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SEC Issues Standards For Imposing Fines On Corporations

Last week the Securities and Exchange Commission, led by new Chairman Christopher Cox, announced the issuance of standards that the SEC will use when it imposes fines on corporations.[1] These standards come in the wake of several mega corporate fines that have been criticized — both within and outside the SEC —as random if not heavy handed. According to Chairman Cox, the SEC will now focus on two principal considerations when calculating an appropriate fine: (1) the presence or absence of a direct benefit to the corporation as a result of the violation; and (2) the degree to which the penalty will recompense or compound harm to the shareholders. Several other factors, including whether the corporation cooperated with authorities and whether the misconduct occurred throughout the corporation and its management, will also be worked into the SEC's calculus. In order to illustrate how these standards may be expected to be applied, the SEC simultaneously announced the filing of two settled actions against corporate issuers McAfee, Inc.[2] and Applix, Inc.[3] McAfee paid money as part of the settlement, while Applix did not. The two settlements are discussed below.

Over the last several years we have witnessed a steady rise in the fines slapped on corporations. As CNN recently reported, prior to 2002, the largest fine ever imposed by the SEC was $10 million. However, fines exceeding that amount have become commonplace, with the SEC imposing more than 15 fines of $10 million or more this past year alone. And several recent fines, such as Time Warner's $300 million, and Worldcom's $750 million, shattered the $10 million ceiling. By the SEC's own admission last week, "recent cases have not produced a clear public view of when and how the Commission will use corporate penalties." By announcing the new standards however, Chairman Cox clearly did not intend to suggest that high corporate fines would no longer be commonplace; rather, he suggested that

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1 Statement of the Securities and Exchange Commission Concerning Financial Penalties, January 4, 2006 at http://www.sec.gov/news/press/2006-4.htm.

2 Litigation Release No. 19520, January 4, 2006 at http://www.sec.gov/litigation/litreleases/Ir19520.htm; *Securities Exchange Commission v. McAfee, Inc.* (U.S.D.D. Northern Dist. of CA) at http://www.sec.gov/litigation/admin/33-8651.pdf.

3 *In the Matter of Applix, Inc.,* Securities Act of 1933 Release No. 8651, January 4, 2006, at http://www.sec.gov/litigation/admin/33-8651.pdf.

the determination of fines will be drawn from more objective and clearly articulated criteria. Thus, those who saw Chairman Cox's appointment last year as a sign that the SEC's tough enforcement and regulatory initiatives had gone the way of former SEC Chairman Donaldson may be in for a disappointment. Moreover, the Commission emphasized that the standards had been unanimously approved by the Commissioners, which is particularly significant in light of the publicly expressed disagreements between the Commissioners on this issue during Chairman Donaldson's tenure.

Among the criticisms recently leveled at the SEC has been the complaint that fines for corporate wrongdoing often take an unfair toll on shareholders who were first harmed by the fraud and then burdened with the payment of a monetary fine to the Government. In arriving at the new standards, the SEC re-examined the legislation that authorized the Commission to seek civil money penalties in enforcement cases, as well as its Congressional history. Through that review the SEC determined (1) that Congress recognized "that shareholders ultimately may bear the cost of penalties imposed on corporate issuers," but (2) that Congress also cautioned the Commission to take into account "whether the penalty would be paid by shareholders who had been the principal victims of the violation," or, conversely, whether the shareholders received an improper benefit as a result of the wrongdoing.

Thus, the Commission announced that going forward it will, in the first instance, look at whether the "corporation itself has received a direct and material benefit from the offense, for example through reduced expenses or increased revenues." In this regard, the "strongest case for the imposition of a corporate penalty is one in which the shareholders of the corporation have received an improper benefit as a result of the violation; the weakest case is one in which the current shareholders of the corporation are the principal victims of the securities law violation." Second, while the likelihood that "a corporate penalty will unfairly injure investors, the corporation, or third parties, weighs against its use as a sanction," the Commission will also consider whether "the penalty itself may be used as a source of funds to recompense the injury suffered by victims of the securities law violations." To this end, Sarbanes Oxley's creation of "Fair Funds" to compensate corporate fraud victims will be a tool of continued and perhaps expanded use by the Commission.

Continuing to draw on the legislation and its history, the Commission also expressly recognized seven other factors in addition to the two principal considerations: (1) the need to deter the particular type of offense; (2) the extent of injury to innocent parties; (3) whether complicity in the violation is widespread throughout the corporation; (4) the level of intent on the part of the perpetrators; (5) the degree of difficulty in detecting the particular type of offense; (6) the presence or absence of remedial steps by the corporation; and (7) the extent of cooperation with Commission and other law enforcement. These considerations are consistent with the guidelines federal prosecutors use in determining whether to file criminal charges against a corporation.

The impact of these factors, and whether they will ultimately serve the Commission's stated purpose, is hard to forecast. The McAfee and Applix settlements, however, may provide some guidance. The software maker McAfee, according to the SEC, overstated its revenues by more than a half billion dollars over a two-year period during which it used its inflated stock to acquire other companies. Given the benefit to the company as well as its financial strength, the SEC imposed a $50 million fine without requiring an admission of wrongdoing by the company. In contrast, another software manufacturer, Applix, landed in the SEC's cross hairs for improper revenue recognition. In Applix, the SEC did not see any benefit to shareholders as a result of the fraud, and determined that a fine would likely have had a disproportionate effect on the relatively small company. Given these factors, as well as Applix's cooperation with the SEC, the SEC did not impose a fine.

While we should not expect corporate fines to decline in either amount or frequency to any great degree, the new standards may bring some predictability and give us greater insight into what action the SEC may take in a given case. Regardless of how the SEC's interpretation of the new standards unfolds, however, it is likely that we will continue to see the heaviest fines imposed on corporations whose crimes or violations harmed innocent investors and were the deliberate acts of top management, whereas companies that quickly disclose wrongdoing and take immediate remedial steps, including cooperating with the Government, have the best chances of escaping a fine, or at least minimizing its size.

This memorandum was written by our partner David N. Kelley, who was until recently the United States Attorney for the Southern District of New York.

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If you have any questions about the issues raised in this memorandum, or if you would like a copy of the materials discussed, please call or email David G. Januszewski at (212) 701-3352 or djanuszewski@cahill.com, David N. Kelley at (212) 701-3050 or dkelley@cahill.com, Jon Mark at (212) 701-3100 or jmark@cahill.com or John Schuster at (212) 701-701-3323 or jschuster@cahill.com.