

Reforming Corporatins through Prosecution: Perspectives from an SEC Enforcement Lawyer

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REFORMING CORPORATIONS THROUGH PROSECUTION: PERSPECTIVES FROM AN SEC ENFORCEMENT LAWYER

Barry W. Rashkover[†]

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INTRODUCTION

After two years of highly publicized business scandals, the prosecution of public companies—not just their officers, directors, and employees—is a permanent fixture of the law-enforcement landscape. The case may be civil, such as enforcement actions by the Securities and Exchange Commission (SEC or Commission), or criminal, such

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as prosecutions by United States Attorneys and other arms of the Department of Justice. The specter of prosecution can motivate corporations to change their long-term behavior, while courts in filed cases can directly compel corporate reform.

In his Article, Professor John Baker disagrees on philosophical grounds with the use of law enforcement to stimulate corporate reform and opposes all criminal prosecution of corporations.¹ He attacks antifraud legislation as “ill-conceived,” the government’s “political branches” for “marching to the drumbeat of the media,” federal judges for applying “overzealous interpretations of federal criminal law,” and the Justice Department for “scatter-shot prosecutions.”² Baker fails to explain in practical terms, however, how it could be anything but good news for the public and the markets when the authorities vigilantly prosecute corporate frauds that cause staggering losses and shake investor confidence—or how it could be anything but beneficial when companies improve internal controls to prevent misconduct.

Baker also fails to acknowledge the reality that complex scandals at large companies frequently involve organizations acting as units: A corporate culture emphasizes the need to meet Wall Street’s expectations over honest disclosure. Inadequate internal controls allow fraudulent accounting entries to appear in the financial statements. Poorly trained subordinates become pawns for those who orchestrate the fraud. Outside directors ignore red flags signaling misconduct. The resulting misrepresentations appear on the company’s public filings and deceive individual and institutional investors in the company’s securities. In fact, prosecuting corporations recognizes that an organization itself can be culpable for misconduct and capable of implementing reforms to prevent violations from recurring.

The following Comment discusses recent approaches that the SEC and criminal authorities have taken toward prosecuting corporations. Part I outlines how the SEC has demonstrated a balanced and effective approach in using enforcement actions to encourage corporations to self-police and self-report, and in obtaining practical remedies against companies to protect investors. Part II argues that, in the securities context, criminal prosecution of corporations can be a valuable supplement to SEC civil enforcement proceedings and can fairly balance public interests as well as the interests of a corporation’s shareholders and employees.

¹ See John S. Baker, Jr., *Reforming Corporations Through Threats of Federal Prosecution*, 89 CORNELL L. REV. 310, 337 (2004).

² *Id.* at 338–39, 351–52.

I
SEC ENFORCEMENT

When an issuer of securities—be it an SEC registrant with publicly traded stock or a closely held corporation with unregistered securities—violates the federal securities laws, the SEC may seek a variety of civil remedies that range in severity. At one end of the spectrum, under the Securities Act of 1933 (Securities Act)³ and the Securities Exchange Act of 1934 (Exchange Act),⁴ the SEC can issue an order in a Commission administrative proceeding directing a company that has violated the securities laws “to cease and desist from committing or causing such violation and any future violation of the same provision, rule, or regulation.”⁵ Further along the spectrum, the SEC can bring an action in federal court to seek a judgment enjoining the company from committing future violations,⁶ and imposing civil monetary penalties.⁷ For corporations or other entities, the civil penalties can be as much as \$600,000 “for each violation” or onetime pecuniary gain to the defendant⁸—formulas that, when applied to widespread misconduct, can result in billion-dollar-plus penalties in mega-financial fraud cases. Furthermore, in federal court, the SEC can seek various equitable remedies.⁹ These include disgorgement of

³ 15 U.S.C. §§ 77a–aa (1997 & Supp. 2003).

⁴ 15 U.S.C. §§ 78a–78mm.

⁵ 15 U.S.C. § 77h-1(a) (1997); *id.* § 78u-3(a). The SEC also can impose administrative sanctions against broker-dealers and other regulated entities. *id.*; § 78u-3(a) *see, e.g., id.* § 78o(b)(4).

⁶ *See* 15 U.S.C. § 77t(b) (providing for authority to issue injunctions under the Securities Act); *id.* § 78u(d) (providing the authority to issue injunctions under the Exchange Act). A corporate entity can violate the law, even though it is not a natural person, under a variety of legal doctrines. *See, e.g., SEC v. Mgmt. Dynamics, Inc.*, 515 F.2d 801, 812–13 (2d Cir. 1975) (clarifying that ordinary principles of agency, and not a “controlling person” standard, apply for violations of securities laws). A partnership can be held liable for the conduct of its partners. *See, e.g., SEC v. H.L. Rodger & Bro.*, 444 F.2d 1077, 1080 (7th Cir. 1971) (imputing the knowledge of an agent acting within the scope of his authority to the partnership); *SEC v. H.K. Freeland & Co.*, 1993 U.S. Dist. LEXIS 928, at *20 (S.D.N.Y. 1993) (“It is a basic tenet of the law of agency that the knowledge of an agent . . . is imputed to the principal.”).

⁷ *See* 15 U.S.C. § 77t(d); *id.* § 78u(d)(3). The SEC also can impose civil monetary penalties on regulated entities in Commission administrative proceedings. *See, e.g., 15 U.S.C. § 78u-2.*

⁸ *Id.* § 77t(d)(2)(C) ; *id.* § 78u(d)(3); 17 C.F.R. § 201.1002 (2003).

⁹ *See* 15 U.S.C. § 78u(d)(5) (codifying Section 305 of the Sarbanes-Oxley Act of 2002 and confirming that “[i]n any action or proceeding brought or instituted by the Commission under any provision of the securities laws, the Commission may seek, and any Federal court may grant, any equitable relief that may be appropriate or necessary for the benefit of investors”); *see also SEC v. Manor Nursing Ctrs., Inc.*, 458 F.2d 1082, 1105 (2d Cir. 1972) (emphasizing that federal courts have the general power to grant equitable relief in SEC actions).

ill-gotten gains,¹⁰ the appointment of receivers and corporate monitors,¹¹ and orders compelling companies to undertake specific reforms.¹²

Professor Baker questions the authority of unspecified “federal agencies” to promote good corporate citizenship through enforcement.¹³ Under the federal securities laws, however, the SEC plainly does have that authority. Transparency in corporate disclosure, accurate books and records, and effective internal accounting controls are substantive requirements for public companies under the Exchange Act. The SEC may charge corporations with fraud under Section 10(b) and Rule 10b-5¹⁴ when, for example, their financial statements and other public filings are materially false and misleading.¹⁵ The agency also may charge public corporations when they fail to maintain internal books and records or lack adequate internal accounting controls.¹⁶ Further, the SEC may enforce provisions of the Sarbanes-Oxley Act of 2002 (Sarbanes-Oxley Act).¹⁷ The general guidelines of the statutes and case law call on the courts in SEC cases, and the Commission in administrative proceedings, to examine surrounding circumstances, such as the likelihood that the defendant will violate the law again, when determining whether certain remedies are appropriate.¹⁸

¹⁰ See, e.g., *Manor Nursing*, 458 F.2d at 1104 (reasoning that the deterrent effect of an SEC enforcement action would be diminished if violators could reap the fruits of their misconduct).

¹¹ See, e.g., *SEC v. Am. Bd. of Trade*, 830 F.2d 431, 436 (2d Cir. 1987).

¹² See, e.g., *SEC v. WorldCom, Inc.*, Exchange Act Release No. 17,594, 2002 SEC LEXIS 1676 (June 28, 2002). If the company has filed for relief under Chapter Eleven of the Bankruptcy Code, the SEC can seek the appointment of a trustee because, as claimant, the SEC is a party in interest. See 11 U.S.C. § 1104(a) (2000) (providing that a “party in interest” may request the appointment of a trustee).

¹³ Baker, *supra* note 1, at 314–16.

¹⁴ 15 U.S.C. § 78j(b); 17 C.F.R. § 240.10b-5 (1951); see also Exchange Act, Pub. L. No. 291, § 13(a), ch. 404, 48 Stat. 881, 894 (1934) (codified as amended at 15 U.S.C. § 78m(a) (1997)).

¹⁵ See 15 U.S.C. § 78j(b); 15 U.S.C. § 78m(a); 17 C.F.R. § 240.10b-5 (1951).

¹⁶ See 15 U.S.C. § 78m(b)(2) (2003); see also 17 C.F.R. §§ 240-13b2-1 (1979) (proscribing the falsification of records and the making of materially false or misleading statements).

¹⁷ See Pub. L. No. 107-204, § 3(b), 116 Stat. 745 (2002) (equating a violation of the Sarbanes-Oxley Act with a violation of the Exchange Act). The Act legislates corporate reform by, for example, prohibiting issuer loans to directors and executives, *id.* § 402; mandating SEC rules requiring issuer disclosure of internal controls, *id.* § 404, and code of ethics, *id.* § 406; requiring SEC rules that the principal executive and financial officers certify, among other things, that their corporation’s quarterly and annual filings are accurate and that they have designed and evaluated the company’s internal controls, *id.* § 302; and requiring national securities exchanges to prohibit listing any security of an issuer who does not comply with the requirements for audit committees, *id.* § 301.

¹⁸ See, e.g., 15 U.S.C. § 78u(d)(3)(B)(i) (providing that civil penalties in federal court actions “shall be determined by the court in light of the facts and circumstances”); *SEC v. First Jersey Sec., Inc.*, 101 F.3d 1450, 1477–78 (2d Cir. 1996) (finding a permanent injunc-

A. The Seaboard 21(a) Report

The SEC has exercised its enforcement powers in a balanced and equitable manner that credits corporations for self-reporting and self-reforming and encourages responsible corporate citizenship. When evidence of misconduct emerges at a company, the Commission may assess the company's response to that discovery and its general compliance attitude when determining whether to charge the company and, if charges are appropriate, the causes of action and remedies. The Commission articulated that position most comprehensively in October 2001, when it issued a report arising out of an investigation into financial reporting by the Seaboard Corporation.¹⁹ That report, referred to as the Seaboard 21(a) Report, stated that the Commission, in its discretion, may take into account a company's compliance attitude, cooperation, and internal controls when assessing the appropriate enforcement response against the company.²⁰ The Commission explained that "[w]e hope that this Report . . . will further encourage self-policing efforts and will promote more self-reporting, remediation and cooperation with the Commission staff [by companies]."²¹

In the Seaboard 21(a) Report, the SEC set forth nonexclusive factors that it may consider when determining its enforcement response—"from the extraordinary step of taking no enforcement action [against the company] to bringing reduced charges, seeking lighter sanctions, or including mitigating language in documents [the SEC] use[s] to announce and resolve enforcement actions."²² Those factors concentrate on four themes: self-policing, self-reporting, remediation, and cooperation.²³

For example: "What compliance procedures were [already] in place to prevent the misconduct now uncovered," and "[d]id senior personnel participate in, or turn a blind eye toward, obvious indicia of misconduct?"²⁴ "How was the misconduct detected and who uncov-

tion appropriate in SEC cases in which there is a likelihood of future violations demonstrated by, among other factors, the recurrent nature of the violation and defendant's willingness to admit wrongdoing); *Steadman v. SEC*, 603 F.2d 1126, 1140 (5th Cir. 1979) (stating that, in administrative proceedings, the SEC considers, among other factors, "the isolated or recurrent nature of the infraction, the degree of scienter involved, the sincerity of the defendant's assurances against future violations, [and] the defendant's recognition of the wrongful nature of his conduct").

¹⁹ See Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934 and Commission Statement on the Relationship of Cooperation to Agency Enforcement Decisions, Exchange Act Release No. 44,969, 2001 SEC LEXIS 2210 (Oct. 23, 2001) [hereinafter 21a Report].

²⁰ *Id.* at 2-3.

²¹ *Id.* at 9.

²² *Id.* at 5.

²³ See *id.* at 5-9.

²⁴ *Id.* at 6. As the SEC's Director of Enforcement has said, "If you start thinking about the 21(a) Report only after you receive a subpoena, you're too late." Stephen M. Cutler,

ered it?"²⁵ How long after the discovery of the misconduct did it take to notify law enforcement and implement an effective response?²⁶ Is the company conducting an investigation and, if so, is it truly independent and probing?²⁷ Is the company cooperating with the SEC investigation by, among other things, responding quickly and candidly to subpoenas and information requests, sharing the results of the company's internal investigation with the SEC staff, and reporting other misconduct as it is uncovered, even if outside the scope of the staff's inquiries?²⁸ "Did the company immediately stop the misconduct?"²⁹ What action did the company take against culpable individuals?³⁰ "Did the company adopt and ensure enforcement of new and more effective internal controls and procedures designed to prevent a recurrence of the misconduct?"³¹ In the particular case at issue in the Seaboard 21(a) Report, the SEC opted not to charge the company at all—only its ex-controller—for financial reporting violations because of, among other things, the company's exemplary response to the discovery of misconduct and its cooperation with law enforcement.³²

B. Beyond Seaboard

Since the Seaboard 21(a) Report, the SEC has implemented a discretionary policy of calibrating its enforcement response toward corporations to reflect, among other factors, the company's compliance attitude, degree of cooperation, and the nature of the underlying misconduct. The Commission also has obtained specific relief in enforcement actions against corporations to promote, and at times compel, internal reform.

1. *The SEC in Settlements Has Given Corporations Credit for Cooperating, Self-Reporting, and Self-Remediating*

Professor Baker complains that law enforcement fails to give corporations sufficient credit for self-reporting and for maintaining compliance programs.³³ But recent SEC actions show otherwise. A case in point is the SEC's enforcement action arising out of the financial

Remarks Before the Investment Company Institute, Securities Law Developments Conference (Dec. 6, 2001), available at <http://www.sec.gov/news/speech/spch527.htm>.

²⁵ 21(a) Report, *supra* note 19, at 6.

²⁶ *Id.* at 6–8.

²⁷ *Id.* at 7.

²⁸ *Id.* at 7–8.

²⁹ *Id.* at 7.

³⁰ *Id.*

³¹ *Id.* at 9.

³² *Id.* at 1–2.

³³ Baker, *supra* note 1, at 317 (opining that the "‘carrot and stick’ approach [of the criminal sentencing guidelines] never had much carrot to it").

fraud at Homestore.com Inc., *SEC v. John Giesecke, Jr.*,³⁴ in which the SEC brought charges against culpable individuals but not against the company. Three senior executives had orchestrated a sham that artificially inflated the company's online advertising revenue, and then exercised their stock options at prices that reflected those overstated revenues.³⁵ The individuals settled the Commission's charges, pleaded guilty to felonies in a parallel criminal case, and agreed to cooperate with the government's ongoing investigation.³⁶ The Commission declined to "bring any enforcement action against Homestore because of its swift, extensive and extraordinary cooperation in the Commission's investigation."³⁷ Although declining to bring *any* charges against a company is an extraordinary step, the SEC has also credited corporate cooperation by settling cases for less severe charges or sanctions.³⁸

2. *The SEC Has Obtained Civil Penalties Against Corporations When They Have Not Cooperated with Law Enforcement, Self-Policed, or Otherwise Demonstrated a Commitment to Compliance*

In *SEC v. Xerox Corp.*,³⁹ the Commission charged Xerox with financial fraud in violation of Exchange Act Section 10(b) and other provisions.⁴⁰ Xerox settled the district court case by consenting to pay

³⁴ Exchange Act Release No. 17,745, 2002 SEC LEXIS 2423 (Sept. 25, 2002).

³⁵ *Id.* at 1–2.

³⁶ *Id.*

³⁷ Press Release, SEC, SEC Files Financial Fraud Case Charging Three Former Homestore Executive; Defendants Agree to Repay \$4.6 Million in Illegal Trading Profits (Sept. 25, 2002), available at <http://www.sec.gov/news/press/2002-141.htm>. The Commission's press release explained that Homestore's cooperation included:

reporting its discovery of possible misconduct to the Commission immediately upon the audit committee's learning of it, conducting a thorough and independent internal investigation, sharing the results of that investigation with the government (including not asserting any applicable privileges and protections with respect to written materials furnished to the Commission staff), terminating responsible wrongdoers, and implementing remedial actions designed to prevent the recurrence of fraudulent conduct.

³⁸ See, e.g., *In re Rite-Aid Corp.*, Exchange Act Release No. 46,099, 2002 SEC LEXIS 1595 (June 21, 2002). There, the SEC ordered Rite-Aid to cease-and-desist from violating periodic reporting and books-and-records provisions of the Exchange Act—Sections 13 (a) and 13(b)(2), 15 U.S.C. §§ 78m(a)-(b)(2) (2003), and rules thereunder—in a financial fraud case involving two-plus years of overstated income and, at the time, the largest restatement of income by a public company. *In re Rite-Aid Corp.*, 2002 SEC LEXIS 1595, at 2–3. The SEC administrative order noted: "Rite Aid cooperated in the Commission's investigation of this matter, including declining to assert its attorney-client privilege with regard to various matters relevant to the investigation and voluntarily providing the Commission staff with full access to an internal investigation conducted by Rite Aid's counsel," and "[t]he Commission has considered the value of this cooperation in determining the appropriate resolution of this matter." *Id.* at 4.

³⁹ Exchange Act Release No. 17,465, 2002 SEC LEXIS 896 (Apr. 11, 2002).

⁴⁰ *Id.* at 5.

a \$10 million civil penalty and other relief.⁴¹ The Commission explained in its press release that the penalty, the largest imposed against a public company at the time, reflected the fact that the company's management allowed the fraud to continue for several years and failed to cooperate with law enforcement—specifically, that “‘Xerox’s senior management orchestrated a four-year scheme to disguise the company’s true operating performance,’” that “[s]uch conduct calls for stiff sanctions,” and that “[t]he penalty also reflect[ed], in part, a sanction for the company’s lack of full cooperation in the investigation.’”⁴² The \$10 million civil penalty in *Xerox* has since been dwarfed by penalties in more recent settlements such as in *SEC v. WorldCom, Inc.*,⁴³ in which the U.S. District Court for the Southern District of New York approved a \$2.25 billion civil penalty against WorldCom in what might be the largest financial fraud case yet.⁴⁴ The SEC likewise obtained civil penalties against Dynegy, Inc. when Dynegy initially failed to cooperate with the Commission’s investigation and inaccurately described its accounting irregularities in a press release.⁴⁵ Similarly, the Commission has sought civil penalties against Adelphia Communications Corp. in a case alleging that the controlling shareholders continued to loot the company even after the SEC’s investigation began.⁴⁶

3. *Minimizing the Impact on Innocent Shareholders When the Corporation Pays Penalties for Past Misconduct*

The SEC has shown that it is sensitive to the concern that imposing civil penalties against a corporation could indirectly burden innocent shareholders. When the SEC announced its settlement with Dynegy, Inc., for example, the SEC press release stated that “[i]n assessing a penalty directly against Dynegy, the Commission was mindful of the impact that a penalty on a corporate entity can have on the

⁴¹ *Id.*

⁴² Press Release, SEC, Xerox Settles SEC Enforcement Action Charging Company with Fraud (Apr. 11, 2002), available at <http://www.sec.gov/news/press/2002-52.txt>.

⁴³ 2003 U.S. Dist. LEXIS 11394 (S.D.N.Y. 2003).

⁴⁴ *Id.* at *13–16.

⁴⁵ See *SEC v. Dynegy, Inc.*, Exchange Act Release No. 17,744, 2002 SEC LEXIS 2415 (Sept. 25, 2002); Press Release, SEC, Dynegy Settles Securities Fraud Charges Involving SPEs, Round-Trip Energy Trades (Sept. 24, 2002), available at <http://www.sec.gov/news/press/2002-140.htm> [hereinafter *Dynegy Settles*].

⁴⁶ See *SEC v. Adelphia Communications Corp.*, Exchange Act Release No. 17,627, 2002 SEC LEXIS 1878 (July 24, 2002); see also Press Release, SEC, SEC Charges American International Group and Others in Brightpoint Securities Fraud (Sept. 11, 2003), available at <http://www.sec.gov/news/press/2003-111.htm> (announcing settled enforcement action in which American International Group, Inc., among other things, agreed to pay a \$10 million civil penalty for fraud charges because of the “gravity of the misconduct” and misconduct by the company’s counsel during the SEC investigation).

entity's innocent shareholders.'"⁴⁷ The recent Sarbanes-Oxley Act could go far to address that concern in future cases: under Section 308 ("Fair Funds For Investors"),⁴⁸ civil penalties in SEC enforcement actions need not go to the United States Treasury, but may be added to a disgorgement fund used to compensate victims, including defrauded shareholders.

For example, in *SEC v. WorldCom, Inc.*,⁴⁹ the court granted the SEC's motion to approve a settlement in which WorldCom, currently in Chapter Eleven bankruptcy proceedings, will pay \$500 million in cash and \$250 million in WorldCom stock to satisfy the SEC's claim for civil penalties.⁵⁰ Under the settlement, pursuant to Section 308, "these payments will be made initially to a Distribution Agent appointed by [the] Court, who will then undertake to distribute the cash and, at a suitable time, the proceeds of the stock, to the qualifying claimants," including "shareholder victims."⁵¹ The court praised the settlement as "not only fair and reasonable but as good an outcome as anyone could reasonably expect in these difficult circumstances."⁵²

4. *In Litigation, Charging Corporations Has Proven To Be Beneficial for the Public Because the Commission Has Obtained Productive Relief Resulting in Internal Company Reform and Preventing Further Misconduct*

In enforcement actions against corporations, as with other defendants, the SEC may invoke the equitable power of the courts to fashion remedies that benefit shareholders.⁵³ The SEC has obtained worthwhile equitable relief against public companies in recent cases. In *SEC v. WorldCom Inc.*,⁵⁴ the SEC obtained creative relief shortly after the company announced that revenues were fraudulently inflated by

⁴⁷ See Dynegy Settles, *supra* note 45.

⁴⁸ Pub. L. No. 107-204, § 308, 116 Stat. 745, 784-85 (2002).

⁴⁹ 2003 U.S. Dist. LEXIS 11394 (S.D.N.Y. 2003).

⁵⁰ *Id.* at *13-14.

⁵¹ *Id.* at *10, 14.

⁵² *Id.* at *16. As of the Summer of 2003, the SEC had sought to distribute civil penalties to investors pursuant to Section 308 of the Sarbanes-Oxley Act in over two dozen cases. See, e.g., SEC v. Merrill Lynch & Co., Exchange Act Release No. 18,038, 2003 SEC LEXIS 620 (Mar. 17, 2003) (publicizing that, for aiding and abetting Enron's fraud, Merrill Lynch agreed to pay \$80 million in disgorgement, civil penalties and interest, which the SEC intended to distribute to victims); Press Release, SEC, SEC Settles Enforcement Proceedings Against J.P. Morgan Chase and Citigroup (July 28, 2003), available at <http://www.sec.gov/news/press/2003-87.htm> (reporting that for aiding and abetting Enron fraud, J.P. Morgan Chase agreed to pay \$135 million in disgorgement, penalties, and interest, which the SEC intended to distribute to victims).

⁵³ See *supra* notes 9-12 and accompanying text.

⁵⁴ See Exchange Act Release No. 17,588, 2002 SEC LEXIS 1645 (June 27, 2002) (announcing charges against WorldCom for a \$3.8 billion financial fraud); see also *id.* (announcing the SEC's amended complaint against WorldCom and identifying the statutory charges).

over \$3 billion (a figure WorldCom later amended to approximately \$9 billion).⁵⁵ One day after charging WorldCom with violating antifraud and other provisions of the federal securities laws,⁵⁶ the Commission obtained a court order, with WorldCom's consent. That order provided for the appointment of a corporate monitor "having oversight responsibility with respect to all compensation paid by WorldCom" to its employees, and forbidding WorldCom to "pay[] more than \$100,000 to any present or former officer, director or employee, or any of its affiliates; . . . or making any extraordinary payment" to officers or directors until the monitor was in place.⁵⁷ Later, in November 2002, WorldCom consented to a partial judgment upholding the Commission's charges and ordering that WorldCom undertake to improve corporate governance, enhance internal accounting controls, and adequately train officers and certain other employees to help prevent future violations of the securities laws.⁵⁸

To tailor specific reforms in the context of court-ordered undertakings, the SEC frequently defers to independent consultants. The November 2002 partial final judgment for the Commission in *WorldCom* is a good example.⁵⁹ To improve internal corporate governance, the court-ordered settlement required that WorldCom's special investigative committee provide the corporate monitor with a report on WorldCom's corporate governance procedures and that the corporate monitor, in turn, review the adequacy of these procedures and summarize his recommendations in a report.⁶⁰ The judgment further required that WorldCom's board report to the court and the Commission on its progress in acting on the corporate monitor's recommendations 60 days after receiving his report.⁶¹ The judgment also required WorldCom to hire a qualified independent consultant to monitor the company's efforts to remedy its internal-controls deficiencies.⁶²

⁵⁵ *Id.*

⁵⁶ *See id.*

⁵⁷ SEC v. WorldCom, Inc., Exchange Act Release No. 17,594, 2002 SEC LEXIS 1676, 1-2 (June 28, 2002).

⁵⁸ SEC v. WorldCom, Inc., Exchange Act Release No. 17,866, 2002 SEC LEXIS 3043, 1 (Nov. 26, 2002).

⁵⁹ *See id.*

⁶⁰ *Id.* at 3-4.

⁶¹ *Id.* at 4.

⁶² *Id.* at 4-5; *see also, e.g.*, SEC v. Credit Suisse First Boston Corp., 2002 U.S. Dist. LEXIS 2416 (D.D.C. 2002). In that case, the SEC alleged that the Credit Suisse First Boston Corp. (CSFB) improperly allocated "hot" IPO stock to customers in exchange for kickbacks from profits the customers received when selling the IPO shares into the aftermarket. *See* Press Release, SEC, SEC Charges CSFB with Abusive IPO Allocation Practices (Jan. 22, 2002), *available at* <http://www.sec.gov/news/press/2002-14.txt>. While agreeing to injunctions and payment of \$100 million to settle the SEC action and a related

In federal court, the SEC may seek temporary restraining orders and preliminary injunctions appointing receivers, freezing assets, and granting other emergency relief to halt ongoing fraud. Although most SEC emergency relief cases have involved private companies, the Commission may obtain temporary receivers and asset freezes over public companies when appropriate. In *SEC v. 800America.com, Inc.*,⁶³ the Commission alleged a multifaceted, ongoing fraud orchestrated by 800America.com, Inc. (800America), an OTC Bulletin Board company that operated commercial websites and engaged in e-commerce retailing; 800America's CEO; and an "undisclosed control person" over the company.⁶⁴ The SEC alleged that the defendants falsified virtually all of 800America's reported revenues and millions in expenses and assets, committed insider trading, and engaged in other fraud.⁶⁵ When the Commission filed the case, the court granted its application for emergency relief, including the appointment of a temporary receiver over the public company, and an asset freeze over all defendants.⁶⁶ The receiver, who remained in place after the court granted the SEC's motion for a preliminary injunction,⁶⁷ took control of 800America, prevented further depletion of assets, measured the assets and liabilities of the company, and placed 800America in bankruptcy.

5. *Charging Entities Other Than Securities Issuers*

Professor Baker contends that corporations cannot act with intent or other level of culpability, and that they cannot be rehabilitated or deterred from committing crime, because they are legal creations rather than natural persons.⁶⁸ Yet, even he ultimately admits that "carrots and sticks" of law enforcement work in the real world to motivate corporations to take compliance seriously:

Corporate self-policing or compliance plans have become pervasive since the 1991 adoption of the guidelines for sentencing of organizations. The Sentencing Guidelines have spawned a "compliance" industry of lawyers, accountants, consultants, and corporate vice presidents, who draft codes of corporate conduct and provide employee training in both the codes and appropriate practices—which, in turn, they audit for compliance.⁶⁹

NASD case, CSFB agreed to improve its IPO stock allocation methods and to retain an independent consultant to review CSFB's new policies after one year.

⁶³ Exchange Act Release No. 17,835, 2002 SEC LEXIS 2870 (Nov. 13, 2002).

⁶⁴ *Id.*

⁶⁵ *Id.*

⁶⁶ *Id.* at 1-2.

⁶⁷ *SEC v. 800America.com, Inc.*, Exchange Act Litigation Release No. 17,863, 2002 SEC LEXIS 3042, 1-2 (Nov. 25, 2002).

⁶⁸ See Baker, *supra* note 1, at 311, 317-18, 320, 345, 350.

⁶⁹ *Id.* at 316 (internal footnote omitted).

Given that the incentives and disincentives posed by law enforcement *can* prompt better company practices, the SEC staff has signaled a desire to apply factors in the Seaboard 21(a) Report more broadly, such as when the Commission assesses charges against accounting firms.⁷⁰ Traditionally, the SEC followed a discretionary policy of charging firm partners and employees for improper professional conduct or fraud associated with a failed audit, but not the firm itself unless the audit failure involved the firm's senior management.⁷¹ However, in December 2002, Stephen Cutler, the SEC's Director of Enforcement, announced his view that the Commission should "adopt a new enforcement model—a new paradigm: one that holds an accounting firm responsible for the actions of its partners; one that *reverses* the current presumption *against* suing firms for an audit failure, no matter how improper the individual auditor's conduct."⁷² Cutler proposed that the Commission apply the factors from the Seaboard 21(a) Report when weighing charges against audit firms. He further observed that audit failures often amount to a failure by the firm as a whole rather than just a few individuals:

[A]udit work supplied by an accounting firm is very much a product of that firm's culture, personnel, systems, training, supervision, and procedures. If that product is defective, the causes may well be found in the firm. The current practice of suing individual auditors without also charging their firms may not adequately reflect—at least in some cases—the role and responsibility of firms in these matters.⁷³

II

CRIMINAL PROSECUTION TO SUPPLEMENT SEC ENFORCEMENT

Though potent and effective, the SEC's civil remedies never have been considered the only law enforcement tools to combat securities fraud. Criminal sanctions are a valuable supplement for use against individuals and entities. Professor Baker, however, opposes *all* criminal prosecution of corporations: "[m]odern corporations," he argues, "are abstract, impersonal, utilitarian entities," "not human," and therefore "should not be the subjects of criminal prosecution."⁷⁴ Baker essentially disputes a century of case law upholding corporate

⁷⁰ Stephen M. Cutler, Remarks Before the American Institute of Certified Public Accountants (Dec. 12, 2002), *available at* <http://www.sec.gov/news/speech/spch121202smc.htm>.

⁷¹ *Id.*

⁷² *Id.*

⁷³ *Id.*

⁷⁴ Baker, *supra* note 1, at 35.

criminal liability⁷⁵ and cynically shrugs off modern antifraud statutes as ill-considered, crowd-pleasing measures intended primarily to attract votes for elected officials.⁷⁶ His argument has little practical appeal for several reasons.

First, there are sound policies behind why the securities laws provide for criminal prosecution, including cases against entities: some violations are egregious enough to warrant more than civil punishment, and some defendants simply are not “deterred by civil sanctions alone.”⁷⁷ Cheating investors out of their savings by falsifying a company’s public filings, lying in unregistered securities offerings, and manipulating stock prices are examples of egregious frauds that can warrant criminal sanctions against entities in appropriate cases. Thus, Section 32(a) of the Exchange Act, for example, provides criminal sanctions for willful securities law violations.⁷⁸ The statute specifically contemplates criminal charges against any person including any “person other than a natural person”—corporations and other entities.⁷⁹ Indeed, Congress amended Section 32(a) in 1988 specifically to include any person “other than a natural person” precisely because it sought to broaden the statute to allow for criminal prosecutions against business organizations.⁸⁰ The securities laws also authorize

⁷⁵ See, e.g., *United States v. A & P Trucking Co.*, 358 U.S. 121, 125 (1958) (referring to corporations when explaining that “it is elementary that such impersonal entities can be guilty of ‘knowing’ or ‘willful’ violations of regulatory statutes”); *N.Y. Cent. & Hudson River R.R. Co. v. United States*, 212 U.S. 481, 494–95 (1908) (admitting that, although corporations doctrinally cannot commit certain crimes, “there is a large class of offenses . . . wherein the crime consists in purposely doing the things prohibited by statute. In that class of crimes we see no good reason why corporations may not be held responsible for and charged with the knowledge and purposes of their agents”); *United States v. Inv. Enters., Inc.*, 10 F.3d 263, 266 (5th Cir. 1993) (holding corporations “criminally liable for the unlawful acts” of their agents, if they acted within the scope of actual or apparent authority); *United States v. Basic Constr. Co.*, 711 F.2d 570, 572–73 (4th Cir. 1983) (imputing the criminal act of an agent to the corporation when the agent acted within the scope of his authority to benefit the corporation, even if the act was contrary to stated corporate policy).

⁷⁶ Baker, *supra* note 1, at 338–39.

⁷⁷ *Testimony Concerning the Involvement of Organized Crime on Wall Street Before the House Subcomm. on Finance and Hazardous Materials*, 106th Cong. 2 (2000) (statement of Richard H. Walker, Director, Division of Enforcement, SEC), available at <http://www.sec.gov/news/testimony/ts142000.htm>.

⁷⁸ See 15 U.S.C. § 78ff (2000).

⁷⁹ Prior to 1988, Section 32(a) covered only natural persons, and “exchanges.” 15 U.S.C. § 78ff(a); see Securities Act, Pub. L. No. 22, § 24, 48 Stat. 74, 87 (1933) (codified as amended at 15 U.S.C. § 77x (1997)). Courts have held that criminal and SEC investigations may proceed simultaneously. See, e.g., *SEC v. Dresser Indus., Inc.*, 628 F.2d 1368, 1377 (D.C. Cir. 1980) (“Effective enforcement of the securities laws requires that the SEC and Justice be able to investigate possible [securities laws] violations simultaneously.”).

⁸⁰ Insider Trading and Securities Fraud Enforcement Act of 1988, Pub. L. No. 100-704, § 4, 102 Stat. 4677, 4680. The House Report explained that “this section changes current law by making all non-natural persons subject to the higher criminal penalty; current law imposes the higher burden only on exchanges.” H.R. REP. NO. 100-910, at 23

the SEC to refer evidence of violations to criminal authorities, and do not distinguish between acts by individuals or entities.⁸¹ Similarly, although the Commission can enforce its orders and judgments in federal court, criminal prosecutors can help by seeking criminal contempt for violations of SEC injunctions.⁸²

“By creating a dually enforceable system of laws, the drafters of the securities statutes understood that not all securities violations warrant the same degree of punishment.”⁸³ When an individual’s conduct is particularly alarming, criminal enforcement makes sense. Why should it be any different if the villain is a corporate enterprise acting through the collective efforts of several individuals? When an individual is a recidivist violator of SEC injunctions and orders, criminal prosecution often is the next appropriate step. If criminal authorities refrained altogether from charging corporations, there would be no further coercive action to take against recidivist corporate violators beyond successive SEC civil suits.⁸⁴

Against this landscape, the Sarbanes-Oxley Act reaffirms that criminal prosecutions, including cases against corporations, are necessary tools for combating securities fraud. The Act reflects congressional approval for criminal prosecution of corporations by increasing, from \$2.5 million to \$25 million, the criminal fines available under Exchange Act Section 32(a) applicable to any “person other

(1988). Representative John D. Dingell noted that the amendment contained criminal fines for “corporations and partnerships.” 134 CONG. REC. H7,465, 7,469 (1988). Senator H. John Heinz, III similarly stated that criminal fines applied to “investment banking firms and corporations.” 134 CONG. REC. S17,218, 17,219 (1988).

⁸¹ See, e.g., 15 U.S.C. § 78u(d)(1) (2003) (“The Commission may transmit such evidence as may be available concerning such acts or practices as may constitute a violation of any provision of this title or the rules or regulations thereunder to the Attorney General, who may, in his discretion, institute the necessary criminal proceedings under this title.” (emphasis added)).

⁸² See, e.g., *United States v. Senffner*, 280 F.3d 755, 759–60 (7th Cir. 2002) (affirming defendant’s criminal contempt conviction for violating an SEC injunction and obstructing SEC proceedings); *United States v. Taylor*, 139 F.3d 924, 928–29 (D.C. Cir. 1998) (denying defendant’s appeal asking for withdrawal of his guilty plea to a criminal contempt charge for violating an SEC injunction); *United States v. Gibbons*, 968 F.2d 639, 643 (8th Cir. 1992) (validating defendant’s conviction of criminal contempt for violating an SEC injunction).

⁸³ Harvey L. Pitt, Remarks Before the U.S. Department of Justice Corporate Fraud Conference (Sept. 26, 2002), available at <http://www.sec.gov/news/speech/spch585.htm>.

⁸⁴ Much of Professor Baker’s argument rests on his subjective opinions and observations, many of which are debatable. He says, for example: “‘white collar’ guilty pleas are suspect” because defendants do not know they are violating the law. Baker, *supra* note 1, at 338. Do sophisticated executives really think that the law allows them, for example, to direct inaccurate adjustments to a general ledger to exaggerate their company’s stated results; to lie to auditors; to issue false press releases; or to trade stock based on inside information? Baker also says that federal prosecutions “proceed without much public scrutiny of the charges.” *Id.* at 351. Would not a survey of recent television and print media coverage reveal just the opposite—a routine use of commentators to explain legal issues surrounding criminal and SEC cases?

than a natural person.”⁸⁵ In addition, the President’s 2002 Executive Order creating the Department of Justice’s Corporate Fraud Task Force envisions criminal prosecutions against “commercial entities.”⁸⁶

Second, criminal authorities recognize that, in prosecuting entities, they should weigh competing interests. On one hand, the public has an interest in forcefully addressing criminal conduct by a corporate villain; on the other hand, prosecuting a corporation could trigger undesirable collateral consequences if the stigma of the lawsuit pushes the company to fold, or otherwise suffer financially or in reputation. Professor Baker’s concern, that overzealous federal prosecutors will bring unwarranted charges against corporations,⁸⁷ gives short shrift to Justice Department guidelines that the prosecutors apply when deciding whether to charge business organizations. Most recently, in a January 2003 memorandum from Deputy U.S. Attorney General Larry D. Thompson (Thompson Memorandum),⁸⁸ the Department of Justice has instructed prosecutors to consider factors including (a) “nature and seriousness of the offense”; (b) “the pervasiveness of the wrongdoing”; (c) “the corporation’s history of similar conduct”; (d) the corporation’s self-reporting and cooperation with law enforcement; (e) “the existence and adequacy of the corporation’s compliance program”; (f) “the corporation’s remedial actions”; (g) “collateral consequences”; (h) “the adequacy of the prosecution”; and (i) “the adequacy of remedies such as civil or regulatory enforcement.”⁸⁹ The memorandum goes into more detail, explaining how to approach each discrete factor. For example, when

⁸⁵ Pub. L. No. 107-204, § 1106, 116 Stat. 745, 810 (2002). Congress also adopted a new crime of securities fraud, *see id.* § 807, toughened the sanctions for obstructing government investigations, *see id.* § 805, and amended related criminal statutes. *See, e.g., id.* §§ 901–906 (amending various white collar crime statutes). These provisions cover both individuals and entities. *See, e.g., id.* § 3 (defining the scope of the Commission’s enforcement).

⁸⁶ The Executive Order states that the Corporate Fraud Task Force shall “provide direction for the investigation and prosecution of cases of securities fraud, accounting fraud, mail and wire fraud, money laundering, tax fraud based on such predicate offenses, and other related *financial crimes committed by commercial entities* and directors, officers, professional advisers, and employees.” Exec. Order No. 13,271, 67 Fed. Reg. 46,091 (July 9, 2002) (emphasis added).

⁸⁷ *See Baker, supra* note 1, at 351–52. Indictments do not necessarily mean the collapse of the corporate defendant. Witness, for example, the prosecutions of Hilton Hotels (convicted of Sherman Act violations, *United States v. Hilton Hotels Corp.*, 467 F.2d 1000 (9th Cir. 1972)); Bankers Trust Co. (pled guilty to falsely recording unclaimed checks, *U.S. v. Bankers Trust Co.*, No. 99 Cr. 250 (S.D.N.Y. Mar. 11, 1999)); and the auction house Sotheby’s (pled guilty to conspiracy to fix prices, *U.S. v. Sotheby’s Holdings, Inc.*, No. 00 Cr. 1081 (S.D.N.Y. Oct. 5, 2000)).

⁸⁸ Memorandum from Larry D. Thompson, Deputy Attorney General, to Heads of Department Components, United States Attorneys, Principles of Federal Prosecution of Business Organizations (Jan. 20, 2003), *available at* http://www.usdoj.gov/dag/cftf/business_organizations.pdf [hereinafter Thompson Memorandum].

⁸⁹ *Id.* at 3.

prosecutors consider the undesirable collateral consequences that may arise, they

may take into account the possibly substantial consequences to a corporation's officers, directors, employees, and shareholders, many of whom may, depending on the size and nature (e.g., publicly vs. closely held) of the corporation and their role in its operations, have played no role in the criminal conduct, have been completely unaware of it, or have been wholly unable to prevent it.⁹⁰

In a similar vein, the Thompson Memorandum urges prosecutors to consider, before charging a company, whether criminal charges add value in the case, or whether civil charges against the entity are sufficient to serve law enforcement goals.⁹¹

At the same time, the Thompson Memorandum recognizes that “[v]irtually every conviction of a corporation, like virtually every conviction of an individual, will have an impact on innocent third parties.”⁹² According to the memorandum, criminal prosecution of the company might nevertheless be appropriate where “the scope of the misconduct in a case is widespread and sustained within a corporate division (or spread throughout pockets of the corporate organization),” or “where the top layers of the corporation’s management or the shareholders of a closely-held corporation were engaged in or aware of the wrongdoing and the conduct at issue was accepted as a way of doing business for an extended period.”⁹³ Thus, stigmatizing a company through criminal charges actually may serve the public interest where criminal conduct is pervasive within the entity and directed from the top. As Deputy Attorney General Thompson said after the indictment of Arthur Andersen LLP, “it would [be] unfortunate for our criminal justice system if any individual or any entity could say

⁹⁰ *Id.* at 13; see also Larry D. Thompson, ‘Zero Tolerance’ for Corporate Fraud, WALL ST. J., July 21, 2003, at A10 [hereinafter ‘Zero Tolerance’ (reporting that the Justice Department “has issued guidance to prosecutors directing them to consider a number of factors before deciding whether to seek an indictment against a corporation[,] . . . including disproportional harm to shareholders and innocent employees”).

⁹¹ See Thompson Memorandum, *supra* note 88, at 2, 13. Although predating the Thompson Memorandum, the indictment of Arthur Andersen LLP for obstruction of justice was consistent with this consideration. In *United States v. Arthur Andersen LLP*, No. 02 Cr. 121 (S.D. Tex. Mar. 7, 2002), the crime was solely a criminal offense, and the firm otherwise demonstrated that civil law enforcement remedies were inadequate to alter its conduct. The conduct that formed the basis for the criminal charges took place after Andersen settled an unrelated SEC action in which the district court permanently enjoined the firm from violating antifraud provisions of the federal securities laws and imposed \$7 million in civil penalties. *SEC v. Arthur Andersen LLP*, No. 01 Civ. 1348 (D.D.C. June 19, 2001), available at <http://www.sec.gov/litigation/litreleases/lr17039.htm>.

⁹² Thompson Memorandum, *supra* note 88, at 13.

⁹³ *Id.* at 12–13.

that he or she or it was too big or too important, so [that] it couldn't be indicted."⁹⁴

Third, Professor Baker is out of step in claiming that it is somehow unfair to encourage corporations to self-report misconduct. A company's refusal to disclose when it learns that its publicly filed annual, quarterly, or other SEC filings are false and misleading might constitute ongoing fraud, even apart from the past violations the company committed when it initially filed those misstated reports. Corporations have no Fifth Amendment right against self-incrimination.⁹⁵ Similarly off base is Professor Baker's claim that the Federal Sentencing Guidelines unfairly treat corporations differently from individuals by taking into account the entity's compliance program and cooperation for sentencing purposes.⁹⁶ Individuals analogously can receive credit at sentencing if they accept responsibility for an offense by admitting to their conduct, withdrawing from criminal associations, and helping the authorities.⁹⁷

Finally, joint prosecutions of companies by the SEC and criminal authorities can yield tangible benefits for victims and the public. The parallel cases *United States v. Republic New York Securities Corp.*,⁹⁸ *In the Matter of Republic New York Securities Corp.*,⁹⁹ and *In the Matter of Republic New York Securities Corp.*,¹⁰⁰ illustrate this point. In these cases, the U.S. Attorney's Office for the Southern District of New York, the SEC, and the Commodity Futures Trading Commission (CFTC) brought charges against Republic New York Securities Corporation (Republic Securities) for participating in a massive "Ponzi" scheme orchestrated by the firm's clients, Princeton Economics International, Ltd. (Princeton), and its principal, Martin Armstrong (Armstrong).¹⁰¹ Between 1994 and 1999, Princeton and Armstrong raised several billion dollars by selling promissory notes, falsely claimed that they would segregate note proceeds in investor accounts at Republic Securities, and

⁹⁴ News Conference: Arthur Andersen Indictment (Larry D. Thompson, Mar. 14, 2002), available at <http://www.usdoj.gov/dag/speech/2002/031402newsconferncearthurandersen.htm>; see *Zero Tolerance*, *supra* note 90.

⁹⁵ See *Braswell v. United States*, 487 U.S. 99, 104–05 (1988) (“[W]e have long recognized that, for purposes of the Fifth Amendment, corporations and other collective entities are treated differently from individuals.”).

⁹⁶ Baker, *supra* note 1, at 319–21. The Federal Sentencing Guidelines call upon the court to consider whether the organization had an “[e]ffective [p]rogram to [p]revent and [d]etect [v]iolations of [l]aw” and the extent of the organization’s “[s]elf-[r]eporting, [c]ooperation, and [a]cceptance of [r]esponsibility” when determining the appropriate criminal sentence against the entity. U.S. SENTENCING GUIDELINES MANUAL § 8C2.5 (2002).

⁹⁷ *Id.* § 3E1.1, cmt. n.1 (2002); see also *id.* § 5K1.1 (regarding “Substantial Assistance to Authorities”).

⁹⁸ No. 01 Cr. 1180 (S.D.N.Y. Dec. 17, 2001).

⁹⁹ Exchange Act Release No. 45,157, 2001 SEC LEXIS 2595 (Dec. 17, 2001).

¹⁰⁰ Comm. Fut. L. Rep. (CCH) ¶ 28,701 (Dec. 17, 2001).

¹⁰¹ See *infra* notes 102–06 and accompanying text.

diverted over \$100 million of investor funds.¹⁰² Republic Securities officials aided the scheme by distributing false net asset value letters to Princeton, which forwarded them to its clients.¹⁰³ After halting the fraud by charging Princeton and Armstrong,¹⁰⁴ the SEC, CFTC, and the U.S. Attorney's Office jointly investigated and prosecuted Republic Securities. In a global settlement announced on December 17, 2001, Republic Securities pleaded guilty to criminal charges and agreed to pay \$606 million in criminal restitution to defrauded investors.¹⁰⁵ On the civil side, Republic Securities consented to orders by the SEC and CFTC revoking its registration as a broker-dealer of securities and commodities, and agreed to pay a \$5 million penalty in the CFTC case.¹⁰⁶ Victims benefited from the criminal restitution, and the public benefited from the revocation of the firm's registrations.

CONCLUSION

Criminal and civil prosecution of corporations is a necessary and well-established component of the securities law enforcement landscape. Some may lament the passage of an era, before federal regulation, when common law precluded corporate criminal liability. The federal securities laws, however, provide for vigorous law enforcement precisely because Congress and the public recognized long ago that common law protections were wholly inadequate by themselves to protect the investing public.¹⁰⁷

¹⁰² See *United States v. Republic N.Y. Sec. Corp.*, No. 1180, 01 Cr. at 5-6.

¹⁰³ *Id.* at 13-15.

¹⁰⁴ See *SEC v. Princeton Economics Int'l Ltd.*, No. 99 Civ. 9667 (S.D.N.Y. Sept. 13, 1999); *U.S. v. Armstrong*, No. 99 Cr. 997 (S.D.N.Y. Sept. 13, 1999).

¹⁰⁵ Press Release, SEC, SEC Revokes Registration of Republic New York Securities Corp., a Broker-Dealer Pleading Guilty to Securities Fraud in Related Criminal Action (Dec. 17, 2001), available at <http://www.sec.gov/news/press/2001-148.txt> [hereinafter *SEC Revokes Registration*].

¹⁰⁶ See *In re Republic N.Y. Sec. Corp.*, Exchange Act Release No. 45,157, 2001 SEC LEXIS 2595 (Dec. 17, 2001); *SEC Revokes Registration*, *supra* note 105.

¹⁰⁷ See *Herman & MacLean v. Huddleston*, 459 U.S. 375, 389 (1983) ("An important purpose of the federal securities statutes was to rectify perceived deficiencies in the available common[-]law protections by establishing higher standards of conduct in the securities industry.").