Section 204.77.

[98] In order to use the direct contracting provision, DCIA requires the agency to refer the debt to a contractor prior to 180 days.

may prevent the dissipation of potentially available assets for recovery. Generally, the likelihood of recovery on a debt decreases with the debt's age.

There are also disadvantages. Given the greater degree of specialization that may be necessary to collect Commission debt, the Commission may need to offer a higher contingency fee rate than what is currently awarded under the Treasury program. Careful study of the market is required. Further, the Commission would need additional staffing and technology expenditures to oversee and audit such a program. While the Commission is striving to find alternatives to improve its collections program, given its current resource limits, the Commission is carefully weighing this option.

b. Private Collection Law Firms

The Commission is also examining the possibility of contracting-out the collection of its debt to private law firms. There are, however, legal issues concerning the Commission's ability to procure such a program. As noted above, there are restrictions on contracting-out collection services. Unless Commission penalties become part of the disgorgement fund as a Fair Fund, once collected, penalties are ultimately deposited with the Department of the Treasury. As such, non-Fair Fund penalties would likely be considered "Federal funds," or "public funds," as defined in FAR.[99] Thus, the collection of non-Fair Fund penalties would be considered an inherently governmental function that under FAR could not be contracted-out. Likewise, the collection of non-Fair Fund penalties would likely be characterized as monies received "for the Government."[100] Absent an exception to the Treasury statute prohibiting deductions from such monies, the collection of penalties could not be done on a contingency basis. As noted above, DCIA provides such an exception to the Commission and other government agencies for the contracting-out of only non-litigation collection services on a contingency fee basis.

Disgorgement, however, is not considered money for deposit in the Treasury and therefore may not bear the same restrictions as penalty monies. When practicable, disgorged money is made available to pay investors victimized by securities law violators. Congress has given the Commission broad statutory authority regarding returning disgorgement to investors.[101] Pursuant to this statutory authority, the

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[99] 48 C.F.R. Sections 2.101 and 7.503(a).

[100] 31 U.S.C. Section 3302.

[101] The statutes concerning disgorgement provide that:

> The Commission is authorized to adopt rules, regulations, and orders concerning payments to investors, rates of interest, periods of accrual, and such other matters as it deems appropriate to implement this subsection.

Section 8A of the Securities Act; Sections 21B(e) and 21C(e) of the Exchange Act; Sections 203(j) and 203(k)(5) of the Advisers Act; Sections 9(e) and 9(f)(5) of the Investment Company Act.

Commission regulates how and when disgorgement monies may be provided to investors, and provides that non-employee administrators of the disgorgement fund can be paid from fund proceeds.[102] As noted earlier in this report, court-appointed receivers also traditionally take their fees from the disgorgement fund prior to distribution to investors. Therefore, disgorgement funds could be used to pay those hired to litigate their collection, as both statute and regulation have provided that fees can be deducted from the disgorgement fund. However, while the authority to pay such litigators on a contingency fee basis appears evident, it is less clear that the requisite hiring authority exists in light of the concerns addressed above in regard to contracting-out litigation of penalty collection.

Thus, there are some questions about the Commission's authority to contract with private collection counsel on a contingency fee basis. In Section VII.B., below, the Commission recommends legislative amendments to resolve the uncertainties in this area.

VII. Recommendations for Legislation

A. Amend the Fair Fund Provision

Currently, the Fair Fund provision permits the Commission to add penalty money to distribution funds in limited circumstances. If a defendant is ordered only to pay a penalty, then that defendant's penalty amount cannot be added to the disgorgement fund. Moreover, if no defendants in a case are ordered to pay disgorgement, then no penalties may be distributed to injured investors. Some issuer financial fraud and reporting cases do not result in any disgorgement orders because no defendant received a tangible profit causally connected to the fraud.[103] For example, in an issuer financial fraud involving reporting of inflated profits, the wrongdoers may be planning to sell their securities at inflated prices, and the financial fraud is uncovered before they are able to execute their plans. In such an instance, the Commission might not seek disgorgement because, depending on the circumstances, the wrongdoers may not have been enriched as a result of the fraud. For these situations, a change in the law permitting defendants' penalty payments to be placed into a disgorgement fund would result in more money available to compensate harmed investors.

Prior to the enactment of the Fair Fund provision, the Commission's practice was to ensure that disgorgement be paid by defendants before penalties. In cases where a defendant does not have enough money to fully pay disgorgement and penalty amounts, the Commission's practice is to apply payments first to disgorgement; if, and only if, disgorgement is fully paid, payments are then applied to penalty orders. In settlement or at the conclusion of successful litigation, when available amounts were insufficient to pay

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[102] Rules of Practice 600-630, 17 C.F.R. Sections 201.600 - 201.630.

[103] *See, e.g.,* SEC v. David C. Guenthner, et al., Lit Rel. 17297 (January 8, 2002) (Commission alleges issuer financial fraud and reporting violations by the former chief financial officer and assistant controller relating to issuer InaCom Corp. but does not seek disgorgement).

for both penalties and disgorgement, the Commission would forgo the imposition of previously requested penalties to ensure that disgorgement payments would be as high as possible. Thus, to the extent legally permissible, the Commission had been implementing the aims of the Fair Fund provision prior to its enactment.

What the Commission has been unable to do, and is still unable to do, though, is to take penalties paid by defendants who did not tangibly profit from a fraud, or whose profits could not be reasonably approximated by a court, and add them to payments made by those who did for purposes of distribution to defrauded investors. This is a shortcoming in existing law, because there are cases where the addition of penalty money could make a distribution to investors economically feasible. By amending the Fair Fund provision to allow defendants' penalties to be distributed to investors irrespective of whether the defendant has been ordered to disgorge money, Congress could allow more monies to be returned to harmed investors.

Therefore, we recommend that the Fair Fund provision be amended in one of two ways: (1) to permit the Commission to use penalty monies ordered in a particular matter for distribution to injured investors in that matter regardless of whether disgorgement was ordered; or (2) to permit the Commission to apply penalties paid by any defendant in a case to a disgorgement fund if at least one defendant in the same or related case was ordered to pay disgorgement.

The Commission believes that first proposed amendment described in the paragraph above is preferable in that it provides for the greatest flexibility in using penalty money to recompense injured investors. Situations do exist, and they are among the most difficult for the Commission to address, in which defendants cause far more investor losses than the profit the defendants make from their fraud. The first proposed amendment, if enacted, would have important application in some issuer financial fraud and reporting cases. For example, in SEC v. R. Bruce Acacio,[104] the Commission sued the issuer, California Software Corp., and Acacio, its chairman and chief executive officer, for issuer financial fraud and reporting violations primarily involving improper revenue recognition practices that the company employed. Neither the issuer nor Acacio received any wrongful profits resulting from the fraud, so the Commission did not seek disgorgement. The court, though, ordered Acacio to pay a penalty. Under the current Fair Fund provision, none of the money paid in penalties by defendants like Acacio could be added to a disgorgement fund and returned to investors who suffered financial loss. The recommended amendment to the Fair Fund provision would provide the Commission with the greatest ability to use penalty payments for the benefit of injured investors.

B. New Legislation Granting Express Authority to Contract with Private Collection Attorneys

The Commission believes that any successful collection program must have a strong litigation component. If the collector does not have the direct and timely ability to invoke litigation during the collection process, it dramatically lowers the opportunity for

[104] Lit. Rel. 17292 (January 2, 2002) (relating to issuer California Software Corporation).

success. Judgment enforcement litigation diverts staff resources from investigating and stopping on-going fraud. Contracting-out this function would conserve staff resources for major mission functions, while increasing the Commission's collection rate. Further, local counsel expertise may provide quicker returns. As noted above, to execute on disgorgement judgments, the Commission must employ state law procedures, requiring the staff to become proficient in the law and procedures of multiple jurisdictions. Local counsel would have such expertise readily available.

There are also disadvantages. Again, the Commission would need to devote additional staffing and technology resources to oversee and audit such a program. Despite these limitations, the Commission believes that a legislative remedy would be appropriate. The Commission proposes that the Congress expressly authorize the Commission to directly hire private debt collection litigation counsel. The Commission proposes that this authority mirror the current DOJ authority to hire such counsel. DCIA grants express authority to DOJ to contract for, on a contingency fee basis, litigation services to collect debt by private law firms.[105] It is expected that the contract attorney functions would be similar to those used in DOJ's contracts. Specifically, the contract attorneys would appear in court proceedings where they would file liens and other papers, and would represent the Commission in settlement and compromise negotiations. Authority to approve any settlement would remain with the Commission. For budgetary reasons, the contract attorneys would be paid on a contingency fee basis determined by the Commission based on the market for collections attorneys. However, unlike the DOJ contractors, the Commission's contractors would also be expected to have the ability to conduct litigation tailored to the collection of disgorgement. Instead of limiting services to a few judicial districts, the Commission could procure contracts nationwide to fit our needs.

C. New Legislation To Exclude Securities Cases From State Law Property Exemptions

The Commission also recommends that Congress enact legislation to remove state law impediments to the recovery of Commission judgments and administrative orders. All states have statutes that exempt certain property from collection by creditors. Some debtors use these exemptions to shelter their assets from collection. For example, in certain states, debtors can shelter millions of dollars in their homesteads that might otherwise be available for collection by the Commission. As noted above in Section D(1)(a)(i), in its civil contempt proceedings to recover unpaid disgorgement, the Commission has successfully avoided certain state law exemptions in many jurisdictions.[106] Even under the cited precedents, however, district judges have discretion whether to override state law exemptions. The state law exemptions were only avoided after protracted litigation. Legislation would make the override automatic and thus

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[105] 31 U.S.C. Section 3718(b).

[106] *See e.g.,* SEC v. Huffman, 996 F. 2d 800 (5th Cir. 1993); *see also,* SEC v. AMX International, Inc., 7 F. 3d 71 (5th Cir. 1993).

eliminate the need for protracted litigation on the issue. Further, the Commission cannot avoid state law exemptions when collecting on penalties because the FDCPA specifically allows debtors to elect state law exemptions.[107] Thus, the exclusion of securities judgments and administrative orders from state law property exemptions would increase available assets for recovery to investors and obviate the need for protracted contempt litigation to recover disgorgement.

VIII. Conclusion

Returning funds to investors is an important Commission objective. The Fair Fund provision is an innovative device that the Commission intends to use to return more funds to investors, though an amendment is recommended to improve its usefulness. To more fully compensate investors, the Commission also intends to continue "real time" enforcement and implement planned improvements in collection efforts.

[107] 28 U.S.C. Section 3014.

Appendix A
Sampling Method

The Sarbanes-Oxley legislation requires the Commission to conduct a study with regard to disgorgements and penalties. This appendix describes the methodology that was used to determine how cases were selected for analysis. Given current resources, the Commission had to make a choice between (1) examining all cases, (2) subjectively selecting cases to examine or (3) selecting a scientifically representative sample of cases. If all cases were examined, resource constraints would have likely prevented the completion of a thorough analysis. If Commission staff had subjectively selected a sample of cases for study, it would be difficult to apply the findings to the universe of disgorgement and penalty outcomes. Thus, the Commission decided to conduct a scientific sample since it would be reflective of all cases (within a level of statistical certainty) and would allow for more in-depth analysis of the cases included in the sample. The Division of Enforcement consulted with the Office of Economic Analysis (OEA) to determine the sampling methodology.

The universe of potential cases that could be selected for this study includes all Commission cases resulting in awards of disgorgements and/or penalties between 8/4/97 and 7/30/02. The universe consists of 2,613 such cases within the period of examination.

The sample is selected in a two-phase process. The optimal size of the sample is determined in the first phase. The sample cases are selected in the second phase. In the first phase, the variance of the disgorgement awards is estimated. The estimate of this variance together with a specification of the degree of precision is used in a statistical formula (described below) that suggests the optimal sample size for each disgorgement size category. In the second phase, cases are assigned pseudo-random numbers, and the appropriate number of cases are selected at random for inclusion into the study.[1]

In the first phase, we found that the variability of the disgorgement award was very high and correlated with the size of the award. Thus, we categorized the cases by the magnitude of the award and sampled within each size category. This had the effect of reducing the variability within each class. This allowed us to have a smaller overall sample size for a given level of precision.

Formally, if X_j denotes the disgorgements ordered from a given population of size m, the mean and variance of the disgorgement, calculated by m exploratory observations, is respectively given by:

(1) $$\overline{X} = \frac{1}{m}\sum_{j=1}^{m} X_j \; ;$$

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[1] In practice, it is not possible to develop algorithms to generate pure random numbers. However, it is possible to generate numbers that are very close to random (pseudo-random numbers). The pseudo-random numbers used in this analysis are derived from an algorithm developed by SAS software.

(2) $$S^2 = \frac{1}{m}\sum_{j=1}^{m}(X_j - \overline{X})^2$$

To achieve the required level of precision and confidence, we would need the minimum number of observations:[2]

(3) $$n = \frac{k^2}{D^2}\frac{S^2}{\overline{X}^2}$$

In equation (3), the value selected for k determines the probability that the sample result will have a relative error of no more than plus or minus D.

The Division of Enforcement and OEA made the determination that it would be appropriate to set k equal to two and D equal to 20 percent. That is, we specify the required precision for each category to be the sample size necessary to achieve 95 percent confidence that the sample estimate will be plus or minus 20 percent of the true parameter being estimated.

Applying equation (3), the sample size for this degree of accuracy for each size category is as follows:

Sample Size	Needed to achieve 95 percent confidence that the sample estimate will be plus or minus 20 percent
N	Disgorgement Category
48	less than 100000
50	less than 1 million
4	less than 2 million
24	less than 10 million
38	less than 100 million
4	greater than 100 million
168	Total Across Categories

Subsequently, for the cases in the universe of each category, the cases were randomly sampled until they achieved the defined sample sizes. This was done by assigning pseudo-random numbers to each case, and selecting pseudo-random numbers in descending sequence until the sample size for a particular category was reached. This defines the basis for the 168 cases examined in this study.

[2] Hansen, M.H., Hurwitz, W.N., and Madow, W.G. (1953). *Sample Survey Methods and Theory*. John Wiley and Sons, New York, Vol. I.