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Fair Funds and the SEC's Compensation of Injured Investors

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FAIR FUNDS AND THE SEC'S COMPENSATION OF INJURED INVESTORS

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Abstract

The Fair Fund provision of Sarbanes-Oxley allows the SEC to distribute money penalties to injured investors, heralding a new compensatory role for the agency. The SEC has announced that it will direct money to injured investors whenever possible, but has not articulated clear priorities. This Article fills the gap by introducing terms of debate and proposing a framework for the SEC's exercise of its discretion.

The Article introduces the concept of "public class counsel," a public actor that has the dual function of deterrence and victim compensation. The concept describes—and suggest limits to—the SEC's role in a system in which public and private remedies for securities violations increasingly converge. The Article then draws on the analogy between the "public class counsel" and the "private attorney general" to propose an answer to the question: When should the SEC exercise its discretion to create a Fair Fund? This Article suggests that the SEC focus on distributing penalties gathered from aiders and abettors of securities fraud because such an approach would minimize two significant concerns with investor compensation: first, that compensation of injured investors often amounts to a transfer of money among equally innocent investors and, second, that giving the SEC and private actors a role in compensation risks duplication of costs.

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I. INTRODUCTION

In one of the largest accounting scandals this decade, WorldCom announced in June 2002 that it would restate its financials for 2001 and the first quarter of 2002.[1] The day after this announcement, the Securities and Exchange Commission filed a civil complaint against WorldCom alleging that the company had overstated its income by $9 billion.[2] The harm to investors—approximately $200 billion[3]—was unprecedented, as was the $2.25-billion penalty the Commission obtained.[4] Although ultimately reduced to $750 million in bankruptcy,[5] the penalty formed part of what SEC Chairman Christopher Cox called a "trend" toward large penalties

1. Official Comm. of Unsecured Creditors of WorldCom, Inc. v. SEC, 467 F.3d 73, 75 (2d Cir. 2006).

2. *Id.* at 75–76.

3. SEC v. WorldCom, Inc., 273 F. Supp. 2d 431, 431 (S.D.N.Y. 2003).

4. *See* Final Judgment as to Monetary Relief at 2, SEC v. WorldCom, Inc., 452 F. Supp. 2d 531 (S.D.N.Y. 2006) (No. 02-CV-4963), *available at* http://www.sec.gov/spotlight/worldcom/wcjudg070703.pdf.

5. *See id.*

and a "sea change . . . in the SEC's use of its penalty authority . . . ."[6] WorldCom—now defunct—became the poster child for the financial scandals of the beginning of this century, prompting (with Enron) the Sarbanes-Oxley securities legislation.[7]

The WorldCom enforcement also served as the testing ground for one of the novel provisions of Sarbanes-Oxley: the Federal Account for Investor Restitution ("FAIR") Funds provision, which allows penalty money to be directed, at the SEC's discretion, to injured investors instead of to the United States Treasury.[8] As a result of this provision, large

6. Christopher Cox, Chairman, Secs. and Exch. Comm'n, Statement of Chairman Cox Concerning Objective Standards for Corporate Penalties (Jan. 4, 2006), *available at* http://www.sec.gov/news/speech/spch010406cc.htm. A $10 million penalty against Xerox in 2002 was the largest the SEC had ever imposed against an issuer. SEC v. Xerox Corp., Xerox Settles SEC Enforcement Action Charging Company with Fraud, Agrees to Pay $10 Million Fine, Restates Its Financial Results and Conduct Special Review of Its Accounting Controls, Litigation Release No. 17,465 (Apr. 11, 2002), *available at* http://www.sec.gov/litigation/litreleases/lr17465.htm. That amount quickly came to seem like small change—that is what Banc of America Securities paid in 2004 for failing to cooperate with the SEC staff during its investigation. *See* Stephen M. Cutler, Director, Div. of Enforcement, Secs. and Exch. Comm'n, Speech by SEC Staff: 24th Annual Ray Garrett Jr. Corporate and Securities Law Institute (Apr. 29, 2004), *available at* http://www.sec.gov/news/speech/spch042904smc.htm; *In re* Bank of America, Order Instituting Proceedings Pursuant to Sections 15(b)(4) and 21C of the Securities Exchange Act of 1934, Making Findings, and Imposing Remedial Sanctions and a Cease-and-Desist Order, Exchange Act Release No. 49,386 (Mar. 10, 2004), *available at* http://www.sec.gov/litigation/admin/34-49386.htm; *see also* SEC v. Time Warner, Inc., SEC Charges Time Warner With Fraud, Aiding and Abetting Frauds by Others, and Violating a Prior Cease-and-Desist Order; CFO, Controller, and Deputy Controller Charged with Causing Reporting Violations, Litigation Release No. 19,147 (Mar. 21, 2005), *available at* http://www.sec.gov/litigation/litreleases/lr19147.htm (noting the order to Time Warner to pay a $300 million penalty). Although the SEC's discretion to set penalty amounts makes the size of penalties a moving target, at least for now the penalties continue to be high in comparison to the SEC's historical practices. As SEC Chairman Cox testified in May 2008: "In the 17 years since the Congress gave the SEC authority to collect penalties against companies, this [2007 amount] is the fifth highest penalties and disgorgement total ever, and $1 billion above the pre-Enron average of the 1990s." *Fiscal 2009 Appropriations: Financial Services: Hearing Before the Comm. on S. Appropriations Subcomm. on Financial Services and General Government*, 110th Cong. (May 7, 2008) (statement of Christopher Cox, Chairman, Sec. and Exch. Comm'n) *available at* 2008 WLNR 8763903.

7. *See A Price Worth Paying?—Auditing Sarbanes-Oxley*, ECONOMIST, May 19, 2005, at 72 ("[The Act's] original aim, on the face of it, was modest: to improve the accountability of managers to shareholders, and hence to calm the raging crisis of confidence in American capitalism aroused by the scandals at Enron, WorldCom and other companies."); *see also* James Fanto, *Paternalistic Regulation of Public Company Management: Lessons From Bank Regulation*, 58 FLA. L. REV. 859, 860 (2006) (observing that Sarbanes-Oxley was a "significant intrusion" by the federal government in corporate governance regulation). *See generally* Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (codified in scattered sections of 11, 15, 18, 28, and 29 U.S.C.) [hereinafter Sarbanes-Oxley].

8. Section 308 of Sarbanes-Oxley states:

penalties in WorldCom's settlement will potentially result in substantial distributions by the agency to injured investors.[9] As the WorldCom enforcement matter illustrates, the Fair Fund provision heralded an increasingly important compensatory role for the SEC. During the provision's first four years in effect, the Commission collected approximately $8 billion in penalties and disgorgement for distribution to injured investors.[10] As of June 2008, the SEC had distributed more than $3.9 billion.[11]

Even as WorldCom represented a new scale of harm, it advanced a new regime of SEC-driven investor compensation. Although couched as a discretionary distribution mechanism, the Fair Fund provision enabled investor compensation to gain ground as a significant part of the Commission's role. Nonetheless, the SEC's compensatory role since the advent of the Fair Fund provision has received limited scholarly attention,[12] and the SEC has not articulated clear priorities about how it

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> Civil penalties added to disgorgement funds for the relief of victims. If in any judicial or administrative action brought by the Commission under the securities laws . . . the Commission obtains an order requiring disgorgement against any person for a violation of such laws or the rules or regulations thereunder, or such person agrees in settlement of any such action to such disgorgement, and the Commission also obtains pursuant to such laws a civil penalty against such person, the amount of such civil penalty shall, on the motion or at the direction of the Commission, be added to and become part of the disgorgement fund for the benefit of the victims of such violation.

15 U.S.C. § 7246(a) (2006).

9. As of June 2007, $500 million of the $750 million WorldCom Fair Fund had been distributed. Press Release, SEC, SEC Distributions to WorldCom Fraud Victims Top Half-Billion Dollar Mark (June 14, 2007), http://www.sec.gov/news/press/2007/2007-118.htm (quoting SEC Chairman Cox as saying that "[i]n the last four years, through this and other SEC distributions, the Commission has returned nearly $2 billion to investor victims" and that he "anticipate[d] substantial additional distributions to investors in the near future").

10. 72 SEC ANN. REP. 23 (2006), http://www.sec.gov/about/secpar/secpar2006.pdf. Distribution has lagged behind collection. *See, e.g.*, *id.* (noting that approximately $700 million were distributed to injured investors during fiscal year 2006).

11. Press Release, SEC, SEC Announces $26 Million Fair Fund Distribution in Banc of America Securities LLC Settlement (June 23, 2008), http://www.sec.gov/news/press/2008/2008-118.htm.

12. *See* Barbara Black, *Should the SEC Be a Collection Agency for Defrauded Investors?*, 63 BUS. LAW. 317, 345 (2008) (examining the impact of Fair Funds on investor protection and concluding that "effective enforcement policy is not necessarily compatible with a dominant emphasis on recovering and returning funds to investors"); James D. Cox & Randall S. Thomas, with Dana Kiku, *SEC Enforcement Heuristics: An Empirical Inquiry*, 53 DUKE L.J. 737, 738–42 (2003) (evaluating the potential impact of the Fair Fund provision on investor compensation as part of an empirical study of private securities fraud class actions); *see generally* Don Carillo, Comment, *Disgorgement Plans Under the Fair Funds Provision of the Sarbanes-Oxley Act of 2002: Are Creditors and Investors Truly Being Protected?*, 6 DEPAUL BUS. & COM. L.J. 315 (2008) (arguing that courts should review Fair Fund distribution plans under a heightened standard because

will exercise its discretion under the law. This Article proposes the concept of "public class counsel" to fill these gaps.

The Fair Fund provision marked an increasing convergence of the remedies that can be sought by the Commission as "public class counsel" and by private plaintiffs as "private attorneys general." In theory, private damages can promote the general good of securities law enforcement by deterring violations as well as obtaining compensation for the class of injured investors. SEC money penalties potentially do the same: they obtain compensation for the class of injured investors as well as deter. This Article draws on this analogy between public class counsel and private attorney general to propose an answer to the following question: When should the SEC exercise its discretion to create a Fair Fund for investor compensation?

Part II elaborates on the analogy between the private attorney general and public class counsel. Part III traces the emergence of the SEC's role in compensating injured investors and examines the Fair Fund provision in the context of the SEC's other main compensatory mechanism, the equitable remedy of disgorgement. Parts IV and V analyze two aspects of the compensation conundrum: first, whether compensation of injured investors is ever warranted and, second, when the SEC, as opposed to private litigants, should undertake it. This Article looks first at the commonalities between the private attorney general and the public class counsel, and then to the differences. In doing so, it relates the SEC's actions under Fair Funds to the circularity critique of investor compensation: that, in the secondary market, compensation simply transfers funds among innocent investors. It also details the costs of enlarging the SEC's public class counsel role. Part VI draws on this analysis to propose a way for the SEC to prioritize Fair Fund distributions to minimize concerns with circularity and cost duplication. It concludes that the SEC should focus first on distributing money gathered from aiders and abettors. Such a focus would minimize concern with circularity. Moreover, as the Supreme Court's recent decision in *Stoneridge Investment Partners, LLC v. Scientific-Atlanta, Inc.*[13] highlights, only the

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the provision is aimed at compensation rather than deterrence). Other commentators have addressed the tension between the Fair Fund provision and the bankruptcy provisions that call for the claims of shareholders to be subordinated to those of creditors, an issue that the WorldCom enforcement case and bankruptcy brought to the fore. *See* Zack Christensen, Note, *The Fair Funds for Investors Provision of Sarbanes-Oxley: Is It Unfair to the Creditors of a Bankrupt Debtor?*, 2005 U. ILL. L. REV. 339, 375 (2005) (arguing that Congress should amend the Fair Fund provision to prevent it from "alter[ing] the well-established distributional priorities of the Bankruptcy Code"); *see generally* Douglas A. Henry, Comment, *Subordinating Subordination: WorldCom and the Effect of Sarbanes-Oxley's Fair Funds Provision on Distributions in Bankruptcy*, 21 EMORY BANKR. DEV. J. 259 (2004) (arguing that the Fair Fund provision should be applied in bankruptcy to further congressional intent to compensate investors of securities fraud).

13. 128 S. Ct. 761 (2008).

SEC can obtain investor compensation from aiders and abettors because private litigants have no cause of action.

II. THE CONCEPT OF "PUBLIC CLASS COUNSEL"

The starting point for the "public class counsel" concept is the analogy to the "private attorney general." Securities laws have long been enforced through both public and private actions.[14] The securities acts, in addition to giving the SEC enforcement power, have given rise to express and implied causes of action for private plaintiffs.[15] This Article envisions the field of securities law actions as occupied by two principal categories of players—the private attorney general and the public class counsel—both of whom serve deterrent and compensatory functions.

Judge Jerome Frank, a securities law expert who sat on the U.S. Court of Appeals for the Second Circuit, coined the term "private attorney general" to describe litigation by private plaintiffs to prevent a government official from exceeding his statutory powers: "Such persons, so authorized, are, so to speak, private Attorney Generals [sic]."[16] Courts have drawn upon the concept to explain the use of private litigation to enforce statutory and constitutional rights.[17] Although the phrase has come to mean different things to different people, at its core is the concept that private litigation can enforce public policies.[18] Private remedies have often been justified as serving the dual function of compensation and deterrence on the theory that, as well as compensating injured investors, payment of damages promotes the general good of law enforcement by deterring violations.[19]

The archetypal private attorney general in the securities area is a profit-seeking counsel who brings a class action with the purpose of earning fees, and not with the purpose of deterring violations of the

14. Cox & Thomas, *supra* note 12, at 738–42 (detailing the "public-private partnership for the enforcement of the securities laws").

15. *See, e.g.*, Securities Act of 1933 § 11, 15 U.S.C. § 77(k) (2006) (expressly providing for private cause of action); J.I. Case Co. v. Borak, 377 U.S. 426, 431 (1964) (recognizing an implied private cause of action under the Securities Exchange Act).

16. Associated Indus. of N.Y. State, Inc. v. Ickes, 134 F.2d 694, 704 (2d Cir. 1943) (holding that Congress can confer standing on private persons, not simply to recover compensation for specific victims, but also "to vindicate the public interest"), *vacated as moot*, 320 U.S. 707 (1943).

17. *See* Mills v. Elec. Auto-Lite Co., 396 U.S. 375, 396 (1970); Newman v. Piggie Park Enters., Inc., 390 U.S. 400, 402 (1968); Cooper v. Allen, 467 F.2d 836, 841 (5th Cir. 1972); Lee v. S. Homes Site Corp., 444 F.2d 143, 145 (5th Cir. 1971); Sims v. Amos, 340 F. Supp. 691, 694 (M.D. Ala. 1972), *aff'd*, 409 U.S. 942 (1972); *see also* John C. Coffee, Jr., *Rescuing the Private Attorney General: Why the Model of the Lawyer as Bounty Hunter Is Not Working*, 42 MD. L. REV. 215, 215 & n.1 (1983); Comment, *Court Awarded Attorney's Fees and Equal Access to the Courts*, 122 U. PA. L. REV. 636, 666–70 (1974) (tracing the development of the private attorney general theory).

18. Coffee, *supra* note 17, at 215–16.

19. *See id.*

relevant statute.[20] The goal of deterrence does not motivate these attorneys, except to the extent that policymakers adjust attorneys' incentives to fulfill that purpose. The private securities class action is often loved or hated depending on whether—or how well—the class and its counsel act as a "private attorney general,"[21] and courts have become less willing to imply a private right of action when they see a clear gap between the promise of private enforcement and its practice.[22]

This Article proposes an analogous model of "public class counsel." The basic similarity between the private attorney general and the public class counsel is that, in theory, both have compensatory and deterrent functions. Regardless of whether a private attorney general or a public class counsel brings the action, the beneficiaries of an action are the same. Injured investors benefit by recovering money and the public, which includes injured investors, benefits from deterrent effects.[23] The public class counsel could be any governmental actor, whether an enforcement branch of an agency or an independent office that undertakes actions on behalf of consumers or employees. It refers to any public actor that obtains compensation for private parties.

The utility of the public class counsel concept does not rely on resolving the many normative and descriptive issues about the private attorney general; instead, the term is intended to be a term of debate that raises comparable issues concerning public actors who undertake a traditionally private role. As a term of debate, the concept is open to the same criticism as that of private attorney general—that it cannot, by itself, answer the difficult questions about whether private litigation or public actions deter or compensate.[24] Nonetheless, the concept of private attorney

20. The concept of "public class counsel" developed in this Article focuses on the "entrepreneurial" model ("bounty hunter" model) of private attorney general—the profit-seeking model described above—because it is characteristic of private securities litigation. *Id.* at 217–18. Contrast this type with the "ideological" type: A private attorney general who consciously uses the private action to pursue a strategy of enforcement and is "typically organized into 'public interest' law firms, is financed by foundations or membership donations, and tends in general to be faithful to, and closely controlled by, the social and political groups that he is serving." *Id.* at 235.

21. *See* Cox & Thomas, *supra* note 12, at 739–41 ("[T]here are two very different perspectives of the role of private suits in the enforcement of the securities laws: one perspective enlists plaintiffs as private attorneys general, and the other perspective paints the same plaintiffs as vexatious litigants."). *See generally* Howard M. Erichson, *CAFA's Impact on Class Action Lawyers*, 156 U. PA. L. REV. 1593 (2008) (examining the impact of the Class Action Fairness Act of 2005 on plaintiffs' lawyers).

22. *See* Coffee, *supra* note 17, at 218–19; *cf.* Stoneridge Inv. Partners v. Scientific-Atlanta, Inc., 128 S. Ct. 761, 772–74 (2008) (finding that actions against customers and suppliers fell beyond the scope of the 10(b)(5) private right of action).

23. The analogy is helpful, but not perfect. For instance, private damages can deter without any actor having made a conscious choice to use damages for deterrence, whereas the use of money penalties for compensation requires the SEC to choose to direct the money to a private party.

24. *See* Coffee, *supra* note 17, at 216 n.1 (noting that the concept of the private attorney

general has shaped the analysis in many areas of the law over the years since Judge Frank introduced it. The public class counsel can exert analogous influence.

In the securities context, the SEC compensates injured investors through the disgorgement remedy and, since the enactment of the Fair Fund provision, through distribution of money penalties. Because the Fair Fund provision made another potentially large category of funds available for compensation, it signaled the enlargement of the SEC's public class counsel role. Identifying the SEC as public class counsel highlights the hybrid nature of the SEC's monetary remedies and the pressure this new compensatory role puts on the relationship between public and private enforcement of the securities laws.

Moreover, the idea of public class counsel reaches beyond the securities context. Envisioning a field as comprising public class counsel and private attorneys general can bring to the fore new compensatory roles for public actors. As victim restitution statutes are enacted, for instance, criminal prosecutors might be characterized as public class counsel because of their dual function, which may shift the actor's focus to deterrence. Other public actors, such as the Equal Employment Opportunity Commission, have long performed this hybrid function, sometimes choosing individual cases in part because of their deterrent effect. While this Article focuses on the SEC and its intensified compensatory role under the Fair Fund provision, the utility of the public class counsel concept comes in part from understanding these disparate public actors (SEC, EEOC and others) as being in the same category. The concept allows comparisons to be drawn more easily and suggests the variety of ways in which compensation and deterrence interact as goals of public actors.

III. THE EMERGENCE OF THE SEC'S ROLE IN COMPENSATING INJURED INVESTORS

Far from embracing the purpose of compensating individual investors, the SEC long disclaimed any role as an instrument for private individuals to recover money. Indeed, the purpose of SEC enforcement was traditionally described as detecting violations through investigation and taking steps to prevent or penalize violations.[25] In the 1970s, the "primary function" of the SEC was to "protect the public from fraudulent and other

general is essentially a way of asking whether it makes sense to rely on private litigation for public enforcement).

25. *E.g.*, 36 SEC ANN. REP. 92 (1970) ("[E]nforcement activities . . . encompass the detection and investigation of possible violations of the Federal securities laws and the taking of appropriate action to curtail fraudulent and other improper activities."); 1 SEC ANN. REP. 30 (1935) ("[T]he Commission has broad powers to enforce the acts and the rules and regulations . . . through investigations, hearings and injunctions.").

unlawful practices and not to obtain damages for injured individuals."[26]

The use of money penalties[27] to compensate injured investors was even more unknown. As money penalties became a significant tool for administrative agencies in the early 1970s, the Administrative Conference studied their use and recommended ways for federal administrative agencies to implement their penalty authority.[28] A commentator involved in the study wrote confidently that "[b]y definition, a civil money penalty does not serve a 'specific' compensatory function of making whole an identifiable individual specifically injured by the offending conduct." Rather, the function of this "system of private remedies" was compensation.[29]

By 2005, in contrast, the SEC announced that "where possible," it intended to "return funds to harmed investors."[30] By then, the SEC had two main mechanisms for compensating injured investors: distribution of disgorged funds and, after 2002, distribution of money penalties pursuant to the Fair Fund provision.

A. *Disgorgement*

Nothing in the 1933 or 1934 Acts or their legislative histories explicitly gave the Commission the power to seek disgorgement and, in fact, the SEC did not seek disgorgement in federal court for its first three decades,

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26. *See, e.g.*, 42 SEC ANN. REP. 108 (1976); Thomas L. Hazen, *Administrative Enforcement: An Evaluation of the Securities and Exchange Commission's Use of Injunctions and Other Enforcement Methods*, 31 HASTINGS L.J. 427, 449 & n.141 (1979–1980); *see also* John D. Ellsworth, *Disgorgement in Securities Fraud Actions Brought by the SEC*, 1977 DUKE L.J. 641, 649 (1977) (tracing the development of the disgorgement remedy); *cf.* 37 SEC ANN. REP. 100 (1971) ("The Commission's authority, however, does not extend to arbitrating private disputes or controversies between brokerage firms and investors or to assisting investors in the assertion of their private rights.").

27. This Article uses the general definition of "money penalty" (or "civil money penalty") proposed by the Administrative Conference of the United States: a sanction "(i) classified as civil and (ii) money that is, in fact, subject to collection by an agency or a court." Administrative Conference of the United States, Civil Money Penalties as a Sanction, Recommendation 72-6 (1972), *available at* http://www.law.fsu.edu/library/admin/acus/305726.html. Although this Article does not use the term "fine," the Senate Report accompanying the Remedies Act used "fine" interchangeably with "money penalty." S. REP. NO. 101-337, at 3, 7 (1990) [hereinafter S. REP. NO. 101-337]. The SEC has also used these terms interchangeably on occasion. *See, e.g.*, OFFICE OF MGMT. & BUDGET, SEC PERFORMANCE BUDGET FOR FISCAL YEAR 2007, at 20, *available at* http://www.sec.gov/about/2007budgetperform.pdf.

28. *See* William H. Lawrence, *Judicial Review of Variable Civil Money Penalties*, 46 U. CIN. L. REV. 373, 374 n.2 (1977).

29. Colin S. Diver, *The Assessment and Mitigation of Civil Money Penalties by Federal Administrative Agencies*, 79 COLUM. L. REV. 1435, 1456 & n.135 (1979).

30. 71 SEC ANN. REP. 5 (2005). The goal of returning funds to harmed investors first appeared in the description of the SEC's goals in the SEC's first annual report after Chairman Cox took office. *See id.*; *see also, e.g.*, 73 SEC ANN. REP. 6 (2007); 72 SEC ANN. REP. 6 (2006); U.S. SECURITIES & EXCHANGE COMMISSION, FY 2008 CONGRESSIONAL JUSTIFICATION 5 (Feb. 2007).

despite a few earlier instances of obtaining it through settlement.[31] It is now well established that the SEC may seek disgorgement in federal court as part of the courts' equitable powers,[32] as well as in administrative proceedings on statutory bases introduced by the Securities Enforcement Remedies and Penny Stock Reform Act of 1990.[33]

Much has been written about the difficulties of precisely defining equitable remedies such as disgorgement and restitution,[34] and courts sometimes use the terms "disgorgement" and "restitution" interchangeably.[35] Nonetheless, the remedy of disgorgement is often described—and has been described by the SEC—as forcing defendants "to give up the amount by which they were unjustly enriched."[36] The SEC has drawn the line between restitution and disgorgement as follows: "Restitution is intended to make investors whole, and disgorgement is meant to deprive the wrongdoer of their ill-gotten gain."[37] Generally, cases about the securities acts do not address the rationale for distributing

31. *See* Ellsworth, *supra* note 26, at 642.

32. SEC v. Fischbach Corp., 133 F.3d 170, 175 (2d Cir. 1997) (citing cases involving disgorgement); SEC v. Buntrock, No. 02-C-2180, 2004 WL 1179423, at *3 (N.D. Ill. May 25, 2004) (same); REPORT PURSUANT TO SECTION 308(C) OF THE SARBANES OXLEY ACT OF 2002 2, *available at* http://www.sec.gov/news/studies/sox308creport.pdf [hereinafter Fair Fund Report]. *Texas Gulf Sulphur* was the first case to determine that the court had the power to grant the ancillary relief of disgorgement, thereby depriving defendants of their profits from insider trading. SEC v. Tex. Gulf Sulphur, 312 F. Supp. 77, 89, 91 (S.D.N.Y. 1970).

33. Pub. L. No. 101-429, § 102(e), 104 Stat. 931 (1990) (codified as amended at 15 U.S.C. § 80a-9(e) (2006)) ("In any proceeding in which the Commission may impose a penalty under this section, the Commission may enter an order requiring accounting and disgorgement, including reasonable interest. The Commission is authorized to adopt rules, regulations, and orders concerning payments to investors, rates of interest, periods of accrual, and such other matters as it deems appropriate to implement this subsection.").

34. *See, e.g.*, Andrew Kull, *Rationalizing Restitution*, 83 CAL. L. REV. 1191, 1193 (1995) (outlining the difficulties of defining the relationship of restitution to unjust enrichment).

35. *See* Fair Fund Report, *supra* note 32, at 3 n.2; *Tex. Gulf Sulphur*, 446 F.2d at 1308 ("Restitution of the profits on these transactions merely deprives the appellants of the gains of their wrongful conduct.").

36. Fair Fund Report, *supra* note 32, at 3; *see also* SEC v. First Jersey Secs., Inc., 101 F.3d 1450, 1475 (2d Cir. 1996) ("The effective enforcement of the federal securities laws requires that the SEC be able to make violations unprofitable. The deterrent effect of an SEC enforcement action would be greatly undermined if securities law violators were not required to disgorge illicit profits." (quoting SEC v. Manor Nursing Ctrs., Inc., 458 F.2d 1082, 1104 (2d Cir. 1972))); SEC v. Blavin, 760 F.2d 706, 713 (6th Cir. 1985) ("The purpose of disgorgement is to force 'a defendant to give up the amount by which he was unjustly enriched' rather than to compensate the victims of fraud.").

37. Fair Fund Report, *supra* note 32, at 3 n.2; *see also* SEC v. Huffman, 996 F.2d 800, 802 (5th Cir. 1993) ("[D]isgorgement is not precisely restitution . . . . Disgorgement does not aim to compensate the victims of wrongful acts, as restitution does."); SEC v. Commonwealth Chem. Secs., Inc., 574 F.2d 90, 102 (2d Cir. 1978) ("[T]he primary purpose of disgorgement is not to compensate investors. Unlike damages, it is a method of forcing a defendant to give up the amount by which he was unjustly enriched.").

disgorged money—measured by the wrongdoer's gain—to injured investors. The basic contours of the remedy are not specific to the securities context, but are part of the court's equitable powers established in various contexts over many years.[38]

Although the disgorgement remedy differs from restitution, disgorged funds may be distributed to injured investors. Courts have adopted the view that disgorgement is primarily aimed at deterring violators by depriving them of profit. On this ground, they have held that the appropriateness of disgorgement does not depend on the identification of harmed private parties or the distribution of this amount to those harmed.[39]

In the securities context, distribution is at the discretion of the court or the agency, depending on whether the matter is judicial or administrative. Funds that are not distributed to injured investors go to the U.S. Treasury.[40] The SEC has noted that payment to investors of disgorged funds "is not always economically feasible."[41] When small amounts are collected, or when the number of identifiable investors is large in comparison to the amount collected, for instance, the Commission has reported that it "routinely" asks the court to direct the disgorged amount to the Treasury.[42]

38. *See* RESTATEMENT (FIRST) OF RESTITUTION § 1 (1937) ("Unjust Enrichment—A person who has been unjustly enriched at the expense of another *is required* to make restitution to the other." (emphasis added)); DAN B. DOBBS, HANDBOOK ON THE LAW OF REMEDIES, § 4.1, at 223–27 (disgorgement), § 4.2, at 229–40 (history of restitution), § 4.3, at 254–56 (rescission) (1973).

39. *See, e.g.*, SEC v. Fischbach Corp., 133 F.3d 170, 175–76 (2d Cir. 1997); *Huffman*, 996 F.2d at 802 (holding that disgorgement was not "restitution" and therefore not a debt under the Federal Debt Collection Procedures Act of 1990, 28 U.S.C. § 3001 *et seq.*, because "[d]isgorgement does not aim to compensate the victims of the wrongful acts, as restitution does"); *Blavin*, 760 F.2d at 713 ("Once the Commission has established that a defendant has violated the securities laws, the district court possesses the equitable power to grant disgorgement without inquiring whether, or to what extent, identifiable private parties have been damaged by [defendant's] fraud."). *See generally* 5 THOMAS LEE HAZEN, THE LAW OF SECURITIES REGULATION § 16.2[4][B], 26 (5th ed. 2005) (discussing when distribution is appropriate).

40. Fair Fund Report, *supra* note 32, at 4.

41. *Id.* at 14.

42. *Id.* (citing SEC v. Club Atlanta Travel, Inc., Litigation Release No. 17,008 (May 17, 2001) and SEC v. Fuller, Litigation Release No. 16,887 (Feb. 5, 2001) as examples of disgorgement that did not warrant distribution to investors); *see also* SEC Rules of Practice, 17 C.F.R. § 201.1102(b) (2008) ("When, in the opinion of the Commission or the hearing officer, the cost of administering a plan of disgorgement relative to the value of the available disgorgement funds and the number of potential claimants would not justify distribution of the disgorgement funds to injured investors, the plan may provide that the disgorgement funds and any civil penalty shall be paid directly to the general fund of the United States Treasury.").

As disgorgement became accepted as an ancillary remedy,[43] it became "an important source of recovery for private plaintiffs" through SEC actions.[44] Disgorgement amounts could be quite significant—for instance, Michael Milken paid $47 million in disgorgement.[45] Accordingly, distributions to injured investors could also reach these heights. Before penalties became a source of investor compensation, the Commission followed a policy of allocating money first to disgorgement, which could be distributed to injured investors, and then to penalties, which could not.[46]

B. *The SEC's Power to Impose Money Penalties: The Remedies Act*

By the 1990s, members of Congress began to express discontent with how well the disgorgement remedy deterred bad actors: disgorgement simply returned violators to their previous position.[47] The granting of money penalty authority was, in part, a response to this limitation. Many administrative agencies had obtained the power to impose civil money penalties in the 1970s,[48] but the SEC had been left out of that trend. The Commission's broad power to impose money penalties dates only to 1990, when Congress passed the Remedies Act.[49] Before then, the SEC could

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43. Although calling monetary relief "ancillary" may seem odd now that it has become a main feature of relief imposed by the SEC and because it often is unaccompanied by the injunctive relief to which it is ancillary, these terms reflect the many years during which the SEC's main remedy was injunctive. Comm. on Fed. Regulation of Secs., *Report of the Task Force on SEC Settlements*, 47 BUS. LAW. 1083, 1098 (1992).

44. H.R. REP. 98-355, at 25 (1983), *reprinted in* 1984 U.S.C.C.A.N. 2274, 2297; *see also* Comm. on Fed. Regulation of Secs., *supra* note 43, at 1120. Although disgorgement and then disgorgement plus penalties have been the major sources of investor compensation, the appointment of a receiver, who often distributes or generates funds for the investors in the company, has also performed this function. *See* Cox & Thomas, *supra* note 12, at 753 & n.56.

45. Fair Fund Report, *supra* note 32, at 6 (describing the disgorgement order imposed on Milken for violation of a Commission order barring association with a broker). Disgorgement amounts may also be large in the post-Fair Fund era. For example, in 2007, AIM Advisors and AIM Distributors agreed to pay $30 million in civil penalties and $20 million in disgorgement to settle allegations of market timing of mutual funds. *In re* AIM Advisors, Inc., Order Approving a Modified Distribution Plan, Exchange Act Release No. 57,859 (May 23, 2008).

46. Fair Fund Report, *supra* note 32, at 27.

47. S. REP. NO. 101-337, *supra* note 27, at 7–9 ("[D]isgorgement requires only that the law violator give up his unlawful gains and exacts no cost for his actions.").

48. *See* Jonathan I. Charney, *The Need for Constitutional Protections for Defendants in Civil Penalty Cases*, 59 CORNELL L. REV. 478, 480 n.14 (1973–1974). The Administrative Conference encouraged their use, viewing them as useful to "moderate an otherwise too harsh response." *See* Administrative Conference of the United States, Civil Money Penalties as a Sanction, Recommendation 72-6 (1972), *available at* http://www.law.fsu.edu/library/admin/acus/305726.html.

49. *See* 15 U.S.C. §§ 77t(d)(1), 78u(d)(3)(A), 80a-41(e)(1), 80b-9(e)(1) (2006). Besides giving the SEC the power to seek disgorgement in administrative proceedings as well as court cases, the Act also enlarged some of the agency's other powers.

impose penalties only in certain Foreign Corrupt Practices Act cases and, beginning in the 1980s, in insider trading cases.[50]

The 1984 Insider Trading Sanctions Act served, in part, as a trial run of SEC penalty authority that led up to the broader grant in the Remedies Act. The legislative history of the Insider Trading Sanctions Act highlighted the need to allow the SEC to fine violators so that it could effectively deter violations of the securities laws.[51] Built into the Act was a provision directing Congress to revisit the question of whether the SEC should get broader money penalty authority. The answer, according to Congress, was apparently "yes."

In 1990, the Remedies Act expanded the SEC's penalty authority to reach most violators of securities laws.[52] The main purposes of money penalties, according to the legislative history of the Remedies Act, were to give the agency forceful enough tools to deter violators and enough flexibility to tailor remedies to the violation.[53] The statute directed that the money penalties be paid into the U.S. Treasury.[54] The SEC could seek

50. *See, e.g.*, 15 U.S.C. § 78ff(c)(1)(B) (2006) (providing that the SEC can bring an action for a civil monetary penalty for violation of anti-bribery provisions in the Foreign Corrupt Practices Act); Insider Trading Sanctions Act of 1984, Pub. L. No. 98-376, 98 Stat. 1264 (1984) (codified as amended at 15 U.S.C. § 78u-1(b)(1)(A) (2006)). *See generally* Colleen P. Mahoney et al., The SEC Enforcement Process: Practice and Procedure in Handling an SEC Investigation After Sarbanes-Oxley, 77-3d C.P.S. CBNA) (outlining the monetary remedies of the SEC before the passage of the Remedies Act).

In addition, a little-used section also allows a penalty of $100 a day. *See* Arthur B. Laby & W. Hardy Callcott, *Patterns of SEC Enforcement Under the 1990 Remedies Act: Civil Money Penalties*, 58 ALBANY L. REV. 5, 7 (1994) (noting that Exchange Act Section 32(b) allows a penalty of $100 a day against an issuer who does not file required reports, although the SEC had invoked it only once as of 1990); Mercantile Properties, Inc., Litigation Release No. 360 (Aug. 27, 1946) (invoking section 32(b)).

51. H.R. REP. NO. 100-910, at 11 (1988), *reprinted in* 1988 U.S.C.C.A.N. 6043, 6048 (indicating that the SEC needed to "go beyond disgorgement of illegal profits to add the imposition of a significant fine as a needed deterrent"); H.R. REP. NO. 98-355, at 2 (1983), *reprinted in* 1984 U.S.C.C.A.N. 2274, 2275 ("This legislation provides increased sanctions against insider trading in order to increase deterrence of violations.").

52. *See* 15 U.S.C. § 77t(d)(1) (2006) (reaching violators of the securities acts, the "rules or regulations thereunder, or a cease-and-desist order"). *See generally* Matthew Scott Morris, Comment, *The Securities Enforcement Remedies and Penny Stock Reform Act of 1990: By Keeping Up With the Joneses, the SEC's Enforcement Arsenal Is Modernized*, 7 ADMIN. L.J. AM. U. 151, 153 (1993) (discussing the Remedies Act's "numerous important and powerful changes to the federal securities laws").

53. Annette L. Nazareth, Chairman, Secs. and Exch. Comm'n, Speech by SEC Commissioner: Remarks Before the SEC Speaks Conference (Mar. 3, 2006), *available at* http://www.sec.gov/news/speech/spch030306aln.htm#foot6; *see also* S. REP. NO. 101-337, *supra* note 27, at 8 (saying that the expanded sanctioning authority, including money penalty authority, would increase deterrence and enable the SEC to tailor enforcement remedies to the conduct, whereas the remedies earlier available to the SEC would have been "too severe or, alternatively too weak").

54. *See* Securities Enforcement Remedies and Penny Stock Reform Act of 1990, Pub. L. No.

money penalties in federal court or against certain directly regulated entities and individuals such as broker-dealers or in administrative proceedings against certain directly regulated entities and individuals.[55] If the SEC chose the first route, the Act established a three-tier structure of maximum penalties, with increasing penalties for increasing culpability.[56] A maximum amount per "violation" was specified at each level, and persons and non-persons were distinguished, with non-persons receiving a higher maximum fine at each tier.[57]

The court also had the option of imposing a penalty equal to the defendant's "gross amount of pecuniary gain," which the Senate Report defined as the "amount by which the defendant was unjustly enriched as a result of the violation."[58] Therefore, in actions in federal court, the disgorgement amount may be the yardstick for the penalty amount. This practice mirrored a common remedy under the Insider Trading Sanctions Act: disgorgement of trading profits (or losses avoided) plus a penalty equal to the disgorgement amount.[59]

101-429, § 101, 104 Stat. 931 (1990) (codified as amended at 15 U.S.C. § 77t (d)(3)(A) (2006)) [hereinafter Remedies Act].

55. *See* 15 U.S.C. § 78o(b)(4) (2006) (concerning broker dealers and associated persons), 15 U.S.C. § 78o(b)(6) (2006) (concerning an associated person), 15 U.S.C. § 78o-4(c)(2) (2006) (concerning municipal securities dealers), 15 U.S.C. § 78o-5(c)(1)(A) (2006) (concerning government securities dealers), 15 U.S.C. § 78q-1(c)(3) (2006) (concerning clearing agencies and transfer agents) of the Exchange Act of 1934, 48 Stat. 881 (1934) (codified as amended at 15 U.S.C. §§ 78a–78oo (2006)); *see also* § 9(b) of the Investment Company Act of 1940, 54 Stat. 789 (1940) (codified as amended at 15 U.S.C. § 80b-9 (2006)); § 203(e)–(f) of the Investment Advisers Act of 1940, 54 Stat. 847 (codified as amended at 15 U.S.C. §§ 80b-3(e)–(f) (2006)). *See generally* William R. McLucas et al., *SEC Enforcement: A Look at the Current Program and Some Thoughts About the 1990s*, 46 BUS. LAW. 797 (1990) (describing the SEC's penalty power under the Remedies Act). A proposal to extend the power to impose money penalties against any entity—as opposed to only regulated entities—in an administrative proceeding never became law. *See* Securities Fraud Deterrence and Investor Restitution Act of 2003, H.R. 2179, 108th Cong. (2003), *available at* http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=108_cong_bills&docid=f:h2179ih.txt.pdf.

56. The highest penalties—tier-three penalties—apply when the violation "involved fraud, deceit, manipulation, or deliberate or reckless disregard of a regulatory requirement" and caused "substantial losses" or the "risk of substantial losses." 15 U.S.C. § 77t(d) (2006).

57. 15 U.S.C. § 77t(d)(3)(A) (2006).

58. S. REP. NO. 101-337, *supra* note 27, at 10.

59. Stephen M. Cutler, Dir., Div. of Enforcement, Secs. and Exch. Comm'n, Speech by SEC Staff: 24th Annual Ray Garrett Jr. Corporate and Securities Law Institute (Apr. 29, 2004), *available at* http://www.sec.gov/news/speech/spch042904smc.htm; *see, e.g.*, SEC v. Abide, SEC Files Civil Fraud Action Against Mark P. Abide, Former WorldCom Director of Property Accounting; Abide Consents to Fraud Injunction and Agrees to Pay Disgorgement, Prejudgment Interest and Civil Money Penalties, Litigation Release No. 19,776 (July 27, 2006) (announcing SEC settlement with former WorldCom Director of Property Accounting for charges including insider trading and imposing $57,947 (plus interest) in disgorgement and a penalty of $57,947), *available at* http://www.sec.gov/litigation/litreleases/2006/lr19776.htm.

A separate provision of the Remedies Act enabled the SEC to seek money penalties against certain entities and individuals through an SEC administrative proceeding. Again, the Act established a three-tier penalty structure with maximum penalties for each "act or omission" that increase as the conduct becomes more culpable.[60] The statute directs the administrative law judge to decide whether to impose a money penalty (and in what amount) by determining, with reference to six permissive factors, whether imposition of money penalties would further the "public interest."[61]

The Remedies Act included no provision dealing directly with investor compensation, or suggesting that investor compensation was or should be a goal of the Commission. As noted above, the Act directed that penalties be paid to the U.S. Treasury.[62] In addition, while disgorgement—the traditional source of SEC-distributed investor compensation—continued to be available,[63] the legislative history emphasized that disgorgement was aimed at deterrence, not compensation. The House Report stated: "In contrast to damages granted in private actions, which are designed to compensate the victims of a violation, disgorgement 'is a method of forcing a defendant to give up the amount by which he was unjustly enriched.'"[64]

Investor harm under the Remedies Act was simply a factor that helped judges or the agency gauge the egregiousness of the violation, the culpability of the conduct and actor, and the social harm that needed to be deterred. So, for example, one of the factors ALJs may consider when deciding whether money penalties would be "in the public interest" is the harm to other people resulting from the act or omission.[65] When the SEC seeks money penalties in federal district court, similar judicially developed factors include "whether defendants' conduct created substantial losses or the risk of substantial losses to other persons."[66]

60. 15 U.S.C. § 78u-2(b) (2006); *see also* 17 C.F.R. § 201.1002 (2008) (calling for the adjustment of civil monetary penalties for inflation pursuant to the Debt Collection Improvement Act of 1996).

61. 15 U.S.C. § 78u-2(c) (2006).

62. *See* Remedies Act, Pub. L. No. 101-429, § 101, 104 Stat. 931 (1990) (codified as amended at 15 U.S.C. § 77t (d)(3)(A) (2006)).

63. SEC v. DiBella, 409 F. Supp. 2d 122, 131–32 (D. Conn. 2006) (rejecting a challenge to the SEC's pre-Sarbanes-Oxley power to seek disgorgement and reviewing the legislative history). *See generally* Comm. on Fed. Regulation of Secs., *supra* note 43, at 1097, 1118 & n.178 (arguing that the legislative history of the Remedies Act supports the survival of these remedies).

64. H.R. REP. 101-616, at 31 (1990), *reprinted in* 1990 U.S.C.C.A.N. 1379, 1389.

65. 15 U.S.C. § 78u-2(c) (2006). Other factors are whether the act or omission "involved fraud, deceit, manipulation, or deliberate or reckless disregard of a regulatory requirement;" the extent of unjust enrichment, "taking into account any restitution made to persons injured by such behavior;" whether the person has previously violated federal or state securities laws or rules of a self-regulatory organization; "the need to deter such person and other persons from committing such acts or omissions;" and "such other matters as justice may require." *Id.*

66. SEC v. Lybrand, 281 F. Supp. 2d 726, 730 (S.D.N.Y. 2003). The Remedies Act directs

In sum, under the Remedies Act before passage of the Fair Fund provision, disgorgement continued to be the main source of investor compensation obtained by the SEC, while money penalties were directed to the U.S. Treasury and served the traditional purpose of deterrence.

C. *The Sarbanes-Oxley Fair Fund Provision*

Courts and Congress had described the Remedies Act penalty power in terms of the traditional goals of civil fines: "punishment of the individual violator and deterrence of future violations."[67] The passage of the Sarbanes-Oxley Act of 2002 brought a new twist, changing the disposition of the money penalties so that the penalties began to serve the dual purpose of deterring potential violators of the securities laws and compensating harmed investors. Whereas until then any civil money penalties had been required to be paid into the U.S. Treasury,[68] the Fair Fund provision of Sarbanes-Oxley allowed penalties paid in enforcement actions to be added to disgorgement funds and paid to the injured investors:

> Civil penalties added to disgorgement funds for the relief of victims. If in any judicial or administrative action brought by the Commission under the securities laws . . . the Commission obtains an order requiring disgorgement against any person for a violation of such laws or the rules or regulations thereunder, or such person agrees in settlement of any such action to such disgorgement, and the Commission also obtains pursuant to such laws a civil penalty against such person, the amount of such civil penalty shall, on the motion or at the direction of the Commission, be added to and become part of the disgorgement fund for the benefit of the victims of such violation.[69]

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courts to determine a civil penalty "in light of the facts and circumstances" of the particular case. 15 U.S.C. § 78u(d)(3)(B)(i) (2006). General factors that courts look to in imposing those penalties include "(1) the egregiousness of the violations at issue; (2) defendants' scienter; (3) the repeated nature of the violations; (4) defendants' failure to admit to their wrongdoing; (5) *whether defendants' conduct created substantial losses or the risk of substantial losses to other persons*; (6) defendants' lack of cooperation and honesty with authorities, if any; and (7) whether the penalty that would otherwise be appropriate should be reduced due to defendants' demonstrated current and future financial condition." *Lybrand*, 281 F. Supp. 2d at 730 (emphasis added).

67. SEC v. Moran, 944 F. Supp. 286, 296 (S.D.N.Y. 1996); *see also* SEC v. Credit Bancorp, Ltd., No. 99 Civ. 11395, 2002 WL 31422602, at *3–4 (S.D.N.Y. Oct. 29, 2002); SEC v. Coates, 137 F. Supp. 2d 413, 428 (S.D.N.Y. 2001); SEC v. Kenton Capital Ltd., 69 F. Supp. 2d 1, 17 (D.D.C. 1998).

68. *See* Remedies Act, Pub. L. No. 101-429, § 101, 104 Stat. 931 (1990) (codified as amended at 15 U.S.C. § 77t (d)(3)(A) (2006)).

69. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 308, 116 Stat. 745 (codified as amended at 15 U.S.C. § 7246(a) (2006)).

The Commission decides at its discretion whether penalties are used to compensate investors: the Fair Fund provision directs that money penalties "shall" be added to a disgorgement fund for distribution to injured investors "on the motion or at the direction of the Commission."[70] In one way, the provision is fairly broad in its reach, as it can be invoked in judicial or administrative actions,[71] whether resolved in an order or settlement, and the provision does not distinguish between penalties against individuals and entities.[72] A penalty amount may be distributed to investors, however, only if ordered against a defendant against whom there is also a disgorgement order—a disgorgement order against a co-defendant does not suffice.[73] As the SEC and commentators have pointed out, this prerequisite may limit investor compensation by preventing distribution in cases where disgorgement is inappropriate;[74] for instance, when an issuer commits financial fraud but does not profit from it.[75] To an extent, though, this result may be avoided by ordering nominal disgorgement in addition to penalties, as SEC internal guidance seems to advocate.[76]

The Commission has announced that it will distribute the money to injured investors whenever possible,[77] although it may choose to direct penalties to the U.S. Treasury when penalties are small in comparison to

70. *Id.*

71. The SEC is responsible for monitoring all Fair Funds, regardless of whether they are created through administrative or judicial proceedings. *See* U.S. GOV'T ACCOUNTABILITY OFFICE, REP. NO. GAO-07-830, SEC: ADDITIONAL ACTIONS NEEDED TO ENSURE PLANNED IMPROVEMENTS ADDRESS LIMITATIONS IN ENFORCEMENT DIVISION OPERATIONS 14 (2007), *available at* http://www.gao.gov/new.items/d07830.pdf [hereinafter GAO REPORT 1].

72. *Id.* at 13.

73. *See* Cox & Thomas, *supra* note 12, at 754.

74. *See id.*; Fair Fund Report, *supra* note 32, at 34 (noting the disgorgement prerequisite and recommending that the Fair Fund provision be amended either "to permit the Commission to use penalty monies ordered in a particular manner for distribution to injured investors in that matter regardless of whether disgorgement was ordered . . . or . . . to permit the Commission to apply penalties paid by any defendant in a case to a disgorgement fund if at least one defendant in the same or related case was ordered to pay disgorgement").

75. *See* Fair Fund Report, *supra* note 32, at 34 (giving the example of SEC v. Acacio, Litigation Release No. 17,292 (Jan. 2, 2002), *available at* http://www.sec.gov/litigation/litreleases/lr17308.htm).

76. According to the General Accounting Office, internal SEC guidance recommends seeking such nominal disgorgement to trigger the Fair Fund provision. *See* U.S. GOV'T ACCOUNTABILITY OFFICE, REP. NO. GAO-05-670, SEC AND CFTC PENALTIES: CONTINUED PROGRESS MADE IN COLLECTION EFFORTS, BUT GREATER SEC MANAGEMENT ATTENTION IS NEEDED 28 (2005), *available at* http://energycommerce.house.gov/Press_109/109-GAO-05-670.pdf [hereinafter GAO REPORT 2].

77. *E.g.*, Fair Fund Report, *supra* note 32, at 22 ("The Commission intends to use the provision whenever reasonably possible, consistent with its mission to protect investors."); *see also* 72 SEC ANN. REP. 6 (2006); 71 SEC ANN. REP. 4, 58 (2005).

the number of injured investors.[78] This policy continues the pre-Fair Funds practice of directing disgorgement amounts to the U.S. Treasury rather than to injured investors based on a similar calculation of economic feasibility.[79]

The practical effect of the provision depends on how the SEC elects to exercise its discretion. The amount investors recover under the Fair Fund provision depends further on two sets of choices made by the agency: (1) the size of the penalties and (2) whether the money is offset against private recoveries or cumulative with private recoveries. Why penalty amounts matter is straightforward. When distributed to injured investors, higher penalties reduce losses more than lower ones. Moreover, small penalties may not be used for compensation because distribution is not cost-effective.

Rules about offsets determine how much the investors recover from a defendant where private and public actions are brought based on substantially the same violations. Take, for example, the actions against McAfee. McAfee was a computer software company that settled with the SEC to charges of overselling its product to distributors, secretly paying them to hold the extra inventory, and sometimes using a wholly-owned subsidiary to repurchase the excess from distributors.[80] A private action against McAfee settled for $70 million, and an SEC action imposed a $50-million penalty, which the agency earmarked for distribution to investors.[81] Whether the two figures are combined or offset makes a big difference in what the injured investors recover—their portion of $120 million (if combined) or $70 million (if offset). Since the Fair Fund provision, some consent decrees include a provision in which settling companies agree not to offset penalty amounts paid to the SEC against damages paid out by the defendant in any related private actions.[82] Under

78. *See* Adoption of Amendments to the Rules of Practice and Delegations of Authority of the Commission, Exchange Act Release No. 34-49412, 66 Fed. Reg. 13,166, 13,173 (Mar. 12, 2004) ("Allowing monies that otherwise would go into a Fair Fund to be paid to the Treasury where investors would receive only *de minimis* distributions will prevent those monies from being consumed by administrative costs, although at a cost to victims who might have received a minimal payment from a Fair Fund."); *It's Only Fair: Returning Money to Defrauded Investors: Hearing Before the Subcomm. on Capital Markets, Insurance, and Government Sponsored Enterprises Before the H. Comm. on Financial Services*, 108th Cong. 10 (2003) [hereinafter *It's Only Fair*] (statement of Rep. Richard H. Baker, Chairman, Subcomm.) ("At the current time, if the award or penalty is small in relation to the number of investors and it is not practical to make a meaningful distribution, money still is returned to the treasury, as opposed to being used internally.").

79. *See* Fair Fund Report, *supra* note 32, at 14.

80. SEC v. McAfee, Inc., SEC Sues McAfee, Inc. for Accounting Fraud, McAfee Agrees to Settle and Pay a $50 Million Penalty, Litigation Release No. 19,520 (Jan. 4, 2006), *available at* http://www.sec. gov/litigation/litreleases/lr19520.htm.

81. *See id.*; *see also* Settlement Notice, *In re* Network Assocs., Inc. II Secs. Litig., No. CV-00-4849-MJJ (N.D. Ca. 2001), *available at* http://scas.issproxy.com/pdf/27416-12475set.pdf.

82. *See, e.g.*, *In re* Nevis Capital Mgmt., LLC, Order Making Findings and Imposing

this offset rule, injured investors in the McAfee example would receive a portion of $120 million rather than of $70 million.

As the Commission has pointed out, the legislative history of the Fair Fund provision is "scant."[83] It was added to the bill during the conference process, apparently proposed by Representative Richard Baker, Republican of Louisiana, and co-sponsored by Representative Michael Oxley, Republican of Ohio.[84] The function of the Fair Fund provision—to permit the SEC to make another category of monetary relief available for distribution to injured investors—and the text's reference to "the relief of victims" indicate that its purpose was to compensate injured investors.[85] Another section of the Fair Fund provision is more explicit about this goal. Part of the provision required the SEC to study five years of enforcement actions to identify when these actions might be used to "efficiently, effectively and fairly provide restitution for injured investors" and to analyze other methods to further the aim of investor restitution.[86] The provision directed the SEC to use its findings "to revise its rules and regulations as necessary" and suggest legislative or regulatory action that would address its concerns.[87] The resulting report reiterated that "[r]eturning funds to investors is an important Commission objective."[88]

The goals of investor compensation were even more prominently featured in proposed follow-on legislation: The Securities Fraud Deterrence and Investor Restitution Act of 2003.[89] This bill was introduced in the House in May 2003 by Representative Baker and five co-sponsors, including Representative Oxley,[90] but never became law. Apart from its

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Remedial Sanctions and Cease-and-Desist Order, Investment Advisers Act Release No. 2,214, at 10 (Feb. 09, 2004) (The respondent agreed not to "benefit from any offset or reduction of any investor's claim by the amount of any Fair Fund distribution to such investor in this proceeding that is proportionally attributable to the civil penalty paid by [the] Respondent" and to pay the Treasury or a Fair Fund any offsets or reductions granted by a court in a private action.); *In re* Banc of Am. Secs. LLC, Exchange Act Release No. 55,466, at 16 (Mar. 14, 2007).

83. Statement of the Securities & Exchange Commission Concerning Financial Penalties, SEC News Release, (Jan. 4, 2006), *available at* http://www.sec.gov/news/press/2006-4.htm.

84. 2 JOHN T. BOSTELMAN, THE SARBANES-OXLEY DESKBOOK § 26:3.2, at 26-9 (Practising Law Institute 2003) (citing Harvey L. Pitt, Chairman, Secs. and Exch. Comm'n, Speech by SEC Chairman: Remarks before the U.S. Department of Justice Corporate Fraud Conference (Sept. 26, 2002), *available at* www.sec.gov/news/speech/spch585.htm); Press Release, House Comm. on Fin. Services, Baker Proposes FAIR Account to Return Funds to Defrauded Investors (July 17, 2002), http://financialservices.house.gov/news.asp?FormMode=release&id=151.

85. 15 U.S.C. § 7246(a) (2006).

86. *Id.* § 7246(c).

87. *Id.*

88. Fair Fund Report, *supra* note 32, at 36.

89. Securities Fraud Deterrence and Investor Restitution Act of 2003, H.R. 2179, 108th Cong. (2003), *available at* http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=108_cong_bills&docid=f:h2179ih.txt.pdf.

90. The co-sponsors in addition to Representative Oxley were Representatives Sue Kelly, Doug Ose, David Scott, and Patrick Tiberi. *See id.*

controversial provisions preempting some state regulation,[91] the bill proposed increasing penalty amounts ten-fold and endorsed many of the revisions to the Fair Fund provision that the SEC had proposed in the Fair Fund Report.[92]

Implementation of the Fair Fund program has not been easy. For instance, the General Accounting Office has repeatedly reported that distribution of funds under the Fair Fund provision has been limited and that the SEC Enforcement division had "not developed adequate systems and data to fulfill its oversight responsibilities."[93] Nonetheless, the Fair Fund provision has increased the amounts the SEC can distribute to compensate investors by allowing penalties as well as disgorged profits to be used.[94]

The SEC collected approximately $8 billion in disgorgement and penalties in the first five years the provision was in effect.[95] In 2007, the SEC distributed $176.8 million to the Treasury and $580.5 million to injured investors.[96] As of June 2007, $1.8 billion of the $8.4 billion ordered since 2002 had been distributed.[97] As of June 2008, the SEC had

91. *See id.* (identifying "State Attorneys Limitation of Power bill" as an alternative "popular" title); *see also The Securities Fraud Deterrence and Investor Restitution Act of 2003: Hearing on H.R. 2179 Before the Subcomm. on Capital Markets, Insurance, and Government Sponsored Enterprises of the H. Comm. on Financial Servs.*, 108th Cong. (2003); Christopher R. Lane, *Halting the March Toward Preemption: Resolving Conflicts Between State and Federal Securities Regulators*, 39 NEW ENG. L. REV. 317, 318–19 (2005) (describing the controversy over the bill); Gretchen Morgenson, *Bill to Limit Oversight of Wall St. Gains*, N.Y. TIMES, July 11, 2003, at C2.

92. For instance, it proposed eliminating the requirement that the penalty be obtained against the same defendant against whom disgorgement was ordered, and eliminating the need for separate actions for money penalties and cease-and-desist orders. Securities Fraud Deterrence and Investor Restitution Act of 2003, H.R. 2179, 108th Cong. (2003), *available at* http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=108_cong_bills&docid=f:h2179ih.txt.pdf.

93. GAO REPORT 2, *supra* note 71, at 2. *See generally* GAO REPORT 1, *supra* note 76.

94. *See* Fair Fund Report, *supra* note 32, at 1 ("[T]he Fair Fund provision should increase the funds available to investors injured as a result of violations of the federal securities laws."). Disgorgement too continued to be an option after the enactment of the Fair Fund provision, as suggested by the provision's reference to the continuing existence of disgorgement orders and disgorgement funds (to which penalty amounts may be added). Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 308, 116 Stat. 745 (codified as amended at 15 U.S.C. § 7246 (2006)). Furthermore, the statute explicitly authorized the Commission to seek "any equitable relief"—presumably including disgorgement—"that may be appropriate or necessary for the benefit of investors." 15 U.S.C. § 78u(d)(5) (2006) (authorizing equitable relief "[i]n any action or proceeding brought or instituted by the Commission under any provision of the securities laws").

95. 73 SEC ANN. REP. 26 (2007), *available at* http://www.sec.gov/about/secpar/secpar2007.pdf.

96. *Id.* at 18. The same year, the SEC ordered approximately $1.6 billion in disgorgement and penalties. *See* OFFICE OF MGMT. & BUDGET, SEC PERFORMANCE BUDGET FOR FISCAL YEAR 2008, 157, *available at* http://www.sec.gov/about/2008budgetperform.pdf [hereinafter 2008 BUDGET].

97. GAO REPORT 2, *supra* note 76, at 5.

distributed more than $3.9 billion.[98] Although the difficulties of collection[99] and distribution mean that not all funds designated for injured investors will reach them, these figures suggest that the amounts have the potential to be quite high.

After the passage of the Fair Fund provision, the SEC may distribute all of the money it collects, whether as disgorgement or money penalties, to injured investors. As compensation emerges as a potentially important part of the SEC's role, the functions of the private attorney general and the public class counsel increasingly overlap.

IV. DOES INVESTOR COMPENSATION EVER MAKE SENSE?

The concept of the private attorney general, as Jack Coffee has pointed out, is at its core a way of asking "to what extent can we sensibly rely on private litigation as a mechanism of law enforcement?"[100] The concept of public class counsel raises a parallel policy issue: to what extent can we sensibly rely on public enforcement as a mechanism of victim compensation? This Part of the Article and the next address two questions that arise about compensation: first, whether compensating injured investors is ever a worthwhile goal and, second, if so, which entity or mechanism should be used to obtain compensation.

To answer these questions, it is useful to identify the types of actions that could give rise to a monetary penalty. The Fair Fund provision does not differentiate among types of payors or actions. It provides that, when the SEC obtains a penalty against a person, "the amount of such civil penalty shall, on the motion or at the direction of the Commission, be added to and become part of the disgorgement fund for the benefit of the victims of such violation."[101] The Remedies Act, which established the SEC's broad power to impose civil monetary penalties, gave the SEC penalty authority that reached most violators of the securities laws.[102] The consequence of the Fair Fund provision and the broad penalty authority read together is that almost any violator of the securities laws could be the source of a money penalty distributed through a Fair Fund.[103]

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98. Press Release, SEC, SEC Announces $26 Million Fair Fund Distribution in Banc of America Securities LLC Settlement (June 23, 2008), http://www.sec.gov/news/press/2008/2008-118.htm.

99. For instance, 55% of disgorgement and penalties ordered was collected in 2007 and 88% was collected in 2006, although the percentage varies widely from year to year. 73 SEC ANN. REP. 30 (2007), *available at* http://www.sec.gov/about/secpar/secpar2007.pdf.

100. Coffee, *supra* note 17, at 218.

101. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 308, 116 Stat. 745 (codified as amended at 15 U.S.C. § 7246 (2006)). There must also be an order of disgorgement against the person. *Id.*

102. *See* 15 U.S.C. § 77t(d)(1) (2006) (reaching violators of the securities acts, the "rules or regulations thereunder" or a cease-and-desist order). *See generally* Morris, *supra* note 52.

103. A strict reading of the language of the Fair Fund provision suggests that cases in which

The key distinction for addressing whether compensation of injured investors makes sense is between issuers that cause harm in the secondary market for their stocks, and other securities law violators. In the secondary-market example, the investor purchases stock from another shareholder in the secondary market and alleges that the issuer's misleading statement or omissions caused the price to be inflated.[104] Many of the highest-profile cases fall into this category. In fact, this type of violation motivated the passage of Sarbanes-Oxley. Enron and WorldCom involved issuer fraud and reporting violations in which the gain to the defendant was a small portion of the amount of losses caused to investors.

This Part examines two critiques of compensation that apply both to private attorneys general and to the SEC and other public actors. After addressing the problem of low investor recovery, it turns to the concern that the notion of compensation as a transfer from a wrongdoer to a victim often does not hold when corporations and their shareholders are involved.[105] Both critiques apply with most force in the issuer context.

A. *Low Investor Recovery*

The SEC has characterized the Fair Fund provision as "an innovative device that the Commission intends to use to return more funds to investors."[106] Returning more money to investors should not be confused with making investors whole, however. As the Commission has reported, in many cases, penalties "reduce," but do not eliminate, "losses to injured

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no one was unjustly enriched and, accordingly, no disgorgement order is appropriate, should not give rise to distributions under the Fair Fund provision. *See* § 308 of Sarbanes-Oxley (codified as amended at 15 U.S.C. § 7246 (2006)) ("If . . . the Commission obtains an order requiring disgorgement . . . and the Commission also obtains pursuant to such laws a civil penalty against such person, the amount of such civil penalty shall . . . become part of the disgorgement fund."). So, although almost any securities law violator may be the source of a money penalty, a violation where an individual made no profit may not give rise to disgorgement, and thus Fair Funds may not be triggered. The disgorgement requirement may not impose significant limits, however, because most SEC matters are settled. *See, e.g.*, U.S. Gov't Accounting Office, Rep. No. GAO-03-138, Financial Statement Restatements: Trends, Market Impacts, Regulatory Responses, and Remaining Challenges (2002), *available at* http://www.gao.gov/new.items/d03138.pdf; U.S. Gov't. Accounting Office, Rep. No. GAO-06-678, Financial Restatements: Update of Public Company Trends, Market Impacts, and Regulatory Enforcement Activities (2006), *available at* http://www.gao.gov/new.items/d06678.pdf [hereinafter GAO REPORT 3]. Treating these consent decrees as contracts, courts often respect the monetary relief agreed to by the parties, regardless of whether it complies with the statutory language and regardless of the difficulties of showing the appropriateness of disgorgement in an adjudicated matter. *See, e.g.*, SEC v. Levine, 881 F.2d 1165, 1178–79 (2d Cir. 1989).

104. *See* John C. Coffee, *Reforming the Securities Class Action: An Essay on Deterrence and its Implementation*, 106 COLUM. L. REV. 1534, 1556 (2006).

105. *See* Paul Rose, *The Corporate Governance Industry*, 32 J. CORP. L. 887, 889 (2007).

106. Fair Fund Report, *supra* note 32, at 36.

parties."[107] In particular, investor fraud and reporting cases "may cause investor losses that dwarf, by several orders of magnitude, any profit that the violators may have made."[108] These actions, like private securities class actions, return a small percentage of the losses to investors.[109]

WorldCom is an apt example of an issuer fraud that caused investor harm far exceeding the penalty amounts. The district court estimated the loss to shareholders as $200 billion.[110] In the action brought by the SEC, the court imposed a money penalty of $2.25 billion, which was ultimately reduced to $750 million in bankruptcy.[111] To explain why injured investors recovered only a small percentage of their losses—listed (unsurprisingly) among the "Frequently Asked Questions"on the claims website—the fund administrator told claimants that "investors lost money in WorldCom's fraud on a vast and unprecedented scale," including "more than $145 billion on WorldCom stock alone and tens of billions more on bonds and other securities."[112] According to the fund administrator, the $750 million penalty, although "a very significant amount," allowed payment to victims of "only a fraction of the total eligible losses."[113] To be more precise, injured investors recovered only 5.5% to 6% of their losses.[114]

Investors recover low percentages of their losses in both private and public actions. Whether they receive more in one or the other depends in part on sheer amounts and in part on costs, an issue that the next Part addresses. In the private securities class action, the median investor recovery in 2007 was only 2.4% of investor losses.[115] In some of the major

107. 2008 BUDGET, *supra* note 96, at 157; *see also* Adoption of Amendments to the Rules of Practice and Delegations of Authority of the Commission, Exchange Act Release No. 34-49412, 66 Fed. Reg. 13,166, 13,173 (Mar. 12, 2004) (stating that, under the Fair Fund provision, investors "are *more likely* to be made whole") (emphasis added); Cox & Thomas, *supra* note 12, at 755–56 ("It is unlikely that profit disgorgements generated by the Fair Fund provision can be expected to displace private recoveries in many situations . . . . Even though these [penalty and disgorgement] sums can be considerable, . . . this amount can pale when compared to the harm proximately caused by the defendants' violation.").

108. Fair Fund Report, *supra* note 32, at 20–21.

109. *See generally* GAO REPORT 3, *infra* note 103, at 162.

110. SEC v. WorldCom, Inc., 273 F. Supp. 2d 431, 431 (S.D.N.Y. 2003).

111. Final Judgment as to Monetary Relief at 2, SEC v. WorldCom, Inc., 452 F. Supp. 2d 531 (S.D.N.Y. 2006) (No. 02-CV-4963), *available at* http://www.sec.gov/spotlight/worldcom/wcjudg070703.pdf.

112. WorldCom Victim Trust, http://www.worldcomvictimtrust.com (providing an official website for the SEC's program to distribute the proceeds of the WorldCom case to investors) (last visited Sept. 19 , 2008).

113. *Id.* (noting, as of September 2008, that the administrator had completed claims with eligible losses of more than $12 billion).

114. *Id.*

115. Stephanie Plancich et al., Nat'l Econ. Research Assocs., Recent Trends in Shareholder Class Actions: Filings Return to 2005 Levels as Subprime Cases Take Off; Average Settlements Hit New High 14 (2007), http://www.nera.com/image/BRO_Recent_Trends_12-07_web_3_

scandals where both private and public actions were brought, private damages were several times greater than the public penalty.[116]

At first glance, the explanation for lower public recoveries seems to lie in statutory limits on SEC penalty amounts. The Remedies Act formally caps the penalties at $50,000, $250,000, and $500,000 for entities at the three tiers. However, these caps are unlikely to impose a meaningful limit on public recoveries for at least three reasons. First, under the Remedies Act, one possible measure of the maximum penalty for an action in federal court is the "gross amount of pecuniary gain."[117] In some cases the maximum may be so high that it provides little practical limit to the penalty that the agency might seek or impose.[118] Second, even when gross pecuniary gain is not the measure, the tiered penalties in the Remedies Act are maximums per "violation," a key term that the statute does not define.[119] Large penalties may be justified by arguing that massive frauds within large, complex entities result in many violations. In fact, commentary by the SEC staff—although not representing agency policy—called the per-violation penalty a "formula[] that, when applied to widespread misconduct, can result in billion-dollar-plus penalties in mega-financial fraud cases."[120] Third, most SEC enforcement actions are resolved through consent decree.[121] Although settlements of civil court

FINAL.pdf (finding that the median investor recovery, calculated by comparing settlement amounts to investor losses, was 3.1% in 2005, 2.4% in 2006, and 2.1% in 2007, and noting that settlement size has increased, but the percentage of investor recovery has decreased). This figure overstates the percentage, as it is calculated before any costs of distribution and other costs are deducted from the settlement amount. *See also* Coffee, *supra* note 104, at 1545.

116. Coffee, *supra* note 104, at 1543 tbl.3.

117. *See* Remedies Act, Pub. L. No. 101-429, § 101, 104 Stat. 931 (1990) (codified as amended at 15 U.S.C. § 77t (2006)); *see also* S. REP. NO. 101-337, *supra* note 27, at 10 (explaining that gross pecuniary gain meant the "amount by which the defendant was unjustly enriched as a result of the violation").

118. WorldCom was one such case. The district court estimated the maximum penalty in that case was $10 to $17 billion, the amount "that the company [had] gained from its fraud." SEC v. WorldCom, Inc., 273 F. Supp. 2d 431, 434 (S.D.N.Y. 2003).

119. The closest the statute comes to defining "violation" is in the context of a cease-and-desist order, but this passage is unhelpful because it adds the additional concept of "offense." *See* 15 U.S.C. § 78u(d)(3)(D) (2006) ("In an action to enforce a cease-and-desist order entered by the Commission . . . each separate violation of such order shall be a separate offense, except that in the case of violation through a continuing failure to comply with such an order, each day of the failure to comply with the order shall be deemed a separate offense."). *See generally* 25 MARC I. STEINBERG & RALPH C. FERRARA, SECURITIES PRACTICE: FEDERAL AND STATE ENFORCEMENT § 6:9 n.7 (2d ed. 2001).

120. Barry W. Rashkover, Comment, *Reforming Corporations Through Prosecution: Perspectives from an SEC Enforcement Lawyer*, 89 CORNELL L. REV. 535, 537 (2004).

121. GAO REPORT 3, *supra* note 103, at 162 (noting that most SEC enforcement cases settle); Arthur B. Laby & W. Hardy Callcott, *Patterns of SEC Enforcement Under the 1990 Remedies Act: Civil Money Penalties*, 58 ALBANY L. REV. 5, 21 (1994); Harvey J. Goldschmid, *Report in Support of Recommendation 72-6: An Evaluation of the Present and Potential Use of Civil Money Penalties*

cases must be approved by the federal district court as "fair, reasonable, and adequate," deferential standards of review apply.[122] Moreover, courts often respect the contractual terms to which the parties have agreed, regardless of whether the relief complies with the statutory language.[123] So we have to look elsewhere for an explanation of the lower public recoveries, perhaps to political constraints or budgetary limitations on the SEC.

Particularly in issuer fraud and reporting cases, low investor recovery brings into question the compensatory rationale for actions brought by both private attorneys general and public class counsel. It may have more force as a critique of the SEC because historically the agency has had lower recoveries than its private counterparts.

B. *The Circularity Critique*

Whether investor compensation ever makes sense depends not only on the amount of recovery, but also on the source of the compensation. For the SEC, the answer depends on the source of SEC-imposed monetary penalties.

The Enron and WorldCom matters are well-known and heavily litigated examples of the "issuer" or "secondary market" case, but they are only the most prominent of a whole category of actions. One of many other examples is ConAgra Foods, Inc., which agreed to pay a $45-million penalty to the SEC to settle charges that it had engaged in improper accounting practices.[124] The SEC has announced its intention to distribute this penalty through a Fair Fund to injured investors—investors who engaged in secondary-market transactions that were affected by the

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as a Sanction by Federal Administrative Agencies, *in* 2 RECOMMENDATIONS AND REPORTS OF THE ADMINISTRATIVE CONFERENCE OF THE UNITED STATES 896, 899 (July 1, 1970–Dec. 31, 1972), *quoted in* William H. Lawrence, *Judicial Review of Variable Civil Money Penalties*, 46 U. CIN. L. REV. 373, 374 n.2 (1977).

122. *See, e.g.*, *WorldCom*, 273 F. Supp. 2d at 436 ("A Court reviews such a settlement proposal not on the basis of what it might itself determine is the appropriate penalty but on the basis of whether the settlement is fair, reasonable, and adequate . . . . Moreover, where one of the settling parties is a public agency, its determinations as to why and to what degree the settlement advances the public interest are entitled to substantial deference." (internal citations omitted)); 1 KENNETH B. WINER & SAMUEL J. WINER, SECURITIES ENFORCEMENT: COUNSELING AND DEFENSE § 17.08 (2007).

123. SEC v. Levine, 881 F.2d 1165, 1178–79 (2d Cir. 1989) ("A consent judgment, though it is a judicial decree, is principally an agreement between the parties [and, as such,] 'should be construed basically as contracts, *without reference to the legislation the Government originally sought to enforce* but never proved applicable through litigation.'" (emphasis added) (quoting United States v. ITT Continental Baking Co., 420 U.S. 223, 236–37 (1975))).

124. SEC v. ConAgra Foods, Inc., SEC Charges ConAgra Foods, Inc. in Financial Fraud and Accounting Case, ConAgra Agrees to Pay $45 Million Penalty to Settle Charges, Litigation Release No. 20,206 (July 25, 2007), http://www.sec.gov/litigation/litreleases/2007/lr20206.htm.

issuer's misstatements.[125] The issuer case can be contrasted with SEC penalties imposed on others, including individuals such as officers, directors, and third parties such as accountants, lawyers, and banks.

The distinction between the issuer case and others is important because it has become conventional wisdom among securities law scholars that compensation from an issuer does not make sense because of a circularity problem. When a corporation pays compensation, the current shareholders indirectly bear the costs; the compensation goes to holders of shares within the time period in which material misinformation allegedly affected the market.[126] Accordingly, compensation in these circumstances amounts to a wealth transfer between shareholders, none of whom is culpable.[127] Furthermore, diversified investors may both receive and pay compensation because they are current shareholders (paying the penalty) and also were shareholders during the relevant period (receiving compensation, minus administrative costs).[128] Finally, in the aggregate, diversified investors are not harmed: they are just as likely to gain from fraud as to lose from fraud.[129] This circularity critique of compensation is not limited to the public class counsel context (that is, when a public entity obtains compensation). Instead it reaches any action to compensate victims of securities fraud in the secondary market, and, in fact, has been articulated primarily in the context of private securities class actions.

Although evaluating this accepted wisdom is beyond the scope of this Article,[130] this Article does reach the issue of whether, despite the circularity critique, the SEC is an appropriate mechanism even in the secondary-market case. It does so in part because compensation for

125. *Id.*

126. *Coffee*, *supra* note 104, at 1556–57.

127. *Id.*

128. *Id*. at 1558.

129. *See, e.g.*, Janet Cooper Alexander, *Rethinking Damages in Securities Class Actions*, 48 STAN. L. REV. 1487, 1502 (1996); Donald C. Langevoort, *On Leaving Corporate Executives "Naked, Homeless and Without Wheels": Corporate Fraud, Equitable Remedies, and the Debate Over Entity Versus Individual Liability*, 42 WAKE FOREST L. REV. 627, 633 (2007) [hereinafter Langevoort, *Corporate Executives*] ("For diversified, active investors, the gains and losses will . . . tend to net out over time" because an investor has "roughly the same likelihood of being the lucky beneficiary of a fraud as its victim."); Letter from Donald C. Langevoort, Thomas Aquinas Reynolds Professor of Law, Georgetown Univ. Law Ctr., to Christopher Cox, Chairman, U.S. Secs. and Exch. Comm'n (Aug. 2, 2007), *available at* http://fortunelegalpad.files.wordpress.com/2007/11/chairman-cox-sec-letter.pdf [hereinafter Langevoort, Letter].

130. Some recent commentators have contradicted the accepted wisdom, offering reasons that some investors, both diversified and undiversified, actually suffer compensable losses. *See* Alicia Davis Evans, *The Investor Compensation Fund*, 33 J. CORP. L. 223, 225 (2007). Others have suggested that compensation may be appropriate in special circumstances—for instance, where the Enron employees were urged to invest all of their retirement funds, undiversified, in Enron stock. Langevoort, *Corporate Executives*, *supra* note 129, at 634–35.

investor losses seems to be a political reality unlikely to be eliminated.[131] The Fair Fund provision's history and the rhetoric surrounding its passage support this conclusion. Nowhere is the goal of compensation questioned; instead, supporters of the legislation framed it as an issue of fairness. When describing the purpose of the Fair Fund provision, Representative Baker likened the payment of SEC money penalties into the U.S. Treasury to "the call to the sheriff's office when you report your car stolen, the sheriff calls you back two days later and says, 'Good news, we found the car; bad news is, I am keeping it.'"[132] Representative Kelly likewise appealed to basic fairness: "By establishing that fund, we said that wrongdoers are going to be punished and that every effort is to be made to make the people who have been victimized whole."[133]

Moreover, even if the conventional wisdom were correct that compensation of injured investors by issuers is rarely an appropriate independent goal, that concession does not end the analysis of whether the Fair Fund provision and, through it, the assignment to the SEC of a public class counsel function are socially useful for some other reason. For instance, the provision arguably enhances deterrence by making large penalties more palatable because injured investors are their beneficiaries. Here the analogy to the private attorney general holds: as some scholars and lawmakers have discarded or questioned the compensatory rationale for private securities class actions, deterrence has emerged as a possible justification.[134] Finally, and most significantly, penalties obtained from issuers are not the only possible source of Fair Funds. Fair Funds can be created from money penalties gathered from any violator of the securities laws, as long as disgorgement is also ordered. In other words, penalties imposed on individuals (e.g., officers or directors) and third parties (e.g., banks) are also eligible for distribution to injured investors. Compensation funded by penalties against individuals gives rise to less of a concern with circularity because the penalties transfer wealth from the culpable to the victim. This point reduces but does not eliminate the concern with circularity because the existence of indemnification and insurance often means that the corporation bears the costs of actions and penalties against individuals, either through indemnification or through higher insurance premiums.[135]

131. On this point, I agree with Professor Alicia Davis Evans that "as a practical matter, political exigencies make achieving the end of shareholder compensation in the post-Enron era unlikely" and that, accordingly, "what is most appropriate . . . is an exploration of ways to provide compensation more effectively and efficiently." Evans, *supra* note 130, at 225–26.

132. *It's Only Fair*, *supra* note 78, at 1 (statement of Rep. Richard H. Baker).

133. *Id.* at 3 (statement of Rep. Sue W. Kelly).

134. *See* Jill E. Fisch, *Class Action Reform, Qui Tam, and the Role of the Plaintiff*, 50 LAW & CONTEMP. PROBS. 167, 174–75 (1997); Langevoort, *Corporate Executives*, *supra* note 129, at 628–29 & nn.7–8.

135. *See, e.g.*, Coffee, *supra* note 104, at 1569–70.

Fair Funds might also be funded through recoveries from third parties, such as banks[136] and consultants or auditors.[137] Using penalties imposed on aiders and abettors as the source of Fair Funds reduces the concern about the circularity critique because actions against aiders and abettors are essentially suits against third parties.[138] Unlike penalties against an issuer in the secondary-market context, victims do not fund the compensation of other victims. Instead, a third-party wrongdoer internalizes the harms it has caused to innocent shareholders, an effect more akin to entity liability in the tort context.[139] Notably, the circularity critique is not entirely eliminated by focusing on aiders and abettors. If the aider or abettor is a publicly held corporation, diversified investors may both receive compensation as victims and pay the penalty because they own shares in the aider or abettor.

For simplicity, this Article contrasts "issuers" (the secondary-market case) with "non-issuers" (e.g., individuals and third parties). However, the story is more complicated. For instance, issuers and their shareholders who benefit from misstatements do not fit comfortably into either camp. One such example is the primary market case in which the issuer has sold its shares and may benefit.[140] This Article does not include this scenario in the "issuer" category, but rather treats it separately as an intermediate case between the issuer/secondary-market case and non-issuer cases because the wealth transfer is not exclusively victim to victim. Instead, some shareholders benefited from the conduct, so transferring money from them to innocent shareholders is less troubling.[141]

In sum, the SEC should take into account the circularity critique of compensation in the secondary-market case and prioritize distribution of penalties where this effect is less of a concern, such as those cases against individuals and aiders and abettors.

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136. Cent. Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A., 511 U.S. 164, 177, 190–91 (1994) (rejecting a reading of § 10(b)(5) that would allow a private cause of action for aiding and abetting a § 10(b)(5) violation in the context of an indenture trustee for bond issues); *see also* Stoneridge Inv. Partners v. Scientific-Atlanta, Inc., 128 S. Ct. 761, 773–74 (2008) (finding that actions against customers and suppliers exceeded the scope of the § 10(b)(5) private right of action).

137. *See, e.g.*, SEC v. Gardner, Former KPMG Consulting Principal Settles SEC Charges for Role in Peregrine Accounting Fraud, Litigation Release No. 20,449 (Feb. 6, 2008) (settling charges that a former KPMG principal and managing director aided and abetted a financial fraud at a software company by signing sham license agreements and signing a false audit confirmation, and imposing an $80,000 financial penalty).

138. John C. Coffee, *Corporate Securities: Memo to Congress: Reform and Its Perils*, N.Y. L.J., Nov. 15, 2007, at 5.

139. Coffee, *supra* note 104, at 1562.

140. *Id.* at 1556–57 (distinguishing between "non-trading issuers" and issuers in the primary market context).

141. *Id.* at 1556.

V. SHOULD THE SEC COMPENSATE INJURED INVESTORS?

Assuming that in some circumstances compensation of injured investors makes sense, or that compensation is a political fact of life, the second question about compensation is which entity or mechanism should secure it and, in particular, whether (or when) the SEC is a better means than the private securities class action. This Part considers what is special about compensation obtained by the SEC as public class counsel.

The starting point is to evaluate whether all responsibility for compensating injured investors could be transferred from the private sector to the SEC. For several reasons, the SEC is unlikely to be able to take over the compensatory role from private litigants. The limited resources of the agency and the immense size of investor harm in comparison to the monetary relief obtained by the SEC make it unlikely that the SEC can supplant private actions.[142] The SEC has suggested this itself in the Fair Fund Report.[143] Coverage of the private action extends beyond the SEC's reach: empirical work has found that only 15% of the settled private securities fraud class actions in a pre-2002 sample had a parallel SEC action.[144] Moreover, sanctions imposed in private securities class actions overwhelm those in actions by the SEC.[145] Finally, even someone convinced of the efficacy of investor compensation would not be satisfied by replacing the private action, which has compensation as a primary aim, with actions by an agency where compensation is one of many competing goals. So it seems unlikely that the SEC should, or could, take over this compensatory function entirely.

The more difficult question is whether SEC actions could complement, rather than replace, private actions. One can imagine the field of securities enforcement and compensation for securities law violations as occupied by private attorneys general and public class counsel, each with dual functions (compensation and deterrence). Just as we think of private actions as having the potential to complement public deterrence, in theory, public actions could complement private compensation.

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142. Other commentators have explored this issue. *See* Cox & Thomas, *supra* note 12, at 755–57; *see id.* at 779 ("[E]ven after the enactment of the Fair Fund provision, the SEC is not armed in most instances with authority to recover from the wrongdoers sums equal to those that can be recovered in private suits. Thus, even when there is a SEC enforcement action, the private suit provides a more encompassing remedy for the injured investors."); Ellsworth, *supra* note 26, at 651 (describing the SEC's resource constraints).

143. Fair Fund Report, *supra* note 32, at 20 ("The ability of investors to fully recover their losses . . . may largely depend on the use of private actions. Further, courts have recognized that the Commission's limited resources may oblige it to prosecute only the most 'flagrant abuses,' and that private actions complement Commission enforcement action and allow for the fullest investor recovery." (footnotes omitted)).

144. *See* Cox & Thomas, *supra* note 12, at 777, 779 n.113.

145. *See* Coffee, *supra* note 104, at 1543.

This Part concludes that, even assuming that compensation of injured investors is sometimes appropriate, using the SEC to compensate investors makes sense only in limited circumstances. First, it makes sense when no private action is available either practically or legally. Second, where both private and public actions are available, pursuing compensation through the SEC might make sense when the costs of obtaining and distributing compensation are significantly lower in an SEC action than in a private one and a mechanism exists for coordinating private and public actions to take advantage of the lower costs and avoid cost duplication. One rationale for the Fair Fund provision was that it avoided attorney's fees.[146] This Part examines the countervailing costs and identifies some costs that are shifted rather than avoided by assigning the SEC a compensatory role.

A. *SEC Compensation When No Private Right of Action Exists*

If any investors should be compensated, the SEC is the "best" entity to do so when it is the only one; that is, when the only possible recovery is through an SEC action.[147] That a private action is "unavailable" might mean either that, as a practical matter, no private attorney would undertake the representation or that, as a legal matter, no private right of action exists.

A cause of action might be practically unavailable when too little money is at stake for a private attorney to undertake the case, when developing or supporting a case is difficult, or when standing requirements or statutes of limitation block the private plaintiff.[148] At least when the amounts at stake are unattractively low, these cases are unlikely to be a source of SEC-distributed compensation. The SEC has announced that it is unlikely to distribute small amounts, particularly when they are low in comparison to the number of injured investors.[149]

What remains are causes of action that are legally unavailable to private plaintiffs. Some of the actions available only to the SEC, such as actions for books and records violations, do not result in money damages or do not have an obvious injured party, and so are unlikely to trigger compensation.[150] However, one target stands out as a potentially

146. Black, *supra* note 12, at 338 (noting that Republican sponsors of Sarbanes-Oxley and Commissioner Atkins have "asserted that actions under section 308 provide better value than private securities fraud suits because investors' recoveries are not reduced by attorney's fees").

147. *See, e.g.*, George W. Dent, Jr., *Ancillary Relief in Federal Securities Law: A Study in Federal Remedies*, 67 MINN. L. REV. 865, 931–32 (1983) (making this point in the context of disgorgement).

148. Cox & Thomas, *supra* note 12, at 744.

149. *See supra* note 42 and accompanying text.

150. *See* Securities Exchange Act of 1934 § 13(b)(2), 15 U.S.C. § 78m(b)(2)(A) (2006) (requiring registered companies to maintain adequate books and records); *see also* Securities Exchange Act Rule 15c3-1, 17 C.F.R. § 240.15c3-1 (2008) (outlining net capital requirements of brokers). *See generally* Cox & Thomas, *supra* note 12, at 744.

significant source of investor compensation: aiders and abettors of securities fraud. Unlike the books-and-records example, violations by aiders and abettors of securities fraud are more likely to result in money damages and have an identifiable injured party. Moreover, the cause of action belongs solely to the SEC. The Supreme Court's decision in *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, rejected a reading of 10(b)(5) that would allow a private cause of action for aiding and abetting a 10(b)(5) violation.[151] This decision triggered a debate in Congress as to whether it should pass legislation permitting such a private cause of action.[152] Congress ultimately responded by confirming (or reinstating, depending on the interpretation of *Central Bank*) the SEC's power to pursue actions for aiding and abetting and declining to establish a private right of action.[153]

Central Bank left open questions, some of which were resolved in *Stoneridge Investment Partners v. Scientific-Atlanta, Inc*.[154] In *Stoneridge Investment Partners*, the Court found that actions against customers and suppliers were beyond the scope of the 10(b)(5) private right of action.[155] For the purposes of how the SEC should prioritize the creation of Fair Funds, the *Stoneridge* case is important because it signals a restrictive reading of private causes of action under 10(b)(5), leaving the SEC as the actor who can pursue compensation from aiders and abettors of securities fraud.

This category of cases is also potentially important in light of the circularity critique. Using penalties imposed on aiders and abettors as the source of Fair Funds reduces the concern that compensation is, in some circumstances, circular. If compensation is disfavored in the secondary-market context because of its essential circularity, a potential source of deep pockets—non-trading issuers—is eliminated. Aiders and abettors may have deep pockets (e.g., banks and other entities). Even putting aside the circularity critique, these deep pockets may be the only ones available to fund investor compensation when an issuer is insolvent. In sum, the "easy case" for invoking the Fair Fund provision is when no private action is available. Seen in conjunction with the circularity critique, aiders and abettors stand out as an important category for the SEC's exercise of its discretion under the Fair Fund provision.

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151. *Cent. Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164, 177 (1994) (referring to § 10(b) of the Securities and Exhange Act of 1934).

152. *See* Stoneridge Inv. Partners v. Scientific-Atlanta, Inc., 128 S. Ct. 761, 768–69 (2008) ("The decision in *Central Bank* led to calls for Congress to create an express cause of action for aiding and abetting within the Securities Exchange Act . . . . Congress did not follow this course.").

153. 15 U.S.C. § 78t(e) (2006) (creating aiding and abetting liability in SEC actions but not in private actions).

154. *See generally* 128 S. Ct. at 766–73 (interpreting the congressional response to *Central Bank*).

155. *Id.* at 766.

B. *SEC Compensation When Private and Public Actions Are Available*

So far this Part has looked at matters in which only the SEC can recover for injured investors. However, securities laws have long been enforced through both public and private actions, which sometimes overlap.[156] In fact, a recent study suggests that in 55% of SEC enforcement actions studied by the SEC in the Fair Fund Report, parallel private suits were brought.[157] When both public and private actions are available, compensation through an SEC action may make sense if it is "cheaper" and, if so, if it replaces the private action in that instance rather than simply duplicating the compensatory mechanisms and associated costs.

This Part provides a framework for analyzing the costs of SEC actions, both the distribution and collection costs in an individual action and the systemic costs of asking the SEC to undertake the public class counsel function. It also suggests that more reporting and study of the costs is needed.[158] Given that SEC actions are unlikely to be able to replace private actions altogether, it suggests that it only matters that an SEC action is cheaper if a mechanism is in place for the SEC to replace the private action. In the absence of assurance that the costs of SEC compensation are low or coordination of private and public actions, the compensatory rationale for the Fair Fund provision weakens whenever a private action is also available.

The Fair Fund provision should be seen against the backdrop of congressional restrictions on private actions, driven by Congress' concern that these actions are frivolous and benefit only the plaintiffs' bar.[159] In the Fair Fund context, some commentators have argued that compensation by the SEC, rather than by private actors, is desirable because it avoids attorneys' fees: proposing, for instance, that "[t]hese 'Fair Funds,' while suffering from bugs of government bureaucracy, are still more efficient and fair than the contingency fees of up to 30% to trial lawyers."[160] This assertion might be elaborated into an argument that the public class counsel should replace the private attorney general where possible to maximize the fairness and efficiency of investor compensation. The

156. Cox & Thomas, *supra* note 12, at 738.

157. *See id.* at 777, 779 n.113.

158. The General Accounting Office has similarly noted both that this data is not being collected and that it should be. *See* GAO REPORT 1, *supra* note 71, at 29 ("Enforcement does not collect key data, as we recommended in 2005, to aid in division oversight of the Fair Fund program.").

159. *See, e.g.*, Erichson, *supra* note 21 (describing a succession of legislation motivated by mistrust of class-action lawyers).

160. Ted Frank, Op-Ed., *Arbitrary and Unfair*, WALL ST. J., May 31, 2007, at A14 (suggesting, as a member of the American Enterprise Institute, that the Fair Fund provision allows "one [to] help investors without paying billions to the likes of [plaintiffs' lawyers]").

problem is that the Fair Fund provision includes no directive about administration, and the "bugs of government bureaucracy"[161] are never quantified.

In a private action, a settlement payout will include the costs of distribution, which might come out of the fund or be paid separately by the payor, and legal fees, which will come out of the fund. When the SEC brings an action, its costs fall in the same categories: the administrative costs and the "attorney fees." The first category is similar for both public and private actors in the nature of the costs (e.g., consultants) and who bears the cost (injured investors or payor). The nature of the "attorney fees" differs, however. In the public case, these are the costs of having the SEC undertake this compensatory role. Unlike the attorney fees in a private action, which are taken out of the fund, the costs of assigning the SEC a compensatory role are borne more broadly by taxpayers. All of these costs should be considered when choosing whether a public or private action is the best means to investor compensation.

In any single action, administrative costs include payment to consultants, known as Independent Distribution Consultants or IDCs, who design and administer Fair Fund plans.[162] For instance, in 2007, AIM Advisors and AIM Distributors agreed to pay $30 million in civil penalties and $20 million in disgorgement to settle allegations of market timing of mutual funds.[163] The resulting $50 million Fair Fund was implemented through a "Twenty-Five Step Process" that involved an IDC, an "economic, financial and management" consulting firm, a law firm, a fund administrator, a tax administrator, and an escrow agent.[164] This pattern of required consultants is typical of SEC-ordered Fair Funds.[165]

Some of these costs are borne by the payor. In the AIM example, the distribution plan called for AIM to pay the Fund Administrator and IDC, while the fund paid the tax administrator.[166] The GAO found that 70% of Fair Fund distribution plans provide that administrative expenses are paid with fund proceeds, while in 30% the sued entity or individual bore the administrative costs of the Fair Fund.[167] These costs are not unique to SEC

161. *Id.*

162. GAO REPORT 1, *supra* note 71, at 6, 14. Although, as enforcement officials acknowledge, this information is a key piece of assessing the costs of implementing this provision, it is not being tracked, although an information system is reportedly in development. *See id.* at 6.

163. Proposed Distribution Plan, *In re* AIM Advisors, Inc., Admin. Proceeding File No. 3-11701, 1, 2 (June 25, 2007), http://www.sec.gov/litigation/admin/2007/34-56027.htm (follow "Proposed Distribution Plan" hyperlink) [hereinafter AIM Plan].

164. *Id.* at 2–4, 6, 8.

165. GAO REPORT 1, *supra* note 71, at 14.

166. AIM Plan, *supra* note 163, at 3, 5, 8.

167. GAO REPORT 1, *supra* note 71, at 29 n.39. *See, e.g.*, SEC, Claims Fund, *In re* Strong Capital Mgmt., http://www.sec.gov/divisions/enforce/claims/strongcapital.htm (last visited Oct. 15, 2008). Strong Capital Management paid for the "Independent Distribution Consultant." *Id.* While

as opposed to private actions; they would have been incurred in a private action as well. The concern is that parallel distributions may duplicate administrative costs when both private and public actions are brought for the same conduct against the same actors.[168]

Notably, the Fair Fund administrative costs exist despite the fact that the Fair Fund provision is couched as simply adding money to existing disgorgement funds,[169] which presumably already have administrative expenses. The creation of a new distribution office at the SEC indicates that Fair Funds involve new tasks. Furthermore, because passage of the Fair Fund provision was accompanied by an increase in the numbers and size of penalties, distributions are larger and maybe more frequent, both because of how the agency exercises its discretion to distribute these funds and because distribution of smaller amounts is not cost-effective.[170] Accordingly, the disgorgement prerequisite does not avoid new costs associated with Fair Funds.

In addition to the costs of administering funds, the SEC has had to divert resources to the distribution function. For instance, in 2007, the percentage of timely enforcement actions (those brought within two years of opening the investigation) was the lowest in five years.[171] In explaining this result, SEC officials cited the "significant resources" the agency devoted to "the SEC's responsibility to distribute Fair Funds to injured investors" and to "establish[ing] and support[ing] an accounting and recordkeeping system to appropriately track these distributions."[172] Enforcement officials complained that the decentralized administration of Fair Fund plans "diverts investigative attorneys from their primary law enforcement mission"[173] and have reported that coordination with the IRS and the Department of Labor about taxation of the distributions and about ERISA issues have resulted in delayed distribution and devotion of staff

in theory these administrative costs might be accounted for in the process of bargaining the penalty and disgorgement amounts, the use of round numbers (or prominent solutions)—the $50 million penalty, for instance—suggests that they are not, or at least that they are not being used in a precise way.

168. The concern about duplication assumes some fixed costs that do not depend on the size of the settlement. It is worth noting that the SEC has on occasion added the money tagged for distribution under Fair Funds to an existing private class-action fund, avoiding the duplication of distribution costs, but that is not universal practice. *See* 72 SEC ANN. REP. 23 (2006) ("[W]here appropriate, the SEC seeks to save costs by distributing funds together with related private class actions.").

169. The provision requires an accompanying order of disgorgement and states that the money penalties will be "added to disgorgement funds for the relief of victims." Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 308, 116 Stat. 745 (codified as amended at 15 U.S.C. § 7246 (2006)).

170. *See supra* note 42 and accompanying text.

171. 73 SEC ANN. REP. 27 (2007).

172. *Id.*

173. GAO REPORT 1, *supra* note 71, at 6, 28 ("[D]uring peak periods [the Fair Fund workload] can consume about 50 to 75 percent of a staff attorney's time.").

time.[174] Partially in response to these concerns, in early 2008 the Commission formed and staffed a new office to handle Fair Fund distribution: the Office of Collections and Distributions.[175] The agency has also invested in a new computerized tracing system.[176]

When evaluating these costs, possible countervailing benefits of these structures should be weighed. For instance, the tracking system may streamline enforcement procedures. Furthermore, once in place, the Fair Fund mechanism and its growing apparatus may be used to further other goals, as some recent scholarship has recommended. It might, for instance, serve as the basis for whistleblower bounties[177] or the beginnings of an investor insurance fund.[178]

While, at first glance, the Fair Fund provision should affect primarily *distribution* costs because it greatly increases the agency's role in distributing compensation, costs of *collection* should also be considered. Moreover, collection costs under Fair Funds should be compared both to SEC collection costs before Fair Funds and to the costs of private collection. More empirical research is needed, but the Fair Fund provision may actually lower the costs of collection for the SEC in comparison to pre-Fair Fund collection to the extent that the SEC begins to prefer money penalties over disgorgement. After Fair Funds, the SEC can allocate to either category without affecting the funds' availability to injured investors. That means that the agency can choose which remedy to pursue for other reasons, including costs of collection. The collection procedures that apply to these two remedies differ and collection of penalties may be less expensive or quicker. The SEC made this point in the Fair Fund Report, contrasting the collection methods for disgorgement to those for penalties and concluding that

> [b]ecause under the Fair Fund provision, all monies recovered from either the disgorgement or penalty proceeding can be returned to investors, the Commission has greater flexibility to choose the most advantageous remedy. For example, an action to recover penalties in some cases could provide a quicker means to capture limited assets . . . .[179]

174. *Id.* at 26–27.

175. 73 SEC ANN. REP. 30 (2007); GAO REPORT 1, *supra* note 71, at 30. Heads of the office, Richard D'Anna and Lynn Powalski, were appointed in February 2008. Press Release, SEC, SEC Chairman Cox Announces Creation of New Office, Appointment of Leaders, to Expedite Distribution of Billions to Injured Investors (Feb. 6, 2008), http://www.sec.gov/news/press/2008/2008-12.htm; Karey Wutkowski, *SEC Forms Oiffice to Pay Back Wronged Investors*, REUTERS, Feb. 5, 2008, *available at* http://www.reuters.com/articlePrint?articleId=USN054378522008025.

176. 73 SEC ANN. REP. 30 (2007); GAO REPORT 1, *supra* note 71, at 8.

177. Geoffrey Christopher Rapp, *Beyond Protection: Invigorating Incentives for Sarbanes-Oxley Corporate and Securities Fraud Whistleblowers*, 87 B.U. L. REV. 91, 147–49, 155 (2007).

178. Evans, *supra* note 130, at 226.

179. Fair Fund Report, *supra* note 32, at 27. This is not to say that penalties will always be favored. For instance, disgorgement may be the only monetary relief available if the statute of

To compare these to private collection costs requires more information about the amount of costs, who bears the costs, and the risks of duplication in the context of parallel private and public actions.

In addition to distribution and collection costs, the Fair Fund provision introduces a risk of side litigation over who has the rights to a Fair Fund.[180] It does so because it introduces the possibility that funds gathered as money penalties but distributed to injured investors should be treated as equivalent to private damages. For instance, WorldCom creditors had challenged the Fair Fund distribution plan in that case, arguing in part that the deferential standard of review adopted in disgorgement case law was inapposite because disgorgement had a deterrent purpose while penalties, under the Fair Fund provision, had the purpose of compensating victims of securities fraud.[181] The court ultimately rejected the contention that the passage of the Fair Fund provision changed the SEC's compensatory role.[182] Nonetheless, as has been said about disgorgement funds before them, Fair Funds are pots of money that may attract claimants (and potential litigants) "like flies to honey."[183]

limitations has run. *See* SEC v. Dibella, 409 F. Supp. 2d 122, 127 (D. Conn. 2006) (holding that the statute of limitations did not apply to disgorgement because it was "strictly remedial" and did not qualify as a "civil fine, penalty, or forfeiture" for the purposes of 28 U.S.C. § 2462).

180. The SEC's concern with limiting rights of potential fund beneficiaries is reflected in the rules that govern proceedings before the SEC. Rule 1106 of the SEC's Rules of Practice provides for comments to be submitted as part of the plan approval process, but states that "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" or its distribution plan or individual eligibility for disbursements. U.S. SEC. & EXCH. COMM'N, RULES OF PRACTICE AND RULES ON FAIR FUND AND DISGORGEMENT PLANS 107 (Jan. 2006, corrected Mar. 2006).

181. Brief of Appellant at 13, Official Comm. of Unsecured Creditors of WorldCom v. SEC, 467 F.3d 73 (2d Cir. 2004) (No. 04-4710).

182. *Unsecured Creditors of WorldCom*, 467 F.3d at 83 ("Deterrence is also the SEC's goal in seeking civil penalties, and the Fair Fund provision does no more than permit civil penalties subsequently to be distributed in the same way as disgorged profits." (internal citations omitted)); SEC v. WorldCom, Inc., No. 02-CV-4963, 2004 WL 1621185, at *1 (S.D.N.Y. July 20, 2004) (rebuffing attempts made by potential claimants to challenge the way the funds are distributed).

The SEC's enforcement action in WorldCom resulted in two judicial opinions concluding that compensation of injured investors had been (under disgorgement-only), and remained, a secondary purpose of the agency. The WorldCom court reasoned that the Fair Fund provision merely "mention[s]" compensation, which provided insufficient grounds for determining that the agency's "role in distributing funds to injured investors" had changed. *Unsecured Creditors of WorldCom*, 467 F.3d at 83. Relying on the fact that the Fair Fund provision is discretionary rather than mandatory, the court further held that "the fact that the SEC is not required to distribute Fair Fund proceeds to injured investors belies the Committee's assertion that the Fair Fund provision makes compensation the primary purpose of the distribution." *Id.*

183. Rory C. Flynn, *SEC Distribution Plans in Insider Trading Cases*, 48 BUS. LAW. 107, 108 (1992).

In addition to these costs, the introduction of compensation as a possible goal of the SEC gives rise to the concern that the compensatory goal will cause either overdeterrence or underdeterrence of securities law violations. It might overdeter if the SEC were to pursue penalties that compensated injured investors but were not needed for deterrence. For instance, a penalty against a corporation may be inappropriate for deterrence because it does not reach the wrongdoer[184] or because the corporation has already done everything the regulator wants it to do, but nonetheless the conduct caused great harm and the corporation is a potential deep pocket for investor compensation. In those circumstances, a choice to impose a penalty because of its compensatory effect would overdeter. Alternatively, the SEC might underdeter if penalties were foregone because they could not be used to compensate investors. Either one represents a cost to the SEC's law enforcement role.

There are also policy reasons to limit the SEC's compensatory role based on differences between the private attorney general and public class counsel. The private attorney general is valued in part for the transfer of some of the burden of enforcement from the resource-constrained government to the resource-rich private sector. For instance, in *J.I. Case Co. v. Borak*,[185] the Court relied on the idea that "[p]rivate enforcement . . . provides a necessary supplement" to public law enforcement.[186] It reasoned that a private right of action should be implied "to make effective the congressional purpose" at least in part based on the sheer volume of proxy statements the SEC had to examine a year, which limited the review it could perform.[187]

This rationale simply does not hold for the public class counsel. In fact, the effect is the opposite: transferring the responsibility for investor compensation to the SEC can be viewed as a transfer from the resource-rich private sector to the resource-constrained public.[188]Arguably, the SEC has other, non-monetary resources that could be leveraged on behalf of injured investors—more investigative powers or lower

184. *See* Langevoort, *Corporate Executives*, *supra* note 129, at 635 (describing the critique of entity liability that "executives themselves will not be deterred from misconduct when their personal gain from perpetrating or concealing the fraud exceeds the impact they would suffer should the corporation have to pay").

185. 377 U.S. 426, 432 (1964). In *Touche Ross & Co. v. Redington*, 442 U.S. 560, 577 (1979), the Court, while declining to revisit the holding of *Borak*, also refused to read *Borak* "so broadly that virtually every provision of the securities Acts gives rise to an implied private cause of action." Commentators frequently cite *Cort v. Ash*, 422 U.S. 66 (1975), as effectively abandoning *Borak* without actually overruling it.

186. *Id.*; *see also* Coffee, *supra* note 17, at 218 & 220 n.8.

187. *Borak*, 377 U.S. at 433; *see also* Coffee, *supra* note 17, at 218, 220 n.8.

188. *See* Cox & Thomas, *supra* note 12, at 757 & n.75 (reviewing the agency's resource constraints).

information costs, for instance. That point, however, runs into the problem that convergence between the SEC's remedies and private remedies may undermine arguments that the agency's powers and legal standards for its actions should differ from those available in private actions, gradually eliminating exactly these non-monetary resources.[189]

A second difference between the concepts of private attorney general and public class counsel suggests another reason to limit the SEC's compensatory role: the private attorney general represents the injured investors and also benefits a larger class—the public. When the SEC acts as public class counsel, in contrast, it represents the public and also benefits the injured investors, a smaller class of the public. Another way of thinking about this point is to identify who pays private counsel and who pays the agency. Private counsel is paid by injured investors through a cut of the settlement money, money that would otherwise have gone to the class. The SEC is paid out of funds gathered from taxpayers. So the private action, according to the private attorney general theory, provides a more general benefit from a private transaction, whereas when the SEC compensates investors, taxpayers as a group fund a service that allows particular injured investors to collect money while avoiding their full share of the costs of obtaining the compensation.[190]

This concern with allocation of costs is captured by another term used to describe the SEC when it used the disgorgement remedy to compensate investors pre-Fair Funds. SEC Chairman William Cary expressed misgivings about turning the SEC into a private collection agency.[191] The concept evokes the concern that when the SEC compensates investors, taxpayers as a group fund a service—the "collection agency"—that allows injured investors to collect money while avoiding their share of the costs of collection. The concept of public class counsel, however, has analytical advantages over the "collection agency." Collection agencies typically

189. *See* Ellsworth, *supra* note 26, at 650 & n.57; Lon E. Musslewhite, *The Measure of the Disgorgement Remedy in SEC Enforcement Actions*: SEC v. MacDonald, 12 SEC. REG. L.J. 138, 158–61 (1984) (describing how the SEC distinguishes its enforcement actions from private recovery actions in order to avoid problems involved in private litigation).

190. The Supreme Court ruled against the Federal Trade Commission because of such concerns in the context of an early attempt by the FTC to step in to resolve a dispute between two individuals: "[T]he mere fact that it is to the interest of the community that private rights shall be respected is not enough to support a finding of public interest. To justify filing a complaint the public interest must be specific and substantial." FTC v. Klesner, 280 U.S. 19, 28 (1929); *see also* Ellsworth, *supra* note 26, at 649 ("The Supreme Court has rejected the notion that a federal agency vested with authority to protect the public interest can use that authority to act primarily for the benefit of a wronged individual.").

191. *See* William L. Cary, Book Review, 75 HARV. L. REV. 857, 860–61 (1962) ("[W]e must weigh the extent to which a regulatory agency like the SEC should bring restitution proceedings for private parties."); *see also* Dent, *supra* note 147, at 931–32 (arguing that SEC actions to compensate individuals when effective relief is already available through a private action "reduces the SEC to little more than a collection agency, contrary to the intentions of Congress").

participate in an action only once it has been determined that someone has a right to collect a particular amount of money from someone else. They do not decide who owes what to whom and in what amount, but rather specialize in extracting the money—a single purpose, uncomplicated by multiple functions. With this limited function, the "collection agency" does not capture the issues at the heart of the SEC's emerging compensatory role, which are the hybrid nature of the SEC's monetary remedies and the relationship between public and private enforcement of securities laws.

The final point about the costs of assigning the SEC a public class counsel role is that, even if the SEC action were less costly than private ones, or the action were preferred because of who bears the costs (i.e., taxpayers as a whole) or who gets the money (i.e., not plaintiffs' lawyers), the problem of coordinating public and private actions remains. Even where the SEC route to compensation is preferable, the distribution mechanism and costs may simply be duplicated absent coordination between private and public actions. Currently no such distribution mechanism exists. Actions may overlap and, with the exception of "global" settlements, once one action reaches settlement, the other actions are not precluded. One way to coordinate is for the SEC to exercise its discretion under the Fair Fund provision by disfavoring compensation when it is already available through a private action.

This Part has outlined the types of costs that should be considered when evaluating whether compensation should be obtained by the private attorney general or by the public class counsel. While more information-gathering would be useful, these costs suggest that the SEC should prioritize distributions when a private action is unavailable because doing so avoids the problem of duplicated administrative costs and the unmet need for coordination between public and private actions.

VI. CRITERIA FOR CREATING A FAIR FUND

This Part suggests that the SEC prioritize distributions under Fair Fund to minimize concerns with circularity and with the potential duplication of costs when both public and private actors pursue the same matter. This Article concludes that the SEC should prioritize distribution of penalties gathered from aiders and abettors and other non-issuers. It also describes the most problematic category of distribution: distribution of penalties against issuers (the secondary-market case) when private and public actions are both available. This Article suggests the following hierarchy:

1. Distribution of penalties against non-issuers when only the SEC has a cause of action.

2. Distribution of penalties against non-issuers when either a private or public action is available.

3. Distribution of penalties against issuers (secondary-market case) when only the SEC has a cause of action.

4. Distribution of penalties against issuers (secondary-market case) when either a private or public action is available.

In addition, this Article joins others in concluding that the SEC is unlikely to be able to take over the compensatory role altogether, and in recommending that the costs of SEC actions under the Fair Fund provision be further tracked and analyzed.[192]

First, the recommended focus on aiders and abettors can be stated more generally to encompass any distribution to injured investors of money penalties paid by non-issuers in an SEC action where the cause of action is available only to the SEC. By excluding penalties obtained from issuers for harms in the secondary market, this type of distribution reduces the concern that compensation of injured investors in the secondary market amounts to transfers among different categories of injured investors, or from one investor's pocket to another's (minus administrative costs), or that diversified investors cannot be said to have suffered a harm because their risk of being on the losing side of a transaction is the same as their risk of being on the winning side.[193] Because in this category of cases the SEC's discretion to create a Fair Fund would be exercised only when no private action is available, such distribution also avoids the concern that parallel public and private actions will simply duplicate costs, and collection and distribution mechanisms.

Non-issuers include individuals such as officers and directors, third-party individuals such as individual lawyers and auditors, and third-party entities. Money penalties against aiders and abettors are a potentially significant source of SEC-obtained investor compensation. As noted above, the Supreme Court restricted private actions against aiders and abettors in *Central Bank* and confirmed these limits in *Stoneridge*, and Congress has stepped in to preserve the SEC's right to bring such an action.[194] Accordingly, actions against aiders and abettors are squarely in the SEC's domain. Creative lawyering will likely result in other types of private actions against alleged aiders and abettors, particularly those with deep pockets, but, after the Supreme Court's decisions, duplicate actions are not at issue. Compensation funded by aiders and abettors transfers money from third parties to injured investors, largely (but not entirely) avoiding the circularity problems inherent in the secondary-market case.

192. The Government Accounting Office has made similar recommendations. *E.g.*, GAO REPORT 1, *supra* note 71, at 29 ("Enforcement does not collect key data, as we recommended in 2005, to aid in division oversight of the Fair Fund program.").

193. *See supra* Part IV.B. Circularity is less of a concern when issuers, such as issuers in the primary market, benefit from the misstatement. *See supra* Part III.B.

194. *See supra* notes 151, 154–55 and accompanying text.

Finally, to the extent that meaningful compensation requires deep pockets to fund investor recoveries, aiders and abettors—especially entities—may have the necessary resources.

Second, the SEC should look to penalties against non-issuers when either a private or public action is available. When the SEC distributes penalty money obtained for violations outside the secondary-market case, it avoids the circularity critique for the reasons detailed above. However, the agency must still be concerned about the duplication of costs in parallel private and public actions and the absence of mechanisms to address this duplication. Any time that a private action is available as well as the SEC action, more needs to be known about the comparable costs (read broadly to include costs to the SEC's other goals, especially that of deterrence) of the two alternatives. In addition, to take advantage of lower costs, if any, public and private actions need coordination, which is currently absent. In the terms of this Article, the field of securities enforcement can be envisioned as occupied by public class counsel and private attorneys general. At the moment, their actions overlap without coordination. As a group of prominent scholars conveyed in a letter to the SEC, "the Commission must become more engaged in discussions about the workings of private securities litigation: there is an inevitable and growing overlap between private recoveries and fair fund distributions, which has to be reconciled."[195] It may be addressed in part through the SEC's exercise of its discretion under the Fair Fund provision.

Third, distribution of penalties against issuers when a private action is unavailable raises the problem of whether it is ever reasonable to compensate investors injured in the secondary market using penalties imposed against issuers. This Article takes the critique seriously, arguing it should influence the priorities of the SEC when it considers distributions, but also suggests that the political reality of compensation and the search for deep pockets in light of large investor harm may keep compensation by issuers on the agenda and on the list of the SEC's priorities.

Penalties in the secondary-market case when only an SEC action is available and the penalties outside the secondary-market context when private and public actions are available each avoids one of the critiques. Duplication of costs is an issue where the public and private actions are both available. Circularity is a problem when an issuer supplies the penalty. The order in which these two sources of penalties should be prioritized depends on which of these problems—circularity or cost duplication—seems more intractable. Underlying the order this Article suggests is the idea that the circularity problem is more fundamental and that costs are susceptible to both study and adjustment.

Fourth, the most problematic category is distribution of penalties

195. Langevoort, Letter, *supra* note 129.

against issuers where private and public actions are available. This type of distribution suffers from circularity and potential cost duplication. This type of distribution is particularly troublesome absent coordination of public and private actions and a mechanism to ensure that the administrative costs of collection and distribution are lower in SEC actions than in private ones.

VII. Conclusion

Through the Fair Fund provision, Congress has assigned to the SEC a newly intensified public class counsel role, which should be recognized and scrutinized. The analogy between public class counsel and private attorney general helps answer the narrow question of when the SEC should exercise its discretion to create a Fair Fund and use money penalties for victim compensation. This Article proposes that the SEC prioritize distributions to minimize two concerns about compensating injured investors: the circularity critique and the duplication of costs. Aiders and abettors of securities fraud are a potentially important source that meets both criteria.

On a broader level, although this Article has focused on the SEC's role as public class counsel in the context of the Fair Fund provision, the concept of public class counsel has applications beyond the securities context. The concept may describe criminal prosecutors in the context of victim restitution statutes as well as other public actors assigned the dual functions of compensation and deterrence. Identifying these disparate actors as being in the same category allows easier comparison and identifies multiple models for pursuing both compensation and deterrence. Beyond that, the concept triggers important questions about these public actors. As soon as we acknowledge the role of public class counsel, we can ask "Counsel to whom?", "Who is the class?" and other questions worth asking.

Finally, this snapshot of the SEC's remedial authority at the beginning of this century implicates larger questions about whether a public agency should be in the traditionally private business of compensating injured investors. As the analogy between the private attorney general and the public class counsel suggests, the SEC's increasingly significant compensatory mechanisms put pressure on the balance between private and public enforcement of securities laws. This Article maps necessary first steps towards addressing the underlying policy question: the extent to which we can sensibly rely on public enforcement for victim compensation. The concept of public class counsel offers a much-needed way to frame the debate.