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# Enhancing the Compensatory Roles of Financial Regulatory Agencies in South Korea: Lessons from the U.S. SEC's FAIR Fund

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**ENHANCING THE COMPENSATORY ROLES OF  
FINANCIAL REGULATORY AGENCIES IN SOUTH KOREA:  
LESSONS FROM THE U.S. SEC'S FAIR FUND**

DAEIL KIM

Submitted to the faculty of Indiana University Maurer School of Law

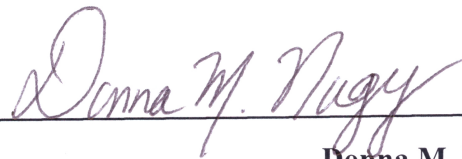
in partial fulfillment of the requirements

for the degree

Master of Laws – Thesis

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Accepted by the faculty, Indiana University Maurer School of Law, in partial fulfillment of the requirements for the degree of Master of Laws – Thesis.

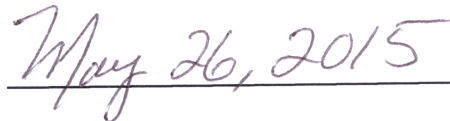
A handwritten signature in cursive script, reading "Donna M. Nagy", written over a horizontal line.

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Submission date of thesis

A handwritten date in cursive script, reading "May 26, 2015", written over a horizontal line.

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[Daeil Kim]

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“Your life is a dashing and bold adventure.” Unbelievably, my first fortune cookie message that I got soon after having arrived in Bloomington was true. Not just living in a different culture, but also studying a different legal system has always been adventurous to me. Although writing this paper was not easy, the experience gave me great pleasure and expanded my understanding of financial regulation. I hope this thesis helps our country to improve, at least a little, the financial regulatory system. Lack of my capacity and several limitations of this study made this paper less satisfactory to myself. Obviously I should have done better with this thesis, but such regret will inspire my next goal, the S.J.D dissertation. Very Long ago, approximately ten years ago as I remember, I had a dream that I would study law academically and made an effort to realize this dream during the past years. Eventually, I took another step forward towards achieving my dream, even though I have a long way to go before it is realized. Until I realize my dream, I will continue to make my best effort incessantly.

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[Daeil Kim]

Enhancing the Compensatory Roles of Financial Regulatory Agencies in  
South Korea: Lessons from the U.S. SEC's FAIR Fund

Recent financial scandals in South Korea that caused massive harms to financial consumers instigated voices that financial regulators should play a more active role in recompensing victims for losses incurred by misconduct in the financial market. In this regard, this thesis aims to suggest several considerations in developing the compensation scheme for injured financial consumers in Korea. This thesis first reviews the Federal Account for Investor Restitution (FAIR) Fund operated by the U.S. Securities and Exchange Commission. Specifically, it broadly addresses the history, overall process, operation, and major issues related to the FAIR Fund. Based on the FAIR Fund review, this thesis suggests several considerations financial regulators and legislators in Korea should take into account when developing a public compensation system.

In brief, this thesis suggests that public compensation in Korea needs to be considered in conjunction with the strength of monetary sanctions in the financial regulatory arena. It also suggests that policymakers should consider other factors such as the availability of private compensation, the adequacy of procedures, and the regulatory agency's mission and resources. This study also emphasizes that, in developing a compensation scheme, the focus should be on how the regulators can enhance their compensatory role while maintaining the deterrence effect of securities enforcement actions.

# Table of Contents

<b>I.</b>	<b>Introduction</b>	<b>1</b>
A.	Background	1
B.	Purpose and Synopsis	5
<b>II.</b>	<b>Current Compensatory Schemes in Korea</b>	<b>8</b>
A.	Financial Regulatory System in South Korea	8
B.	Current Compensatory Schemes	10
1.	Financial Disputes Mediation	10
i.	Overview	10
ii.	FDM process	11
iii.	FDM cases filed in the FSS	14
2.	Refund of Damages Incurred by Phishing Frauds	15
i.	Overview	15
ii.	Process for the damage refund	16
iii.	Refund amount	17
3.	Limitations of Current Compensatory Schemes	18
i.	FDM	18
ii.	Damage Refund System	19
<b>III.</b>	<b>Overview of the SEC’s Disgorgement and Civil Monetary Penalty</b>	<b>21</b>
A.	Disgorgement	21
B.	Civil Monetary Penalty	25



C. Two-Track System: civil and criminal monetary penalties .....	27
<b>IV. Review of the SEC’s Fair Fund .....</b>	<b>32</b>
A. Overview .....	32
B. Creation and Distribution of the Fair Fund .....	37
1. Creation of a Fair Fund .....	37
2. Plan of Distribution .....	39
3. Administration of Plans .....	41
4. Distribution of Funds .....	42
C. Empirical Data on Fair Funds .....	45
1. Fair Fund Creation .....	45
2. Trend in Fair Fund Creation Over Time .....	47
3. Completion of Distribution .....	51
D. Major Fair Fund Issues .....	52
1. Circularity of the Fair Fund Distribution .....	52
2. Conflict with the Bankruptcy Code .....	54
3. Duplication of Securities Class Action Suits .....	56
4. Conflict with the SEC’s Missions .....	63
5. Lack of Procedural Protection .....	67
E. The SEC’s Enforcement Actions in Light of the Fair Fund .....	70
1. Aiders and Abettors .....	71
2. Market Intermediaries .....	72
3. Individual Offenders .....	74

<b>V.</b>	<b>Considering Public Compensation under the Legal Environment</b>	
	<b>in Korea</b>	<b>78</b>
A.	Compensatory Aspect Should Be Considered in Monetary Sanctions	78
1.	Current Monetary Sanctions in Financial Regulation	78
i.	Typical form of monetary sanction	79
ii.	Penalty surcharge	81
2.	Need for penalty surcharge in financial regulation	86
3.	Importance of compensatory aspect in monetary sanctions	87
4.	Considering the penalty surcharge in terms of compensation	88
B.	Availability of Private Action Should Be Considered	90
C.	Standards and Procedures for Distribution Should Be Provided	92
D.	The Agency’s Mission and Resources Should Be Considered	94
<b>VI.</b>	<b>Conclusion</b>	<b>97</b>
	<b>Bibliography</b>	<b>99</b>

## I. Introduction

### A. Background

Starting in late 2013, South Korea's financial regulators have struggled to provide relief for victims aggrieved by two financial scandals that occurred one after the other: first, the 'Tong Yang crisis' that resulted from the Tong Yang affiliates' fraudulent issuance of securities,<sup>1</sup> and second, the massive leak of personal information by major credit card companies.<sup>2</sup> These two scandals resembled each other in that they gave rise to

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<sup>1</sup> Five affiliates of the Tong Yang Group, which was South Korea's 38th largest conglomerate, filed for bankruptcy reorganization in court on September 30, 2013 (two other affiliates filed on October 1, 2013). Since shortly before filing in court the Group had aggressively issued corporate bonds and commercial papers to individual investors in an effort to make up for their liquidity deficit; it was alleged that Tong Yang affiliates fraudulently issued securities to investors even though the companies knew in advance that they would be unable pay off their maturing debts and had even prepared for the court filing. It was also alleged that the Tong Yang Securities Company, which was the affiliated brokerage firm, sold affiliates' securities to investors without sufficiently explaining the relevant risks on investment in order to promote sales. Soon after this incident occurred, the FSS and the prosecution began an investigation of related parties including issuers, their officials, and an affiliated brokerage firm. For more details on this case, *see Three Tong Yang Affiliates File for Court Receivership*, THE KOREA HERALD, Sep. 30, 2013, *available at* <http://www.koreaherald.com/view.php?ud=20130930000259> (last visited on May 18, 2015); Yon-se Kim, *Tong Yang Under Fire for Unethical Deal*, THE KOREA HERALD, Oct. 2, 2013, *available at* <http://www.koreaherald.com/view.php?ud=20131002000740> (last visited on May 18, 2015); Press Release, FSS, Geumgamwon Bunjaengjojeongwi Dongyanggeulub Tuja Gwanlyeon Bunjaengjojeong Gyeoljeong [The Financial Disputes Mediation Committee of the FSS made mediation decision on disputes related to investment on Tong Yang Group], July 31, 2014 (hereinafter "PRESS RELEASE ON TONG YANG MEDIATION"), *available at* [http://www.fss.or.kr/fss/kr/promo/bodobbs\\_view.jsp?seqno=18010&no=56&s\\_title=%B5%BF%BE%E7&s\\_kind=title&page=1](http://www.fss.or.kr/fss/kr/promo/bodobbs_view.jsp?seqno=18010&no=56&s_title=%B5%BF%BE%E7&s_kind=title&page=1) (last visited on May 18, 2015).

<sup>2</sup> The massive client data leakage of credit card companies became known through the prosecution's investigation. According to the prosecution, the personal information of credit card holders, including names, social security numbers, addresses, phone numbers, incomes, and designated bank account numbers on 104 million credit cards issued by three credit card companies were leaked outside the companies. The information leakage was caused by a young technician who was hired by an individual credit rating company. *See* Press Release, Changwon District Prosecutor's Office, Kadeuhoesa Gogaegjeongbo Yuchul Sageon Junggan Susagyeolgwa [Interim Brief for investigation on Client Information Leak of Credit Card Companies] (Jan. 8, 2014), *available at* [http://www.spo.go.kr/changwon/notice/press/press.jsp?mode=view&article\\_no=567739&pager.offset=0&search:search\\_val:search=%25C4%25AB%25B5%25E5%25C8%25B8%25BB%25E7&search:search\\_val0:equals0=&search:search\\_key:search=article\\_title&search:search\\_field0:equals0=A.etc\\_char1&board\\_no=2](http://www.spo.go.kr/changwon/notice/press/press.jsp?mode=view&article_no=567739&pager.offset=0&search:search_val:search=%25C4%25AB%25B5%25E5%25C8%25B8%25BB%25E7&search:search_val0:equals0=&search:search_key:search=article_title&search:search_field0:equals0=A.etc_char1&board_no=2)

widespread harm to financial consumers, such as investors and credit card holders, and regulators were blamed for failing to manage the misconduct in the financial market.<sup>3</sup> Even though victims and political entities called for prompt measures from regulators to rectify their damages, Korean regulators did not have much more to do than impose sanctions on violators and mediate related disputes between customers and the financial intermediary.<sup>4</sup> In the wake of these scandals, arguments were raised that the government should play a more active role in recompensing victims for losses incurred by financial institutions' violation of the law.<sup>5</sup> Similarly, the National Assembly amended the law to

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&stype= (last visited on May 18, 2015); Sang-Hun Choi, *Theft of Data Fuels Worries in South Korea*, N.Y. TIMES, Jan. 20, 2014, available at [http://www.nytimes.com/2014/01/21/business/international/theft-of-data-fuels-worries-in-south-korea.html?\\_r=0](http://www.nytimes.com/2014/01/21/business/international/theft-of-data-fuels-worries-in-south-korea.html?_r=0) (last visited on May 18, 2015).

<sup>3</sup> The FSS reported that more than 41,000 retail investors suffered collective losses of an estimated 1.7 billion dollars from the Tong Yang affair. PRESS RELEASE ON TONG YANG MEDIATION, *supra* note 1, at 8. Investors not only filed a number of suits including securities class actions against Tong Yang affiliates, but also filed for mediation in the FSS to seek compensation from Tong Yang Securities Company. In the personal information leak case, even though it has been rarely reported that victims experienced actual economic losses, such as a third party's loan application based on the leaked information, a number of actions were filed to recover damages for emotional.

<sup>4</sup> In the Tong Yang case, after the FSS's investigation, the Securities and Futures Commission reported related parties, including the chairman of Tong Yang Group, to the prosecution on charges of securities law violations in January 2014. See Press Release, FSC & FSS, Jabonsijang Bulgongjeonggeolae Daehan Josagyeolgwa Jochi [Regulatory Actions on Unfair Trading in the Capital Market] (Jan. 8, 2014), available at [http://www.fss.or.kr/fss/kr/promo/bodobbs\\_view.jsp?seqno=17493&no=251&s\\_title=%BA%D2%B0%F8%C1%A4%B0%C5%B7%A1&s\\_kind=title&page=2](http://www.fss.or.kr/fss/kr/promo/bodobbs_view.jsp?seqno=17493&no=251&s_title=%BA%D2%B0%F8%C1%A4%B0%C5%B7%A1&s_kind=title&page=2) (last visited on May 18, 2015). In addition, the FSS is currently proceeding with the disciplinary procedure against Tong Yang Securities Company. To deal with investors' claims against the brokerage firm that sold securities, the FSS also collectively received filings from investors' for dispute mediation. The mediation committee held the brokerage firm liable in 24,000 contracts out of 36,000 contracts made by 16,000 investors who filed for mediation, and made a mediation decision that investors are eligible to recover 15 percent to 50 percent of investment amounts from the brokerage firm, depending on such factors like the individual's investment experience, knowledge, age, and occupation. PRESS RELEASE ON TONG YANG MEDIATION, *supra* note 1, at 3.

<sup>5</sup> See, e.g., Dae Hyeong Jo, *Geumyungsobijabohogigeum Doib Nonuiwa Gaeseongwaje* [Discussion for implementation of the Financial Consumer Protection Fund and Issues for its Improvement], 902 ISYUWA NONJEOM [ISSUE & POINT], National Assembly Research Service (Aug. 26, 2014) (reviewing the importance and legal issues of the Financial Consumer Protection Fund in light of ex-post financial consumer protection).

require that the regulatory authority take responsibility for matters on damage relief such as restitution.<sup>6</sup>

In addition, in response to recent financial disasters and a strong deregulation drive led by President Park Geun-hye, voices are increasing that financial regulators should tighten supervision over financial institutions and have a stronger arsenal in order to prevent financial incidents which may increase in the aftermath of deregulation.<sup>7</sup> To this end, it is suggested that Korea's financial regulator should retain the authority to make use of monetary sanctions more actively in its enforcement actions to deter future violations of financial laws.<sup>8</sup>

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<sup>6</sup> The Congress amended the Act on the Establishment, etc. of Financial Services Commission in May 2014 in order to assign the FSC its new mission of relieving financial consumers' damages. The amendment added "matters concerning remedies for damage, such as the protection of and compensation to financial consumers" as one of the FSC's roles in subparagraph 5 of Article 17. Ki Sik Kim, a congressman who submitted the bill, explained the reason for proposal as follows:

A series of massive financial harms caused by financial institution's violation of laws show that the FSC's current function of sanction is not sufficient to accomplish the legislative intent to establish sound credit order and fair financial transaction practices, and protect financial consumers such as depositors and investors. In specific, the FSC currently do not have any authority that the Commission forces a financial institution to retribute quickly and adequately widespread harms caused by the financial incident.

The proposal originally intended to adopt the Consumer Redress Scheme utilized by the U.K. Financial Services Authority for financial consumers' damage relief, but the National Policy Committee of the National Assembly which reviewed the proposal, decided to stipulate the statute more broadly so as that government can study and develop adequate compensation model. *See* National Policy Committee, Geumyungwiwonhoeui seolchideunge gwanhan beoblyul ilbugaejeongbeoblyulan geomtobogoseo [Review on the amendment of the Act on the Establishment, etc. of Financial Services Commission] (May 1, 2014).

<sup>7</sup> To keep pace with the deregulation drive, in July 2014, the FSC announced the 'Financial Regulation Reform Plan' which aims to improve 700 cases selected after review of 1,700 cases of regulations. The FSC also stressed the importance of strengthening the internal control system of the financial institutions and enhancing the effectiveness of the monetary penalty in order to block the side effects of deregulation. Press Release, FSC, Geumyunggyuje Gaehyeogbangan Balpyo: Hyeonjang Jungsimeulo Sogdogamissge Chujin [Announcing the Financial Regulation Reform Plan: Pushing Ahead with Speed], July 9, 2014, *available at* [http://www.fsc.go.kr/info/ntc\\_news\\_view.jsp?bbsid=BBS0030&page=1&sch1=subject&sword=%EA%B7%9C%EC%A0%9C&r\\_url=&menu=7210100&no=29906](http://www.fsc.go.kr/info/ntc_news_view.jsp?bbsid=BBS0030&page=1&sch1=subject&sword=%EA%B7%9C%EC%A0%9C&r_url=&menu=7210100&no=29906) (last visited on May 18, 2015).

<sup>8</sup> *See generally*, Yong Chan Lee, *Monetary Sanction on Financial Institutions in Korea: Problems and Proposals for Improvement*, 9-3 CHUNG-ANG L. REV. 537 (2007) (pointing out that while disciplinary

However, under the current monetary sanction system, when the financial regulator imposes monetary sanctions on violators, the collected monies are transferred to the National Treasury account. Accordingly, as the penalty amounts increase, it may raise the question of whether it is proper for the government to keep the funds stemming from a violator's misconduct that caused financial consumers' damages without distributing those monies for the relief of victims.<sup>9</sup>

Therefore, when discussing how to improve the monetary sanction system in the financial regulatory domain, the use of the monies collected from monetary sanctions also needs to be considered at the same time. In this respect, the history of securities regulation in the United States (U.S.) offers a valuable example for Korean regulators. In the U.S., section 308<sup>10</sup> of the Sarbanes-Oxley Act of 2002 ("SOX")<sup>11</sup> authorizes the U.S. Securities and Exchange Commission ("SEC") to distribute civil monetary penalties through the Federal Account for Investor Restitution (FAIR) Fund for the relief of investors victimized

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sanction is to take place mainly in the form of professional sanctions, monetary sanction is limited both in its scope and imposition, and also arguing that the government should supplement current monetary sanction in the short run, and initiate the penalty surcharge against individual employees in the long run); Byoung Youn Kim, *Introduction of Financial Penalty against Unfair Transaction Under Capital Market and Financial Investment Service Act*, 32-4 COMMERCIAL L. STUDY 73, 78-79 (2014) (arguing that in addition to the criminal penalty, the monetary sanction needs to be imposed in order to put teeth in the regulation of unfair trading such as insider trading, market manipulation, and fraudulent trading).

<sup>9</sup> See, e.g., Taeseong Lee, *Kadeusa Yuchul Pihajaneun Gugmininde ... Gwajinggeumeun Jeongbuga Kkulkkeog?* [*The Public Was Damaged by Credit Card Information Leak, But Will the Government Gulp Down the Monetary Penalty?*], MONEY TODAY, Feb. 3, 2014, available at <http://www.mt.co.kr/view/mtview.php?type=1&no=2014020311255473049&outlink=1> (last visited on May 18, 2015) (stressing that punitive penalty system which the government is pushing is far from compensation for victims).

<sup>10</sup> 15 U.S.C. § 7246.

<sup>11</sup> Pub. L. No. 107-204, 116 Stat. 745 (codified in scattered sections of 11, 15, 18 and 28 U.S.C.).

in connection with securities law violations.<sup>12</sup> While “Fair Fund” distributions provide defrauded investors with the opportunity to recover their financial losses, on the other hand, some aspects have raised regulatory concerns. Therefore, reviewing the SEC’s Fair Fund will provide useful guidance to Korean financial regulators and legislators when they develop a compensation scheme commensurate with the Korean financial regulatory regime.

## **B. Purpose and Synopsis**

The purpose of this study is to review the operation of and major issues with the U.S. SEC’s Fair Fund and provide Korean financial regulators and lawmakers with suggestions for developing the compensation scheme for widespread harm caused in the financial market. Specifically, since the SEC’s Fair Fund is unfamiliar under the Korean legal system and has never been studied by Korean law scholars, this study describes the Fair Fund in detail to provide useful information to readers.

This study consists of six parts. Part II begins with an overview of Korea’s financial regulatory system, and subsequently reviews the current compensatory schemes exercised by financial regulators: the first is financial dispute mediation, which has traditionally been used to resolve disputes between financial consumers and financial institutions. The other is the refund of damages incurred by phishing frauds, which has

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<sup>12</sup> Section 308(a) of the SOX (codified at 15 U.S.C. § 7246(a)).

been recently introduced. Part II also argues that the current compensatory functions are restrictive for handling compensation for massive harms caused by violations of financial laws.

Before reviewing the Fair Fund, Part III provides a brief overview of the history of the SEC's authority over monetary sanctions in its enforcement actions. Even though the SEC retains a variety of tools in its enforcement to impose sanctions on a securities law violator, the ability to seek disgorgement and civil monetary penalties is relatively recent in the SEC's history. The SEC's authority to seek civil monetary penalties in its enforcement actions raised questions about the relationship with criminal penalties. Thus, Part III examines the relationship between civil and criminal monetary penalties from the perspective of parallel civil and criminal proceedings.

Part IV comprehensively reviews the Fair Fund under the U.S. securities regulatory system. First, Part IV provides an overview of the history of the Fair Fund and the SEC's efforts to improve the Fair Fund distribution. Next, it explores the overall process from creation of the Fair Fund to the termination of distributions, and introduces statistics and analyses of past Fair Fund distributions. Third, despite the SEC's efforts, scholars have criticized the Fair Fund in several respects. Thus, Part IV discusses criticisms of the Fair Fund distribution such as the circularity or wealth transfer problem, conflicts with bankruptcy law, duplication of private litigations, conflicts with the SEC's missions, and lack of procedural protection. Further, this Part suggests several cases where the Fair Fund can serve as a useful remedy without creating potential problems.

Based on the Fair Fund review, Part V suggests several considerations in developing the compensation scheme for injured financial consumers in Korea. It



suggests that public compensation needs to be considered in conjunction with the strength of monetary sanctions in the financial regulatory arena. It also suggests that policymakers should consider other factors such as the availability of private compensation, the adequacy of procedures, and the regulatory agency's mission and resources. Part VI concludes with a summary of this study.

## II. Current Compensatory Schemes in Korea

Before reviewing the SEC's Fair Fund, this Part briefly overviews the financial regulatory system in Korea and introduces the two compensation schemes Korean regulators currently use to relieve damages to financial consumers incurred in the course of financial transactions: (1) Financial Disputes Mediation and (2) Refund of Damages Incurred by Phishing Frauds.

### A. Financial Regulatory System in South Korea<sup>13</sup>

Unlike the U.S. where federal financial regulatory authority over financial institutions is dispersed among different federal agencies such as the SEC, CFTC, OCC, NCUA, FHFA, and Consumer Financial Protection Bureau, Korea has an integrated financial supervisory system, which means that a variety of financial institutions are under the supervision of the same regulatory agencies.<sup>14</sup> Such regulatory authority is primarily vested in the Financial Services Commission ("FSC"), the Securities and Futures Commission ("SFC"), and the Financial Supervisory Service ("FSS") pursuant to the Act

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<sup>13</sup> See generally, FINANCIAL SUPERVISORY SERVICE, FSS HANDBOOK, 1, 11-21 (2014), available at <http://english.fss.or.kr/fss/en/publications/system/list.jsp?bbsid=1289364537633> (last visited on May 18, 2015).

<sup>14</sup> The current integrated supervisory system was initiated in 1999 based on recommendations by the Presidential Committee on Financial Reform in 1997. This regulatory reform led to the consolidation of four financial supervisory bodies, which were the Office of Bank Supervision (OBS), the Securities Supervisory Board (SSB), the Insurance Supervisory Board (ISB), and the Non-bank Supervisory Authority (NSA), into a single supervisory agency, the Financial Supervisory Service. Along with consolidation, the Financial Supervisory Commission (currently Financial Services Commission) and the Securities and Futures Commission were established in 1998 to supervise the integrated agency. *Id.* at 11-12.

on the Establishment, etc. of Financial Services Commission (“FSC Establishment Act”) and related financial laws.

First, the FSC has broad authority on matters related to financial markets such as planning financial market policy, establishing financial supervisory regulations, issuing licenses to new businesses or revoking licenses, and imposing sanctions on violators of financial laws and regulations.<sup>15</sup> Second, the SFC has authority over capital market investigations, accounting standards, and reviewing audit reports.<sup>16</sup> In addition, the SFC conducts preliminary review of matters relating to the securities and futures market to be deliberated by the FSC. Lastly, the FSS, which is an independent agency and not a part of the administration, primarily engages in regulatory activities such as the ongoing supervision and on-site examination of financial institutions, investigating the capital market, and consumer protection.<sup>17</sup> The FSS largely performs matters that belong to the authority of the FSC and the SFC by delegation under the statutes. The FSC and FSS also have rule-making authority to regulate matters delegated by the relevant financial laws.

In matters dealing with financial law enforcement such as examinations of financial institutions or investigations of capital market violations, the FSS staff are the first to initiate the examination or investigation process. When the FSS staff discover an

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<sup>15</sup> The FSC is led by nine Commissioners including the Chairman and the Vice Chairman who serve a three-year term and are appointed by the President. The FSC has six bureaus and one division with over 251 officials. *Id.* at 16.

<sup>16</sup> The SFC consists of five Commissioners and the Vice Chairman of the FSC concurrently holds the position of the Chairman of the SFC. *Id.* at 17.

<sup>17</sup> The FSS is headed by the Governor. Under the law, up to four Senior Deputy Governors, up to nine Deputy Governors, and a Chief Executive Auditor may be appointed under the Governor. The Governor and the Chief Executive Auditor are appointed by the President with the recommendation of the Chairman of the FSC. *Id.*

alleged violation as a result of the examination or investigation, and after review by the Enforcement Review Committee (in the case of an examination) or the Deliberative Committee (in the case of an investigation), the FSS reports its findings and proposed sanctions of the alleged violation to the FSC or SFC unless the sanction is authorized by the Governor of the FSS pursuant to the laws. After deliberating on a proposal in the meeting, the FSC or SFC approve or deny the proposal, or amend the proposal to impose the decided upon sanction. If a violation is subject to criminal penalties, the FSC or SFC refers the case to the criminal authorities such as the prosecution.

## **B. Current Compensatory Schemes**

### **1. Financial Disputes Mediation**

#### **i. Overview**

The Financial Disputes Mediation (“FDM”) is an alternative dispute resolution in which financial consumers can seek a monetary remedy for the allegedly illegal and abusive activities of financial institutions by requesting mediation to the FSS. The FDM aims to use expertise and organization to overcome the disadvantages that occur when financial consumers try to resolve disputes against financial institutions, and to relieve financial consumers of the significant cost and time burden of private litigation.<sup>18</sup> The FSS has taken charge of FDM cases since its establishment in 1999,<sup>19</sup> and has a ‘Dispute

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<sup>18</sup> FSS, Geumyungsobijaboho Baegseo [A White Paper on Financial Consumer Protection], 325 (April 2011).

<sup>19</sup> The FSS was established in January 1999 by consolidating four financial supervisory bodies, which were

Settlement Department' within the agency to deal with FDM cases effectively.<sup>20</sup> The FDM was established in the "Act on the Establishment, etc. of Financial Services Commission."<sup>21</sup> The FSS enacted the "Detailed Regulations on Mediation of Financial Disputes" (hereinafter "Detailed Regulations on FDM") to prescribe procedures for the FDM and the operation of the Financial Disputes Mediation Committee ("FDMC").

## ii. FDM process

The FDM process is generally initiated by filing an application for mediation after a dispute concerning financial matters arises between financial consumers and financial institutions.<sup>22</sup> Financial consumers, financial institutions, and other interested parties may file an application for mediation with the FSS. Applications may be filed jointly, and an appointed representative may perform all acts concerning a case for applicants who

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the Office of Bank Supervision (OBS), the Securities Supervisory Board (SSB), the Insurance Supervisory Board (ISB), and the Non-bank Supervisory Authority (NSA), into a single supervisory organization. As a result, dispute mediation, which had been performed by OBS, SSB, and ISB respectively, was replaced by the FDM of the FSS. See FSS HANDBOOK, *supra* note 13 at 12.

<sup>20</sup> The Dispute Settlement Department is made up of five teams, which are divided by types of financial products such as banking, insurance, and securities. Approximately forty staff members including lawyers review the FDM cases and support the FDMC. For the organization and functions of the Dispute Settlement Department, see FSS website, Organization Chart & Department Guide, available at [http://www.fss.or.kr/fss/kr/about/fss/board\\_list.jsp?p\\_buso=208203000](http://www.fss.or.kr/fss/kr/about/fss/board_list.jsp?p_buso=208203000) (last visited on May 18, 2015).

<sup>21</sup> See Act on the Establishment, etc. of Financial Services Commission § 5.

<sup>22</sup> Financial disputes are defined as "disputes filed against finance-related agencies by other finance-related agencies, financial consumers, such as depositors or such, and other interested parties, as the rights and duties or interests arise in connection with financial services, etc. of finance-related agencies." See Detailed Regulations on FDM § 5(3). Here, finance-related agencies mean financial institutions subject to examination by the FSS. These include banks, non-bank financial institutions, securities-related companies, insurance companies, the National Agricultural Cooperative Federation, the National Federation of Fisheries Cooperatives, and others. See Detailed Regulations on FDM § 3(4).

have selected their representative.<sup>23</sup>

After receiving an application for the FDM, the Disputes Settlement Department reviews the case and proceeds with discovery to verify the facts concerning the disputes.<sup>24</sup> Unless the case is directly settled by the FSS,<sup>25</sup> the FSS refers the case to the FDMC.<sup>26</sup> The FDMC deliberates on a case within sixty days from the date when the case was referred to it, and makes either a mediation decision or decision of dismissal.<sup>27</sup> When the FDMC has made a decision, it prepares a written mediation decision or decision of dismissal, and notifies the Governor of the FSS of the results.<sup>28</sup> Unless the Governor of the FSS requests the FDMC to reconsider the case,<sup>29</sup> the FSS notifies the parties of a written decision of the

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<sup>23</sup> Detailed Regulations on FDM § 12.

<sup>24</sup> The Department may make an inquiry into, or request attendance of, related persons in connection with the case. If deemed necessary, it may perform on-site examinations or request to examine specific departments. *See* Detailed Regulations on FDM § 16.

<sup>25</sup> In cases where details of an application fall under any of subparagraphs enlisted in § 17(1) of the Detailed Regulations on FDM, the FSS may directly settle an application for mediation without reference to the FDMC, or transmit it to the relevant agency to settle it. For example, when the case has already been brought before the court or a lawsuit has been instituted after an application for mediation was made, the FSS may directly settle the case.

<sup>26</sup> The FDMC is composed of thirty members or less, headed by the Deputy Governor of the FSS. The FDMC members are appointed by the Governor of the FSS among assistant governors of the FSS, and are persons who have expertise and experience in law, finance, consumer protection, medical science, etc. Every meeting of the FDMC is comprised of no less than 7 members and not more than 11 members appointed by the Chairperson by not later than one week prior to a meeting, and convened by the Chairperson. A decision of the FDMC is made by a majority of members present at the meeting at which a quorum is present. For composition and operation of the FDMC, *see* Detailed Regulations on FDM Chap. II.

<sup>27</sup> Detailed Regulations on FDM § 25(1).

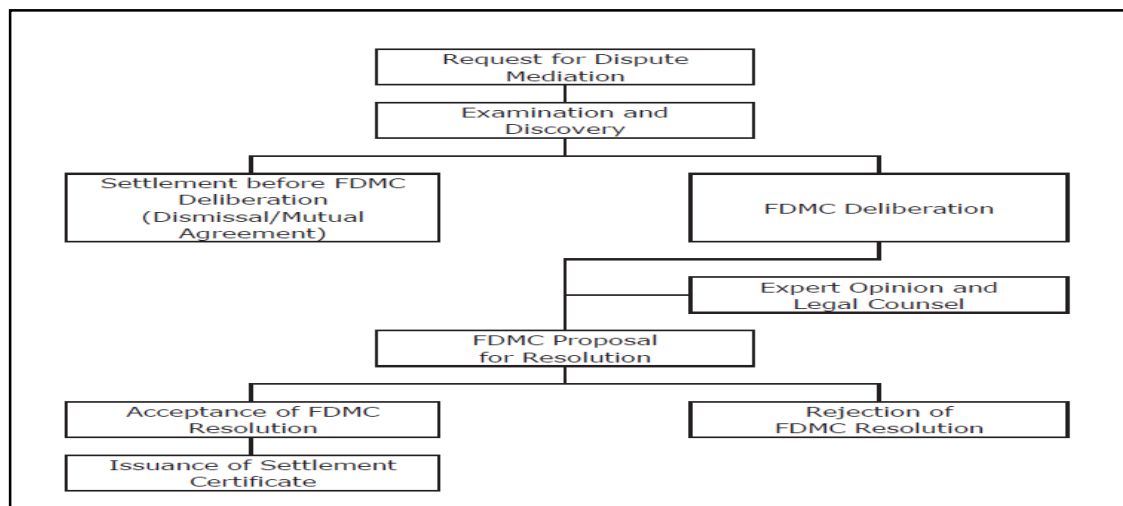
<sup>28</sup> Detailed Regulations on FDM § 26.

<sup>29</sup> For cases where the Governor may request reconsideration, *see* Detailed Regulations on FDM § 27(1).

FDMC.<sup>30</sup>

Acceptance of the mediation terms proposed by the FSS is entirely voluntary, and either party may reject the proposal and seek legal remedies through the court system.<sup>31</sup> Once both parties accept the proposal, such acceptance has the same effect as a judicial settlement.<sup>32</sup> Thus, both parties are bound by the terms of the mediation and are not allowed to further dispute the case in litigation. If the FDMC deems that the measures taken by a financial institution are remarkably unjust, the FSS may provide support to an applicant in a lawsuit by request of the FDMC.<sup>33</sup>

Figure 1. FINANCIAL DISPUTES MEDIATION PROCEDURE<sup>34</sup>



<sup>30</sup> Detailed Regulations on FDM § 28.

<sup>31</sup> FSS HANDBOOK, *supra* note 13 at 148.

<sup>32</sup> Act on the Establishment, etc. of Financial Services Commission § 55.

<sup>33</sup> Detailed Regulations on FDM § 32-2. Under this program, which was initiated in 2002, the FSS may support an applicant's lawsuit against a financial institution by appointing an attorney and paying the attorney's fee at its own expense.

<sup>34</sup> FSS HANDBOOK, *supra* note 13 at 150.

### iii. FDM cases filed in the FSS

Based on recent four-year statistics related to the FDM, more than 25,000 cases were filed annually in the FSS for mediation. The majority of the cases concerned insurance, comprising approximately three quarters of the total, followed by banking & non-banking, and then securities, except in 2013, which reflected securities investors' massive applications to the FDM after the Tong Yang Crisis.<sup>35</sup> According to FDM statistics, 45.4 percent of cases among the total FDM filings during 2010 were decided in favor of the applicant.<sup>36</sup>

Table 1. NUMBER OF THE FDM CASES FILED IN THE FSS<sup>37</sup>

	2010	2011	2012	2013
Banking & Non-banking	4,351	10,036	6,955	6,163
Securities	788	763	442	18,394
Insurance	20,749	22,654	21,159	20,247
Total	25,888	33,453	28,556	44,804

<sup>35</sup> In the aftermath of the Tong Yang affair, investors began to file for the FDM against Tong Yang Securities Company from October, 2013, alleging that the company intentionally did not explain properly and sufficiently the risks related to the investment to investors and recommended the securities indiscriminately without considering investor's experience and knowledge in order to promote sales of its affiliates' securities, which resulted in widespread damages. As of July 2014, approximately 22,000 investors filed a case. PRESS RELEASE ON TONG YANG MEDIATION, *supra* note 1, at 1.

<sup>36</sup> This rate, which is called the "acceptance rate", is calculated by dividing the number of cases that the FSS accepts by the total number of cases completed during the year except cases withdrawn or referred to other agencies. See Press Release, FSS, 2010nyeon Geumyungbunjaengjojeong Siljeog Mich Sojegi Hyeonhwang [Results for Financial Disputes Mediation and Status of Subsequent Lawsuits in 2010], Jan. 31, 2011, available at [http://www.fss.or.kr/fss/kr/promo/bodobbs\\_view.jsp?seqno=14916&no=1&s\\_title=%BC%D2%C1%A6%B1%E2&s\\_kind=title&page=1](http://www.fss.or.kr/fss/kr/promo/bodobbs_view.jsp?seqno=14916&no=1&s_title=%BC%D2%C1%A6%B1%E2&s_kind=title&page=1) (last visited on May 18, 2015).

<sup>37</sup> FSS, FSS website: Financial Disputes Statistics, available at <http://consumer.fss.or.kr/fss/consumer/minwonetc/bbs/list.jsp?bbsid=1329181518731&url=/fss/cm/1329181518731> (last visited on May 18, 2015) (providing the FDM statistics periodically). In this table, non-banking institutions include mutual savings banks, credit-specialized financial institutions (i.e. credit card companies, lease companies), credit unions, etc.



## 2. Refund of Damages Incurred by Phishing Frauds

### i. Overview

A few years ago, the National Assembly authorized financial regulators to perform a new compensatory role. The National Assembly established the ‘Special Act on the Refund of Damages Incurred from Telecommunication Financial Fraud’ (hereinafter “Special Act”) in 2011<sup>38</sup> to relieve financial consumers’ damages from increased phishing fraud.<sup>39</sup> Before the enactment of the Special Act, a victim of phishing fraud had to file a civil suit against the account owner who had transferred the victim’s money in order to recover the balance remaining in the account.<sup>40</sup> That is, even though a balance remained

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<sup>38</sup> As the act was amended to enhance the responsibilities of financial institutions and regulatory authorities for the prevention of phishing fraud, it was renamed as the Special Act on Prevention of Telecommunication Financial Fraud and the Damage Refund [hereinafter “Renewed Special Act”] in July 2014.

<sup>39</sup> Phishing fraud is a specific kind of fraud crime to swindle money out of victims through non-face-to-face transactions using telecommunication financial means. One of the most well-known phishing frauds is voice phishing, which induces victims to transfer money by deceiving them or draws money from the victim’s account by using deceptively obtained financial information in the course of telephone communication. According to the National Police Agency’s statistic, the number of occurrences of phishing fraud and the amount of damages kept increasing until 2011 when the Special Act was established, and they reached their peak in 2011, which amounted to 8,244 cases and 102 billion won respectively. See Boiseupising Jikimi [Voice Phishing Keeper], Overview of Phishing Fraud, available at <http://phishing-keeper.fss.or.kr/fss/vstop/guide/define.jsp> (last visited on May 18, 2015) (website designed to provide the public with information on preventive measures against phishing fraud and refund of damages).

<sup>40</sup> In phishing crime, it is generally known that once a victim remits money to the account employed in the fraud, a defrauder draws money from the account within 5 minutes from the time deposited. Thus, when a victim requests a bank to suspend payment, it is likely that the money that a victim has sent would be already drawn out. However, since monies are deposited from many different victims in the account, there is a possibility that the account retains a certain level of balance at the time of suspension. Moreover, such possibility has increased due to a new delayed withdrawal system, which was initiated in 2012 in order to raise effectiveness of suspension of payment for the account employed in the fraud by delaying the time required to withdraw. Under the new system, cash withdrawals of three million won or more is not possible until at least 10 minutes after the money has been wired. Press Release, FSS, ‘12.6.26II (Hwa) Buteo Jiyeoninchuljeddo Sihaeng [Delayed Withdrawal System Will Be Initiated from June 26, 2012], June 11, 2012, available at [http://www.fss.or.kr/fss/kr/promo/bodobbs\\_view.jsp?seqno=15980&no=1&s\\_title=%C1%F6%BF%AC%C0%CE%C3%E2%C1%A6%B5%B5&s\\_kind=title&page=1](http://www.fss.or.kr/fss/kr/promo/bodobbs_view.jsp?seqno=15980&no=1&s_title=%C1%F6%BF%AC%C0%CE%C3%E2%C1%A6%B5%B5&s_kind=title&page=1) (last visited on May 18, 2015).

in the account employed in the fraud after a bank suspended payment from the account as requested by the victim or other authorities to prevent defrauders from drawing money, a bank may not return the money to the victims unless the account owner agrees or another relevant legal measure is issued, such as a court order.<sup>41</sup> Therefore, many victims gave up trying to recover damages from the balance remaining in the account because of the time and cost required to bring a lawsuit, especially considering the relatively small amounts of money that they may recover.<sup>42</sup> However, the Special Act enabled victims to recover their damages up to the balance remaining in the account used in the phishing fraud by administrative procedures without proceeding with a formal lawsuit.

## ii. Process for the damage refund

The process for a damage refund is initiated with a victim's application to the bank that manages the victim's account or an account used in the phishing fraud.<sup>43</sup> By a victim's request, the bank immediately suspends payment from the account for the entire balance.<sup>44</sup>

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<sup>41</sup> For civil remedies available to victims of voice phishing, *see generally*, Tae Seok Roh & Sung Woo Lee, *A Study on Civil Remedies for Victims of Voice Phishing*, 10-1 KOREAN J. FIN. L. 383, 392-93 (2013).

<sup>42</sup> According to the recent analysis conducted by the FSS, the average amount of damage per phishing fraud case is approximately 11.3 million won. Press Release, FSS, Pisingsagineun 30dae Yeoseong, Daechulsagineun 40dae Namseongeseo Manhi Balsaeng [Men in 30s Are Most Vulnerable to Phishing Fraud, Women in 40s to Phone Loan Fraud], 1, 2, Nov. 12, 2014, *available at* [http://www.fss.or.kr/fss/kr/promo/bodobbs\\_view.jsp?seqno=18195&no=10967&s\\_title=&s\\_kind=&page=4](http://www.fss.or.kr/fss/kr/promo/bodobbs_view.jsp?seqno=18195&no=10967&s_title=&s_kind=&page=4) (last visited on May 18, 2015). However, it is predicted that victims may recover, on average, 20 percent of damages incurred, considering that the damage refund rate by the Special Act was approximately 20 percent in 2012, the year after the act was initiated. *Id.* at 10. Therefore, if the account balance at the time of suspension of payment is not sufficient to recover damages, a victim may not choose to bring a lawsuit because it is not economically feasible.

<sup>43</sup> Renewed Special Act § 3.

<sup>44</sup> Renewed Special Act § 4.

After the suspension of payment, the bank requests the FSS to announce commencement of a procedure terminating an account holder’s right over the deposit balance, and the FSS posts an announcement.<sup>45</sup> If no appeal is raised after two months from the date of announcement, the right over the account balance is finally terminated.<sup>46</sup> Within fourteen days after termination, the FSS decides the refund amount distributed to each victim who remitted the money to the account.<sup>47</sup> In 2011, the FSS established a new team within the Micro-finance Support Department, which is exclusively responsible for refunding damages, educating the public on how to prevent phishing fraud, and publicizing the damage refund system.

### iii. Refund amount

The damage refund system greatly contributed to the recovery of victims’ damages without additional cost and effort. The FSS has assisted fraud victims to recover over 50 billion won, which they otherwise might have relinquished.

Table 2. DAMAGE REFUND BY YEAR<sup>48</sup>

Damage Refund	2012	2013	2014.1-6
Cases	26,002	21,918	14,635
Amount (billion won)	27.2	15.6	11.2
Refund Rate (percent)	20.1	14.6	11.9

<sup>45</sup> Renewed Special Act § 5.

<sup>46</sup> Renewed Special Act § 9.

<sup>47</sup> Renewed Special Act § 10.

<sup>48</sup> Press Release, FSS, Boiseupising, Dasi Jeungga [Rebound of Voice Phishing Cases], 1, 2, *available at* [http://www.fss.or.kr/fss/kr/promo/bodobbs\\_view.jsp?seqno=18089&no=24&s\\_title=%BA%B8%C0%CC%BD%BA%C7%C7%BD%CC&s\\_kind=title&page=1](http://www.fss.or.kr/fss/kr/promo/bodobbs_view.jsp?seqno=18089&no=24&s_title=%BA%B8%C0%CC%BD%BA%C7%C7%BD%CC&s_kind=title&page=1) (last visited on May 18, 2015). As shown in the table, the refund rate has consistently decreased since 2012. For this reason, the FSS explained that the withdrawal of money from the account is much faster, while it takes longer for a victim to recognize phishing fraud as the methods of scamming are more skillful and diversified. *Id.* at 2.

### 3. Limitations of Current Compensatory Schemes

Even though both the traditional FDM and recent damage refund system compensated financial consumers' damages incurred by illegal or unjust conduct in the financial markets, they have some limitations as compensation schemes exercised by the financial regulators. Generally speaking, the current schemes are not appropriate for compensating massive monetary harms incurred by the violation of financial laws that the regulators are responsible for overseeing and sanctioning.

#### i. FDM

The first limitation is that the regulator cannot compel both parties to follow the mediation decision. That is, the mediation only comes into effect if both parties accept the FDMC's decision. Therefore, even if a financial consumer is satisfied with the decision, he or she must assume the risk of undertaking a formal proceeding if a financial institution rejects it.<sup>49</sup> Second, the FDM cannot proceed in cases where a financial institution files a lawsuit in a court after the application for the FDM is filed.<sup>50</sup> In some cases, financial institutions are thought to intentionally take legal actions to avoid the FDM process and improve their negotiating position.<sup>51</sup> Third, the FDM only covers disputes

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<sup>49</sup> Specifically, the acceptance rate of the FDM is relatively low in securities-related disputes because, in many cases, final responsibility of a case is imputed to employees of a securities company. Young-Hoa Son, *A Rational Improvement Idea of the Finance Dispute Mediation System*, 11-3 BEOBGWAJEONGCHAEGYEONGU [L. & POL. STUDY] 929, 954 (2011).

<sup>50</sup> Detailed Regulations on FDM § 17(1)(1).

<sup>51</sup> Of the 28,988 FDM cases filed in 2009, 1,656 cases, or 5.7 percent, were followed by civil suits. Of

with financial institutions. Thus, it is not applicable for issuers and individuals (e.g., officials, employees, etc.) that violate securities laws, such as fraudulent misrepresentation on disclosure documents. And even if a financial institution is related to the dispute, it is unlikely that the case is dealt with through FDM if it requires an extensive investigation or is not directly related to the sale of financial instruments.<sup>52</sup> Fourth, current FDM is more appropriate for resolving disputes involving one or a small number of financial consumers. Under the current system, mediation binds only the parties involved in the process, and has no effect on persons who did not participate in the mediation.<sup>53</sup> Therefore, the FDM may not be appropriate in cases where a large number of victims suffer the same or similar damage by a financial law violation such as securities fraud.

## ii. Damage Refund System

The damage refund system for phishing fraud reflects a more active role by financial regulators in that the system allows victims to directly recover their monetary damage in place of private litigation. However, this system is designed under the specific

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these cases, 1,435 cases, or 86.7 percent, were raised by financial institutions. Press Release, FSS, 2009nyeondo Geumyungbunjaengjojeong Sincheongwanlyeon Sosongjegi Hyeonhwang [Lawsuits Followed by Application of the Financial Disputes Mediation in 2009], March 12, 2010, *available at* [http://www.fss.or.kr/fss/kr/promo/bodobbs\\_view.jsp?seqno=14232&no=14&s\\_title=%BC%D2%BC%DB&s\\_kind=title&page=2](http://www.fss.or.kr/fss/kr/promo/bodobbs_view.jsp?seqno=14232&no=14&s_title=%BC%D2%BC%DB&s_kind=title&page=2) (last visited on May 18, 2015).

<sup>52</sup> See Detailed Regulations on FDM § 17(1)(9).. For instance, if a securities company is negligent for a misleading registration statement, injured investors may not invoke the FDM process to seek compensation.

<sup>53</sup> Recently, some Congressmen proposed a bill to introduce “collective disputes mediation” in FDM cases, which allows victims not participating in the mediation procedure to receive damages after the mediation for the purpose of expediting compensation to victims of major financial scandals. See National Policy Committee, Geumyungwiwonhoeui seolchideunge gwanhan beoblyul ilbugaejeongbeoblyulan geomtobogoseo [Review on the amendment of the Act on the Establishment, etc. of Financial Services Commission] (Nov. 2014).

circumstance of phishing fraud, and is unlikely to extend to compensation schemes for other types of violations that occur in the financial markets. More importantly, phishing fraud is basically a matter belonging to the sphere of criminal law rather than financial regulation. Therefore, it seems strange that financial regulators play a compensatory role on matters over which they have no authority to regulate.

### III. Overview of the SEC’s Disgorgement and Civil Monetary Penalty

When the SEC was created in 1934, the agency’s statutory remedy for securities violations was primarily to seek injunctive relief. It is relatively recent in the SEC’s history that the agency has authority to seek disgorgement and civil monetary penalties in federal securities law violations, and to distribute funds collected from the violators to defrauded investors. This Part provides a brief overview of the history of the SEC’s authority of disgorgement and civil monetary penalties, and the distinction between civil and criminal monetary penalties.

#### A. Disgorgement

Disgorgement is an equitable remedy designed to deprive a wrongdoer of ill-gotten gains and to deter others from violating the securities law. The SEC did not have express authority to seek disgorgement in federal securities law violations before the Securities Enforcement Remedies and Penny Stock Reform Act of 1990 was enacted in 1990.<sup>54</sup> Absent specific statutory authority to seek a monetary remedy, the SEC relied on the court’s general equity powers to grant “ancillary relief” to bolster its enforcement remedy.<sup>55</sup> Insider trading cases gave the SEC the opportunity to seek disgorgement because they involved “identifiable gains from illegal conduct and it was necessary to deter future

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<sup>54</sup> Pub. L. No. 101-429, 104 Stat. 931 (codified as amended in scattered sections of 15 U.S.C.) [hereinafter “Remedies Act”].

<sup>55</sup> See generally, George W. Dent Jr., *Ancillary Relief in Federal Securities Law: A Study in Federal Remedies*, 67 MINN. L. REV. 865 (1983); John D. Ellsworth, *Disgorgement in Securities Fraud Actions Brought by the SEC*, 1977 DUKE L.J. 641 (1977); James R. Farrand, *Ancillary Remedies in SEC Civil Enforcement Suits*, 89 HARV. L. REV. 1779 (1976).

violations.”<sup>56</sup> In *SEC v. Texas Gulf Sulphur Co.*,<sup>57</sup> an appellate court recognized the disgorgement remedy and affirmed the district courts’ order directing corporate insiders to disgorge their illegal profits obtained by material nonpublic information.<sup>58</sup> Further, the court in *SEC v. First City Financial Corp., Ltd.*<sup>59</sup> expanded the application of the disgorgement remedy on securities law violations beyond insider trading by directing defendants to disgorge illegal profits that resulted from a violation of section 13(d) of the Exchange Act.<sup>60</sup> Thereafter, in the Remedies Act of 1990, Congress gave the SEC express authority to order disgorgement in administrative proceedings.<sup>61</sup> The Remedies Act also authorized the SEC to adopt rules concerning payments to investors and other

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<sup>56</sup> Barbara Black, *Should the SEC Be a Collection Agency for Defrauded Investors?*, 63 BUS. LAW. 317, 320 (2008).

<sup>57</sup> 446 F.2d. 1301 (2d Cir. 1971).

<sup>58</sup> In *Texas Gulf Sulphur Co.*, the Second Circuit stated that “the SEC may seek other than injunctive relief in order to effectuate the purposes of the [Securities Exchange] Act, so long as such relief is remedial relief and is not a penalty assessment.” It further stated that “[r]estitution of the profits on these transactions merely deprives the appellants of the gains of their wrongful conduct. Nor does restitution impose a hardship in this case.” *Id.* at 1308. Even though courts at times use “disgorgement” and “restitution” interchangeably, the SEC drew the line between them as follows: “Restitution is intended to make investors whole, and disgorgement is meant to deprive the wrongdoer of their ill-gotten gain.” U.S. SEC. & EXCH. COMM’N, REPORT PURSUANT TO SECTION 308(C) OF THE SARBANES-OXLEY ACT OF 2002, at 3, note 2 [HEREINAFTER “SEC 308(C) REPORT”], available at <https://www.sec.gov/news/studies/sox308creport.pdf> (last visited on May 18, 2015).

<sup>59</sup> 890 F.2d 1215 (D.C. Cir. 1989).

<sup>60</sup> In this case, appellants sought to distinguish section 13(d) violations as a “technical transgression” of reporting rules unlike insider trading. However, the court noted that “section 13(d) is a crucial requirement in the congressional scheme, and a violator, it is legislatively assumed, improperly benefits by purchasing stocks at an artificially low price because of a breach of the duty Congress imposed to disclose his investment position.” The court also stated that “[w]e therefore see no relevant distinction between disgorgement of inside trading profits and disgorgement of post-section 13(d) violation profits.” *Id.* at 1230.

<sup>61</sup> The Act’s legislative history clearly showed that Congress was aware that disgorgement was already available in judicial proceedings. Black, *supra* note 56, at 321 (citing S. REP. No. 101-337, at 8 (1990)).



matters the agency deems necessary to implement the disgorgement provision.<sup>62</sup> And then, SOX gave the SEC express authority to seek equitable remedies in the federal district court.<sup>63</sup>

Even though disgorgement funds, if economically feasible,<sup>64</sup> are returned to the injured investors, the courts and SEC did not view disgorgement as a means of compensating investors, but as an enforcement remedy. Courts often stated that “[t]he primary purpose of disgorgement is not to compensate investors,” and “[u]nlike damages, it is a method of forcing a defendant to give up the amount by which he was unjustly enriched.”<sup>65</sup> Moreover, disgorgement may not be viewed as a penalty assessment. The court in *SEC v. Blatt* held that “[t]he court’s power to order disgorgement extends only to the amount with interest by which the defendant profited from his wrongdoing.”<sup>66</sup> Meanwhile, in connection with measuring disgorgement, the courts do not require the SEC

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<sup>62</sup> Remedies Act, *supra* note 54, §§ 202(a), 203, 104 Stat. at 937-40 (codified at 15 U.S.C. §§ 78u-2(e), 78u-3(e) (2000)).

<sup>63</sup> Section 21(d)(5) of the Exchange Act (codified at 15 U.S.C. §78u(d)(5)).

<sup>64</sup> As the SEC noted in its study, payment to investors is not always economically feasible. In cases where funds are too small, or the number of identifiable investors are too large to justify a distribution, the SEC routinely asked the court to direct that disgorged funds be paid to the U.S. Treasury. SEC 308(C) REPORT, *supra* note 58, at 14.

<sup>65</sup> E.g., *SEC v. Cavanagh*, 445 F.3d 105, 117 (2d Cir. 2006); *SEC v. Commonwealth Chem. Sec., Inc.*, 574 F.2d 90, 102 (1978). Similarly, the SEC also stated that “[i]n 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.” SEC 308(C) REPORT, *supra* note 58, at 3.

<sup>66</sup> 583 F.2d 1325, 1335 (5th Cir. 1978); *see also SEC v. Manor Nursing Centers, Inc.*, 458 F.2d 1082, 1104 (2d Cir. 1972) (stating that “ordering the disgorging of profits and income earned on the proceeds is in fact a penalty assessment.”); Ellsworth, *supra* note 55, at 652-56.

to prove the precise amount of the ill-gotten gains. Rather, “disgorgement need only be a reasonable approximation of profits casually connected to the violation.”<sup>67</sup>

Prior to the Sarbanes-Oxley Act of 2002, even though the SEC obtained disgorgement orders in various types of enforcement actions, the agency most commonly sought disgorgements in insider trading cases where individuals made “identifiable profits” and securities offering frauds and Ponzi schemes where the entity did not have an actual business purpose.<sup>68</sup> Significantly, the SEC did not seek disgorgement from a corporation in cases where it did not sell securities by releasing materially misleading information into the market, even though the corporation benefited from increased market capitalization or improper accounting practices.<sup>69</sup> The reason for not ordering disgorgement by the corporation in such a situation is because it would harm innocent shareholders who did not benefit from the fraud.<sup>70</sup> However, even where a corporation sold its securities whose value had been inflated by disclosing misleading statements, the SEC often sought disgorgement only from insiders who had profited from the fraud.<sup>71</sup> To prevent defendants from dissipating the ill-gotten gains and to facilitate the collection of

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<sup>67</sup> *SEC v. First City Financial Corp., Ltd.*, 890 F.2d 1231 (D.C. Cir. 1989).

<sup>68</sup> Urska Velikonja, *Public Compensation for Private Harm: Evidence from the SEC's Fair Fund Distributions*, 67 STAN. L. REV. 331, 341 (2015).

<sup>69</sup> Black, *supra* note 56, at 321-22.

<sup>70</sup> *Id.* at 322.

<sup>71</sup> *Id.*

disgorgement, especially in cases involving Ponzi schemes, the SEC routinely sought emergency actions such as a temporary restraining order and an asset freeze.<sup>72</sup>

## **B. Civil Monetary Penalty**

The SEC has broad authority to seek civil monetary penalties against defendants in cases involving federal securities law violations. Just like disgorgement, insider trading was the “impetus” for the agency’s civil penalty power.<sup>73</sup> In 1984, Congress first gave the SEC authority to seek civil monetary penalties in insider trading cases by enacting the Insider Trading Sanctions Act of 1984 (“ITSA”).<sup>74</sup> The Act authorizes the SEC to seek a civil penalty in a U.S. district court if it believes that any person has bought or sold a security while in possession of material nonpublic information.<sup>75</sup> It also provides that the penalty may be up to three times the amount of profit gained or loss avoided from insider trading.<sup>76</sup> Four years later, Congress again expanded the scope of civil penalties to controlling persons in the Insider Trading and Securities Fraud Enforcement Act of 1988 (“ITSFEA”).<sup>77</sup> Finally, the Remedies Act enacted in 1990 grants the SEC the power to bring an action in federal district court to seek civil penalties against any defendant for any

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<sup>72</sup> See SEC 308(C) REPORT, *supra* note 58, at 9.

<sup>73</sup> Black, *supra* note 56, at 323.

<sup>74</sup> Pub L. No. 98-376, 98 Stat. 1264 (1984) (codified as amended at 15 U.S.C. § 78u-1).

<sup>75</sup> Exchange Act § 21A(a)(1) (codified as amended at 15 U.S.C. § 78u-1(a)(1)).

<sup>76</sup> Exchange Act § 21A(a)(2) (codified as amended at 15 U.S.C. § 78u-1(a)(2)).

<sup>77</sup> Pub L. No. 100-704, 102 Stat. 4677 (1988) (codified as amended at 15 U.S.C. § 78u-1).

securities law violations.<sup>78</sup> The Act also allows the SEC to assess civil monetary penalties in an administrative forum against certain securities professionals such as broker-dealers, investment advisers, and their associated personnel.<sup>79</sup> Further, Congress authorized the SEC to impose civil monetary penalties on “any” person or entity in cease-and-desist proceedings by enacting the Dodd-Frank Act.<sup>80</sup>

The Remedies Act provides that the penalty amount is determined by a three-tiers system, depending on the seriousness of the violation.<sup>81</sup> Even though each tier limits the maximum dollar amount, adjusted for inflation,<sup>82</sup> the amount of the penalty may equal the “gross amount of pecuniary gain” to the defendant as a result of the violation if it exceeds the monetary cap.<sup>83</sup> This enables the SEC to impose a civil penalty that equals the amount of disgorgement, “doubling the total monetary sanction against the defendant.”<sup>84</sup> Moreover, since the term “violation” is not defined in the Act, the SEC may multiply the maximum amount of the penalty by the number of individual violations, “particularly in the typical financial fraud situation where many defendants have made numerous

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<sup>78</sup> Pub L. No. 101-429, 104 Stat. 931 (1990) (codified as amended in scattered sections of 15 U.S.C.).

<sup>79</sup> E.g. section 21B(a)(1) of the Exchange Act (codified as amended at 15 U.S.C. 78u-2(a)(1)).

<sup>80</sup> Pub L. No. 111-203, § 929P, 124 Stat. 1376, 1862 (2010) (codified as amended at 15 U.S.C. 78u-2(a)(2)).

<sup>81</sup> Securities Act § 20(d) (codified as amended at 15 U.S.C. § 77t); Exchange Act § 21(d) (codified as amended at § 78u(d)).

<sup>82</sup> According to the most recent inflation adjustment, the maximum amount of penalty per violation is \$160,000 for natural persons and \$775,000 for any other person. Adjustments to Civil Monetary Penalty Amounts, 78 Fed. Reg. 14179 (March 5, 2013).

<sup>83</sup> Securities Act § 20(d); Exchange Act § 21(d).

<sup>84</sup> Velikonja, *supra* note 67, at 360.

misstatements that allegedly violate a number of different statutory provisions.”<sup>85</sup> Prior to the SOX, when the SEC collected a penalty it was remitted to the U.S. Treasury. However, this changed after the creation of section 308(c) of the SOX; this will be further discussed in Part IV.

### **C. Two-Track System: civil and criminal monetary penalties**

Meanwhile, the SEC’s new ability to seek civil monetary penalties in its enforcement actions raised critical questions about the implication for criminal monetary penalties. In many federal securities law violation cases, the SEC and criminal authorities such as the U.S. Attorney’s Office and FBI jointly investigate and bring separate actions for the same offense as provided in the securities laws.<sup>86</sup> The Supreme Court in *Standard Sanitary Manufacturing Co. v. United States* held it constitutional for the government to initiate parallel civil and criminal proceedings.<sup>87</sup> Accordingly, violators of securities laws may have to pay both the civil monetary penalty charged by the SEC and the criminal fine by the U.S. Attorney.

As it becomes more common for administrative agencies to seek civil monetary penalties, the conventional distinction of labeling civil law as “remedy” and criminal law

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<sup>85</sup> Black, *supra* note 56, at 325 n 58 (citing, for example, *SEC v. Halianni*, which stated that “each of the quarterly statements sent to each of the investors is a materially false statement that technically constitutes a separate violation.”).

<sup>86</sup> For example, Section 21 and 21A of the Exchange Act provide civil penalties initiated by the SEC and Section 32 of the Exchange Act provides criminal penalties.

<sup>87</sup> 226 U.S. 20, 52 (1912) (stating that “[t]he Sherman Act provides for a criminal proceeding to punish violations and suits in equity to restrain such violations, and the suits may be brought simultaneously or successively.”), cited in *SEC v. Dresser Industries, Inc.*, 628 F.2d 1368, 1374 (1980).

as “punishment,” no longer seems appropriate.<sup>88</sup> When Congress authorized the SEC to seek civil monetary penalties in insider trading cases in 1984, it did not define them as either a “remedy,” or “punishment.”<sup>89</sup> Instead, Congress explicitly stated its aim to be “deterrence.”<sup>90</sup> Interestingly, deterrence is traditionally regarded as an objective of the criminal law system.<sup>91</sup> However, as one commentator has pointed out, “when it comes to deterrence, civil and criminal remedies are essentially indistinguishable and interchangeable.”<sup>92</sup> Thus, to impose two monetary sanctions, which have different labels but seem to serve similar purposes, against the same offense raises the question of whether it would constitute double jeopardy. However, in *Hudson v. United States*, the Supreme Court held that the monetary penalties and occupational debarment sanctions imposed by the Office of the Comptroller of the Currency (“OCC”) did not bar subsequent criminal proceedings against the petitioners for the same misconduct, because the OCC’s

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<sup>88</sup> For discussions on civil and criminal law distinction, *see generally*, Kenneth Mann, *Punitive Civil Sanctions: The Middleground Between Criminal and Civil Law*, 101 YALE L.J. 1795, 1803-10 (1992); Mary M. Cheh, *Constitutional Limits on Using Civil Remedies to Achieve Criminal Law Objectives: Understanding and Transcending the Criminal-Civil Law Distinction*, 42 Hastings L.J. 1325, 1348-69 (1991).

<sup>89</sup> One commentator explained that legislatures and courts avoided labeling them as “punitive” to circumvent the application of criminal-type procedural rules. Mann, *supra* note 88, at 1801.

<sup>90</sup> The House Report stated:

The principal, and often effectively only, remedy available to the Commission against insider trading is an injunction against further violations of the securities laws and disgorgement of illicit profits... [These] serve[ ] only a remedial function and [do] not penalize a defendant for the illegal conduct... The Committee believes the new penalty provided by the legislation will serve as a powerful deterrent to insider trading abuses." H.R. Rep. No. 355, 98th Cong., 2d Sess. 7 (1984), reprinted in U.S.C.C.A.N. 2274, 2281.

<sup>91</sup> E.g. *Kennedy v. Mendoza-Martinez*, 372 U.S. 144, 168 (1963) (describing the traditional aims of punishment as “retribution and deterrence”).

<sup>92</sup> Cheh, *supra* note 88, at 1355.

administrative proceedings were civil, not criminal, actions for the purposes of the double jeopardy clause.<sup>93</sup> The Supreme Court reasoned that Congress had intended that such sanctions imposed by the OCC be “civil in nature,” and there was little evidence to suggest that those sanctions were “so punitive in form and effect as to render them criminal despite Congress’ intent to the contrary.”<sup>94</sup> The Court further stated that “[t]o hold that the mere presence of a deterrent purpose renders such sanctions “criminal” for double jeopardy purposes would severely undermine the Government’s ability to engage in effective regulation of institutions such as banks.”<sup>95</sup>

Even though the SEC can bring actions for civil monetary penalties without much concern about compromising a parallel criminal prosecution for the same conduct,<sup>96</sup> the following questions still remain: Why does the SEC need to seek monetary penalties despite the availability of criminal penalties? Do civil monetary penalties have a greater deterrence effect on securities law violations than criminal penalties? Such questions may be better answered by examining the practical aspects of civil and criminal enforcement actions.

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<sup>93</sup> 522 U.S. 93 (1997). In this case, the Supreme Court largely disavowed the method of analysis used in *United States v Halper*, in which the Supreme Court had previously ruled that “a civil sanction that cannot fairly be said solely to serve a remedial purpose, but rather can only be explained as also serving either retributive or deterrent purposes, is punishment” for the purposes of the double jeopardy analysis. 490 US 435, 448 (1989). Instead, the Court reaffirmed the previously established rule exemplified in *United States v. Ward*, 448 U.S. 242 (1980).

<sup>94</sup> *Id.* at 103-104.

<sup>95</sup> *Id.* at 105.

<sup>96</sup> Thomas C. Newkirk, U.S. Sec. & Exch. Comm’n, Speech by SEC Staff: The Advantage of a Dual System: Parallel Streams of Civil and Criminal Enforcement of the U.S. Securities Laws, Remarks by 16th International Symposium on Economic Crime (Sep. 19, 1998), *available at* <https://www.sec.gov/news/speech/speecharchive/1998/spch222.htm> (last visited on May 18, 2015).

Civil and criminal law enforcement actions differ in terms of the investigation and procedure as well as the available remedies.<sup>97</sup> Even though criminal authorities have more powers of investigation than civil authorities,<sup>98</sup> once a case has been filed, the civil case allows the government much more “leeway” to get at the facts and prove its case.<sup>99</sup> In criminal cases, the Federal Rules of Criminal Procedure and a defendant’s Fifth Amendment right substantially limit the prosecution’s discovery during the criminal proceeding. Most importantly, the prosecution must prove each element of the crime beyond a reasonable doubt. Conversely, in civil cases, discovery rules under the Federal Rules of Civil Procedure allow for more pre-trial gathering of evidence, and a defendant’s refusal to testify allows the trier of fact to draw adverse inferences from such silence. Further, a civil proceeding generally requires a lower burden of proof—a preponderance of the evidence.

Such restrictions in a criminal procedure make successful prosecution difficult in complex or subtler violations such as securities fraud, increasing the risk that the wrongful conduct may not be sufficiently punished and deterred.<sup>100</sup> To avoid such difficulties, lawmakers and law enforcement have increasingly relied on civil penalties to assure

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<sup>97</sup> *Id.* at IV. Practical Differences.

<sup>98</sup> For example, unlike criminal authorities, under the Privacy Act of 1974, a federal agency cannot solicit information from an individual without first identifying himself and explaining the purpose of his inquiry. *See generally*, § 5 U.S.C. 552a.

<sup>99</sup> *Id.*

<sup>100</sup> Robert H. Jackson, *THE STRUGGLE FOR JUDICIAL SUPREMACY* 152 (Vintage ed. 1941) (stating that “the criminal law has long proved futile to reach the subtler kinds of fraud at all, and [is] able to reach grosser fraud, only rarely.”) (cited in Robert G. Blakey & Scott D. Cessar, *Equitable Relief Under Civil RICO: Reflections on Religious Technology Center v. Wollersheim: Will Civil RICO Be Effective Only Against White-Collar Crime?*, 62 NOTRE DAME L. REV. 526, 568, n 191(1987)).



compliance with the law, even when criminal penalties are available. Civil penalties are not only “easier and faster” to implement, but are also regarded as being “more effective in deterring crime in particular instances.”<sup>101</sup> Thus, even though the criminal penalty system might fail to bring a criminal to justice, the civil penalty system operates as a last resort for correction and deterrence.<sup>102</sup> Further, the existence of the civil system allows the criminal authorities to focus on the most egregious cases.<sup>103</sup>

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<sup>101</sup> Peter Finn & Maria O’Brien Hylton, U.S. Dep’t of Justice, National Institute of Justice, Using Civil Remedies for Criminal Behavior: Rationale, Case Studies, and Constitutional Issues, 1, 2, (Oct. 1994) available at <https://www.ncjrs.gov/pdffiles1/Digitization/151757NCJRS.pdf> (last visited on May 18, 2015); Cheh, *supra* note 88, at 1329.

<sup>102</sup> Newkirk, *supra* note 96, at VIII, Parallel Proceedings: The Two Tracks.

<sup>103</sup> *Id.* at X, Conclusion.

## IV. Review of the SEC's Fair Fund

### A. Overview

The Fair Fund provision was included in Section 308 of the SOX, which was enacted in the wake of corporate accounting scandals that caused significant losses to investors in the securities markets. As previously stated, even before its enactment, the SEC could seek disgorgement against securities law violators in judicial or administrative proceedings and distribute collected monies to defrauded investors. During this period, the SEC typically tried to disgorge illegal profits from insiders who benefited from an issuer's misrepresentation, and corporate issuers who defrauded investors without any substantial business operation (known as a "Ponzi scheme") in the securities markets.<sup>104</sup> However, distribution of disgorgement funds during this time was not very impressive. According to the SEC's study, the agency distributed a little over one billion dollars to approximately 125,000 investors in thirty-four district court cases between 1997 and 2002.<sup>105</sup>

Although the legislative history does not make clear what exactly Congress intended with the Fair Fund provision,<sup>106</sup> it allowed the SEC to expand its compensation

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<sup>104</sup> *Id.* at 321-22.

<sup>105</sup> See SEC 308(C) REPORT, *supra* note 58, at 10. During the same period, the SEC distributed or proposed to distribute funds in 16 administrative proceedings, but the total amount and number of investors distributed was not shown in this study. *Id.* at 15.

<sup>106</sup> Professor Black explained the reason why the legislative history of SOX is absent as follows:

While the Senate-passed bill that was the source for most provisions of SOX did not include a comparable provision, the House members of the SOX Conference Committee added section 308 in the joint House-Senate negotiations that produced the final legislation. The Conference Committee did not produce a report on the legislation, and SOX was adopted virtually without debate. See Black, *supra* note 56, at 326.

power by providing the agency with an additional source for distribution to harmed investors, that is, civil penalties which previously remitted to the U.S. Treasury.<sup>107</sup> With the Fair Fund provision, the SEC has “greater flexibility” to establish a compensation fund because the SEC may create a Fair Fund by imposing civil penalties even in situations where it cannot seek disgorgement from the defendants.<sup>108</sup> Moreover, the SEC was recently authorized to seek civil monetary penalties against any person or entity in cease-and-desist proceedings, not just SEC-regulated persons and entities such as broker-dealers, and investment advisers.<sup>109</sup>

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<sup>107</sup> Section 308(a) of the Sarbanes-Oxley Act of 2002 (15 U.S.C. § 7246(a)) provides:

If, in any judicial or administrative action brought by the Commission under the securities laws, the Commission obtains a civil penalty against any person for a violation of such laws, or such person agrees, in settlement of any such action, to such civil penalty, *the amount of such civil penalty shall, on the motion or at the direction of the Commission, be added to and become part of a disgorgement fund or other fund established for the benefit of the victims of such violation.* (Emphasis added).

Section 21(d)(3)(C)(i) of the Securities Exchange Act of 1934 (15 U.S.C. § 78u(d)(3)(c)(i)) also provides:

A penalty imposed under this section shall be payable into the Treasury of the United States, except as otherwise provided in section 308 of the Sarbanes-Oxley Act of 2002 and Section 21F of this title.

<sup>108</sup> See SEC 308(C) REPORT, *supra* note 58, at 27 (stating that “[b]ecause under the Fair Fund provision, . . . the Commission has greater flexibility to choose the most advantageous remedy”). When section 308(a) of SOX was enacted, the SEC was required to order disgorgement to add amounts collected from civil penalties to a Fair Fund. To create a Fair Fund in cases where the SEC could not show the defendant obtained illegal profit from the securities law violation, the SEC often ordered nominal \$1 as disgorgement and imposed hundreds of millions of dollars in a civil penalty. For example, in *SEC v. Lucent Technologies*, the defendant company agreed to pay a \$25 million civil penalty and \$1 in disgorgement. See U.S. GOV’T ACCOUNTABILITY OFFICE, SEC AND CFTC PENALTIES: CONTINUED PROGRESS MADE IN COLLECTION EFFORTS, BUT GREATER SEC MANAGEMENT ATTENTION IS NEEDED, 1, 28 (2005), *available at* <http://www.gao.gov/products/GAO-05-670> (last visited on May 18, 2015). However, this limitation was removed by the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 [hereinafter “Dodd-Frank Act”]. See Section 929B of Dodd-Frank Act of 2010 (15 U.S.C. § 7246(a)).

<sup>109</sup> See DONNA M. NAGY, RICHARD W. PAINTER, & MARGARET V. SACHS, SECURITIES LITIGATION AND ENFORCEMENT: CASES AND MATERIALS 712 (3rd ed. 2012); see also Dodd-Frank Act of 2010 § 92P (15 U.S.C. §§ 77h-1, 78u-2).

From the beginning, although the SEC has discretion to create a Fair Fund, it was eager to impose monetary sanctions and distribute them to harmed investors.”<sup>110</sup> From 2003, the SEC began to seek record-breaking amounts of penalties and proposed distribution plans pursuant to the Fair Fund provision in high-profile cases such as *American International Group, Inc.* (\$800 million),<sup>111</sup> *Worldcom* (\$750 million),<sup>112</sup> *Enron* (\$450 million),<sup>113</sup> *Banc of America Capital Management, LLC* (\$375 million),<sup>114</sup> *Fannie*

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<sup>110</sup> For example, the SEC announced the Fair Fund program as one of the four main objectives in 2004 (stating “wherever practical, continue to seek to return recovered funds to defrauded investors.”). See U.S. SEC. & EXCH. COMM’N, ANN. REP. 2003, 24 (2003), available at <http://www.sec.gov/about/annrep03.shtml> (last visited on May 18, 2015).

<sup>111</sup> American International Group, Inc. (“AIG”) settled the SEC’s charges of material misstatement of financial statements through sham transactions and entities by agreeing to pay \$700 million in disgorgement and \$100 million in penalties. See U.S. Sec. & Exch. Comm’n, Litigation Release No. 19560 (Feb. 9, 2006), available at <http://www.sec.gov/litigation/litreleases/lr19560.htm> (last visited on May 18, 2015). The district court approved the distribution plan in April 2008. See Press Release, U.S. Sec. & Exch. Comm’n, SEC Announces Start of Distribution Process in AIG Settlement; Court Approves Distribution Plan for \$800 Million Fair Fund (May 5, 2008), available at <http://www.sec.gov/news/press/2008/2008-77.htm> (last visited on May 18, 2015).

<sup>112</sup> In this historical accounting fraud case, the SEC obtained the court’s approval of \$750,000,000 in the civil penalty settlement, which is “75 times greater than any prior settlement penalty,” and a nominal \$1 in disgorgement. *SEC v. Worldcom Inc.*, 273 F.Supp. 2d 431 (S.D.N.Y. 2003). The SEC’s distribution plan was approved by the district court in July 2004. See No. 02 Civ. 4963 (JSR), 2004 WL 1621185 (S.D.N.Y. July 20, 2004), *aff’d*, 467 F.3d 73 (2d Cir. 2006).

<sup>113</sup> The SEC took numerous enforcement actions against former Enron employees as well as other related parties such as J.P. Morgan Chase & Co. For details on Enron-related enforcement actions by the SEC, see U.S. Sec. & Exch. Comm’n, Spotlight on Enron, available at <http://www.sec.gov/spotlight/enron.htm> (last visited on May 18, 2015). Through these actions, the SEC collectively obtained \$440 million from settling parties. The district court approved the distribution plan in October 2008. See Enron Victim Trust official website, FAQ1: What are the details of the SEC’s Settlement with the Settling Parties?, available at <http://www.enronvictimtrust.com/Faq.html#1> (last visited on May 18, 2015) (providing Enron investors with information about the Fair Fund).

<sup>114</sup> Banc of America Capital Market, LLC, BACAP Distributors, LLC, and Banc of America Securities, LLC (“respondents”) were prosecuted by the SEC because of mutual fund market timing and late trading. In its administrative proceeding, the SEC accepted the offers by the respondents and ordered the payment of \$250 million in disgorgement and \$125 million in civil penalties. See U.S. Sec. & Exch. Comm’n, Admin. Proc. File No. 3-11818 (Feb. 9, 2005). The distribution plan was approved by the SEC in December 2007. See U.S. Sec. & Exch. Comm’n, Order Approving the Distribution Plan, SEA Release No. 34-57048 (Dec. 27,

*Mae* (\$350 million),<sup>115</sup> and so on. However, these large penalties against corporations raised the concern that penalties on corporations may harm shareholders who are both victims of the violation, and ultimately bear the cost of the penalty.<sup>116</sup> To make clear “when and how the Commission would use corporate penalties,” the SEC announced a new guideline on the corporate penalty in January 2006.<sup>117</sup> According to the guideline, the SEC would consider two factors in deciding whether to impose a penalty on the corporation: “The presence or absence of a direct benefit to the corporation as a result of the violation” and “the degree to which the penalty will recompense or further harm the injured shareholders.”<sup>118</sup> Interestingly, as may be inferred from the second factor, it seems that the Fair Fund provision of SOX, to some extent, justifies the SEC’s large penalties in corporate fraud cases. The SEC remarked that the Fair Fund provision has “the potential

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2007).

<sup>115</sup> The SEC and the Office of Federal Housing Enterprise Oversight (“OFHEO”) settled \$400 million in civil penalties with the Federal National Mortgage Association (“Fannie Mae”), which made false financial statements in violation of Generally Accepted Accounting Principles (“GAAP”). See U.S. Sec. & Exch. Comm’n, Litigation Release No. 19710 (May 23, 2006). Among the penalties, approximately \$350 million assessed by the SEC was transferred to a Fair Fund to compensate damaged investors. The Distribution plan was approved by the district court in April 2007. See Press Release, U.S. Sec. & Exch. Comm’n, SEC Announces Start of \$357 Million Fair Fund Distribution Process in Fannie Mae Settlement (April 30, 2007), available at <http://www.sec.gov/news/press/2007/2007-81.htm> (last visited on May 18, 2015).

<sup>116</sup> Press Release, U.S. Sec. & Exch. Comm’n, Statement of the Securities and Exchange Commission Concerning Financial Penalties [hereinafter “SEC PENALTY POLICY”], SEC Press Release No. 2006-4 (Jan. 4, 2006) (reviewing the Remedies Act legislative history that warned against the SEC’s use of corporate penalty in cases where shareholders are the principal victims of the violation), available at <http://www.sec.gov/news/press/2006-4.htm>.

<sup>117</sup> *Id.*

<sup>118</sup> *Id.* (in addition to the two principal factors, the SEC listed additional considerations in the guideline. Those include: the need to deter the particular type of offense; the extent of the injury to innocent parties; whether complicity in the violation is widespread throughout the corporation; the level of intent on the part of the perpetrators; the degree of difficulty in detecting the particular type of offense; presence or lack of remedial steps by the corporations; and extent of cooperation with Commission and other law enforcement).

to substantially mitigate the concerns” that large civil monetary penalties could do “duplicative harm to victims of fraud” who are shareholders of the wrongdoer in corporate fraud cases.<sup>119</sup>

Meanwhile, the SEC internally initiated several measures to improve the management and operation of the Fair Fund. First, in 2007, the SEC set up the newly created Office of Collections and Distributions (“OCD”) within the Enforcement Division to manage the collection of disgorgement and penalties, and expedite the distribution process of a Fair Fund.<sup>120</sup> The OCD functions as a control tower in matters with a Fair Fund to ensure consistency among cases and standardize the distribution process.<sup>121</sup> Secondly, the SEC began to use a new computer tracking system called “Phoenix” in February 2007 to efficiently manage detailed information on disgorgement and penalties.<sup>122</sup> The SEC also launched an inter-office “working group” in 2009 to improve information sharing and coordination between functions on distribution plans, and to

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<sup>119</sup> Annette L. Nazareth, Comm’r, U.S. Sec. & Exch. Comm’n, Speech by SEC Commissioner: Remarks before the ABA National Institute on Securities Fraud (Sept. 28, 2006), *available at* <http://www.sec.gov/news/speech/2006/spch092806aln.htm> (last visited on May 18, 2015).

<sup>120</sup> U.S. GOV’T ACCOUNTABILITY OFFICE, SECURITIES AND EXCHANGE COMMISSION: INFORMATION ON FAIR FUND COLLECTIONS AND DISTRIBUTIONS (2010), 1, 8 [hereinafter “GAO STUDY”], *available at* <http://www.gao.gov/products/GAO-10-448R> (last visited on May 18, 2015). The SEC reorganized the OCD into the “Office of Collections” and the “Office of Distributions” in 2012.

<sup>121</sup> For example, the OCD provides guidance on developing and administering distribution plans, assigns attorneys at headquarters to partner on Fair Fund cases, sets policies and procedures for streamlined distribution among funds, and introduced templates for forms and documentations. *Id.* at 26-27.

<sup>122</sup> *See* U.S. SEC. & EXCH. COMM’N, OFFICE OF AUDIT, EVALUATION NO. 432, OVERSIGHT OF RECEIVERS AND DISTRIBUTION AGENTS 1, 3 (2007), *available at* <http://www.sec.gov/about/offices/oig/reports/audits/2007/432final.pdf> (last visited on May 18, 2015). Prior to its introduction, financial information was recorded in the Case Activity Tracking System (“CATS”). According to the Report, “Phoenix can accommodate more detailed financial information than CATS did, and unlike CATS, Phoenix provides an audit trail showing changes to system data.” *Id.*

diagnose potential problems that could delay distribution.<sup>123</sup> Lastly, the SEC adopted a new performance metric as part of an effort to facilitate the Fair Fund distribution. According to its 2014-2018 Strategic Plan, the new metric would measure “the percentage of Fair Fund and disgorgement fund plans that have distributed 80 percent of the available funds for distribution within twenty four (24) months of the approval of the distribution plan.”<sup>124</sup>

## **B. Creation and Distribution of the Fair Fund**

### **1. Creation of a Fair Fund**

In enforcement actions against violators, the SEC must consider whether to create a Fair Fund. Although the SEC takes many factors into account when deciding whether to create a Fair Fund,<sup>125</sup> the final decision mainly turns on two factors: first, “whether there is an identifiable class of victims who suffered identifiable harm,” and second, “whether the amount of money likely to be collected from the defendant is large enough to justify a

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<sup>123</sup> See GAO STUDY, *supra* note 120, at 25.

<sup>124</sup> See U.S. SEC. & EXCH. COMM’N, STRATEGIC PLAN FISCAL YEAR 2014-2018, 33 (2014) [hereinafter “2014-2018 STRATEGIC PLAN”], available at <http://www.sec.gov/about/sec-strategic-plan-2014-2018.pdf> (last visited on May 18, 2015). This metric was previously defined as the “percentage of Fair Fund and disgorgement fund plans that distributed the *final tranche* of funds to injured investors *within 24 months of the order appointing the fund administrator*” in the 2010-2015 SEC Strategic Plan (emphasis added). The previous Strategic Plan also measured the “percentage of Fair Fund and disgorgement fund plans approved by final order within the prior fiscal year which had a first tranche of funds distributed under those plans within 12 months of such approval date.” However, this metric was excluded in the current Strategic Plan. See U.S. SEC. & EXCH. COMM’N, STRATEGIC PLAN FISCAL YEAR 2010-2015, 17 (2010), available at <http://www.sec.gov/about/secstratplan1015f.pdf> (last visited on May 18, 2015).

<sup>125</sup> According to the SEC staff, the Office of Distributions conducts a feasibility study on the basis of 30 different factors to decide the likelihood of distribution. See Velikonja, *supra* note 67, at 342 (citing interview with Nichola Timmons, Assistant Director of the SEC Office of Distributions, Dec. 24, 2013).

distribution given the number of potential victims.”<sup>126</sup> If distribution is unlikely to be practical, the SEC may transfer collected monies to either the U.S. Treasury General Fund or the Investor Protection Fund.<sup>127</sup> For example, in *SEC v. Club Atlanta Travel, et al.*, defendants were required to pay \$76,698 as disgorgement. However, since 24,000 investors from the U.S. and Canada had invested a total of \$32,000,000 in this fraud case, it was impossible to make a meaningful distribution to the investors. Thus, the collected money was remitted to the U.S. Treasury.<sup>128</sup> In addition, the SEC might not distribute collected monies unless there are “investor victims.” Thus, for example, distribution may not be appropriate in bribery cases in which the SEC has collected large monetary penalties through Federal Corruption Practices Act (“FCPA”) enforcement actions.<sup>129</sup>

A Fair Fund can be created either in judicial proceedings or administrative proceedings brought by the SEC.<sup>130</sup> Procedures for the creation and distribution of the

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<sup>126</sup> *Id.*

<sup>127</sup> The Investor Protection Fund (“IPF”) was established in 2010 pursuant to section 922 of the Dodd-Frank Act for the purpose of paying awards to whistleblowers and funding the activities of the SEC’s Inspector General such as the Employee Suggestion Program. The IPF is financed by depositing into the Fund any monetary sanction collected through the SEC’s enforcement actions that is not added to a disgorgement fund or a Fair Fund unless the balance of the Fund at the time of collection exceeds \$300 million. *See* Dodd-Frank Act § 922(g)(3) (15 U.S.C. 78u-6(g)(3)). The balance of the Fund amounts to \$439,197,000 as of September 30, 2013. *See* U.S. SEC. & EXCH. COMM’N, FISCAL YEAR 2013 AGENCY FINANCIAL REPORT, 102 (2013), *available at* <http://www.sec.gov/about/secpar/secafr2013.pdf#financial> (last visited May 18, 2015).

<sup>128</sup> U.S. Sec. & Exch. Comm’n, Litigation Release No. 17008 (May 17, 20010); *see* SEC 308(C) REPORT, *supra* note 58, at 14.

<sup>129</sup> Velikonja, *supra* note 67, at 355.

<sup>130</sup> To create a Fair Fund in judicial proceedings, the SEC moves for approval of a proposed distribution plan in the federal court. The agency also asks the court to appoint a distribution agent or claims administrator. Further, if a class action settlement fund already exists, the SEC may ask the court to transfer the funds obtained by the SEC to the settlement fund for distribution. In such case, the SEC also asks of the court that transferred monies not be used for any fees and expenses of class action counsel. *See* KIRKPATRICK & LOCKHART PRESTON GATES ELLIS LLP, THE SECURITIES ENFORCEMENT MANUAL: TACTICS AND STRATEGIES 208-209 (Michael J. Missal and Richard M. Phillips eds., 2nd ed. 2007) [hereinafter “ENFORCEMENT



Fair Fund in administrative proceedings are governed by Sections 1100-1106 of the SEC's Rules of Practice.<sup>131</sup> In an SEC action, a Fair Fund is created by an order instituting proceedings in which the Commission or the hearing officer (hereinafter "Commission") demands a respondent to pay disgorgement and civil penalties.<sup>132</sup>

## 2. Plan of Distribution

The plan for the administration and distribution of funds in a Fair Fund or disgorgement fund (hereinafter "Plan of Distribution") provides detailed guidelines on how funds are administered and distributed to investors.<sup>133</sup> The Commission may order any

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MANUAL"].

<sup>131</sup> See section 1100-1106 of the RULES OF PRACTICE AND RULES ON FAIR FUND AND DISGORGEMENT PLAN (17 C.F.R. § 201.1100-1106) [hereinafter "RULES OF PRACTICE"].

<sup>132</sup> See RULES OF PRACTICE § 1101. Paragraph (a)(5) under section 101 of the Rules of Practice defines hearing officer as "an administrative law judge, a panel of Commissioners constituting less than a quorum of the Commission, an individual Commissioner, or any other person duly authorized to preside at a hearing." Meanwhile, the Commission's order creating a Fair Fund typically includes the following clause:

In any Pursuant to Section 308(a) of the Sarbanes-Oxley Act of 2002, as amended, *a Fair Fund is created for the disgorgement, interest and/or penalties* ... Regardless of whether any such Fair Fund distribution is made, amounts ordered to be paid as civil money penalties pursuant to this Order shall be treated as penalties paid to the government for all purposes, including all tax purposes. To preserve the deterrent effect of the civil penalty, Respondents agree that in any Related Investor Action, they shall not argue that they are entitled to, nor shall they benefit by, offset or reduction of any award of compensatory damages by the amount of any part of Respondents' payment of a civil penalty in this action ("Penalty Offset") (emphasis added). See *e.g.*, U.S. Sec. & Exch. Comm'n., In the Matter of G-Trade Services LLC, et al, Order Instituting Administrative and Cease-and-Desist Proceedings, SEA Release No. 34-71128 (Dec. 18, 2013).

<sup>133</sup> Paragraph (b) under section 1101 of the RULES OF PRACTICE provides that unless otherwise ordered, a plan for the administration of a Fair Fund or a disgorgement fund include the following elements:

*Procedures for the receipt of additional funds*, including the specification of any account where funds will be held, the instruments in which the funds may be invested; and, in the case of a Fair Fund, the receipt of any funds pursuant to 15 U.S.C. 7246(b), if applicable; (2) *Specification of categories of persons potentially eligible to receive proceeds* from the fund; (3) *Procedures for providing notice* to such persons of the existence of the fund and their potential eligibility to receive

party to submit a Plan of Distribution.<sup>134</sup> In such case, the Commission may require the party to retain an Independent Distribution Consultant (“IDC”) to develop the proposed Plan of Distribution.<sup>135</sup> In simple cases, the Division of Enforcement itself would propose a plan within sixty days after the respondent has paid monetary sanctions ordered by the Commission, and there are no appeals of the Commission’s order.<sup>136</sup> Notice of a proposed Plan of Distribution is published in the SEC Docket, on the SEC website, and in other publications as the Commission may require.<sup>137</sup> All persons who want to comment on the proposed plan are allowed to submit their comments, in writing, within thirty days from the date of notice.<sup>138</sup> The Commission must give an order of approval or disapproval of

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proceeds of the fund; (4) *Procedures for making and approving claims, procedures for handling disputed claims, and a cut-off date* for the making of claims; (5) *A proposed date for the termination of the fund*, including provision for the disposition of any funds not otherwise distributed; (6) *Procedures for the administration of the fund*, including selection, compensation, and, as necessary, indemnification of a fund administrator to oversee the fund, process claims, prepare accountings, file tax returns, and, subject to the approval of the Commission, make distributions from the fund to investors who were harmed by the violation; and (7) Such other provisions as the Commission or the hearing officer may require. (Emphasis added).

<sup>134</sup> See RULES OF PRACTICE § 1101(a) (17 C.F.R. 201.1101(a)).

<sup>135</sup> ENFORCEMENT MANUAL, *supra* note 130, at 210.

<sup>136</sup> See RULES OF PRACTICE § 1101(a). See also ENFORCEMENT MANUAL, *supra* note 130, at 209 (stating that developing the distribution plan by the SEC staff is typically made in case where distribution plan is fairly clear-cut (e.g., a pro-rata distribution to a limited number of investors)); Velikonja, *supra* note 67, at 343 (mentioning the interview with the SEC staff explaining “the SEC currently does not have the resources to administer distribution plans in-house, except for the simplest plans where a notice and claims process is unnecessary”).

<sup>137</sup> See RULES OF PRACTICE § 1103 (17 C.F.R. 201.1103)). The SEC lists on its websites the Commission’s orders and notices pertaining to disgorgement and Fair Fund cases in administrative proceedings, *available at* <http://www.sec.gov/litigation/fairfundlist.htm> (last visited on May 18, 2015).

<sup>138</sup> See RULES OF PRACTICE § 1103 (17 C.F.R. 201.1103).

the proposed plan within thirty days after the end of the comment period.<sup>139</sup> In the discretion of the Commission, a proposed plan that is substantially modified prior to adoption may be republished for an additional comment period.<sup>140</sup>

### 3. Administration of Plans

The Commission appoints a fund administrator to ensure proper distribution of funds in accordance with the plan. The fund administrator's tasks include overseeing the fund, obtaining mailing information for the eligible investors, processing claims, preparing accountings, filing tax returns, collaborating with the tax administrator to accomplish income tax compliance, and making distributions from the fund to harmed investors.<sup>141</sup> Though any person may be appointed as a fund administrator,<sup>142</sup> an administrator who is not an SEC employee is required to post a bond to secure distribution of the Fair Fund to the investors.<sup>143</sup> However, the obligation to post a bond may be waived for good cause

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<sup>139</sup> See RULES OF PRACTICE § 1104 (17 C.F.R. 201.1104).

<sup>140</sup> *Id.*

<sup>141</sup> See RULES OF PRACTICE § 1101(b)(6); *e.g.*, U.S. Sec. & Exch. Comm'n, Proposed Plan of Distribution, Admin. Proc. File No. 3-13454 (Feb. 11, 2014).

<sup>142</sup> See RULES OF PRACTICE § 1105(a). Meanwhile, the Commission delegated to the Director of Division of Enforcement the authority to appoint fund administrators from the Commission-approved pool of firms, and to set the amount of the administrator's bond, effective as of August 31, 2013. The Commission approved nine firms as future fund administrators on July 15, 2013. The Office of Distributions evaluates each administrator annually and, if the administrator performs in compliance with the requirements for selection, they may be part of the pool for up to five years. See U.S. Sec. & Exch. Comm'n, Delegation of Authority to Director of the Division of Enforcement, Release No. 34-70049 (Aug. 1, 2013), *available at* <https://www.sec.gov/rules/final/2013/34-70049.pdf> (last visited on May 19, 2015).

<sup>143</sup> See RULES OF PRACTICE § 1105(c) (17 C.F.R. 210.1105(c)).

by the Commission.<sup>144</sup> An administrator that is not an SEC employee, on the Commission's approval, may be paid a reasonable fee for his or her services. Unless otherwise ordered, fees and expenses for administration of the plan is paid from Fair Fund proceeds.<sup>145</sup> In some cases, the Commission orders a respondent to pay such fees and expenses. According to the GAO report, respondents paid Fair Fund expenses in 30 percent of cases.<sup>146</sup> The administrator is required to file an accounting of a Fair Fund within the first ten days of each calendar quarter; prior to being discharged, the administrator must also submit a final accounting for the Commission's approval.<sup>147</sup>

#### **4. Distribution of Funds**

Funds collected from defendants are distributed to eligible investors according to their pro rata share of losses calculated using the methodology included in the distribution plan. In Fair Fund cases, identifying eligible investors is a difficult and time-consuming process due to problems such as omnibus accounting and change of addresses.<sup>148</sup> If

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<sup>144</sup> *Id.* Such instances includes cases where the Fund administrator has no custody of the Fair Fund, funds are held by the federal agencies such as the U.S. Treasury Bureau of Public Debt or held in an escrow account. *See e.g.* U.S. Sec. & Exch. Comm'n, In the Matter of Canadian Imperial Holdings, Inc. and CIBC World Markets Corp., Order Approving Plan, Appointing a Fund Administrator, and Waiving Bond, Admin. Proc. File No. 3-11987 (Feb. 23, 2010).

<sup>145</sup> *See* RULES OF PRACTICE § 1105(c) (17 C.F.R. 210.1105(e)).

<sup>146</sup> *See* U.S. GOV'T ACCOUNTABILITY OFFICE, SECURITIES AND EXCHANGE COMMISSION: ADDITIONAL ACTIONS NEEDED TO ENSURE PLANNED IMPROVEMENTS ADDRESS LIMITATIONS IN ENFORCEMENT DIVISION OPERATIONS 1, 29 (2007) [hereinafter "GAO STUDY 1"] *available at* <http://www.gao.gov/products/GAO-07-830> (last visited on May 18, 2015).

<sup>147</sup> *See* RULES OF PRACTICE § 1105(f) (17 C.F.R. 210.1105(f)).

<sup>148</sup> *See* Deborah Solomon, *Plan to Give Defrauded Investors Money from Fines Faces Hurdles--New Victim Funds Struggle To Locate Shareholders And Decipher Records*, WALL ST. J. (July 7, 2005 12:01 a.m. ET), <http://www.wsj.com/articles/SB112069897817279136> (last visited on May 18, 2015); *see also* Niels Holch,

investors could not be found or did not cash their restitution checks within the stale date, the residual amounts remaining in the Fair Fund are transferred to the U.S. Treasury. In some cases, the amounts not distributed to investors take up a significant portion of the Fair Fund. For example, Gabelli Funds, LLC was required to pay a total of \$16 million as disgorgement and civil penalty.<sup>149</sup> However, after disbursement, the Fair Fund transferred the residual balance of \$6.4 million to the U.S. Treasury.<sup>150</sup> Today, to minimize the funds returned to the Treasury, the SEC and Fair Fund administrators are making more efforts to track eligible investors, but this may take more time and delay distribution of the Fair Fund. Thus, in order to expedite Fair Fund distribution, the SEC began to distribute Fair Funds in tiers or trenches, as eligible claimants are identified.<sup>151</sup>

Injured investors may also recuperate their losses through class actions in addition to Fair Fund distributions. The business community has argued that the amount investors obtain from a Fair Fund should offset the amount they collect in class actions.<sup>152</sup>

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Coalition of Mutual Fund Investors, *Opinion: Should Revamp Its Fair-Funds Process* (Feb. 18, 2014), available at <http://www.investorscoalition.com/sites/default/files/Ignites%20-%20SEC%20Should%20Revamp%20Its%20Fair%20Funds%20Process%202-18-2014.pdf> (last visited on May 18, 2015).

<sup>149</sup> *SEC v. Marc J. Gabelli and Bruce Alpert*, U.S. Sec. & Exch. Comm'n, Litigation Release No. 20539 (April 24, 2008).

<sup>150</sup> U.S. Sec. & Exch. Comm'n, In the Matter of Gabelli Funds, LLC, Order Authorizing the Transfer of Remaining Funds and Any Future Funds Returned to the Fair Fund to the U.S. Treasury, Terminating the Fair Fund, and Discharging the Fund Administrator, SEA Release No. 68733 (Jan. 25, 2013).

<sup>151</sup> GAO STUDY, *supra* note 120, at 16.

<sup>152</sup> See COMMISSION ON THE REGULATION OF U.S. CAPITAL MARKETS IN THE 21ST CENTURY, REPORT AND RECOMMENDATIONS 88-90 (March 2007), available at <http://www.centerforcapitalmarkets.com/wp-content/uploads/2014/06/Commission-on-the-regulation-of-us-cap-markets-report-and-recommendations.pdf> (last visited on May 18, 2015).

However, when the SEC settles a case with the defendants, it allows defendants to offset or reduce the damage amount in related investor actions only by the disgorgement amount paid by the defendants.<sup>153</sup> The SEC does not permit such offsetting for civil penalties in order “to preserve the deterrence effect of the civil penalties.”<sup>154</sup>

Nevertheless, the SEC’s prohibition against offsetting civil penalties does not overcompensate investors. Case law has established the principle that total payments to shareholders cannot exceed the shareholders’ damages. In *SEC v. Risman*, the U.S. Court of Appeals for the Second Circuit held that the SEC is obliged to administer a distribution fund that does not duplicate compensation already made from the restitution.<sup>155</sup> Thus, after distributing penalty amounts to the extent that investors are made whole, any amount left in the Fair Funds is remitted to the Treasury.<sup>156</sup> Similarly, in cases where the SEC settles a case prior to a class action suit, courts consider the amount of losses covered by the Fair Fund in deciding investors’ damages. This is evidenced by market timing and late trading cases first identified by the SEC in 2003. For instance, Strong Capital Management, Inc. and affiliated firms settled the SEC’s charge of market timing by paying \$140 million, but they paid only \$13.5 million in a subsequent class action suit.<sup>157</sup>

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<sup>153</sup> See e.g., U.S. Sec. & Exch. Comm’n, In the Matter of Janus Capital Management LLC, Order Instituting Administrative and Cease-and-Desist Proceedings, Admin. Proc. File No. 3-11590 (Aug. 8, 2004).

<sup>154</sup> *Id.*

<sup>155</sup> *SEC v. Risman*, 7 F. App’x 30, 31 (2d Cir. 2001).

<sup>156</sup> Plaintiff Memorandum in Support of its Motion for Distribution of Settlement Funds and Appointment of Distribution Agent, *SEC v. Dean L. Buntrock*, 2005 WL 2610696 (N.D.Ill., Aug. 26, 2005).

<sup>157</sup> U.S. Sec. & Exch. Comm’n, In the Matter of Strong Capital Management, Inc., et al., Order Instituting Administrative and Cease-and-Desist Proceedings, Admin. Proc. File No. 3-11498 (May 20, 2004); Strong

## C. Empirical Data on Fair Funds<sup>158</sup>

### 1. Fair Fund Creation

Between 2002, when the Fair Fund provision was enacted, and 2013, 241 Fair Funds were created in connection with 143 cases in federal court actions and 100 cases in administrative proceedings. During the same period, the courts and the SEC ordered Fair Fund payments to investors totaling \$14.46 billion, with \$6.188 billion in disgorgements and \$8.276 billion in civil penalties. The courts, in aggregate, ordered more monies than the SEC by \$3.376 billion. This can be best explained by the fact that the courts imposed large civil fines against corporations and their associates for violations in high-profile cases.<sup>159</sup> However, the data did not show a significant difference between the two types of Fair Funds for mean size of distribution plans: \$55 million in the SEC-overseen fund and \$62 million in the court-overseen fund.

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Mutual Fund Market Timing Settlement Website, <http://mutualfundslitigation.com/strong/index.php> (last visited on May 18, 2015).

<sup>158</sup> Though the SEC updates the list of Fair Funds on its website whenever one is created in an administrative proceeding, the agency does not publicize aggregate data on Fair Fund such as total amount ordered, collected, and distributed. Thus, this part mostly relies on the empirical study conducted by professor Velikonja in 2014. In this study, the author analyzed 236 Fair Funds created between July 25, 2002 and December 31, 2013. For detailed methodology adopted in this study, *see* Velikonja, *supra* note 67, at 347-50. This part also refers to a GAO analysis of Fair Funds created between 2002 and 2010 based on data provided by the SEC in 2010. For methodology in this study, *see* GAO STUDY, *supra* note 120, at 10-11.

<sup>159</sup> In the ten largest Fair Fund cases, 5.35 billion dollars, which accounted for 37.4 percent of the overall Fair Fund amount, and, in the most part, belongs to civil fines, were imposed by the federal courts except in two cases. The ten largest cases include AIG, Worldcom, British Petroleum, Enron, Invesco Funds, Banc of America Capital Management, Fannie Mae, State Street, Time Warner, and J.P. Morgan. *See* Velikonja, *supra* note 67, at 351.

By category of securities violation,<sup>160</sup> the majority of SEC-overseen Fair Funds were investment advisor violation cases (54 out of 99 Fair Funds with available information, or 54.5%), followed by 33 broker-dealer violation cases.<sup>161</sup> In contrast, court-overseen Fair Funds were most frequently issuer-reporting violation cases, which were 67 out 143 cases (46.8%). In addition, the two types of Fair Funds show differences in the sources of the funds. While \$3.225 billion in disgorgements, as compared to \$2.319 billion in civil fines, were imposed in the SEC-administered Fair Funds, only \$2.962 billion in disgorgements were imposed in the court-administered Fair Funds, which was far less than the \$5.957 billion in civil fines. This is because corporations rarely obtained identifiable ill-gotten profits from violations in issuer-reporting and disclosure cases, which were addressed predominantly in judicial proceedings,<sup>162</sup> unlike in the SEC Fair Fund cases where investment advisory firms and broker-dealers received ill-gotten fees from their customers.<sup>163</sup>

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<sup>160</sup> Professor Velikonja categorized the type of violation involved with Fair Fund cases in accordance with the classification used in the SELECT SEC AND MARKET DATA report published annually by the SEC: Broker-dealer, insider trading, investment advisor/company, issuer reporting and disclosure, market manipulation, securities offering, municipal. Velikonja, *supra* note 67, at 354.

<sup>161</sup> The phenomenon that most of the SEC cases were concentrated in two categories is likely caused by the limitation of its enforcement authority that the SEC seeks civil monetary penalties only against regulated persons and entities. *See* Velikonja, *supra* note 67, at 352.

<sup>162</sup> *See* Black, *supra* note 56, at 321-22 (stating that the SEC did not seek disgorgement against defendant corporations in cases where they did not sell their securities through their fraudulent misstatements even though they may have benefited in many ways from their increased market capitalization). However, in *SEC v. American International Group, Inc.*, the SEC sought \$700 million in disgorgement on the ground that the defendant inflated “its financial bottom line” from two transactions, one that made \$500 million of phony loss reserves, and another transaction, which hid \$200 million underwriting losses. This “experiment” was not continued in following cases. *Id.* at 334.

<sup>163</sup> *See* Velikonja, *supra* note 67, at 353.



Table 2. SUMMARY OF DATA ON FAIR FUND DISTRIBUTIONS IN SEC-AND COURT-OVERSEEN FUNDS (2002-2013)<sup>164</sup>

	SEC-Overseen Funds	Court-Overseen Funds	Overall
Number of Plans	100	143	243
Total Amount (in \$M)	5,544.7	8,920.0	14,464.7
Disgorgements (in \$M)	3,225.2	2,962.8	6,188.0
Civil Fines (in \$M)	2,319.5	5,957.2	8,276.7
Mean Plan (in \$M)	55.4	62.4	59.5
Median Plan (in \$M)	19.6	10.6	16.5
Maximum (in \$M)*	375.34	816.50	816.50
Minimum (in \$)*	109,330	24,959	24,959
Most Common Category	Investment Advisor (54 of 99)	Issuer Reporting (67 of 143)	Issuer Reporting (71 of 242)

\* All figures, except for those followed by an asterisk, are reported in 2013 dollars. Figures marked with an asterisk are reported in nominal dollars.

## 2. Trend in Fair Fund Creation Over Time

As shown in the following graph, both the number of Fair Funds created and the amount ordered for distribution decreased after 2007. On average, while twenty-five Fair Funds were established yearly distributing \$1.9 billion until 2007, this number decreased to twenty and \$0.6 billion, respectively, after 2007. Since the SEC has discretion to determine whether to create a Fair Fund, this decline may arouse suspicion that the agency

<sup>164</sup> Velikonja, *supra* note 67, at 352.

has drawn back from its previous stance of making zealous efforts in creating Fair Funds.<sup>165</sup> In its Fair Fund study in 2010, the GAO explained that the reason for the recent decline was because the SEC decided that certain types of cases are not suitable for Fair Fund.<sup>166</sup>

Despite the contrasting figures before and after 2007, it is too early to reach the conclusion that the SEC has abandoned its previous position on Fair Funds. Low records in recent years may have resulted from other factors. For example, the imposition of less civil penalties may allow the SEC to establish sizable Fair Funds sufficient to compensate harmed investors. After announcing the statement concerning financial penalties in January 2006, however, the SEC staff had more difficulty obtaining large penalties from corporations than before.<sup>167</sup> As shown in table 3, the amount of civil penalties significantly decreased for several years after 2006. The high figures reported before 2007 may have been “over-shooting” due to the SEC’s experiment with corporate penalties in response to a series of financial fraud scandals after SOX.

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<sup>165</sup> For the SEC’s previous stance on Fair Funds, *see e.g.*, Christopher Cox, Chairman, U.S. Sec. & Exch. Comm’n, Message from the Chairman in 2006 SEC Performance and Accountability Report (Nov. 15, 2006), *available at* <http://www.sec.gov/about/secpar/secpar2006.pdf#chairman> (last visited on May 18, 2015) (emphasizing that “whenever practical, the Commission seeks to return funds to harmed investors through the Fair Fund provision of SOX”).

<sup>166</sup> GAO STUDY, *supra* note 120, at 15 (however, the GAO did not specify the types of cases mentioned in the report).

<sup>167</sup> After announcing the penalty guidelines, the Commission initiated a pilot program, which required the SEC staff to consult with the Commission before entering into settlement negotiations in the corporate penalty cases. This program was terminated in early 2009. Daniel M. Gallagher, Comm’r, U.S. Sec. & Exch. Comm’n, Speech by SEC Commissioner: Remarks at Columbia Law School Conference (Hot Topics: Leading Current Issues in Securities Regulation and Enforcement) (Nov. 15, 2013), *available at* <http://www.sec.gov/News/Speech/Detail/Speech/1370540386071#.VIJL3jHF8nk> (last visited on May 18, 2015).

In addition, the recent decline may be explained by the fact that the SEC has changed its main target among the different types of enforcement actions since 2007, reflecting new market situations that the agency faces.<sup>168</sup> As shown in table 3, between 2004 and 2007, the SEC's enforcement actions were mainly focused on issuer reporting, broker-dealer, and investment advisor/company cases, responding to major issues such as accounting fraud scandals, mutual fund market timing, and late trading.<sup>169</sup> Since the SEC charged Bernard Madoff for his Ponzi scheme in 2008, the agency has put more effort into rooting out these scams.<sup>170</sup> Accordingly, between 2008 and 2011, enforcement actions related to securities offerings significantly increased and targeted more individuals. However, this brought about the creation of a relatively smaller amount of Fair Funds.<sup>171</sup>

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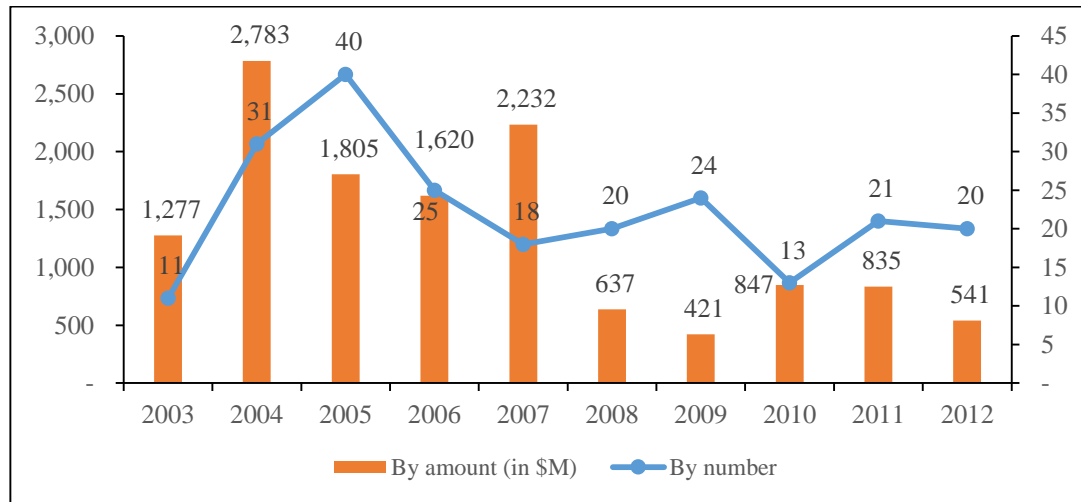
<sup>168</sup> For a detailed explanation about how changes in the SEC's enforcement actions was related to Fair Fund, *see* Velikonja, *supra* note 67, at 356-58.

<sup>169</sup> Among the SEC's diverse enforcement actions, the three types of enforcement actions mentioned above crucially contributed to the creation of Fair Funds: The SEC established 187 Fair Funds of the total cases (78.2%) imposed \$12.469 billion of the total amount (87.2%) through such enforcement actions. *See* Velikonja, *supra* note 67, at 354.

<sup>170</sup> For example, the SEC states on its website that “[c]ulling Ponzi schemes and holding accountable the individuals responsible for these scams is a vital component of the SEC's enforcement program.” *See* Sec. & Exch. Comm'n, SEC Enforcement Action against Ponzi Schemes, *available at* <http://www.sec.gov/spotlight/enf-actions-ponzi.shtml> (last visited on May 18, 2015).

<sup>171</sup> *See* Velikonja, *supra* note 67, at 358 (explaining that in Ponzi scheme cases, “the perpetrators dissipate the assets before the scheme is unmasked and “funds recovered in Ponzi schemes are typically distributed through receivership, not fair funds”).

Figure 2. FAIR FUNDS CREATED AND AMOUNT ORDERED FOR DISTRIBUTION  
BY YEAR (2003-2012)<sup>172</sup>



\* Fair Funds are tallied by calendar year, not by the SEC's fiscal year (October 1 - September 30).

Table 3. SEC ENFORCEMENT ACTIONS BY YEAR (FY 2004-2014)<sup>173</sup>

	FY04	FY05	FY06	FY07	FY08	FY09	FY10	FY11	FY12	FY13	FY14
Total Amt. (1+2)	3.1	3.1	3.3	1.6	1.1	2.5	2.8	2.8	3.1	3.5	4.2
1. disgorgement (\$B)	1.9	1.6	2.3	1.1	0.8	2.1	1.8	1.9	2.1	2.3	2.8
2. penalty (\$B)	1.2	1.5	1	0.5	0.3	0.4	1	0.9	1	1.2	1.4
Total Cases	639	630	574	656	671	664	681	735	734	686	755
Issuer Reporting	179	185	138	219	157	143	126	109	94	68	106
Broker-Dealer	141	94	75	89	60	109	70	113	134	121	166
Investment Advisor/ Investment Company	90	97	95	79	88	81	112	146	147	140	130
Securities Offering	98	60	61	68	121	141	144	123	89	103	81
Delinquent Filings	21	60	91	53	111	92	106	121	127	132	107
Insider Trading	42	50	46	47	61	37	53	57	58	44	52
Market Manipulation	39	46	27	36	52	39	34	35	46	50	63
Others	29	38	41	65	21	22	36	31	39	28	50

\* All dollar amounts are presented in nominal value of reported year.

<sup>172</sup> Velikonja, *supra* note 67, at 357.

<sup>173</sup> Data presented in the table are collected from the SEC's report on Select SEC and Market Data, which is published annually. In the process of preparing the table, FCPA cases are incorporated in the "Issuer Reporting" and all remaining categories other than shown (e.g., Transfer Agent, Municipal, Contempt, SRO or Exchange, Miscellaneous) are into "others." See SEC. AND EXCH. COMM'N, SELECT SEC AND MARKET DATA (2004-2012), available at <http://www.sec.gov/about/secreports.shtml> (last visited on May 18, 2015).

### 3. Completion of Distribution

According to the GAO Study conducted in 2010, most Fair Funds took longer than two years to complete distribution of the funds.<sup>174</sup> Another study also shows that the average time from initial order to termination was over five years in 93 Fair Funds created from corporate violators.<sup>175</sup> Slow distribution is caused by many factors such as difficulty in obtaining investor information from financial intermediaries, objections and appeals from investors, and insufficient information necessary to calculate each investor’s share of funds.<sup>176</sup> Thus, the SEC’s recent Fair Fund efforts have been mostly focused on expediting the distribution process.<sup>177</sup>

Table 4. FAIR FUND DISTRIBUTION BY DURATION<sup>178</sup>

Duration	Fair Funds	Fair Funds ordered but not collected	Fair Funds collected but not distributed	Percent distributed
Ongoing between 2 and 3 years	24	\$104,318,421	\$307,193,044	19.2
Ongoing between 3 and 4 years	24	\$122,787,909	\$237,500,451	86.2
Ongoing between 4 and 5 years	31	\$48,127,690	\$897,545,933	66.8
Ongoing between 5 and 6 years	22	\$40,692,486	\$438,477,621	79.1
Ongoing between 6 and 7 years	10	\$2,357,170	\$490,991,386	62.0
Ongoing between 7 and 8 years	2	\$44,000	\$460,672	0.0
Ongoing for longer than 8 years	1	\$51,733	\$8,401,118	0.0
<b>Total</b>	<b>114</b>	<b>\$318,379,409</b>	<b>\$2,380,570,224</b>	<b>70.5</b>

Source: GAO analysis of SEC data.

<sup>174</sup> GAO STUDY, *supra* note 120, at 21 (stating that “[o]f the 128 Fair Fund cases that have not completed distribution, 114 have been ongoing for longer than 2 years”).

<sup>175</sup> Sonia A. Steinway, Comment, *SEC “Monetary Penalties Speak Very Loudly,” But What Do They Say? A Critical Analysis of the SEC’s New Enforcement Approach*, 124 YALE L.J. 209, 214 (2014) (this study also shows that the time between the initial order and the proposed distribution plan was 816 days).

<sup>176</sup> *Id.* at 22; see also Deborah Solomon, *For Wronged Investors, It’s Payback Time--The SEC Begins Doling Out Funds from Settlement Pools, but the Wait Can Be Long*, WALL ST. J., July 7, 2005, at D1 (reporting that slow distribution is partly due to the complexity of the settlement process).

<sup>177</sup> See *supra* note 122-24 and accompanying text.

<sup>178</sup> GAO STUDY, *supra* note 120, at 21.

## **D. Major Fair Fund Issues**

Though the SEC has made efforts to recompense investors for their losses by distributing penalties whenever possible, the Fair Fund has been criticized by scholars in several respects. This section reviews the major issues that have been raised in relation to Fair Fund distributions. Further, this section illustrates in what circumstances the creation of a Fair Fund is most useful, minimizing concerns with issues that will be discussed.

### **1. Circularity of the Fair Fund Distribution**

Just as in securities class actions,<sup>179</sup> the circularity issue, also known as the wealth transfer problem, is commonly criticized with regard to Fair Fund distribution.<sup>180</sup> This critique is typically raised when the SEC imposes penalties on a corporation to compensate investors who purchased stocks at an inflated price in the secondary market while the corporation was making fraudulent misstatements or omissions of material information.<sup>181</sup> Because the penalty amount is ultimately borne by current shareholders, Fair Fund distributions transfer monies from current shareholders who are not culpable, to investors

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<sup>179</sup> For a discussion on the circularity problem in securities class actions, *see* John C. Coffee, Jr., *Reforming the Securities Class Action: An Essay on Deterrence and its Implementation*, 106 COLUM. L. REV. 1534, 1556-66 (2006) (analyzing the circularity problem in three different settings: simple wealth transfer, wealth transfer under the assumption of diversification, and conflict between “Buy and Hold” investors versus “In and Out” traders).

<sup>180</sup> *See e.g.*, Black, *supra* note 56, at 331; William W. Bratton & Michael L. Wachter, *The Political Economy of Fraud on the Market*, 160 U. PA. L. REV. 69, 139 (2011).

<sup>181</sup> Coffee, *supra* note 177, at 1556-57. The circularity problem is usually addressed in the secondary market case where a corporation and its shareholders do not receive profits directly from misrepresentation, unlike in the primary market case where they benefit from over-priced issuance of the stock. *Id.*

who purchased stocks during the time period in which misleading information allegedly affected the market.<sup>182</sup> Thus, innocent current shareholders may be harmed by this distribution.

The degree of harm they suffer may be somewhat different depending on the situation each investor confronts. To illustrate, if we assume that an investor purchases a company's stock before the misrepresentation and holds it at present, he bears the penalty without any compensation and, therefore, his harm would be the largest as a result of a Fair Fund distribution.<sup>183</sup> In other cases, if an investor buys the stock at an inflated price by the company's misrepresentation and holds it at present, he pays the penalty and receives compensation, minus administrative costs.<sup>184</sup>

However, not all Fair Fund distributions exhibit the circularity issue. According to the empirical study on Fair Funds by Professor Velikonja, approximately one-third of distributions displayed the circularity problem.<sup>185</sup> Among diverse SEC enforcement actions, the circularity problem is most prevalent in issuer-reporting and disclosure cases where a public company pays the penalty.<sup>186</sup> However, even in this category, the problem

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<sup>182</sup> This kind of wealth transfer can be described as “shifting money one pocket to another.” Coffee, *supra* note 177, at 1558. Other commentator also compares this to “robbing Peter to pay Paul” or “robbing Peter to pay Peter.” Black, *supra* note 56, at 331.

<sup>183</sup> See Verity Winship, *Fair Funds and the SEC's Compensation for Injured Investors*, 60 FLA. L. REV. 1103, 1128 (2008).

<sup>184</sup> *Id.*

<sup>185</sup> Velikonja, *supra* note 67, at 375 (explaining that 71 Fair Funds out of the total, which distributed \$6.34 billion to harmed investors, were established in issuer reporting cases and corporations paid \$5.1 billion, that is approximately 35.2% of the total amount of Fair Fund distributions).

<sup>186</sup> *Id.*; Winship, *supra* note 183, at 1129.

does not always exist. According to the same study, in 29 of 71 issuer-reporting cases, the issuers did not pay monetary sanctions into Fair Funds.<sup>187</sup>

In addition, in cases where a corporation wrongfully benefits from the fraudulent issuance of over-priced stock to investors, imposition of monetary sanctions against the company, and indirectly its shareholders, is not “inefficiently circular.”<sup>188</sup> Further, the circularity concern may be significantly reduced in Fair Fund cases where the SEC seeks penalties from individuals such as officers or directors, and third parties such as investment banks or auditors.<sup>189</sup> In fact, the SEC sought disgorgements and civil penalties from third-party defendants in 61 of 71 issuer-reporting and disclosure cases, and they paid \$1.24 billion in settlements.<sup>190</sup>

## 2. Conflict with the Bankruptcy Code

The issue of possible conflicts between Fair Fund distributions and the Bankruptcy Code was first raised when the SEC obtained a \$750 million civil penalty as a settlement to distribute to defrauded shareholders from *Worldcom* who had filed for bankruptcy right after the agency initiated the enforcement action for massive accounting fraud.<sup>191</sup>

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<sup>187</sup> Velikonja, *supra* note 67, at 376.

<sup>188</sup> *Id.* at 377 (comparing such case to damages for price fixing or polluting drinking water and explaining that imposing the penalty on the corporation and its shareholders in such case can induce the company to monitor employee misconduct and internalize a negative externality); *see also*, Coffee, *supra* note 177, at 1562.

<sup>189</sup> *See infra* discussion in Part IV(E)(3).

<sup>190</sup> Velikonja, *supra* note 67, at 376.

<sup>191</sup> *See* U.S. Sec. & Exch. Comm’n, Litigation Release No. 17588, Civil Action 02 CV 4963 (S.D.N.Y.) (June 27, 2002); *SEC v. Worldcom Inc.*, 273 F.Supp. 2d 431 (S.D.N.Y. 2003). For brief history of Worldcom civil and bankruptcy case, *see also* Zack Christensen, *The Fair Funds for Investors Provision of Sarbanes-Oxley:*



According to section 510(b) of the Bankruptcy Code, shareholders' claims for damages arising from the purchase or sale of a security are subordinate to all other creditors of the bankrupt company.<sup>192</sup> However, this provision does not directly prohibit the SEC from distributing collected monies to shareholders for damages after the agency has collected penalties from the bankruptcy estate as an unsecured creditor.<sup>193</sup> Thus, shareholders can recover damages more than they would in the bankruptcy proceeding without the Fair Fund distribution, and shares for other unsecured creditors are proportionately reduced by that amount.<sup>194</sup> The district court and bankruptcy court of the *Worldcom* case recognized a potential problem, but approved the settlement with the SEC.<sup>195</sup>

The priority conflict between the Fair Fund provision and the Bankruptcy Code's absolute priority rule brought criticism that the Fair Fund provision "alter[ed] the well-established distributional priorities of bankruptcy law" and resulted in unfairness to

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*Is It Unfair to the Creditors of a Bankrupt Debtor?*, 2005 U. ILL. L. REV. 339, 355-58 (2005); Marvin E. Sprouse III, *A Collision of Fairness: Sarbanes-Oxley and 510(b) of the Bankruptcy Code*, 24 AM. BANKR. INST. J. 8, 9 (2005).

<sup>192</sup> Section 510(b) provides:

For the purpose of distribution under this title, a claim arising from rescission of a purchase or sale of a security of the debtor or of an affiliate of the debtor, for damages arising from the purchase or sale of such a security, or for reimbursement or contribution allowed under section 502 on account of such a claim, shall be subordinated to all claims or interests that are senior to or equal the claim or interest represented by such security, except that if such security is common stock, such claim has the same priority as common stock.

<sup>193</sup> Velikonja, *supra* note 67, at 366.

<sup>194</sup> *Id.* at 366-67.

<sup>195</sup> See *SEC v. Worldcom Inc.*, *supra* note 57, at 434 (stating that "a penalty that was premised primarily ... might arguably run afoul of the provisions of the Code that subordinate shareholder claims below all others"); *In re Worldcom Inc.*, Ch. 11 Case No. 02-13533, Docket #8125 (Bankr. S.D.N.Y. Aug. 6, 2003) (stating that "[i]n considering approval of a settlement, the court is not required to resolve the underlying legal issues related to the settlement").

innocent general creditors.<sup>196</sup> Specifically, some commentators pointed out that treating shareholders equal to unsecured creditors in bankruptcy does not make sense when looking into the legislative history of section 510(b), which was enacted to correct such unfair treatment.<sup>197</sup> However, after *Worldcom*, the SEC rarely imposed monetary penalties against bankrupt companies.<sup>198</sup> The SEC sought penalties in only two cases among 16 issuer-reporting and disclosure cases<sup>199</sup> where conflict was most likely to occur: *Worldcom* and *Nortel Networks*.<sup>200</sup>

### 3. Duplication of Securities Class Action Suits

Critics of Fair Funds have also claimed that they just “mimic” or “duplicate” private securities class actions and waste resources,<sup>201</sup> and show only “low investor

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<sup>196</sup> Christensen, *supra* note 191, at 344 (arguing that “Congress should amend section 308(a) of Sarbanes-Oxley to clarify that it does not circumvent section 510(b)); *see also* e.g., Black, *supra* note 56, at 332-33 (criticizing that the SEC and courts failed “to appreciate sufficiently the impact on other innocent stakeholders”); Sprouse, *supra* note 191, at 8 (stating that “the courts have not resolved the dissonances between Sarbanes-Oxley and the Code”).

<sup>197</sup> *See* Christensen, *supra* note 191, at 358-60 (explaining that “Congress consciously adopted the underlying premise of the Slain and Kripke argument” that “claims of rescinding shareholders should generally be subordinated to the claims of general unsecured creditors” in the light of the risk allocation of illegal securities issuance between security holders and the issuer’s creditors); Sprouse, *supra* note 191, at 8 (stating that “[t]he era of defrauded shareholder/unsecured creditor distributive equality ended with the enactment of the Code and its §510(b)).

<sup>198</sup> *See* Velikonja, *supra* note 67, at 368 (stating that “[t]he Worldcom Fair Fund cast a dark shadow over the SEC’s distribution efforts, but Worldcom is the exception, not the rule”).

<sup>199</sup> Of 236 Fair Fund cases, 31 primary defendant companies “filed for bankruptcy within two years of the SEC enforcement actions” and 16 of those were issuer-reporting and disclosure cases. *Id.* at 367.

<sup>200</sup> However, in the Nortel Networks case, the company paid a \$35 million civil penalty in November 2007 and filed for bankruptcy in January 2009. Thus, the penalty did not directly affect creditors’ recovery in its bankruptcy proceeding. *Id.*

<sup>201</sup> *Id.* at 15-16; *See also* Adam S. Zimmerman, *Distributing Justice*, 86 NYU L. REV. 500, 519 (2011) (exploring “problems when regulatory agencies mimic class action settlement by forcing wrongdoers to

recovery.”<sup>202</sup> Some argue that when a Fair Fund case accompanies a parallel class action for “the same conduct against the same actors,” it may “duplicate administrative costs” which are paid to the distribution agent or fund administrator.<sup>203</sup> In a situation where both public and private actions are available,<sup>204</sup> if public compensation through the Fair Fund is expensive or “simply duplicating the compensation mechanisms and associated costs,” the Fair Fund compensation would not make sense.<sup>205</sup> Besides administrative costs, some commentators argue that even though the Fair Fund distribution does not directly incur “attorney’s fees” like in private litigation,<sup>206</sup> costs that occur when the SEC performs the

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compensate their victims”); Winship, *supra* note 183, at 1136 (stating that “the parallel distributions may duplicate administrative costs when both private and public actions are brought for the same conduct against the same actors”); Michael D. Sant’Ambrogio & Adam S. Zimmerman, *The Agency Class Action*, 112 COLUM. L. REV. 1992 (2012) (“agencies routinely waste resources on repetitive cases”); Bratton & Wachter, *supra* note 180, at 139 (stating that “[A] Fair Funds distribution to a subset of shareholders is every bit as much an exercise in pocket shifting as is payment of a FOTM settlement.”).

<sup>202</sup> See Winship, *supra* note 183, at 1124-27.

<sup>203</sup> See *e.g.*, *Id.* at 1136.

<sup>204</sup> According to the Velikonja’s study, private class actions were filed in 154 of 238 Fair Fund cases, except 8 cases which “could not be determined whether a parallel class action was filed” between 2003 and 2012. Velikonja, *supra* note 67, at 369-70.

<sup>205</sup> Winship, *supra* note 183, at 1136.

<sup>206</sup> See Paul S. Atkins, Comm’r, U.S. Sec. & Exch. Comm’n, Remarks Before the U.S. Chamber Institute for Legal Reform (Feb. 16, 2006) (emphasizing the advantage of the Fair Fund over the private class action, considering that investors’ recoveries under the Fair Fund provision are not reduced by legal fees to private lawyers unlike in class actions), available at <https://www.sec.gov/news/speech/spch021606psa.htm> (last visited on May 18, 2015). However, professor Black pointed out that “this advantage ... is diminished if, as is likely, securities plaintiffs’ attorneys have greater incentives than government attorneys to negotiate a larger amount because their compensation depends on it.” Black, *supra* note 56, at 339. Professor Coffee also suggested empirical data, explaining that “plaintiff’s attorneys appear to extract more funds from corporate pocketbooks than do all federal and state regulators.” See Coffee, *supra* note 177, at 1542-43 (citing Jackson, Howell E., *Variation in the Intensity of Financial Regulation: Preliminary Evidence and Potential Implications* 15-29 (HARVARD LAW SCH. JOHN M. OLIN CTR. FOR LAW, ECON. & BUS., Discussion Paper No. 521, 2005), available at <http://ssrn.com/abstract=839250> (on file with the Columbia Law Review)).

compensatory role, and that are finally paid by taxpayers, should also be considered in assessing whether public or private actions are better for investor compensation.<sup>207</sup>

Securities class action suits were originally recognized as a means to recompense injured investors for their losses.<sup>208</sup> Nowadays, however, its compensatory function is less meaningful.<sup>209</sup> Scholars have identified flaws with the compensatory role of securities class actions on several grounds. First, recovering from settlement payments by the corporation only results in “transferring money from one pocket to the other” for institutional investors and other shareholders who bought their shares during the class period and still own them when a suit is brought.<sup>210</sup> Second, a fully diversified investor will not experience any damage from securities fraud because his expected gains and losses net out.<sup>211</sup> The investors who are the most likely to be compensated in class actions are

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<sup>207</sup> Winship, *supra* note 183, at 1135.

<sup>208</sup> Amanda M. Rose, *Reforming Securities Litigation Reform: Restructuring the Relationship Between Public and Private Enforcement of Rule 10B-5*, 108 COLUM. L. REV. 1301, 1308-10 (2008).

<sup>209</sup> *Id.* at 1312-13 (explaining that traditional compensatory rationale grew less persuasive and a deterrence-based justification becomes more important); *see also* Coffee, *supra* note 177, at 1545 (stating “[f]rom a compensatory perspective, the conclusion seems inescapable that the securities class action performs poorly.”).

<sup>210</sup> Janet Cooper Alexander, *Rethinking Damages In Securities Class Action*, 48 Stan. L. Rev. 1487, 1503-04 (1996) (pointing out the problem that “the amounts paid by defendants are not delivered fairly and efficiently to class members” in class action); *see also* Rose, *supra* note 208, at 1313. Even though the same result would happen when the SEC imposes penalties on a corporation and distributes them to investors, the SEC may lessen such concern by considering a duplicative harm for shareholders in its enforcement and shifting its targets to individual offenders. *See* discussion *infra* in Part IV(E)(3). However, such behavior is less likely to occur in class actions.

<sup>211</sup> Frank H. Easterbrook & Daniel R. Fischel, *Optimal Damages in Securities Cases*, 52 U. CHI. L. REV. 611, 641 (1985); Donald C. Langevoort, *Capping Damages for Open-Market Securities Fraud*, 38 ARIZ. L. REV. 639, 646 (1996) (“each loser-the buyer or seller disadvantaged by the fraud- is balanced by another winner: the person on the other side of the trade”); Alexander, *supra* note 210, at 1502 (“[a]n investor who is completely diversified will be fully compensated for its trading losses that are due to securities fraud by windfalls on other transactions”); Rose, *supra* note 208, at 1313.

institutional investors who are well diversified, and compensating such investors through class action litigation is unnecessary and only incurs costly attorney's fees and expenses.<sup>212</sup> Third, securities class actions do not provide defrauded investors with sufficient compensation.<sup>213</sup> An empirical study shows that investors continually recover only a small portion of their losses from securities class action suits- in rough measure, approximately 2% of their losses in recent years.<sup>214</sup> Further, investor's recovery will be even smaller after subtracting the costs paid from the settlement such as plaintiffs' attorney's fees and expenses.<sup>215</sup> One commentator argues that the full costs borne by investors in class actions may even exceed the aggregate recovery.<sup>216</sup>

In addition to such shortcomings, class actions become less available for defrauded investors by substantive and procedural restrictions created by the Private Securities Litigation Reform Act of 1995 (PSLRA).<sup>217</sup> Notably, the PSLRA significantly

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<sup>212</sup> Alexander, *supra* note 210, at 1502.

<sup>213</sup> Coffee, *supra* note 177, at 1545-47 (“[s]ettlements recover only a very small share of investor losses”); Rose, *supra* note 208, at 1313.

<sup>214</sup> Renzo Comolli & Svetlana Starykh, NERA ECON. CONSULTING, Recent Trends in Securities Class Action Litigation: 2013 Full-Year Review: Large settlements get larger; small settlements get smaller (2014) available at [http://www.nera.com/content/dam/nera/publications/2014/PUB\\_Year\\_End\\_Trends\\_1.2014.pdf](http://www.nera.com/content/dam/nera/publications/2014/PUB_Year_End_Trends_1.2014.pdf) (last visited May 18, 2015) (according to the study, the median ratio of settlement to investor losses recorded 2.1% in 2013 and the ratio never hit 3% since 2006. Based on analysis of data from 2006 to 2013, the median settlement for cases with investor losses of less than \$20 million has been 17.1% of the investor losses, and the median settlement for cases with investor losses over \$1 billion has been 0.7% of the investor losses).

<sup>215</sup> For the period of 2011-2013, median plaintiffs' attorney's fees and expenses range between 10.7% and 34.1% of settlement value by size of settlement. *Id.* at 34-35

<sup>216</sup> Coffee, *supra* note 177, at 1546 (illustrating that full costs accompanied by class action include “plaintiffs' attorneys' fees and expenses, defense counsels' fees and expenses, Directors' and Officers' (D&O) insurance premiums, and the possible costs of disruption, stigma, and adverse publicity” and arguing that such costs eventually “fall on the corporation's shareholders”).

<sup>217</sup> Pub. L. No. 104-67, 109 Stat. 737 (codified as amended in scattered sections of 15 U.S.C. and 18 U.S.C.).

heightened pleading requirements in Rule 10b-5 actions to limit frivolous securities lawsuits. Under the PSLRA, the complaint is required to allege with specificity: the statement or omission alleged to have been misleading, and the reason;<sup>218</sup> if an allegation is made on information and belief, all facts on which that belief is formed;<sup>219</sup> and facts giving rise to a strong inference that the defendant acted with the required state of mind.<sup>220</sup> The plaintiff must also plead and prove loss causation.<sup>221</sup> Moreover, the PSLRA precludes all discovery during the pendency of a motion to dismiss.<sup>222</sup>

The PSLRA was designed to cut off meritless claims, but it also increased the possibility of dismissing meritorious claims.<sup>223</sup> Some class actions with parallel SEC enforcement actions creating a Fair Fund were dismissed for failing to meet such pleading requirements. For example, the class action against Biogen Idec, Inc. was dismissed for failure to specify ‘scienter’ sufficiently.<sup>224</sup> Another class action against Lehman Brothers

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<sup>218</sup> Exchange Act § 21D(b)(1) (codified as 15 U.S.C. § 78u-4(b)(1)).

<sup>219</sup> *Id.*

<sup>220</sup> Exchange Act § 21D(b)(2) (codified as 15 U.S.C. § 78u-4(b)(2)); see *Tellab, Inc. v. Makor Issues & Rights, Ltd.*, 551 U.S. 308, 318-24 (2007) (holding that “[a] complaint survives only if a reasonable person would deem the inference of scienter cogent and at least as compelling as any opposing inference one could draw from the facts alleged.”).

<sup>221</sup> Exchange Act § 21D(b)(4) (codified as 15 U.S.C. § 78u-4(b)(4)); see *Dura Pharmaceuticals, Inc. v. Broudo*, 544 U.S. 336, 341-43 (2005) (holding that “an inflated purchase price will not itself constitute or proximately cause the relevant economic loss” needed to allege and prove loss causation).

<sup>222</sup> Exchange Act § 21D(b)(3)(B) (codified as 15 U.S.C. § 78u-4(b)(3)(B)).

<sup>223</sup> Rose, *supra* note 208, at 1319-20; Langevoort, *supra* note 211, at 640-41; Velikonja, *supra* note 67, at 371 (explaining that “[PSLRA] also bar many meritorious suits, in particular those that do not fit neatly in the material-misrepresentation-followed-by-subsequent-correction-and-price-decline mold.”)

<sup>224</sup> *In re Biogen Idec, Inc. Civil Action No. 05-10400-WGY* (D. Mass. Oct. 25, 2007) (holding that “[e]ven if inferences of scienter may be drawn from allegations of motive and opportunity, it is not enough to satisfy the PSLRA standard in the absence of other probative factual allegations.”); see also *SEC v. Thomas J. Bucknum*, U.S. Sec. & Exch. Comm’n, Litigation Release No. 19528 (Jan. 12, 2006) (Bucknum, the former

Holdings, Inc. was also dismissed due to failure to plead ‘loss causation.’<sup>225</sup> A study also shows that investors were not compensated in 53.2% of parallel private litigations with Fair Fund distributions.<sup>226</sup> Thus, in such cases, investors have no option but to rely on Fair Fund distributions to recover their losses. In summary, in both theory and reality, securities class action suits have limitations as a compensation scheme and the Fair Fund distribution is not wasteful and duplicative as far as class actions are concerned.

However, to eradicate any risk of the duplication problem, the U.S. may consider restricting securities class actions in cases where the SEC initiates the enforcement action for securities law violations against the defendants. As seen above, even successful class actions merely return a small settlement after subtracting attorney’s fees and expenses to injured investors. Further, parallel litigation of the SEC and class action suits may aggravate problems such as duplication of costs and waste of resources. When the SEC decided to create a \$602 million Fair Fund by a majority vote for victims of S.A.C. Capital Advisors’ insider trading, two dissenting Commissioners expressed the view that creating a Fair Fund in parallel proceedings benefits only class action attorneys and the fund administrators.<sup>227</sup> Thus, it is more efficient for investors to wait until after an SEC

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general counsel of Biogen, settled the SEC’s charges with insider trading in the stock of Biogen by agreeing to pay \$3million); Litigation Release No. 20262 (Aug. 31, 2007) (announcing that SEC initiated \$3 million Fair Fund distribution to purchasers of Biogen common stock).

<sup>225</sup> *Swack v. Lehman Brothers Holdings, Inc.*, Civil Action No. 03-10907-NMG (D. Mass. Aug. 17, 2005) (holding that “[b]ecause the plaintiffs have not adequately pled loss causation, defendant’s motion to dismiss will be allowed.”); *see also SEC v. Lehman Brothers Inc.*, Litigation Release No. 18116 (April 28, 2003).

<sup>226</sup> Velikonja, *supra* note 67, at 369.

<sup>227</sup> Daniel M. Gallagher & Michael S. Piwowar, *Dissenting From an SEC Windfall for Lawyers*, WALL ST. J. (op-ed, Nov. 10, 2014, 7:32 p.m. ET), <http://www.wsj.com/articles/daniel-m-gallagher-and-michael-s-piwowar-dissenting-from-an-sec-windfall-for-lawyers-1415665948> (last visited on May 18, 2015).

enforcement action and Fair Fund distribution. In addition, limiting class actions in such a manner would also be an effective means to prevent frivolous class actions because the SEC's failure to prove the case in its civil action may signal to investors that their claims would also be hopeless considering the higher pleading requirements under the PSLRA. Similarly, for the purpose of minimizing social costs created by duplication and frivolous suits, Congress may consider authorizing the SEC to review private securities class actions before they are filed in court and decide whether the claim should be pursued.<sup>228</sup>

Meanwhile, the SEC has made its own effort to minimize duplicative costs in Fair Fund distributions—the agency employs the same distribution agent in cases where Fair Funds are directed to a class action account.<sup>229</sup> For example, in the *Bristol-Myers Squibb Co.* case,<sup>230</sup> the SEC transferred a \$150 million settlement to the Garden City Group LLC, a claims administrator who was already handling a \$300 million class action settlement.<sup>231</sup> Thus, the Fair Fund was distributed on the same schedule as the class action settlement.<sup>232</sup>

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<sup>228</sup> Rose, *supra* note 208, at 1354-58 (proposing the “oversight approach” authorizing the SEC to prescreen securities class actions).

<sup>229</sup> Velikonja, *supra* note 67, at 386-87 (according to her study, among 222 Fair Fund cases except 18 cases where the SEC ordered defendants to directly compensate victims, “the SEC developed the Fair Fund distribution plan with reference to the class action” in 47 cases).

<sup>230</sup> U.S. Sec & Exch. Comm’n, Litigation Release No. 18820 (Aug. 2, 2004), *SEC v. Bristol-Myers Squibb Company*, Civil Action No. 04-3680 (D.N.J.) (Filed Aug. 4, 2004).

<sup>231</sup> U.S. Sec & Exch. Comm’n, Litigation Release No. 18867 (Sep. 2, 2004), *SEC v. Bristol-Myers Squibb Company*, Civil Action No. 04-3680 (D.N.J.) (Filed Aug. 4, 2004).

<sup>232</sup> *Id.*



This made it possible for Bristol’s investors to recover their losses more quickly and with fewer costs.<sup>233</sup>

Moreover, the SEC often directs defendants to pay costs related to the distribution in cases where funds are distributed through its “customized distribution plan.”<sup>234</sup> One study shows that duplication was not incurred in 171 of 217 Fair Fund cases.<sup>235</sup> The remaining cases can be considered duplicative. However, in all but 6 cases, class actions were settled after the agency’s actions, and the SEC had to distribute funds under its distribution plan first because holding Fair Funds until parallel class actions were completed could have brought criticisms of delay.<sup>236</sup>

#### **4. Conflict with the SEC’s Missions**

Some commentators have raised questions with respect to the SEC’s missions and various goals that the agency seeks, and have argued that the SEC’s compensation efforts may weaken the “effectiveness of the SEC as an enforcement agency.”<sup>237</sup> The SEC describes its mission as “[t]o protect investors, maintain fair, orderly, and efficient markets,

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<sup>233</sup> Solomon, *supra* note 148.

<sup>234</sup> Velikonja, *supra* note 67, at 388 (the SEC developed “customized distribution plan” in 149 of 222 cases). According to the GAO, 70 percent of Fair Fund “have provisions whereby fund proceeds are used to pay administrative expenses.” In remaining 30 percent of cases, “the individual or entity sued in the relevant enforcement action, such as a mutual fund company, pay Fair Fund expenses.” GAO STUDY 1, *supra* note 146, at 29 n.39.

<sup>235</sup> Velikonja, *supra* note 67, at 388.

<sup>236</sup> *Id.* at 388-89.

<sup>237</sup> See e.g., Black, *supra* note 56, at 319-20; Winship, *supra* note 183, at 1139; Steinway, *supra* note 175, at 213 (stating that “[d]etering future misconduct ... was demoted to an “additional” [compensation] concern”).

and facilitate capital formation.”<sup>238</sup> The SEC also set forth four goals to accomplish its missions in its 2014-2018 Strategic Plan.<sup>239</sup> Historically, the SEC accomplished its missions by “enforcing securities law, sanctioning securities law violators, and deterring future frauds,” not by compensating defrauded investors.<sup>240</sup> The SEC did not specifically identify returning money to injured investors “as part of its mission or goals.”<sup>241</sup> Compensating investors is not an internationally recognized objective of securities regulation, either.<sup>242</sup>

However, after the enactment of the Fair Fund provision of SOX, the SEC’s limited resources were devoted to seeking large penalties in enforcement actions against corporations with “deep pockets” and establishing and distributing Fair Funds.<sup>243</sup> One study shows that mean market capitalization of firms that the SEC brought enforcement

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<sup>238</sup> See U.S. Sec. & Exch. Comm’n, About the SEC, What We Do, *available at* <http://www.sec.gov/about/whatwedo.shtml> (last visited on May 18, 2015).

<sup>239</sup> Four goals include establishing and maintaining an effective regulatory environment, fostering and enforcing compliance with the federal securities laws, facilitating access to the information investors need to make informed investment decisions, enhancing the Commission’s performance through effective alignment and management of human, information and financial capital. See 2014-2018 STRATEGIC PLAN, *supra* note 124, at 5-6.

<sup>240</sup> See Black, *supra* note 56, at 319-20, 341; see also U.S. Sec. & Exch. Comm’n, Remarks by Commissioner Richard B. Smith of the Securities and Exchange Commission at Program of Continuing Education of the BAR of the State of California, at Los Angeles (Jan. 12, 1968) (stating that “[t]he Commission attempts to avoid being a collection agency for injured investors”).

<sup>241</sup> Black, *supra* note 56, at 342.

<sup>242</sup> Black, *supra* note 56, at 319. International Organizations of Securities Commissions (IOSCO) identifies three objectives of securities regulation as protecting investors, ensuring that markets are fair, efficient and transparent, and reducing systemic risk. See IOSCO, OBJECTIVES & PRINCIPLES OF SECURITIES REGULATION (June 2010), *available at* <https://www.iosco.org/library/pubdocs/pdf/IOSCOPD323.pdf> (last visited on May 18, 2015).

<sup>243</sup> Winship, *supra* note 183, at 1136.

actions against after 2002 was more than 23 times bigger than before.<sup>244</sup> This raised the concern that the SEC may “divert resources” necessary to develop regulations and seek other important enforcement actions.<sup>245</sup> For example, in 2007, the SEC failed to reach, by 12 percent, its target rate related to enforcement actions, which represents “the percentage of first enforcement actions filed within two years of opening an investigation or inquiry,” and attributed this failure to Fair Fund workload.<sup>246</sup>

In addition, critics have commented that the SEC’s compensatory role is inconsistent with its mission of deterring future violations. One commentator argues that if the SEC pursues compensation as one of its goals, this could “cause either over-deterrence or under-deterrence of securities law violations.”<sup>247</sup> For example, imposing penalties on large corporation to compensate injured investors over-deters because it does not have a deterrence effect on the wrongdoers who caused the harm.<sup>248</sup> Another commentator also argues that the SEC’s mission of deterrence conflicts with its compensatory role when the agency seeks enforcement actions against aiders and abettors.<sup>249</sup> The SEC needs to pursue compensation from aiders and abettors because

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<sup>244</sup> James D. Cox, Randall S. Thomas & Dana Kiku, *Public and Private Enforcement of the Securities Laws: Have Things Changed Since Enron?*, 80 NOTRE DAME L. REV. 893, 902 (2005) (also stating that, after 2002, “average market capitalization of firms subject to both private and SEC actions is more than six times greater than for firms that are the subject only to private actions,” but reverse in pre-2002).

<sup>245</sup> See Zimmerman, *supra* note 201, at 541; see also Black, *supra* note 56, at 344.

<sup>246</sup> See Winship, *supra* note 183, at 1136 (citing U.S. Sec. & Exch. Comm’n, 2007 Performance and Accountability Report, 27 (2007)).

<sup>247</sup> See *Id.* at 1139.

<sup>248</sup> *Id.* (also arguing that it would under-deter if the SEC would not impose the penalty just because it cannot be used for compensation).

<sup>249</sup> Adam Reiser, *Compensating Defrauded Investors While Preserving the SEC’s Mission of Deterrence: A*

private plaintiffs do not have a cause of action against them after the Supreme Court's decision in *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*<sup>250</sup> Securing civil penalties from aiders and abettors also does not raise the circularity problem unlike the penalty against a corporate defendant. However, with respect to deterrence, aiding and abetting cases may be less effective than cases "against large, highly visible primary actors like *Enron* and *Worldcom*," because such prominent cases may send stronger deterrence messages to the industry and the public.<sup>251</sup>

However, the SEC and the courts have expressed different views from these scholarly criticisms. The SEC views the Fair Fund distribution as "a desirable and important objective," and has said it is "consistent with its mission to protect investors."<sup>252</sup> Instead, the SEC has focused on how to improve operational efficiency of the Fair Fund within its limited resources.<sup>253</sup> A U.S. Court of Appeals, in *Official Committee of Unsecured Creditors of Worldcom, Inc. v. SEC*, rejected the Committee's argument that the court should apply a different standard of review from the "fair and reasonable" standard of disgorgement plans because the "Fair Fund provision substitutes compensation for deterrence as the focus of SEC actions."<sup>254</sup> The Court of Appeals reasoned that the Fair

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*Call for Congress to Counteract the Troubling Consequences of Stoneridge*, 2009 UTAH L. REV. 257, 265 (2009).

<sup>250</sup> *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164, 177 (1994).

<sup>251</sup> See Reiser, *supra* note 249, at 264-65; see also James D. Cox & Randall S. Thomas, *SEC Enforcement Heuristics: An Empirical Inquiry*, 53 DUKE L. J. 737, 759 (2003).

<sup>252</sup> SEC 308(C) REPORT, *supra* note 58, at 22.

<sup>253</sup> For the SEC's improvements on Fair Fund operation, see discussion *supra* in Part IV(A).

<sup>254</sup> 467 F.3d 73, 83 (2d Cir. 2006).

Fund provision did not change the SEC’s role, but “merely increase[d] the funds that the SEC may distribute.”<sup>255</sup> Therefore, the SEC’s Fair Fund is a means of promoting ‘ex post’ investor protection by compensating investors, and does not deviate from the agency’s traditional mission of deterrence.

## 5. Lack of Procedural Protection

Other commentators have reviewed the SEC’s Fair Fund distribution from a procedural perspective. One commentator argued that unlike class actions,<sup>256</sup> the SEC did not provide different victims with sufficient opportunity to take part “in the formation of the distribution plan.”<sup>257</sup> The SEC does not permit interested parties to intervene or participate in an agency proceeding, or challenge the distribution plan under the Rules of Practice,<sup>258</sup> except for the opportunity for notice and comment.<sup>259</sup> Thus, the interests of

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<sup>255</sup> *Id.*

<sup>256</sup> Federal Rules of Civil Procedure provides interested parties with the opportunity to participate in the class action. For example, individual notice is made to all identifiable class members. FED. R. CIV. P. 23(c)(2). Moreover, a class may be divided into subclasses so that different interests can be adequately represented by different counsel. FED. R. CIV. P. 23(c)(5).

<sup>257</sup> Zimmerman, *supra* note 201, at 530 (criticizing that “the SEC ... deny parties any voice in the formation of a distribution plan”).

<sup>258</sup> Section 1106 of the RULES OF PRACTICE provides:

Other than in connection with the opportunity to submit comments ... *no person shall be granted leave to intervene or to participate or otherwise to appear* in any agency proceeding or otherwise *to challenge* an order of disgorgement or creation of a Fair Fund ... (emphasis added).

<sup>259</sup> Unlike class actions providing individual notice to class members, notice of proposed distribution plan is published in the Federal Register and on the SEC’s website. Zimmerman, *supra* note 201, at 549 (stating that “[i]n all but three of these thirteen published funds ... no one responded to the invitation for public comment”).

different parties (e.g., shareholders, creditors, or institutional investors) may not be fairly represented in the distribution.<sup>260</sup>

Another commentator argues that when the SEC does not allow interested parties to participate in the course of the settlement along with the defendants, the agency “may miss an important opportunity to calculate damage, identify different interests, and force wrongdoers to accurately account for the harm they cause.”<sup>261</sup> *Global Research Analyst Settlement* is one example that reflects this concern.<sup>262</sup> In this case, the SEC failed to identify injured investors and their losses in some of the settlements.<sup>263</sup> The federal district court scolded the SEC for “fail[ing] to offer a clear framework for formulating and implementing a distribution plan.”<sup>264</sup> In the end, the SEC had no choice but to transfer \$79 million to the U.S. Department of Treasury after wasting over \$13 million in fund costs.<sup>265</sup>

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<sup>260</sup> Zimmerman, *supra* note 201, at 531.

<sup>261</sup> *Id.* at 547-48.

<sup>262</sup> *SEC v. Bear, Stearns & Co.*, 626 F. Supp. 2d 402. In this case, the SEC alleged that investment banks exercised inappropriate influence over research analysts to promote investment banking business and this resulted in conflicts of interest with research analysts. After a lengthy investigation, the agency settled enforcement actions against 12 investment banks and 2 research analysts. *Id.* at 404. For the details of the SEC’s settlement, see Press Release, U.S. Sec. & Exch. Comm’n, Ten of Nation’s Top Investment Firms Settle Enforcement Actions Involving Conflicts of Interest Between Research and Investment Banking (April 28, 2003), available at <http://www.sec.gov/news/press/2003-54.htm> (last visited on May 18, 2015).

<sup>263</sup> *SEC v. Bear, Stearns & Co.*, *supra* note 262, at 405 (stating that “the distribution plan was not tethered to any identified aggrieved investors”).

<sup>264</sup> *Id.* at 404.

<sup>265</sup> *Id.* at 410-11, 420. See also Zimmerman, *supra* note 201, at 567 (stating that “[i]f the SEC had involved plaintiffs earlier in the settlement process with Bear Stearns ... the agency could have avoided the embarrassment of spending resources to restore losses that never actually existed”).

However, other commentators have defended the SEC by arguing that after the *Global Research Analyst Settlement* case, the agency “has made an effort to identify victims during the settlement process.”<sup>266</sup> The writer argues that the fact that defrauded investors can have their voices heard in a parallel class action suit where the Fair Fund is directed mitigates the concern, because the Fair Fund and class action settlement are distributed under the same distribution plan.<sup>267</sup>

To enhance procedural protections for claimants and other interested parties, the SEC might consider adopting guidelines on Fair Fund distributions. In the course of developing such guidelines, the procedures used in class action suits may provide the SEC with useful guidance. This is because both Fair Fund distributions and class actions deal with with collective claims and procedures of aggregate litigation (e.g., class actions), and both strive for consistency, efficiency, and legal access, compared to those methods used by administrative agencies.<sup>268</sup> Specifically, the American Law Institute’s (“ALI”) *Principles of the Law of Aggregate Litigation* (“Principles”) provides general principles for aggregate proceedings and individual principles for aggregate adjudication and settlements.<sup>269</sup> For example, one of the objectives of the Principles is “enabling claimants to voice their concerns and facilitating the rendition of further relief that protects the rights

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<sup>266</sup> Velikonja, *supra* note 67, at 390 (stressing, as its evidence, that the SEC ordered investment banks to compensate the victims directly in recent cases without distributing through the Fair Fund).

<sup>267</sup> *Id.* at 390-91.

<sup>268</sup> Sant’Ambrogio & Zimmerman, *supra* note 201, at 2001 (stating that “[f]ederal court class actions and other aggregate procedures have long sought consistency, efficiency, and legal access”).

<sup>269</sup> AM. LAW INST., *Principles of the Law of Aggregate Litigation* (2012).

of affected persons.”<sup>270</sup> To achieve this objective, the Principles require the court to ensure the participation of class members and objectors in the course of a preliminary review of the proposed settlement.<sup>271</sup> In addition, the Principles contain many provisions applicable to Fair Fund distribution such as settlement criteria,<sup>272</sup> and direct and cy-pres distribution of settlement proceeds.<sup>273</sup> Thus, adopting such guidelines in the distribution process may be helpful in enhancing efficiency, consistency, and fairness in Fair Fund distributions.

#### **E. The SEC’s Enforcement Actions in Light of the Fair Fund**

Based on the discussion above, this section suggests some situations where the SEC’s distribution of a Fair Fund can be useful, minimizing concerns such as the circularity problem and duplication of costs.<sup>274</sup> In brief, the SEC’s effort to distribute the Fair Fund

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<sup>270</sup> Principles § 1.04(b)(5).

<sup>271</sup> Principles § 3.03(a).

<sup>272</sup> Principles § 3.05(a).

<sup>273</sup> Principles § 3.07.

<sup>274</sup> Professor Winship’s suggested criteria for creating a Fair Fund seeks to minimize concerns with circularity and potential duplication of costs. To prioritize different types of Fair Fund creation, she categorized them as four situations, depending on whether penalties are imposed on issuers or non-issuers, and whether only the SEC action is available or both the SEC and private action are available. She argued that Fair Fund is the most appropriate for a situation where the SEC seeks “penalties against non-issuers when only the SEC has a cause of action.” On the other hand, Fair Fund is the most problematic in a situation where it seeks “penalties against issuers when either a private or public action is available.” In deciding the second and third priority, she viewed the circularity problem (issuer or non-issuer categorization) as more fundamental than cost duplication (single or parallel action categorization), which made place the second in priority “distribution of penalties against non-issuers when either a private or public action is available.” *See*



may be sufficiently justified when the agency brings enforcement actions against aiders and abettors, market intermediaries, and individual defendants such as directors and officers. Focusing enforcement actions against those defendants may enable the SEC to compensate harmed investors without compromising the agency's traditional mission of deterrence.

### **1. Aiders and Abettors**

Firstly, the SEC's Fair Fund can be useful when harmed investors have no private right of action. In private securities actions, aiders and abettors such as underwriters, accounting firms, investment advisers and banks, have traditionally been targets for investors as a possible source of investor compensation because investors sought to recover losses from such deep pockets, particularly when an issuer is insolvent. However, in *Central Bank*, the Supreme Court held that liability under 10(b) of the Exchange Act did not extend to aiders and abettors.<sup>275</sup> Responding to the Supreme Court's decision, in §104 of the PSLRA, Congress created an express cause of action for aiding and abetting liability in an SEC enforcement actions, but not in private actions.<sup>276</sup> Further, in *Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc.*,<sup>277</sup> the Supreme Court put a stop to attempts "to

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Winship, *supra* note 183, at 1141-44.

<sup>275</sup> *Central Bank*, 511 U.S. 163, 177 (1994).

<sup>276</sup> Exchange Act § 20(e) (codified as amended at 15 U.S.C § 78t(e)).

<sup>277</sup> *Stoneridge*, 552 U.S. 148 (2008).

upgrade an aider and abettor to a primary violator.”<sup>278</sup> In this case, the Supreme Court significantly restricted private causes of action against aiders and abettors under 10(b).<sup>279</sup> The SEC is now the sole plaintiff who can seek compensation from aiders and abettors. In *Stoneridge*, the Supreme Court also stressed the role of the SEC’s Fair Fund as an alternative for private actions.<sup>280</sup> Further, the SEC’s action against aiders and abettors also benefits from the fact that it may relieve the circularity concern, which has been mostly criticized in Fair Fund cases.<sup>281</sup>

## 2. Market Intermediaries

Secondly, the Fair Fund may also be a useful remedy in actions against market intermediaries such as broker-dealers and investment advisers. Every year, the SEC brings a variety of enforcement actions against market intermediaries for their violations of securities laws,<sup>282</sup> and also creates Fair Funds. Violations include interest rate fixing, undisclosed fees and false advertising, collusive arrangements between investment funds and broker-dealers, mutual fund market timing and late trading, and self-dealing.<sup>283</sup> In

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<sup>278</sup> Reiser, *supra* note 249, at 259.

<sup>279</sup> *Stoneridge*, *supra* note 277, at 159 (the Supreme Court reasoned that reliance by investors upon the deceptive acts is essential in 10(b) private cause of action, but the petitioner failed to show that investors relied respondents’ deceptive acts and indirect chain is too remote for liability.).

<sup>280</sup> *Id.* at 166 (stating that “[e]nforcement power is not toothless. Since September 30, 2002, SEC enforcement actions have collected over \$10 billion in disgorgement and penalties, much of it for distribution to injured investors”).

<sup>281</sup> Winship, *supra* note 183, at 1133.

<sup>282</sup> See Table 3 SEC ENFORCEMENT ACTIONS BY YEAR (FY 2004-13), at 59.

<sup>283</sup> Velikonja, *supra* note 67, at 336-37.

such cases, before the SEC announces its enforcement action, investors may not have even realized that they have been defrauded or victimized.<sup>284</sup> In fact, a study shows that such cases were not usually prosecuted as private class actions.<sup>285</sup> This may be explained by the fact that the amounts are not large enough to bring a private action or it is difficult for the plaintiff to satisfy the heightened pleading standards under the PSLRA.<sup>286</sup> For example, the SEC ordered Morgan Stanley to pay \$50 million,<sup>287</sup> Franklin/Templeton \$20 million,<sup>288</sup> and Hartford Investment Financial Services \$55 million<sup>289</sup> in administrative proceedings, but those cases were dismissed in parallel class actions.

In addition, even when such cases were brought into court, private litigation was not as effective for compensating investors. For example, a Fair Fund study shows that among 64 cases of SEC enforcement actions against investment advisers, 33 cases were accompanied by private litigation and 20 of those settled for an aggregate of \$471 million

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<sup>284</sup> *Id.* at 374.

<sup>285</sup> Cox and Thomas, *supra* note 251, at 750 (reporting that class actions are limited in cases involving market manipulation, broker-dealer, investment company, and investment advisers misconduct).

<sup>286</sup> Velikonja, *supra* note 67, at 369.

<sup>287</sup> U.S. Sec. & Exch. Comm'n, In the Matter of Morgan Stanley DW Inc., SA Release No. 8339 (Nov. 17, 2003) (finding that Morgan Stanley failed to adequately disclose to customers at the point of sale the higher fees associated with large purchases of Class B shares of certain of its proprietary mutual funds and it also failed to explain to customers that those fees could have a negative impact on customers' investment returns).

<sup>288</sup> U.S. Sec. & Exch. Comm'n, In the Matter of Franklin Advisers, Inc. & Franklin/Templeton Distributors, Inc., SEA Release No. 50841 (Dec. 13, 2004) (finding that Franklin, without proper disclosure, used \$52 million of fund assets to compensate brokerage firms for marketing the Franklin Templeton mutual funds and it created a conflict of interest between Franklin Advisers and the mutual funds).

<sup>289</sup> U.S. Sec. & Exch. Comm'n, In the Matter of Hartford Investment Financial Services, LLC, HL Investment Advisors, LLC & Hartford Securities Distribution Company, Inc., SA Release No. 8750 (Nov. 8, 2006) (finding that Hartford failed to disclose that it used \$51 million of the funds' assets to broker-dealers in order to satisfy some of Hartford's shelf space obligations).

in damages.<sup>290</sup> The SEC, in contrast, distributed \$3.87 billion from Fair Funds in such cases.<sup>291</sup> If private litigation is actually unavailable or ineffective for cases against market intermediaries, compensation from the Fair Fund is more persuasive. This is because “brokerage customers and mutual fund investors cannot self-insure through diversification against the risk that their broker will charge excessive commissions, execute trades to benefit the broker-dealer firm, or allow preferred clients to dilute the value of the customer’s mutual fund investment.”<sup>292</sup> Further, like enforcement actions against aiders and abettors, this type of action carries less risk of the circularity problem. The majority of market intermediaries are not publicly held firms and, as a result, the cost of the penalty is borne by shareholders who “manage the firms and are frequently themselves sanctioned by the SEC for the same misconduct.”<sup>293</sup>

### 3. Individual Offenders

Lastly, the Fair Fund distribution is also appropriate when the SEC brings enforcement actions against individual offenders such as the corporation’s directors and officers responsible for the misconduct of the corporation. As discussed earlier, large penalties against the corporation may result in penalizing innocent shareholders who were

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<sup>290</sup> Velikonja, *supra* note 67, at 373.

<sup>291</sup> *Id.*

<sup>292</sup> *Id.* at 51; see Easterbrook, *supra* note 211, at 641 (authors in this article argued that an investor with a diversified portfolio will not experience damages from fraud because their expected gains and losses net out); for refutation of this article, see Alicia Davis Evans, *The Investor Compensation Fund*, 33 J. CORP. L. 223 (2007) (arguing that even diversified investors can suffer substantial loss from fraud and suggesting an investor compensation fund).

<sup>293</sup> Velikonja, *supra* note 67, at 377-78.

already victimized.<sup>294</sup> Thus, targeting culpable individuals can diminish the circularity concerns and also increase the deterrence effect by internalizing the cost of wrongdoing.<sup>295</sup> Further, to achieve such purposes, individuals should pay penalties out of their own pocket. However, in private litigation, individuals rarely contribute to class action settlements due to Directors and Officers liability insurance (D&O insurance) and corporate indemnification.<sup>296</sup> In this case, the circularity concern still remains because a corporation and its shareholders bear the costs of indemnification and higher insurance premiums.<sup>297</sup> Unlike class actions, D&O insurance policies and indemnification are unavailable or limited for SEC enforcement actions.<sup>298</sup>

The SEC itself has also expressed intention of seeking penalties from responsible individuals in its statement concerning financial penalties announced in 2006.<sup>299</sup> However, some have questioned whether the SEC has made such efforts to charge

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<sup>294</sup> See discussion *supra* in Part IV(D)(1).

<sup>295</sup> Ross MacDonald, *Setting Examples, Not Settling: Toward a New SEC Enforcement Paradigm*, 91 TEXAS L. REV. 419, 440-41 (2012) (arguing that “[t]he solution [to efficiently deter wrongdoing] is not to increase the monetary sanctions imposed on the corporations, but rather to initiate a sanctions regime that imposes pain [...] on the decision makers and managers, so that they will internalize the costs of violations and be deterred from authorizing or engaging in them.”).

<sup>296</sup> In securities class actions, individual defendants of corporate fraud cases rarely pay monetary sanctions out-of-pocket because, in many cases, they are covered by Directors and Officers liability insurance (D&O insurance) or indemnification. See Michael Klausner, Jason Hegland & Matthew Goforth, *How Protective is D&O Insurance in Securities Class Action? -An Update*, 26 PLUS JOURNAL 1, 5 (2013), Working Paper Series No. 446, available at SSRN: <http://ssrn.com/abstract=2260815> (showing that officers paid out-of-pocket in only two percent of settlements among securities class action cases filed between 2006 and 2010).

<sup>297</sup> Winship, *supra* note 183, at 1129.

<sup>298</sup> For more explanation, see Velikonja, *supra* note 67, at 384-86.

<sup>299</sup> See SEC PENALTY POLICY, *supra* note 116 (“[w]here shareholders have been victimized by the violative conduct, or by the resulting negative effect on the entity following its discovery, the Commission is expected to seek penalties from culpable individual offenders acting for a corporation.”).

individual offenders in corporate fraud cases. When Judge Rakoff of the U.S. District Court for the Southern District of New York rejected a proposed settlement between the SEC and Bank of America (“BofA”) in 2009, he criticized the SEC for not bringing charges against individual offenders, the BofA’s management responsible for false and misleading proxy statement, and further pointed out that the SEC violated its own penalty policy.<sup>300</sup> Similar criticism was raised when the SEC settled the Goldman Sachs case related to subprime mortgage CDO for \$550 million in 2009, without charging any high-level executives at Goldman Sachs—only a low-level trader, Fabrice Tourre.<sup>301</sup>

Interestingly, a study of the SEC’s enforcement cases filed from 2000 shows that 93% of all cases and 96% of fraud cases include individual defendants.<sup>302</sup> Further, according to the study, the SEC named CEOs as defendants in 56% of cases, CFOs in 58% of cases, and lower executives in 71% of cases, but it targeted solely lower level executives in 7% of cases.<sup>303</sup> In rough measure, individuals also paid money penalties in 65% of cases and disgorgements in 45% of cases.<sup>304</sup> Despite the favorable results of the study for

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<sup>300</sup> See *SEC v. Bank of Am. Corp.*, 653 F. Supp. 2d 507 (S.D.N.Y. 2009) (also stating that “since the fine is imposed, not on the individuals putatively responsible, but on the shareholders, it is worse than pointless: it further victimizes the victims.”).

<sup>301</sup> See *SEC v. Goldman, Sachs & Co.*, Litigation Release No. 21489, 98 SEC Docket 1192, 1192 (Apr. 16, 2010); see also MacDonald, *supra* note 295, at 423 (criticizing that the SEC rarely targeted individuals who work at large commercial and investment banks and financial institutions).

<sup>302</sup> See Michael Klausner & Jason Hegland, *SEC Practice in Targeting and Penalizing Individuals Defendants*, The Harvard Law School Forum on Corporate Governance and Financial Regulation (Sept. 3, 2013 at 9:23 am), <http://blogs.law.harvard.edu/corpgov/2013/09/03/sec-practice-in-targeting-and-penalizing-individual-defendants/> (last visited on May 18, 2015).

<sup>303</sup> *Id.*

<sup>304</sup> *Id.*

the SEC, such blame may originate from the SEC's practice of charging individuals in only certain cases, for example, those related to large and influential investment banks after the global financial crisis.<sup>305</sup> The SEC may have other grounds for defending itself, but even so, the SEC needs to increase its effort to improve transparency as well as consistency in its enforcement actions.

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<sup>305</sup> MacDonald, *supra* note 295, at 433-34.

## **V. Considering Public Compensation under the Legal Environment in Korea**

Based on the discussion of the SEC's Fair Fund, this Part spotlights the issues that financial regulators and legislators should consider in order to enhance public compensation. Specifically, this Part focuses on the legal and regulatory considerations the Korean government should take when implementing monetary compensation such as the Fair Fund scheme.

### **A. Compensatory Aspect Should Be Considered in Monetary Sanctions**

It is unthinkable to implement monetary compensation like the Fair Fund distribution in Korea, absent regulator's authority to impose strong monetary sanctions on violators. In this respect, the current authority to impose monetary sanctions held by Korean financial regulators needs to be reviewed.

#### **1. Current monetary sanctions in financial regulation**

Once the FSS brings violations of financial laws to light in the examination or investigation process, the FSC and FSS proceed with disciplinary actions to impose sanctions on violators pursuant to relevant financial laws. Though disciplinary actions against violators can be enforced with monetary and non-monetary sanctions,<sup>306</sup> the

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<sup>306</sup> Non-monetary sanctions against financial institutions, which are provided in current statutes, are divided into business sanctions and professional sanctions. Business sanctions include revocation of business licenses, suspension of businesses, shut-down or suspension of branches, stop orders against illegal or improper activities, orders to transfer contracts, orders to provide public notice or disclosure of the fact that it has been subjected to a measure due to its violation, warning to the institution as a whole, and caution to the institution as a whole. Professional sanctions include sanctions for officers such as demand for dismissal,



current disciplinary system has strongly relied on non-monetary sanctions, especially professional sanctions against officers and employees of financial institutions<sup>307</sup> However, this tendency has been criticized in that too much emphasis on non-monetary sanctions may weaken the self-regulatory function of financial institutions and may not have a deterrence effect because such sanctions do not impose a substantial loss to financial institutions.<sup>308</sup> Thus, cases in which regulators impose monetary sanctions in addition to non-monetary sanctions to enhance the effectiveness of financial regulation are increasing.

**i. Typical form of monetary sanction**

Under many financial laws, monetary sanctions have typically been provided in the form of a ‘fine’, which is a criminal penalty, or a ‘fine for negligence’, which is a monetary sanction imposed by an administrative agency.<sup>309</sup> However, such monetary sanctions have revealed some limitations as a means of achieving regulatory goals. First,

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suspension of his or her duties, reprimand warning, warning for attention, and sanctions for employees such as removal, suspension of his or her duties, salary reduction, or reprimand. Yong Chan Lee, *supra* note 8, at 538. In translating the terms related to sanctions stipulated in the statutes into English, I followed the translation of ‘Legislative Translation Center’ which officially provides English version of Statutes of the South Korea. For reference to the English version of Korean Statutes, *see* Legislative Translation Center website, [http://elaw.klri.re.kr/eng\\_service/main.do](http://elaw.klri.re.kr/eng_service/main.do).

<sup>307</sup> *E.g., Id.* at 539 (explaining that high dependency on professional sanctions was caused by legal and practical limitations such as the fact that some financial institutions do not have internal control system sufficient to allow financial institutions to sanction their employees at their disposal).

<sup>308</sup> *Id.*

<sup>309</sup> ‘Fine for negligence’ is imposed on relatively minor violations that deter the laws from accomplishing its administrative purposes. *See* Soo Hyun Ahn, *Geumyungaengjeong Jibhaengsudaneuloseo Gwajinggeumjedo Geomto-2008nyeon Geumyungwiwonhoeui Gwajinggeumjedo Gaeseonbanganeul Jungsimeulo* [Review on Penalty Surcharge as Means of Enforcement for Financial Administration – Focused on the FSC’s Proposed Reform on Penalty Surcharge], 32 BUSINESS & FINANCE LAW 76, 78 (Nov. 2008).

the standard of proof in criminal proceedings is higher than in civil or administrative proceedings. Thus, if the prosecution fails to prove a case beyond a reasonable doubt,<sup>310</sup> there exists the possibility that by failing to impose a penalty, the conduct that should be regulated to prevent repetitive violations may continue undeterred.<sup>311</sup> Second, a fine is not an efficient measure to respond to similar violations in the financial market since a criminal proceeding takes a long time before it comes to an end.<sup>312</sup> Third, a fine for negligence is not a proper sanction for violations either. Statutory amounts for fines for negligence are generally much smaller than those for fines. For example, the Financial Investment Services and Capital Market Act (“FSCMA”) provides that the maximum amount imposed in fines for negligence is 50 million won (approximately 45,000 dollars, assuming 1 USD = 1,100 KRW), compared to that for fines which is 2 billion won (approximately 1.8 million dollars). Even taking into account the fact that it is a sanction for relatively minor violations, such a low amount is unlikely sufficient to achieve any regulatory purposes.<sup>313</sup>

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<sup>310</sup> *Id.* at 77 (suggesting that complication, complexness and intelligence of conducts violating financial laws and regulations can make burden of proof more problematic in criminal proceedings).

<sup>311</sup> Won Woo Lee, *Hyeonhaeng Geumyunggamdogbeobsang Gwajinggeumjedoui Jaengjeomgwa Gaeseonbangan* [Issues and Recommendations on Penalty Surcharge under Current Financial Laws], 15 BUSINESS & FINANCE LAW 58, 78 (Jan. 2006).

<sup>312</sup> Byoung Youn Kim, *supra* note 8, at 78-79.

<sup>313</sup> In this regard, the FSC announced a plan in 2013 that it would impose fines for negligence by multiplying the penalty amount by the number of individual violations in order to enhance the effectiveness as a sanction, instead of the longstanding practice that imposes the penalty within the upper limit provided in the statute regardless of the number of violations. Thus, this change will lead to an increase in the amount of fines for negligence imposed. Press Release, FSC, Geumyungganlyeon Gwataelyo Bugwachegye Jeonmyeon Gaepyeon [Overall Reorganization of Imposition System on Fine for Negligence in Finance Area], June 16, 2013, [available at](http://www.fsc.go.kr/info/ntc_news_view.jsp?bbsid=BBS0030&page=1&sch1=subject&sword=&r_url=&) [http://www.fsc.go.kr/info/ntc\\_news\\_view.jsp?bbsid=BBS0030&page=1&sch1=subject&sword=&r\\_url=&](http://www.fsc.go.kr/info/ntc_news_view.jsp?bbsid=BBS0030&page=1&sch1=subject&sword=&r_url=&)

## ii. Penalty surcharge

To overcome the limitations of traditional monetary sanctions, the use of a ‘penalty surcharge’ has been increasing in the administrative law area. A penalty surcharge is a monetary remedy that an administrative agency is authorized to impose on violators for the purpose of encouraging a regulated person to meet obligations required by law.<sup>314</sup> The penalty surcharge was first introduced in 1980 to remove economic gains acquired by violating the law by a business in the fair trade law area.<sup>315</sup> At this time, penalty surcharges were understood as being similar to “disgorgement” or “restitution.” However, as the use of penalty surcharge increased, a variety of “transformed” penalty surcharges emerged. For example, certain agencies impose penalty surcharges instead of ordering the suspension of a business or in cases where a violator acquires no explicit gains.<sup>316</sup> In addition, in many cases, the amount of a penalty surcharge is reached by considering a number of factors such as the seriousness of the violation, the duration and frequency of the violation as well as the scale of gains acquired by the violation.<sup>317</sup> Thus, the monetary

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menu=7210100&no=29196 (last visited on May 18, 2015).

<sup>314</sup> Penalty surcharge was first provided in Monopoly Regulation and Fair Trade Act enacted in December 1980. Securities and Exchange Act first adopted this in April 1999 with regard to securities disclosure violation.

<sup>315</sup> Tae Woo Kim, *Gwajinggeum Jedoui Ibbeoblonjeog Munjejeomgwa Gaeseonbangan* [Legislative Problems and Improvements on Penalty Surcharge], BEOBJE [LEGISLATION] 28, 30 (June 2013).

<sup>316</sup> Yeongchan Choi, *Gwajinggeum Jedoe Gwanhan Gochal: Hyeonhwanggwa Munjejeomeul Jungsimeulo* [Review on Penalty Surcharge], BEOBJE [LEGISLATION] 3, 9-10 (Nov. 2001).

<sup>317</sup> E.g. *see* FSCMA § 430(2).

penalty is now generally viewed as a method of “disgorgement” or “administrative sanction.”<sup>318</sup>

Even though recent trends show that penalty surcharges are used as a means of imposing sanctions,<sup>319</sup> its nature is not viewed as a criminal punishment. In a case where the Fair Trade Commission (“FTC”) imposed a large surcharge upon related business entities of a conglomerate that had conducted acts of unjust support in violation of a provision of the Fair Trade Act, the Constitutional Court held that imposition of a penalty surcharge is not an “exercise of the state authority to criminal punishment” and to impose a criminal penalty and penalty surcharge simultaneously does not necessarily constitute double jeopardy.<sup>320</sup> The Court also reasoned that ‘prevention and inhibition through sanction’ is the original function of administrative regulations, and the double jeopardy clause does not prohibit imposition of any and all sanctions or disadvantageous measures in addition to criminal punishment.<sup>321</sup>

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<sup>318</sup> Dae bub won [Supreme Court], 2000 Du 6206 (Feb. 9, 2009); Heon beob jae pan so [Constitutional Court] 2001 Hun-Ka 25 (July 24, 2003); Kyoung-Hee Shin, *A Study of Unfair Trading Practices and Regulatory Sanctions on the Capital Market & Financial Investment Business Law*, ILKAM LAW REVIEW, VOL 24, 341, 369-71 (2013).

<sup>319</sup> As of 2010, 108 individual statutes provide monetary surcharges. Among them, ninety are classified as substitution for order of suspension of business, eighteen are classified as administrative sanction. Kim, Tae Woo, *supra* note 315, at 30.

<sup>320</sup> 2001 Hun-Ka 25, *supra* note 318 (stating that “the surcharge [] is not punishment as the exercise of the state authority to criminal punishment prohibited by Article 13(1) of the Constitution, and is not in violation of the principle against double jeopardy.”). However, Constitutional Court also made clear that “the state is “not free from the restriction of the constitutional principle of proportionality,” and “the aggregate of various sanctions should not be excessively grave compared with the unlawful act that is being sanctioned.”

<sup>321</sup> *Id.*

However, the penalty surcharge is still narrowly used in the financial law area. Penalty surcharges are limited to certain types of regulatory violations related to the prudential supervision of financial institutions such as the limitation on credit exposure or investment of securities. Significantly, under the FSCMA, a penalty surcharge is not applicable to major violations in the securities law area such as insider trading, market manipulation, and other fraudulent trading, except for violations of disclosure regulations. Such violations are solely regulated by the criminal penalty such as imprisonment and fine.<sup>322</sup> Thus, Korean financial watchdogs are rendered toothless in deterring such fraudulent misconduct in the financial market: after completing an investigation, it merely refers the case to the prosecution without its own remedy.

When the FSC proposed an amendment to the FSCMA in 2011 that included provisions to regulate certain kinds of “market abuse,”<sup>323</sup> and impose monetary surcharges on such activities, the Ministry of Justice (“MOJ”) banned the bill; the FSC proposed the bill without such provisions, and it passed Congress. The opponents of the monetary

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<sup>322</sup> In such violation, a person is punished by imprisonment for up to 10 years or by a fine equivalent to one to three times of the profit accrued or the loss avoided by a violation. If the amount equivalent to three times the profit accrued or the loss avoided by a violation is 500 million won or less, the upper limit of the fine is 500 million won. FSCMA § 443.

<sup>323</sup> The FSC proposed the bill to regulate certain types of activities which are not covered by existing insider trading and market manipulation regulations. These include: (a) an activity ‘indirectly’ acquiring and using material nonpublic information of a listed company in his transaction, (b) directly or indirectly acquiring material nonpublic information by illegal means such as hacking, theft, fraud or threat, and using information in his transaction, (c) an activity producing material nonpublic information in the course of performance of the business and using information in his transaction, and (d) an activity unduly affecting market price ‘without manipulative intention’ such as sudden price change by trading program error. *See* FSC, press release, Sijangjilseo Gyolanhaengwi Gyujeleul Wihan Jabonsijanggwa Geumyungtujaeobe Gwanhan Beoblyul Iibugaejeongbeoblyulan Gugmuhoewi Tonggwa [Amendment of the FSCMA to Regulate Market Abuse Passed the Cabinet Meeting] (Dec. 23, 2014), *available at* [http://www.fsc.go.kr/info/ntc\\_news\\_view.jsp?bbsid=BBS0030&page=1&sch1=subject&sword=%EC%9E%90%EB%B3%B8%EC%8B%9C%EC%9E%A5&r\\_url=&menu=7210100&no=30174](http://www.fsc.go.kr/info/ntc_news_view.jsp?bbsid=BBS0030&page=1&sch1=subject&sword=%EC%9E%90%EB%B3%B8%EC%8B%9C%EC%9E%A5&r_url=&menu=7210100&no=30174) (last visited on May 18, 2015).

surcharge argued that the expansive use of the monetary surcharge to deter violations is not desirable, that the penalty surcharge is not directly related to victims' relief of damages, and that imposing the penalty surcharge on activities without specific intention needs to be reassessed.<sup>324</sup> They also reasoned that the nature of traditional securities violations is similar to 'false pretense,' which is in the sphere of criminal law, and accordingly it cannot be regulated by administrative sanctions.<sup>325</sup>

However, just after a new President took office in February 2013, the FSC pushed the plan forward again. At this time, the FSC proposed the bill without opposition of the MOJ and the bill passed Congress at the end of 2014.<sup>326</sup> Interestingly, passage of the Amendment meant that traditional securities law violations are solely regulated by criminal penalty and newly established 'market abuse' type violations are solely regulated by administrative sanctions—the penalty surcharge.<sup>327</sup> This dichotomy seems to stem from the concern for double jeopardy or excessiveness of dual sanctions, even though the Constitutional Court previously upheld its constitutionality, and the view that the

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<sup>324</sup> Min Gyo Kim, *A Study on Reform of Unfair Trading System in Korean SEA*, YGLB, VOL 3-1, 71, 79 (2011).

<sup>325</sup> Neunghyeon Kim, *Beobmubu Banbale Jeolchungan Malyeondeung Ibbeob Nanhangtss ... Je2 Gichogbeob' Ulyeo* [The FSC's Step-back by the MOJ's Opposition Forewarned Tough Road to Congress. It Be a Return Match Following Previous Debate on Corporate Restructuring Promotion Act?] (June 6, 2011), Seoul Economy, *available at* <http://economy.hankooki.com/lpage/economy/201106/e2011060617461770070.htm> (last visited on May 18, 2015).

<sup>326</sup> The MOJ's silence was partly due to the President's strong drive for eradication of fraudulent activities in the capital market, which was one of her pledges in the Presidential Election Campaign. The Amendment of the FSCMA will be effective as of July 1, 2015.

<sup>327</sup> The Amendment of the FSCMA does not provide any criminal penalty provision for violation of prohibition of market abuse.

appropriateness of a sanction can be divided by the seriousness of the regulated activity. However, it is still questionable whether traditional securities violations can be effectively deterred without administrative sanctions,<sup>328</sup> and whether market abuse activities are really less serious than traditionally regulated activities.<sup>329</sup>

Another issue with the penalty surcharge is that it cannot be imposed on individuals except for violations related to registration statements, tender offer statements, shareholder reports, and newly established market abuse. This reflects the view that imposition of a penalty surcharge on individuals who violate the law for the benefit of the corporation weakens the corporation's effort to prevent its employees from violating the law through preventive measures such as internal controls because the effect of a sanction is not imputed to the entity.<sup>330</sup> However, scholars argue that a penalty surcharge for individuals is necessary to enhance the deterrence effect for illegal conduct by individuals, especially a corporation's officers, major shareholders, or affiliated persons.<sup>331</sup>

The maximum amount for a penalty surcharge under the FSCMA cannot exceed 2 billion won in public disclosure violations or 40% of the total amount in a financial investment business entity's violation of the restrictions on trading with major

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<sup>328</sup> See discussion *supra* in Part III(C).

<sup>329</sup> For example, according to such dichotomy, a tippee is punished differently, depending on whether he 'directly' acquired material nonpublic information from the initial tipper or not. However, it is questionable whether such distinction has a reasonable ground. Unlike this, in the U.S., a tippee's liability derives from that of a tipper. A tippee can civilly or criminally be held liable if the insider has breached a fiduciary duty and the tippee knows or should know that there has been a breach. See *Dirks v. SEC*, 463 U.S. 646 (1983); see also *United States v. Newman*, 773 F.3d 438 (2d Cir. N.Y. 2014) (in this case, the U.S. Court of Appeals for the Second Circuit clarified the requirements of tippee liability).

<sup>330</sup> Soo Hyun Ahn, *supra* note 309, at 96.

<sup>331</sup> *Id.* at 96-97; Lee, Won Woo, *supra* note 311, at 62.

shareholders.<sup>332</sup> In contrast, the Monopoly Regulation and Fair Trade Act (“Fair Trade Act”) allows the FTC to impose penalty surcharges in proportion to the turnover resulting from a violation.<sup>333</sup> Partly due to such differences, the FSC imposed only 37.9 billion won of penalty surcharges and fines for negligence in 2013, compared to the FTC which imposed 418.4 billion won of penalty surcharge in 2013.<sup>334</sup>

## 2. Need for penalty surcharge in financial regulation

Today, both scholars and financial regulators recognize that penalty surcharges should be applied broadly in the financial law area to enhance the deterrence of serious misconduct by financial institutions and other market participants. Specifically, this view is gathering strength after several recent financial scandals. The government recently pushed forward imposition of the punitive penalty surcharge against financial institutions that intentionally or gross-negligently leaked credit information by violating the ‘Use and Protection of Credit Information Act.’<sup>335</sup> However, political parties banned the FSC’s

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<sup>332</sup> FSCMA § 429(1).

<sup>333</sup> Fair Trade Act § 6.

<sup>334</sup> Press release, FTC, 2013nyeon Gongjeongwi Tonggyeyeonbo Balgan [FTC Issued Statistics Yearbook of 2013], April 17, 2014, *available at* [http://www.ftc.go.kr/news/ftc/reportView.jsp?report\\_data\\_no=5619](http://www.ftc.go.kr/news/ftc/reportView.jsp?report_data_no=5619) (last visited on May 18, 2015); Jeong Won Bae, Geumyungwi, Hoesumoshan Gwajinggeum 400 Eogwon Yugbagtss ... “Kaemkoe Hoesueobmu Witag” [Uncollected Penalty Surcharge FSC Is Approaching 40 Billion Won ... FSC Official Said “FSC Will Refer Collection To Kamco], CHOSUN BIZ, July 17, 2014, *available at* [http://biz.chosun.com/site/data/html\\_dir/2014/07/17/2014071702572.html](http://biz.chosun.com/site/data/html_dir/2014/07/17/2014071702572.html) (last visited on May 18, 2015).

<sup>335</sup> For example, responding to massive credit card information leak, the FSC originally announced the plan to impose the punitive penalty surcharge (e.g., imposing certain percentage of sales amounts related to the violation as penalty surcharge without the upper limit) in cases where financial institutions intentionally or gross-negligently divulge consumers’ credit information and do harm to them. *See* Press Release, FSC, Geumyungbunya Gaeinjeongbo Yuchul Jaebalbangji Jonghabdaechaeg [Comprehensive Plans to Prevent a Recurrence of Personal Information Leak in the Financial Sector], March 10, 2014, *available at* [http://www.fsc.go.kr/info/ntc\\_news\\_view.jsp?bbsid=BBS0030&page=1&sch1=subject&sword=%EA%B0](http://www.fsc.go.kr/info/ntc_news_view.jsp?bbsid=BBS0030&page=1&sch1=subject&sword=%EA%B0)



plan, arguing that the punitive penalty surcharge would only increase the government's tax revenue without giving any benefit to injured consumers.<sup>336</sup> To meet the political parties' demand, the FSC proposed an Amendment of the Act, which allows victims of the information leak to seek punitive damages against financial institutions, instead of the punitive penalty surcharge.<sup>337</sup> However, the proposed Amendment also allows the FSC to impose the penalty surcharge on violators up to five billion won.<sup>338</sup>

### 3. Importance of compensatory aspect in monetary sanctions

Strong monetary sanctions against violators of financial laws are a prerequisite for Fair Fund-type compensation schemes. However, this does not mean that the penalty surcharge should be expanded for the purpose of compensating injured financial consumers. Whether penalty surcharges should be given in specific cases depends on many factors such as the magnitude of economic gains from the violation, the effectiveness of deterring repetitive misconduct, etc. And as the National Assembly pointed out, where the collected penalty monies are finally deposited plays an important role in discussing the

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<sup>336</sup> See *Jingbeoljeog Gwajinggeum? Jingbeoljeog Sonhaebaesang? Gongeun Tto Gughoelo* [Punitive Penalty Surcharge? Punitive Damage? Decision is Up to the National Assembly], NEWS 1, Jan. 22, 2014, available at <http://news1.kr/articles/?1507577> (last visited on May 18, 2015).

<sup>337</sup> FSC, *Sinyongjeongboui Iyong Mich Bohoe Gwanhan Beoblyul Jeonbugaejeongbeoblyulan Ibbeobyego* [Notice on the Proposed Amendment of the USE AND PROTECTION OF CREDIT INFORMATION ACT], Nov. 11, 2014, available at [http://www.fsc.go.kr/know/law\\_prev\\_view.jsp?bbsid=BBS0120&page=1&sch1=&sch2=&sch3=&sword=&r\\_url=&menu=7410100&no=30307](http://www.fsc.go.kr/know/law_prev_view.jsp?bbsid=BBS0120&page=1&sch1=&sch2=&sch3=&sword=&r_url=&menu=7410100&no=30307) (last visited on May 18, 2015).

<sup>338</sup> *Id.*

utilization of monetary sanctions in this specific area. Though imposing large penalty surcharges on violators may deter repetition of similar violations, it may also exhaust resources necessary to compensate victims injured by such violations, and accordingly, victims may not recover their damages. Thus, this may raise political concerns because the National Congress is deemed to speak for the interest of the general public. For instance, the Fair Trade Commission (“FTC”), which imposes hundreds of billions of won in penalty surcharges yearly on businesses that violate fair trade laws, has been criticized for merely transferring penalties to the National Treasury, instead of using them for the benefit of harmed consumers.<sup>339</sup> Reflecting such voices, twenty-four Congressmen recently proposed a bill intended to establish a fund sourced from monetary penalties to support victims.<sup>340</sup> Therefore, returning money to injured victims contributes to broadening the application of penalty surcharges in the financial area.

#### **4. Considering the penalty surcharge in terms of compensation**

As discussed in the SEC’s Fair Fund history, an agency’s effort to compensate victims by distributing penalties may cause other adverse effects, such as the circularity problem or conflicts with the bankruptcy code. In addition, the degree of adverse effects differs depending on which entities the penalty is imposed. Thus, it is of value to

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<sup>339</sup> See, e.g., Boyeon Hwang, *Gongjeongwi Gwajinggeum Iljeongbiyul Sobija Pihaebosange Sseoya* [The FTC Needs To Spend Certain Percentage of Money Penalties in Compensating Consumers’ Damages], THE HANKYOREH, April 4, 2011 (pointing out that the government needs to establish the separate public fund to directly recompensate consumers’ damages caused by unfair trading activities of companies), available at [http://www.hani.co.kr/arti/economy/economy\\_general/471398.html](http://www.hani.co.kr/arti/economy/economy_general/471398.html) (last visited on May 18, 2015).

<sup>340</sup> See National Policy Committee, *Dogjeomgyuje mich gongjeonggeolae gwanhan beoblyul deung wibanhaengwi pihaeja jiwongigeumbeoban geomtobogoseo* [Review on the bill for the fund supporting victims harmed by violations of Monopoly Regulation and Fair Trade Act, Etc.] (Feb. 2014).

prioritize different types of entities to assess whether it will be effective to seek the monetary penalty. This is especially important when the agency intends to seek penalty surcharges in a case where the penalty ultimately can be imputed to those who did not directly or indirectly benefit from the violation.<sup>341</sup>

In this regard, imposing the penalty surcharge against corporations is most problematic because, as shown in the Fair Fund cases, it is likely to raise the circularity concern that the penalty causes harm to innocent shareholders.<sup>342</sup> Similarly, large penalties against a bankrupt corporation also cause serious concern with respect to creditor protection.<sup>343</sup> Thus, financial regulators should recognize the danger of imposing penalty surcharges on a public company and consider more proper measures to minimize harm to interested parties affected by the penalty.<sup>344</sup> Instead, the regulators should seek penalty surcharges against individual offenders such as officials and large shareholders as well as financial institutions and aiders and abettors with deep pockets such as investment banks and accounting firms. Targeting such offenders can contribute not only to removing incentives for misconduct, but also securing resources for compensation.

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<sup>341</sup> The legislative history of the Remedies Act includes the following passage:

[B]ecause the costs of such penalties may be passed on to shareholders, the Committee intends that a penalty be sought when the violation results in an improper benefit to shareholders. [When] shareholders are the principal victims of the violations, the Committee expects that the SEC, when appropriate, will seek penalties from the individual offenders acting for a corporate issuer. S. Rep. No. 101-337, at 17 (1990).

<sup>342</sup> See discussion *supra* Part IV(D)(1).

<sup>343</sup> See discussion *supra* Part IV(D)(2).

<sup>344</sup> In corporate fraud cases, injured investors may seek compensation from corporations through securities class actions even though public compensation is unavailable. See discussion *supra* Part IV(D)(3).

## B. Availability of Private Action Should Be Considered

Since recovering damages incurred by a financial institution's misconduct is generally resolved through private litigation, allowing an exception to this general principle requires adequate policy grounds. As witnessed in recent cases in Korea, financial incidents have a tendency to cause massive harm to financial consumers. In such situations, class action suits are considered an appropriate legal remedy to resolve collective harms where a large number of victims are involved. Korea introduced the class action system in 2005 in order to efficiently seek relief for collective injuries that occurred in the course of securities trading.<sup>345</sup> However, the current class action system only applies to certain limited types of securities claims.<sup>346</sup> In addition, it is also argued that the requirements for a class action lawsuit, such as those for representative party and attorney, are too strict<sup>347</sup> and the cost burden of lawsuits is too high.<sup>348</sup> Partly due to such

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<sup>345</sup> Securities Related Class Action Act. For discussion on class actions in Korea, *see generally*, Young Hoa Son, *Improvement of Securities Class Action System*, 24-4 COMMERCIAL CASES STUDY 45 (2011.12); Jung-Sik Choi, *Proposal for the Invigoration of Securities Class Action System*, 53 BEOBHAG YEONGU [JOURNAL OF JURISPRUDENCE] 311 (2014).

<sup>346</sup> To be eligible, securities should be issued by a stock-listed corporation and claims should be related to the material misstatement on the registration statement or periodic reports (i.e., annual report), insider trading, market manipulation, or accounting auditor's liability. Securities Related Class Action Act § 3.

<sup>347</sup> The Act exemplifies the person who is likely to receive the largest economic benefit from the class action as a representative party. However, it can be problematic because it is not sure that such person would always recover his loss through class action. In addition, an attorney who has engaged in more than three class action lawsuits during the preceding three years is disqualified from becoming the attorney of the plaintiff. Securities Related Class Action Act § 11(1), (3). *See also* Jung-Sik Choi, *supra* note 345, at 324-25.

<sup>348</sup> The plaintiffs have to pay costs necessary for the notice, public notification and appraisal and also pay fees for stamps affixed to the written complaint of the class action lawsuit, which amount up to 50 million won. *See id.* at 325-26.

restrictions on class actions, only eight class action lawsuits have been brought since the system was put into effect.<sup>349</sup>

The limitations of class actions may justify public compensation for widespread harm. Unlike in the U.S. where class actions are widely used, current class actions in Korea do not cover major violations in the financial area except for certain securities related matters. Moreover, in cases where a majority of victims suffer small amounts of damage, such claims may not succeed in private litigations but only class actions. However, such cases should also be brought in order to deter future violations by forcing violators to pay the financial damages suffered by victims.<sup>350</sup> In such cases, monetary sanctions imposed by financial regulators and a subsequent distribution of the penalty may be the most effective way to recover victims' losses as well as to deter similar violations.

Criticism that the SEC's Fair Fund simply duplicates the class action does not hold true in Korea. Policymakers should consider the fact that the availability of class action suits in Korea is very limited when designing the compensation scheme. In this regard, priority consideration for public compensation should be given to claims in which class actions are unavailable, leaving corporate fraud cases in which class actions are available out of the discussion.

In addition, some argue that FDM can work as an alternative for class actions in claims against financial institutions. However, FDM may not be an adequate measure

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<sup>349</sup> Jibdansong Yumyeongmusiltss ... Doib 10 Nyeongan 8 Geonppun [Class Action Is Almost Obsolete ... Only 8 Cases Were Brought For Past 10 Years], *SEGYEILBO*, Nov. 23, 2014, *available at* <http://www.segye.com/content/html/2014/11/23/20141123002269.html> (last visited on May 18, 2015).

<sup>350</sup> For a discussion on the compensation and deterrence rational for class actions, *see* Coffee, *supra* note 179, at 1545-56.

because collective mediation procedures, which are essential for claims related to massive harm with a large number of victims, is not yet introduced.<sup>351</sup> In addition, FDMC has no authority to bind interested parties to its decision, even though, in fact, financial institutions often accept its decision in many cases due to the regulator's broad authority to supervise them.<sup>352</sup> Thus, it is difficult to consider FDM as it currently stands as a stable compensation device to resolve such massive claims.

### **C. Standards and Procedures for Distribution Should Be Provided**

First, policymakers in Korea should establish statutory grounds and standards for determining when a penalty surcharge collected from violators is distributed to harmed financial consumers. Unlike the SEC, which has broad authority to decide whether it creates a Fair Fund, it is not easy for administrative agencies in Korea to exercise authority unless it is empowered by statute.<sup>353</sup> The lack of clear standards might cause conflicts between harmed consumers who benefit from the distribution, and taxpayers who are afraid to bear higher taxes that would not exist otherwise. Moreover, absent such standards, financial regulators might confront political pressure and complaints from victims demanding for distributions, even in situations where public compensation is unlikely to

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<sup>351</sup> For limitations of the current FDM system, *see* discussion *supra* in Part II(B)(3)(i).

<sup>352</sup> According to an anonymous FSS official, financial institutions rarely file lawsuits to object to the FDMC's mediation decision.

<sup>353</sup> According to the general principles of administrative laws in Korea, the government action that imposes a burden on related persons should have grounds for such action in the statute. However, even government actions that benefit related persons are generally grounded in a statute.

be feasible. Thus, providing clear standards in the related laws and rules can help financial consumers reasonably anticipate whether public compensation for their harm is available.

In addition, sufficient procedures in the distribution process should also be developed in order to protect related parties' interests and make an adequate and effective distribution. As seen in the SEC's cases such as the Global Research Analyst Settlement, the SEC was criticized for its lack of procedural protections, which limited participation of parties interested in the Fair Fund distribution, and caused the agency's failure to adequately compensate investors.<sup>354</sup> To prevent such mishap, the opportunity should be provided for interested parties to participate and express their opinions in the course of developing the distribution plan. Doing so enables the financial regulators to properly identify parties and claims that should be included in the distributions.

Further, in designing procedures for distribution, policymakers should consider how to expedite the distribution process. As seen in the Fair Fund distribution process, it can take over two years from creation to termination of the Fair Fund, and the SEC has continuously made efforts to expedite the distribution process. In this regard, regulatory agencies should build a close collaboration with the judiciary and financial intermediaries to acquire information essential to distribution, such as eligible claimants and their share of the fund.

On the other hand, there may be a concern that victims are compensated more than the financial losses actually incurred in cases where victims seek private litigation after

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<sup>354</sup> See discussion *supra* Part III(E)(5).

they recover their damage fully or partly from distributions paid by the defendants. Thus, the court needs to consider recoveries from other sources such as penalties in assessing damages to prevent over-compensation.<sup>355</sup>

#### **D. The Agency's Mission and Resources Should Be Considered**

Financial regulatory agencies' missions and resources are also important factors to consider in designing an efficient compensation scheme. As provided in the statute, FSC and FSS's mission is to assist the development of financial industry, maintain the stability of the financial market, form fair market practices, and protect financial consumers.<sup>356</sup> To achieve their missions in cooperation with the FSC, the FSS supervises and examines financial institutions, oversees and investigates illegal activities and misconduct in the financial market, and addresses financial consumers' complaints and mediates financial disputes.<sup>357</sup> On the other hand, just like other agencies, the FSS also has limited resources. Specifically, since the FSS is primarily funded by fees paid by the regulated financial institutions and securities issuers, expansion of its resources would increase the burden on market participants.<sup>358</sup>

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<sup>355</sup> See *supra* note 155 and accompanying text.

<sup>356</sup> Act on the Establishment, etc. of Financial Services Commission §1.

<sup>357</sup> In establishing compensatory schemes, final authority related to compensation such as approval of distribution plan would be reserved by the FSC. However, since the FSS would deal with practical matters, functions and resources of the FSS are important in the discussion. For FSS' major functions and organization, see FSS HANDBOOK, *supra* note 13, at 17-20.

<sup>358</sup> The FSS adopts zero-balance budget system and its operating revenues are composed of contributions from the regulated financial institutions, securities issuers and Bank of Korea, and other revenues. As of fiscal year of 2014, contributions from the regulated financial institutions and securities issuers take up 70



In this respect, a compensation scheme should be designed to minimize conflicts with the FSS's other major functions and resources. As previously reviewed, scholars pointed out that the SEC's compensatory effort may weaken the SEC's other functions or conflict with them.<sup>359</sup> Carrying out a compensatory system within the FSS may divert the agency's resources in order to establish a new office with skilled staff, develop computerized systems, and administer distributions. More seriously, taking on a compensatory role may lead the agency to increase efforts on high-profile cases and pay less attention to other enforcement actions, which do not produce compensation, but are necessary to maintain market confidence and protect financial consumers. To prevent such danger, the FSS should set the priorities and strategic goals of its different missions and evaluate them objectively. The FSS also needs to reorganize closely related functions to manage its resources effectively and avoid conflicts among them. For example, the FSS has an Enforcement Review Department that reviews sanctions proposed by the Examination Departments and Investment Departments. Thus, a new office to take charge of compensation needs to be organized within the same division as the Enforcement Review Department to avoid conflicts between the two functions and enhance consistency.<sup>360</sup> Further, in order to relieve the burden of administering funds, the FSS

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percent and 27 percent of the total, respectively. FSS, FSS website, Disclosure of Management Information: Budget Analysis: 2014, *available at* <http://www.fss.or.kr/fss/kr/open/finance/budget.jsp> (last visited on May 18, 2015).

<sup>359</sup> See discussion *supra* Part IV(D)(4).

<sup>360</sup> The SEC also established the Office of Collections and Distributions within the Enforcement Division. See *supra* note 120-21 and accompanying text.

needs to appoint fund administrators to administer distribution processes according to the distribution plan.

## **V. Conclusion**

This study explored the Fair Fund program administered by the SEC in the United States and suggested several considerations Korea should take into account in designing a compensation scheme. Even though Korea's financial regulatory system has followed those of the U.S. in many areas, the authority over enforcement actions shows major differences between both countries' regulatory agencies. Thus, it is very unlikely that the Korean regulatory system will adopt the Fair Fund program as the U.S did without considering such differences.

However, analyzing the Fair Fund provides important lessons for Korea as it develops its own compensation model. Most of all, although current discussions about expanding financial regulator's monetary sanctions are made without considering the utilization of the penalty surcharge and its impact on the financial regulatory system, legislators and regulators should recognize that both are closely related and should be discussed at the same time. Further, it should also be noted that emphasizing the compensatory role of financial regulators might compromise the traditional mission of deterrence unless it is supported by substantive and procedural principles that are clearly established and prioritized, and the regulatory agencies maintain sufficient resources. Thus, in developing a compensation scheme in Korea, the focus should be on how the regulators can enhance their compensatory role while maintaining the deterrence effect of securities enforcement actions.

A compensation scheme that distributes monies collected through monetary sanctions requires many changes to the current legal and regulatory system of Korea, such

as the penalty surcharge and class action systems. Thus, it may take a long time to establish such a scheme in Korea even when the government and the National Assembly attempt to push it forward. In this respect, it is also important to consider improvements to the current compensatory system such as the FDM in the short term in order to resolve the urgent matter to relieve widespread harms occurring in the financial markets.

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