IT'S ONLY FAIR: RETURNING MONEY TO DEFRAUDED INVESTORS

HEARING

BEFORE THE

SUBCOMMITTEE ON
CAPITAL MARKETS, INSURANCE, AND
GOVERNMENT SPONSORED ENTERPRISES

OF THE

COMMITTEE ON
FINANCIAL SERVICES

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IT'S ONLY FAIR: RETURNING MONEY TO DEFRAUDED INVESTORS

Wednesday, February 26, 2003

U.S. House of Representatives,
Subcommittee on Capital Markets, Insurance,
And Government Sponsored Enterprises
Committee on Financial Services,
Washington, D.C.

The subcommittee met, pursuant to call, at 10:02 a.m., in Room 2128, Rayburn House Office Building, Hon. Richard Baker [chairman of the subcommittee] presiding.

Present: Representatives Baker, Gillmor, Kelly, Biggert, Green, Capito, Hart, Kennedy, Tiberi, Brown-Waite, Harris, Renzi, Kanjorski, Meeks, Inslee, Moore, Lucas, Clay, McCarthy, Baca, Matheson, Lynch and Scott.

Chairman Baker. [Presiding.] I would like to call this meeting to order to discuss the Sarbanes-Oxley Act, specifically section 308(c) which requested the agency to study, evaluate and make appropriate recommendations with regard to what is known as the Fair Fund contained in that bill.

Before the passage of Sarbanes-Oxley, if the SEC was engaged in pursuit of wrongdoers and in fact assessed penalties for inappropriate conduct, those penalties would not directly benefit any wronged investor, but would return to the U.S. Treasury. With the passage of the Fair Fund, we have now created a mechanism where disgorgements, that is the return of ill-gotten gains, or penalties assessed now will be funneled into the Fair Fund for what is determined to be appropriate allocation to those who were victims of the wrongdoing.

I have been particularly stunned by the actions of some prominent enforcement authorities, not within the SEC, in their diligence in pursuit of those who have committed acts that are inappropriate. Specifically, taken from one web page, the statement, "The money that was being abused, the money that was lost, the money of people like you who took their pension money, their 401(k)s, their IRAs, the money they had set aside for their kid's college education or a mortgage payment or their vacation, that was the money being used and violated by those on Wall Street who thought they were beyond the reach of the law." I am with him all the way to that point. It is just the next step that bothers me. When the award was finally settled, he kept the money. I likened it 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.″ I find this vindication something less than whole.

So this is a new first step and effort to try to provide governmental assistance to individuals who have been defrauded that is meaningful. This is a first effort, and recognizing that, I have reviewed the report of the SEC and find it very constructive, and will after listening to further explanation this morning construct legislation, which I am hopeful other members of the committee will find of interest, for introduction soon, that will address those areas that the report identifies, as well as some other areas that I have found to be of importance, to move forward and make the Fair Fund more meaningful to more investors across the country. I think this is a very good start, and I am appreciative to the agency for their hard work and effectiveness in making the legislative concept an operating reality.

Mr. Kanjorski, do you have an opening statement?

Mr. KANJORSKI. Thank you, Mr. Chairman.

We meet today to examine the issue of investor restitution, an issue of great importance to me. Last month, the Federal Reserve determined that the United States stock ownership increased to 51.9 percent in 2001. Because more and more Americans continue to make investments in our securities markets, we have an obligation to ensure that these individuals are appropriately safeguarded in cases of wrongdoing.

Accordingly, I have made investor protection one of my priorities for work on our committee. Last year, in the wake of a tidal wave of cases of corporate wrongdoing, we worked to enact into law the Sarbanes-Oxley Act. This law advanced investor protection in a number of important ways, including the creation of the Fair Fund. The Fair Fund, as you know, allows the Securities and Exchange Commission to further help the victims of securities law violations by permitting the agency to add any civil penalties collected in enforcement cases to its disgorgement orders.

However, in order for the Fair Fund to work well, serving as a deterrent and as a means of returning funds to harmed investors, we must ensure that the SEC has an effective program that to the maximum extent possible collects the fines, penalties and disgorgements it orders. As you know, Mr. Chairman, I have been a leader in the congressional effort to examine these issues in recent years. In March, 2001, for example, I joined with a number of my Democratic colleagues in ordering an investigation by the General Accounting Office of the SEC's disgorgement policies. Last July, the GAO determined that the SEC's efforts to recover illegal gains from financial scam artists had fallen dramatically and required tougher oversight. Between 1995 and 2001, the SEC collected roughly $426 million or about 14 percent of the $3.1 billion owed in disgorgement cases. This finding represented a sharp drop from the 50 percent collection rate the GAO previously found in 1994. As a result, I call upon the SEC to tighten its disgorgement collection monitoring and to implement other oversight improvements.

In recent years, the GAO has also examined the success of securities regulators in collecting fines and penalties. In the next few months, I expect to receive a follow-up report from the GAO regarding this issue. A previous GAO report completed in July, 2001, determined that these collection rates have generally improved in recent years, but that more improvements can be made. The SEC, for example, now collects about 91 percent of assessed penalties and fines, an increase from the 83 percent in a similar GAO study in 1998. Despite this improvement, the GAO found that the SEC could take steps to enhance the collection of fines referred to the Treasury Department's Financial Management Service under the Debt Collection Improvement Act of 1996.

When we hear from our distinguished witness later today, I hope that he will address this important issue. The effective implementation of the Fair Fund in improving disgorgement and fine collection practices are important efforts to ensure that investors receive at least partial compensation for losses they incur as a result of securities fraud. However, the most meaningful route for investors to receive restitution for their losses is through private litigation. We need to ensure that investors harmed by corporate wrongdoers can seek legal redress in our nation's courts.

Accordingly, I was particularly pleased to read the SEC's report to Congress about the benefits of private litigation. As the SEC notes, investor lawsuits complement government enforcement action by providing a mechanism to compensate investors through the award of restitution or damages. While the SEC's enforcement actions often have several aims, the objective of private litigation is exclusively to compensate injured investors. In this report, the SEC also refers a number of recommendations for improving the effectiveness of the Fair Fund. For example, the SEC calls for legislation to exclude securities cases from state law property exemptions, such as homestead exemptions. The SEC additionally suggests that we amend the Fair Fund law to permit the agency to use penalty monies ordered in a particular matter for distribution to injured investors regardless of whether disgorgement was ordered. These ideas have merit and we should work to address them.

In closing, Mr. Chairman, I look forward to hearing from our witness on the issue of investor restitution. I also look forward to hopefully working with you to examine and adopt the legislative recommendations offered by the SEC in the weeks and months ahead.

Thank you, Mr. Chairman.

Chairman BAKER. I thank the gentleman for his comments.

Ms. Kelly, did you have a statement?

Mrs. KELLY. Thank you, Mr. Chairman, Mr. Kanjorski. I want to thank you for holding this hearing this morning.

It is a pretty simple principle we are talking about here. People who were damaged deserve to get some money back. If we can make them whole, so much the better. That is the whole principle that we put behind the Fair Fund last year. That was a significant step in the right direction. 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.

What is important now, I think, is that we understand how our direction is being implemented, and make sure that it is being implemented in a way that fully meets the expectations of Congress when we put the Fair Fund Act in place.

I think it is imperative that the Commission have the tools that it needs to protect investors, and it is my hope that this hearing will shed some light on whether or not the Fair Fund Act gives the Commission sufficient ability to collect payments and then disburse funds back to the harmed investors. If any modifications are needed, I hope that we can reach an agreement in a timely fashion and in a manner that maintains the strong focus we have in the Fair Act of directing funds back to the harmed investors. That is the top priority.

I expect through the testimony of you, Mr. Cutler, that we can all gain a better perspective and a better understanding of what the Commission's efforts and perspectives are in implementing the Fair Act. I think strengthening investor confidence through a strong protection in this way has got to be something that the investors understand, and it is clearly something that is needed in the markets today. The implementation of the Fair Fund Act is absolutely essential to that confidence.

I want to thank you, Mr. Cutler, for being here today. I very much look forward to your testimony, I hope it will help us get in the direction that we hoped to accomplish when we passed the Fair Act.

Thank you, Mr. Chairman. I yield back.

Chairman BAKER. Thank you, Ms. Kelly.

Mr. Scott, did you have a statement this morning?

Mr. SCOTT. No.

Chairman BAKER. Mr. Lynch?

Mr. LYNCH. No, thank you.

Chairman BAKER. Ms. McCarthy?

Mrs. MCCARTHY OF NEW YORK. No, sir.

Chairman BAKER. Does any member have a further statement? Mr. Renzi?

Mr. RENZI. Thank you, Mr. Chairman.

Mr. Cutler, I also want to thank you for coming today and for your testimony that we are about to hear. I am really specifically interested in the concept of debt collection focusing on the company itself, and not so much the individual. I realize in looking at the statistics and reading them last night that there has been very little success in going after individuals who defrauded investors. I would ask you to please look at the model that we see in our own military, where generals are called on the carpet after years and years of service. They are reprimanded and their pay and retirement is taken away from them. Now, it is easier because the government of the United States controls the flow of money, but it is also because we direct our focus to the DOD and to the agency.

So in your testimony and in your discussions today I hope you will talk about the possibility of our law stretching further than just the individual, but the possibility of it including the ability to go after the company itself who pays out the golden parachute to that individual, and the responsibility for the excessiveness in that golden parachute, so that we are going after two entities, not just one.

Thank you, sir.

Chairman BAKER. Thank you, Mr. Renzi.

Does any other member have an opening statement? If not, at this time I would like to call on our only witness today for this hearing, Mr. Stephen Cutler, who is the Director of the Division of Enforcement for the Securities and Exchange Commission. Welcome, Mr. Cutler.

STATEMENT OF STEPHEN M. CUTLER, DIRECTOR, DIVISION OF ENFORCEMENT, U.S. SECURITIES AND EXCHANGE Commission

Mr. CUTLER. Thank you, Mr. Chairman.

Chairman Baker, Ranking Member Kanjorski, and distinguished members of the subcommittee, good morning. I am pleased to be here today to testify on behalf of the Securities and Exchange Commission. I commend you for inviting me here and I commend the subcommittee for holding a hearing on the important and timely issue of returning funds to investors.

Clearly, this is a topic of mutual concern to the subcommittee and the SEC. Today you asked that I discuss the following matters: first, the principal findings and legislative recommendations in the Commission's report pursuant to section 308(c) of the Sarbanes-Oxley Act of 2002; second, the Fair Fund provision in the Sarbanes-Oxley Act; third, the difficulties the Commission encounters in collecting disgorgement; fourth, the Commission's efforts to improve the effectiveness of its collection program and return more money to defrauded investors.

I will touch on each of these subjects briefly, but I request that my more extensive written statement be included in the record.

Chairman BAKER. Without objection.

Mr. CUTLER. Thank you, sir.

On July 30, 2002, President Bush signed into law the Sarbanes-Oxley Act of 2002. A particularly novel provision of the act that should benefit investors significantly is the Fair Fund provision, section 308(a). The Commission receives payments from wrongdoers in the form of disgorgement and civil money penalties. While the Commission has always been empowered to distribute payments of disgorgement to harmed investors in appropriate circumstances, prior to Sarbanes-Oxley, the Commission was required by law to transmit penalty amounts to the Department of the Treasury. Penalty amounts could not be paid to harmed investors.

Now, as a result of the Fair Fund provision, in Commission actions where both disgorgement and penalties are obtained against a defendant or a respondent, the amount of the penalty may be added to the disgorgement fund for the benefit of victims of the violation. Within the first six months of the enactment of Sarbanes-Oxley, the Commission has authorized the Division of Enforcement at the SEC to seek approval of Fair Fund distributions on more than a dozen occasions.

Section 308(c) of Sarbanes-Oxley required the Commission to review its enforcement actions over the previous five years to determine how such proceedings may be best utilized to provide recompense to injured investors. The principal findings of the Commission study were set forth in a report submitted to Congress on January 24 of this year. The report found that significant payments or the failure to make such payments by a small number of defendants has a disproportionate impact on the Commission's overall collection success. Emergency actions, where appropriate, can limit investor losses and increase the chances of returning funds to investors in almost all types of cases, particularly when the Commission receives early notice of the misconduct.

The appointment of a receiver, where appropriate, can enhance the Commission's ability to maximize investor recovery. The Commission's historic practice of allocating defendants' payments first to disgorgement and then to penalties has produced results within prior statutory restrictions consistent with the principle on which the Fair Fund provision is based, that is that all monies recovered in Commission actions be made available to compensate the victims of securities fraud.

Now, I want to briefly describe the Commission's collection process and some of the difficulties the Commission encounters in collecting disgorgement and penalty amounts. When an SEC defendant or respondent fails to pay disgorgement or penalty amounts owed in a timely manner, there are two primary means by which the Commission staff collects judgments, through the efforts of Commission enforcement attorneys, which we call in-house collection, and through referrals to the Department of the Treasury.

In-house collection may involve litigation or non-litigation efforts, including contempt actions, asset foreclosures, and wage garnishments. Treasury administers two collection programs in which the Commission participates. The first, called the Treasury offset program or TOP, is a centralized process that matches and offsets certain federal payments such as tax rebates, against debts owed to the government. The other program is Treasury's collection services program. In this program, Treasury employs traditional collection agency services.

As described in the Commission's report, there are a number of factors that hinder our ability to collect money judgments owed by securities law violators, whether through in-house or outside means. First, substantial recovery of the fraudulent proceeds is often not possible because the violators have spent investors' money to bring in more investor money. Second, wrongdoers often hide assets, for instance in overseas accounts, to hinder collection efforts. Nevertheless, in appropriate circumstances, the Commission expends significant resources tracking down hidden assets and compelling defendants to satisfy monetary judgments.

Third, in many cases the Commission or criminal authorities may obtain remedies that contribute to defendants' inability to pay amounts owed. For example, the Commission can obtain an order barring a defendant from serving as an officer or director of a public company, or an order barring an respondent from associating with a broker or dealer. Criminal authorities may prosecute defendants and obtain jail sentences. These measures may limit or even eliminate an individual's employment opportunities and thus reduce defendants' ability to pay.

In the last year, the Commission has taken a number of steps to enhance its collection program. We have developed written guidelines for staff on how to pursue collections, established a collection tracking system, and designated collection monitors to oversee the collection program in each of our regional and district offices. Additionally, the Commission created and filled a position for an attorney dedicated solely to collections. We believe that these measures are improving the Commission's ability to collect on judgments, within the constraints I mentioned previously, and to monitor the effectiveness of our collection program.

Now, I want to briefly describe the legislative proposals recommended by the Commission to enhance our collection activities and strengthen the Commission's enforcement program. As I noted earlier, the Fair Fund provision changed the law to permit penalty amounts collected to be added to disgorgement funds in certain circumstances. However, there is a technical limitation in the wording of the Fair Fund provision that only permits the Commission to add penalty amounts to disgorgement funds when a penalty is collected from the same defendant who has been ordered to pay disgorgement. This limitation means that in certain cases, penalties collected from defendants may not be distributed for the benefit of harmed investors.

The Commission recommends making technical amendments to the Fair Fund provision to permit the Commission to use penalty monies for distribution funds in these additional circumstances.

Recommendation two relates to removing certain state law impediments to Commission collection efforts. All states have statutes that exempt certain property, such as a primary residence, from collection by creditors, including the SEC. Some defendants use these exemptions to buy lavish homes, and thus shelter their assets from collection. Currently when trying to collect disgorgement, the Commission staff faces the prospect of protracted litigation to overcome state law exemptions.

Accordingly, the Commission recommends that Congress enact legislation to remove state law impediments such as the homestead exemption to the Commission's debt collection efforts.

The Commission's third recommendation would enhance our ability to collect funds in litigation. Currently, the Commission can contract only for non-litigation collection services. If a private attorney does not have the direct and timely ability to invoke litigation during the collection process, however, it can dramatically lower the opportunity for success. The Commission recommends legislation to expressly authorize the Commission to hire private attorneys to conduct collection litigation, just as the Department of Justice is able to do.

The remaining recommendations I will discuss relate to strengthening the Commission's enforcement power generally, and thus can lead to greater success in returning funds to defrauded investors. First, in order to avoid duplication and increase efficiency, the Commission recommends authorizing the Department of Justice, subject to judicial approval in each case, to share grand jury information with the Commission staff in more circumstances and at an earlier stage than is currently permissible. This proposed modification of the grand jury secrecy rule would be modeled on the law that currently applies to bank and thrift regulators.

Second, also to help the Commission's enforcement staff gather information more efficiently, the Commission recommends that Congress amend the securities laws to allow persons or entities who produce privileged or otherwise protected material to the Commission to do so without fear that by virtue of such production alone, they would be deemed to have waived the privilege or protection as to anyone else.

Third, to increase the effectiveness and decrease the expense of SEC litigation, the Commission recommends legislation to make nationwide service of trial subpoenas available in the Commission's civil actions filed in federal district court. Under current law when witnesses are located outside of a district court's subpoena range and fail to volunteer to appear at trial, the staff must take the witness' depositions and then use those depositions at trial. Such deposition testimony is more expensive and less effective than live testimony.

The fourth and final Commission recommendation I will discuss was not previously included in the Commission's reports to Congress. The Commission recommends that Congress amend the federal securities laws to authorize the Commission to impose civil money penalties in additional cease and desist proceedings. Currently, the Commission has two primary means of seeking civil penalties, in administrative proceedings against entities and persons directly regulated by the Commission, or in federal court actions against any entity or person. The Commission also has the authority to seek remedies other than civil penalties against an entity or person in an administrative proceeding.

The result of this patchwork is that in some circumstances, the Commission must file two separate actions against the same entity or individual to obtain the appropriate array of relief. Moreover, under current law, if the Commission charges a respondent with causing another party's violation of the securities laws, a concept similar to aiding and abetting in a cease and desist proceeding, the Commission can impose a monetary penalty only in very limited circumstances. By granting the Commission additional authority to seek penalties in cease and desist proceedings, Congress would eliminate inefficiency, give the Commission added flexibility to proceed administratively, and strengthen the Commission's ability to hold those who assist in violating the securities laws financially accountable for their action.

In conclusion, the Commission is dedicated to improving its collections record and providing greater recovery to defrauded investors. We look forward to working with this subcommittee on additional measures to further these important goals. I would be pleased to answer any questions any of the members may have.

Thank you.

[The prepared statement of Stephen M. Cutler can be found on page 49 in the appendix.]

Chairman BAKER. Thank you, Mr. Cutler. For the record, I will incorporate all of the recommendations of the SEC report into legislation, which we hope to have prepared for next week. I would just make the statement for members interested, if they have interest in being involved with that matter, please let our office know.

There are a couple of issues that are circling around the construction of the Fair Fund. One is with regard to, or at least alleged complexity of the distribution of assets to wronged investors. Isn't it the case that in prior years the SEC has on many occasions with the result of disgorgements identified a class of wronged investors and made distributions in previous reconciliations of events of this sort?

Mr. CUTLER. The short answer to that question is yes, on numerous occasions.

Chairman BAKER. So the short answer to the complexity issue is, you have done it, we know how to do it, and that should not stand in our way of moving forward with these collections.

Mr. CUTLER. I agree with you.

Chairman BAKER. Secondly, with regard to staffing allocations, my understanding is the SEC generally has about 3,000 employees, but I do not know how many are allocated to the Division of Enforcement.

Mr. CUTLER. It is approximately 1,000 people nationwide, that is spread out over 12 offices, with approximately 375 people in Washington and the balance in 11 offices located throughout the country.

Chairman BAKER. And primarily those would be seeking out wrongdoers, to differentiate that from the collection side, how many folks are actually in the business of pursuing return of assets?

Mr. CUTLER. The way we are structured currently, Mr. Chairman, is to have the members of the staff who are investigating and litigating our cases also pursuing the judgments in connection with those cases. Recently, we hired a collections expert, someone who is steeped in collections law, which is much different, as you know, from the federal securities laws and requires a different sort of expertise, to spearhead our collection efforts. Certainly, with increased staffing that I think the current budget contemplates, we are grappling with whether we ought to expand the group of people that we have who really devote all of their time exclusively to collection efforts.

Chairman BAKER. Let me help on that point. 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. It would be my recommendation in the bill we are to consider to have a structured requirement that first every effort be made for investor restitution; secondly, that funding for investor education be at its optimal level; and thirdly, that any residual funds remaining after penalties, disgorgement or other activities that net income to the agency, then be utilized for additional collection services within the agency.

I understand the professional concern about the outward appearance of incentivizing people to go after wrongdoers for their personal gain or the growth of the agency, but if we structure it in such a fashion where it first must go to the investor, secondly goes to education purposes, and then only if all those needs are met, would it wind up in the hands of the collection services, it seems to me to be appropriate, especially in light of the section of the report which identified the need to contract with outside services for litigation and/or collection purposes. One of the limiting factors to engage in that is resources to supervise it.

I will make it as hard as I can for you to answer this wrong. Would you object to inclusion of that approach in legislation the Congress might carefully consider?

Mr. CUTLER. Let me say first, Mr. Chairman, I so appreciate the support and the sentiment of that notion. I think we should be making every effort, and with your help and the subcommittee's help, we have been and will continue to make efforts to return money to investors. Certainly, we can use all of the budget help that we can get, and I think this Congress and this subcommittee have been instrumental in that regard.

Chairman BAKER. Well, you are a unique regulator. Every other one I have read about in recent weeks has not only collected, they have kept it all and not given any back to the investor. At least we are starting with the premise that we are going to give it back to the investor, then we are going to educate investors, and only then would we keep the money for the purposes of helping other wronged investors.

I find it especially troubling when I read the papers where a particular state government is going to use the proposed, not yet received settlement figures, to build a DMV office. Maybe that is because we want to catch the guys in the cars as they are leaving the state with your money. I do not know what the connection is to wronged investors, but we really have to get a handle on this.

Mr. Kanjorski?

Mr. KANJORSKI. Thank you, Mr. Chairman.

Mr. Cutler, in the report on page 19 and 20, it talks about the benefits of private litigation. Let me read a few sentences to you; "Private litigation, however, offers the dual benefit of compensating Commission enforcement action and providing a mechanism to compensate investors through the award of restitution of damages. In contrast to Commission enforcement actions which have several aims, the aim of private litigation is solely to compensate injured investors. The ability of investors to fully recover their losses, indeed, may largely depend on the use of private actions."

In other words, the Fair Fund and the disgorgement actions are well and good as far as they go, but the most meaningful route for investors to receive restitution for their losses is through private lawsuits. Is that correct?

Mr. CUTLER. Yes, sir. I think it is clearly the primary goal of law enforcement and civil law enforcement to deprive a wrongdoer of ill-gotten gains. I think the brilliance of the Fair Fund provision is that it takes that goal and does not do anything to diminish it, but at the same time I think satisfies another goal, which is to try to get as much money as possible back to the harmed investors, but it is certainly not the only means of doing that. Private litigation is an important part of the landscape in the federal securities law area.

Mr. KANJORSKI. As you know, in 1994 in the case of Central Bank of Denver, the Supreme Court ruled that private parties cannot recover damages from aiders and abettors of fraud, such as the accounting firms and investment banks that assist in perpetuating frauds. Soon after this ruling, the Congress restored aiding and abetting liability for the SEC, but not for private litigants. The report on aiding and abetting liability that the SEC submitted to our committee says that from a period of January 1, 1998 until December 31, 2001, the SEC concluded enforcement actions including against aiding and abetting actions over 1,700 securities professionals.

My question is, given your acknowledgement that private lawsuits are really the place that investors should look to recoup their losses, does it make sense not to allow those investors to sue aiders and abettors just like the SEC can? And wouldn't that help us achieve our goal of full recovery for victims of securities fraud?

Mr. CUTLER. I have not studied the issue of the impact of eliminating aiding and abetting liability in private actions. I will say that my sense of where our judicial system is going is to expand the concept of liability such that the division between aiding and abetting and primary liability has become less important. I think the primary example I can think of in that regard is Judge Harmon's decision in the Enron matter in Texas, where she refused to dismiss the case against a number of defendants who had argued that essentially the claim was another way of stating an aiding and abetting claim, as opposed to a primary claim. She rejected that motion on the part of those defendants.

Mr. KANJORSKI. Don't you think that Central Bank of Denver would have to be reversed by the court for that to stand up?

Mr. CUTLER. I think it would be imprudent of me to comment on what a court might do with respect to Judge Harmon's ruling. The Commission, if my recollection is correct, filed an amicus brief in support of the plaintiffs in that Enron matter and I believe that Judge Harmon could decide to refuse to dismiss that case, which is what she did.

Mr. KANJORSKI. Since the Congress has restored aiding and abetting to the SEC, why can't we in this legislation just restore across the board to investors, too, in private lawsuits?

Mr. CUTLER. You certainly could. I do not think the agency has taken a position, and I do not think it has done a study of the impact of the aiding and abetting provision.

Mr. KANJORSKI. Can you get us some information on that?

Mr. CUTLER. We can try to do that.

Mr. KANJORSKI. I appreciate that.

One other thing, Mr. Chairman, before I relinquish my time, if you do contract out, how are we going to be certain that there is not a good old boys club on the assignment of these cases? Are they going to be pursued in some way through, I know it is very difficult to bid out professional services. Are you going to use contingency fees or are you going to pay hourly rates?

Mr. CUTLER. Let me grapple with the second question first, the method of payment. I think most firms in this area do work on contingency, but the fact is since we have not gotten the authority yet, we have not really thought about whether it makes more sense to pursue one form of payment over another. In terms of making sure that there is not a good old boy network in connection with who is selected to pursue a judgment, we are subject to and we go through whenever we contract with outside parties, a very rigorous process to make sure that it is done fairly and equitably, and that the best party to do the job is selected to do the job. I know that we are committed to ensure that happens here if we get the authority to go ahead.

Mr. KANJORSKI. There is some feeling on the Hill about contingency fees. That is part of the problem and the need for tort reform, so you have to be very careful. This is going to be an issue that some of my friends on the other side of the aisle do not believe in contingency fees, that they are inherently bad. So you have to be very careful how you tread on that.

Mr. CUTLER. I am sure we will be careful, sir.

Chairman BAKER. Ms. Kelly?

Mrs. KELLY. Thank you, Mr. Chairman.

Mr. Cutler, there is a well known fact that civil lawsuits take forever, and this may not be the best way for us to return people's money. There is one other thing. A single agency working with the authority can freeze money before it goes offshore. Those are just a couple of things to think about as you address some of the concerns that Mr. Kanjorski has raised. I think that the points need to be thought through and certainly I know that this committee would work with you to try to speed the recovery and the redistribution of ill-gotten gains by some of the people. That is what the Fair Fund Act is all about.

I wanted to ask you another question as well. It seems to me that our governmental agencies do not work with each other very well. You have asked authority to have the Department of Justice share grand jury information. When you are thinking about contracting out, would it not be helpful to you to perhaps work with the DOJ, and if there is a suit that has to be run, run the civil and criminal suits together, your agency and the DOJ. It seems to me that would streamline the process and get to where we in Congress are interested, and that is get the money and get it back to the people. Do you want to comment on that?

Mr. CUTLER. Sure, Representative Kelly. We do try very hard to coordinate what it is that we are doing on the civil side with what our criminal law enforcement counterparts are doing on the criminal side. Yesterday, as you may know, we announced an action against eight executives and employees of Qwest Communications, at the same time that the Department of Justice announced criminal indictments against four of those employees. I do think it is critical that we do everything we can to leverage the government's resources to go after the wrongdoers as aggressively as we can.

I think the reason why we have proposed lifting some of the restrictions on grand jury information is I think it would help us to be able to coordinate those actions in a way that is much more efficient and makes much more sense. As of right now, if our criminal law enforcement authority counterparts proceed through a grand jury, we will not have access to that information. Just earlier this week, we held a two-day conference at the SEC in order to train some of our criminal law enforcement counterparts, including members of U.S. attorneys offices around the country, FBI agents and others, on securities law issues that come up in the criminal law context. It is an issue where we have tried to be very sensitive to the coordination.

Mrs. KELLY. I am specifically thinking right now about the Enron case, where there were members of the boards of directors there that also participated in enriching themselves at the price of costing their investors. I would hope that in a case like that, there would be a case to get after those people through not only civil, but also criminal suits. It would be I think important that we force those people to recognize their fiduciary responsibility as being board members. We have laws on the books that are bringing them to a criminal, there are criminal penalties attached there, I believe. If you need some support there, please let us know because we have got to try to get this money back to people, and that is the whole focus as I see it of the Fair Fund Act.

Thank you, Mr. Chairman. I yield back.

Chairman BAKER. Thank you, Ms. Kelly.

Mr. Scott, you are next on recognition.

Mr. SCOTT. Yes, Mr. Cutler, you had mentioned in your testimony that you would like for Congress to exempt from the security cases the states' homestead exemptions. Why is that, and what examples, or what has been the extent of debtors using or abusing the Homestead Exemption Act?

Mr. CUTLER. It has certainly been the case, particularly when it comes to disgorgement, we have been faced with protracted litigation, or the prospect of protracted litigation, in connection with homestead exemptions. I think we have all seen photographs of some very lavish homes that have been built by respondents and defendants in federal securities law civil enforcement actions. While I do not have any particular examples, we can provide those to you, Representative Scott, of instances where we have sought disgorgement, but we have been confronted with a homestead exemption. I know that it happens with some frequency. What we are trying to do is get as much money as we can back to investors. The homestead exemption can really stand in the way.

Mr. SCOTT. I yield back.

Chairman BAKER. Thank you, Mr. Scott.

Mr. Renzi?

Mr. RENZI. Thank you, Mr. Chairman.

Mr. Cutler, thank you for your report and your testimony, and for fielding our questions. I appreciate you coming over today with your staff.

I come out of Arizona, home to Charles Keating. I can remember selling insurance out there in Arizona during those days. We were trying to sell directors and officers insurance to the banking industry. There was an old saying that came out of the banking industry, which was that the fastest way to make a good businessman a bad businessman was to lend him too much money.

I recall trying to sell directors and officers insurance to the thrift savings industry. If you recall back, that whole debacle that we went through in those days, one of the solutions we found was that the board of directors of the thrifts and the savings could be held liable because of the excessive payouts that they would make, for the excessive loans, or the sweetheart deals that they would give to people who came and borrowed money. I cannot help but draw the correlation now between where we are in those days and where we are now.

Although I very much compliment you for your report, I notice we are focusing specifically on the defendants. I think I gave you fair warning in the introduction, to ask you now, shouldn't we look at the liability of the board of directors? Shouldn't we be able to say that their fiduciary obligation includes a personal responsibility to the investors that when they pay out these golden parachutes and they provide these excessive benefits at a time when the company's books or the stocks are in question, is that truly sound? And should corporate assets be also an area where we look for collection? Could you also, a second part of my question, answer unintended consequences by going after board members and corporation assets?

Thank you, sir.

Mr. CUTLER. That is an excellent question, Congressman. This is an issue that we are very sensitive to. First, I should say there is no financial reporting case that we investigate where we do not look at the conduct of the board of directors. Very recently the Commission sued Mr. Walsh, a Director of Tyco, in connection with his actions relating to that company. Again, I feel very strongly that we have to look at this whenever there is a financial reporting failure on the part of a public company.

In connection with efforts to ensure that companies do not pay out money, when they have done something wrong, pay out money to the wrongdoers; I think a good example of the Commission's sensitivity to that issue is the WorldCom matter, where the Commission went into court within 48 hours of WorldCom's announcement of its accounting misstatements and asked the court for an order freezing or prohibiting extraordinary payments of money absent court approval. That is something that the Sarbanes-Oxley Act also makes it much easier for us to do. I think you can expect that we will use opportunities in the future to take actions like that to ensure that monies are not paid out to the wrongdoers or to the alleged wrongdoers.

There have been other cases, I can tell you, where companies, because of Sarbanes-Oxley, and because of what they saw that we did in WorldCom, are much warier of paying out money, paying out golden parachutes to someone that they have severed ties with otherwise because of alleged wrongdoing.

Chairman BAKER. Thank you, Mr. Renzi.

Mr. Lynch?

Mr. LYNCH. Thank you, Mr. Chairman.

Mr. Cutler, I also want to thank you for coming here today with your staff, and your willingness to testify and help the committee with its work. I value the recommendations that you have offered the committee. I agree that restitution is a noble cause, and I think that given the history that we have heard here earlier about the Enron case and WorldCom and others, there has got to be a way that we can repair at least some of the losses to investors.

I do want to go back to Mrs. Kelly's remarks, though. I think that beyond restitution and beyond disgorgement, there is also an inherent value in relentless enforcement of the law. It goes beyond the ability to put all the money back into the investor's pocket. It goes beyond extracting as much of the ill-gotten gains from any of these individuals. It goes to the very enforcement of the law for the purpose of protecting values that we in this society have prioritized, if you will.

I noticed in your written testimony, although you necessarily abbreviated your remarks, that you talk about, for example, this

Crazy Eddie case, the SEC versus Crazy Eddie. Crazy Eddie apparently was not that crazy. He hid his money in at least six different countries, and required us to try to get as much back as possible. I am sure that there are many of his creditors and investors who, even if presented with the reality that it is very difficult to get that money back because he has taken such time and lengths to conceal his assets, I think that those investors and creditors would be well-served in knowing that through your efforts and others, that Crazy Eddie would never have a moment of peace. I think that it is the power of example that we offer in the diligent and relentless pursuit of justice that is a big part of your role.

So while I certainly understand from one standpoint your concerns whether or not the efforts of prosecuting a disgorgement action would actually pay for itself or the costs of that disgorgement action would actually be justified with the resulting distribution, I do not think that is the end of the equation. I think that we can very much hope that future behavior might be impacted on the way we handle these scandals, and that it needs to go as far up the chain as possible. I know that the chairman has mentioned about the board of trustees, and others have mentioned about making sure we go to every corner of the corporate structure in order to extract restitution, disgorgement, or just plain justice. I just hope that we do not make this a profit and loss analysis in enforcing the law.

That is all I have, Mr. Cutler.

Mr. CUTLER. I could not agree with you more, Representative Lynch. I think it is critical that law enforcement work other than on a profit and loss basis. That is why we did pursue Eddie Antar to the corners of the globe. That is why we pursued Robert Brennan, and that is why we pursued Paul Bilzerian. We have a mission to protect investors, but also to achieve deterrence. A very important part of that is that we send the message loudly and clearly that we will pursue you; that we will go after you if you have broken the law. This is not just about how much money we can get back, and how much money we can return to investors.

Mr. LYNCH. Thank you.

Chairman BAKER. The gentleman yields back?

Mr. LYNCH. Yes, thank you.

Chairman BAKER. Thank you, Mr. Lynch.

Ms. Biggert?

Mrs. BIGGERT. Thank you, Mr. Chairman.

Mr. Cutler, it seems like there is an awful lot of process here that many parties are partaking in. My question involves the states. I know you cannot divulge some of the details concerning the enforcement actions, but some statements about the global statement have talked about that only the federal portion of the funds are potentially available to provide investors with restitution. Do you know whether any states intend to provide the restitution, or will the states simply place the money in their treasuries?

Mr. CUTLER. Representative, I am constrained about what I can say in connection with the global settlement of the research analyst matter. It has not yet been finalized or approved by our Commission. I think I can say that at this point I do not know whether any states intend to put any of the money that they receive as a result of the settlement in a distribution fund for investors.

Mrs. BIGGERT. Okay. Then you talk about how the Commission needs to have people that are well aware of many different jurisdictions; the State laws. And then later on, you talk about having them do away with so many of the State law impediments for the collection of judgments, and administrative orders. Will the states still be involved, then, in this type of litigation?

Mr. CUTLER. Well, there certainly will still be state law issues in connection with collection matters. Federal rule of civil procedure 69 provides that it is the state law method of collection that should be the basis for our efforts, even in Federal court.

Mrs. BIGGERT. So you are not recommending changing—

Mr. CUTLER. Well, it is something I think we should give some thought to, Representative. I do not think we have done enough thinking about that issue to date. As the law currently stands, I know that state law expertise is something that is very helpful in the collections area.

Mrs. BIGGERT. Thank you.

Thank you, Mr. Chairman.

Chairman BAKER. Thank you, Ms. Biggert.

Mr. Meeks?

Mr. MEEKS. Thank you, Mr. Chairman.

I am sorry I missed your testimony, so I hope that I am not repeating anything that you might have said, but since there is only a few of us here, then maybe for my edification you can expound upon them.

The first, I was just wondering about the collections of penalties. How much money in addition to the disgorgements before penalties, how much additional money do you think that put in the pots so that people can be reimbursed or for restitution?

Mr. CUTLER. Mr. Representative, that is so variable. When I say that, I mean that it really depends on what kind of case that we are bringing. Just by way of example, in this past year we brought an action against Credit Suisse First Boston in connection with their IPO allocation practices. In that case, the penalty amount was $30 million. That is a significant amount, but that is unusual and we do not have those every day.

Certainly, recently we have had some very large penalty amounts. I think in that regard, it is very helpful that the Fair Fund provision allows the government to put that money toward investor recovery, as opposed to just paying it to the treasury.

Chairman BAKER. Would the gentleman yield on that point?

Mr. MEEKS. Yes.

Chairman BAKER. I would just like to point out, although not yet agreed to, the potential global settlement of about $1.4 billion, published reports indicate that about $900 million of that could be made available for investor restitution, by far the largest amount potentially agreed to. For what it is worth, of course I am very interested in seeing that agreement move in that direction, not wanting to influence anybody inappropriately, but I would hope that if we reach that kind of agreement, that the investors would see that significant assistance.

I thank the gentleman for yielding.

Mr. MEEKS. The other thing, I have noticed in the report it indicated that as far as collection is concerned, the lack of resources and staff and personnel have something to do with the hindrance of collections. I know that this committee has recently appropriated more money. I was wondering, will that be sufficient so that we can go and have better collections, with reference to disgorgement funds?

Mr. CUTLER. I think the recent budgetary measures will help considerably. You always have to do a balancing. What resources do you want to take away from pursuing ongoing securities fraud and devote to the collection process? You have got to do that balancing because it is important that we collect, because if we do not, that diminishes the effectiveness of the enforcement process overall. But I think given staffing levels that we can anticipate as a result of Congress' recent budget action, I am hoping that we can devote more resources to the collection effort.

Mr. MEEKS. Finally, my last question, and maybe you can answer this, because I am still unclear in my own head, just looking back at the entire root cause of the current issue, whether or not the breakdown in investor safeguards, whether that was initially a problem of sophisticated accounting techniques that were fooling the auditors, or whether it was collusion on the part of the auditing companies, just so we could try to develop and focus on what the root causes are so that we do not have to worry about going after the folks to help individuals who have been defrauded.

What do you think the root causes were? How did we get into this mess?

Mr. CUTLER. It is such a complicated question, Mr. Representative. There are so many causes, and I think academics and others smarter than I are going to spend a lot of time trying to figure out what all the causes are. Certainly there have been systemic issues that I think Sarbanes-Oxley and some of this subcommittee's efforts were designed to address problems with the integrity of the reporting process; incentives on management in connection with the financial reporting process. The role of auditors is one that has to be looked at very carefully. There are so many causes, and I am not sure that I am the person to turn to. I think of my role as going after the people who did it, and I think less about why it has happened, and more about doing our job and going after the people who caused the problem.

Mr. MEEKS. I yield back, Mr. Chairman.

Chairman BAKER. I thank the gentleman.

Mr. Inslee?

Mr. INSLEE. Thank you.

I want to make sure I understand your answer about contingency fees. I thought you said that you had not been given authority for that, or maybe you can tell me what your plan is on recoupment.

Mr. CUTLER. One of our proposals is that we be given the authority to outsource the collection efforts, the litigation collection efforts. What we have not grappled with is how those outside collection efforts would be paid for, that is, by contingency fee or by other methodology.

Mr. INSLEE. You do not need congressional approval to make that position, do you?

Mr. CUTLER. I do not believe so. What we do not have so far is congressional approval to actually outsource the litigation efforts.

Mr. INSLEE. I see. Well, as just one person, I hope you do consider contingency fees as an effective way to make sure you have people working on viable cases. Contingency fees separate viable from non-viable cases very effectively, because the pursuer makes a decision very quickly whether it makes sense economically or not. I think it makes sense for you to consider that. I hope you will do that.

A second issue, you made reference to potentially giving you the authority to get some grand jury information to you quicker. You made reference to other scenarios where that is done. Can we just graft those situations directly to your situation at the SEC? Is there any difference we would have to do in doing that? Do you have any guidance on that?

Mr. CUTLER. I believe that is right. Why don't I after this hearing is over confirm that, and we will get back to you Mr. Congressman. I think that what we are looking for is something comparable to what the banking regulators have in this regard.

Mr. INSLEE. Great. I am Jay Inslee from the State of Washington. If you can give me some of that information, I would be happy to work with you on it.

Mr. CUTLER. Thank you, sir.

Mr. INSLEE. Thank you.

Chairman BAKER. I have a follow-up question that I want to revisit; the observation about the outside collection issue. Quoting the report, setting aside for the moment whether it is contingency by the hour or what the reimbursement methodology might be, on page 32 of the report it says the Commission would need additional staffing and technology expenditures to oversee and audit such a program. So there is a resource limitation issue as well, which returns me back to the original question posed about funding at least, if we cannot feel comfortable with SEC staff growth, it would seem to me to be very defensible to have penalties that cannot be returned, penalties that are not needed for investor education, at least go to the program that is funded to oversee outside collection activities, because that purely benefits the individuals who have been wronged.

Given the committee members' comments, I think there is considerable support for granting whatever authority we need to grant. Maybe that is an approach we could pursue that would be more professionally acceptable to the agency, if you do not want to see the money come directly back to the agency for funding additional staff personnel. Is that a potential area to explore?

Mr. CUTLER. I think so. I appreciate any effort to separate out monies that would come to the agency or for the work of the agency from our enforcement activities. As you mentioned, and I think you are very sensitive to, Mr. Chairman, there is an appearance issue when our staff pursues actions and as a result of those actions can enhance our own coffers. I never want to be accused of pursuing an enforcement action, pursuing a collection action because it some way redounds to the agency's benefit. So if there is any way to insulate our enforcement activities from funding and fee issues, I think that is very useful.

Chairman BAKER. I do not want to diminish that attitude. It is so rare. I certainly feel that I want to compliment the agency for that obviously professional concern, because so many are pursuing wrongdoers and keeping the money. But at this juncture, there has got to be a way, given the repetitive statements in the report where actions are limited because of resource limitations to work this out. We will converse with you over the next few weeks to try to figure out if there is a methodology that makes professional conduct permissible.

I want to again express my appreciation to the agency, since we have no further members for questions, for the good work you have done, the timeliness of your report. I hope that in perhaps some formal if necessary, but at least informal way, we can get at least an annual report of dollars generated through disgorgements and penalties that have been distributed, not by individual name, but at least in categorical amounts, how much has been returned to investors as a result of this new activity, so we can assess our effectiveness and judge whether additional modifications to the statute may be warranted.

We will certainly have legislation drafted for the agency's review within the next few days and hope to be successful in seeing its consideration in a very timely manner.

Again, thank you for your courtesies. Our meeting stands adjourned.

[Whereupon, at 11:05 a.m., the subcommittee was adjourned.]

APPENDIX

February 26, 2003

Statement of the Honorable Rahm Emanuel
U.S. House of Representatives
Committee on Financial Services
Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises
February 26, 2003

Mr. Chairman,

In the wake of the corporate scandals involving Enron, WorldCom, Tyco International, Sprint, Adelphia and many other public companies, we discovered that the interests of employees and shareholders had been disregarded by CEOs who viewed their companies as their own personal 'piggy banks'. The scope of corporate malfeasance was greater than anyone had anticipated. As these companies imploded, millions of investors lost money; thousands more lost their retirement savings because, encouraged by dishonest CEOs, they continued to purchase shares of their own companies as stock prices plummeted. At the same time, CEOs and other top managers were aggressively selling their shares. As investor confidence fell, so did the Dow Jones Industrial Average and the NASDAQ. Trillions of dollars of value were lost, and thousands more were laid off from their jobs. Investors in my home state were hit particularly hard. Illinois' pension funds estimate that they lost more than $107 million because of the drop in the value of WorlCom stock after accounting irregularities were exposed. This was on top of the $45 million these pensions lost in the Enron collapse. The Illinois State University Retirement System and Teachers' Retirement System, which invest retirement monies on behalf of hard-working teachers and municipal employees, suffered massive losses as a result of these corporate meltdowns.

The Sarbanes-Oxley Act was aimed at protecting average investors and restoring integrity to the capital markets. Sarbanes-Oxley imposed tough new requirements on auditors and company management, and represents a critical first step in changing the way Wall Street operates. The recent 'global settlement,' agreed to by the SEC, NASD, NYSE, New York Attorney General's office and the largest and best-known broker-dealers is another positive step. This agreement will help clean up the undue influence of investment banking interests on securities research and IPOs at brokerage firms.

However, the Securities and Exchange Commission and exchanges such as the NYSE and the NASD still face substantial challenges in making these reforms a reality. Until small investors see concrete evidence that public companies are being operated honestly, they will not invest their hard-earned money in the equity markets. I encourage SEC Chairman Donaldson to make it his first order of business to appoint a Chairman of the Public Accounting Oversight Board, and to move aggressively to restore the SEC's reputation for independence and effectiveness. The Administration and the Congress should move to fully fund the SEC, which faces a budget and staffing crisis as it attempts to deal with ever more complicated corporate tax avoidance schemes, an increased number of corporate filings, and the implementation of Sarbanes-Oxley.

I commend Chairman Baker and my colleagues for their efforts to return unfairly lost money back into the hands of investors. Corporations and greedy corporate executives should be required to disgorge any of their ill-gotten gains. However, as the SEC stated in its report, the disgorgement process does not work well in all cases. Indeed, there are many instances where the investors' only opportunity for meaningful recourse is through a private right of action. The SEC has consistently maintained this position, and I agree that the FAIR program does not obviate the need in many cases for private lawsuits. I am very interested in hearing today from Steven Cutler, Director of the SEC's Enforcement Division, and I look forward to working with my colleagues on these critical issues.

February 26, 2003

Opening Statement by Congressman Paul E. Gillmor
House Financial Services Committee Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises
Hearing entitled, "It's only FAIR: Returning Money to Defrauded Investors"

Thank you, Mr. Chairman, for scheduling this important hearing today. In the 107th Congress, this committee acted swiftly to address the startling revelations of accounting fraud and other corrupt practices in some of our nation's largest corporations. The Sarbanes-Oxley Act set forth the necessary reforms to our outdated regulatory system that contributed to these transgressions and sought to restore investor confidence in American markets.

An integral part of this legislation was Section 308(a), which established the Federal Account for Investor Restitution, or FAIR Fund, by authorizing the Securities and Exchange Commission (SEC) to take civil penalties collected in enforcement cases and add them to disgorgement funds for the benefit of victims of securities laws violations. These defrauded shareholders must be compensated, if not fully, at least equivalent to any profits received by the perpetrators.

The subcommittee's review, this morning, of The SEC report on enforcement actions required by the Sarbanes-Oxley Act is an important part of our evaluation of the actual effects in practice of the FAIR program. We must pursue all options available to increase the monies recovered in fraud cases for this provision to function effectively. I am particularly interested to hear any ideas from the SEC on how to improve their success rate in acquiring illiquid assets, such as property, cars, etc., and those held overseas and returning those monies to the victims.

I would like to thank Chairman Baker for taking the lead on this issue and working to ensure that investor confidence in our financial system is restored. I look forward to hearing Director Cutler's testimony and being further informed on the legislative changes the SEC would like to see passed to aid in implementation of this provision.

**OPENING STATEMENT OF
RANKING DEMOCRATIC MEMBER PAUL E. KANJORSKI**

**SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE,
AND GOVERNMENT SPONSORED ENTERPRISES**

HEARING ON RETURNING MONEY TO DEFRAUDED INVESTORS

WEDNESDAY, FEBRUARY 26, 2003

Mr. Chairman, we meet today to examine the issue of investor restitution, an issue of great importance to me. Last month, the Federal Reserve determined that U.S. stock ownership increased to 51.9 percent in 2001. Because more and more Americans continue to make investments in our securities markets, we have an obligation to ensure that these individuals are appropriately safeguarded in cases of wrongdoing. Accordingly, I have made investor protection one of my priorities for my work on our committee.

Last year, in the wake of a tidal wave of cases of corporate wrongdoing, we worked to enact into law the Sarbanes-Oxley Act. This law advanced investor protection in a number of important ways, including the creation of the Fair Fund. The Fair Fund, as you know, allows the Securities and Exchange Commission to further help the victims of securities law violations by permitting the agency to add any civil penalties collected in enforcement cases to its disgorgement orders.

However, in order for the Fair Fund to work well -- serving as a deterrent and as a means of returning funds to harmed investors -- we must ensure that the SEC has an effective program that to the maximum extent possible collects the fines, penalties, and disgorgements it orders. As you know, Mr. Chairman, I have been a leader in the congressional efforts to examine these issues in recent years.

In March 2001, for example, I joined with a number of my Democratic colleagues in ordering an investigation by the General Accounting Office of the SEC's disgorgement policies. Last July, the GAO determined that the SEC's efforts to recover illegal gains from financial scam artists had fallen dramatically and required tougher oversight. Between 1995 and 2001, the SEC collected roughly $424 million, or about 14 percent, of $3.1 billion owed in disgorgement cases. This finding represented a sharp drop from the 50-percent collection rate the GAO previously found in 1994. As a result, I called upon the SEC to tighten its disgorgement collection monitoring and to implement other oversight improvements.

In recent years, the GAO has also examined the success of securities regulators in collecting fines and penalties. In the next few months, I expect to receive a follow-up report from the GAO regarding this issue. A previous GAO report, completed in July 2001, determined that these collection rates have generally improved in recent years, but that more improvements can be made. The SEC, for example, now collects about 91 percent of assessed penalties and fines, an increase from 83 percent in a similar GAO study in 1998.

Despite this improvement, the GAO found that the SEC could take steps to enhance the collection of fines referred to Treasury Department's Financial Management Service under the Debt Collection Improvement Act of 1996. When we hear from our distinguished witness later today, I hope that he will address this important issue.

(more)

The effective implementation of the Fair Fund and improving disgorgement and fine collection practices are important efforts to ensure that investors receive at least partial compensation for the losses that they incur as a result of securities fraud. However, the most meaningful route for investors to receive restitution for their losses is through private litigation. We need to ensure that investors harmed by corporate wrongdoers can seek legal redress in our Nation's courts.

Accordingly, I was particularly pleased to read in the SEC's report to Congress about the benefits of private litigation. As the SEC notes, investor lawsuits complement government enforcement action by providing a mechanism to compensate investors through the award of restitution or damages. While the SEC's enforcement actions often have several aims, the objective of private litigation is exclusively to compensate injured investors.

In its report, the SEC also offers a number of recommendations for improving the effectiveness of the Fair Fund. For example, the SEC calls for legislation to exclude securities cases from state law property exemptions, such as homestead exemptions. The SEC additionally suggests that we amend the Fair Fund law to permit the agency to use penalty monies ordered in a particular matter for distribution to injured investors regardless of whether disgorgement was ordered. These ideas have merit, and we should work to address them.

In closing, Mr. Chairman, I look forward to hearing from our witness on the issue of investor restitution. I also look forward to hopefully working with you to examine and adopt the legislative recommendations offered by the SEC in the weeks and months ahead.

Opening Statement
Congressman Ed Royce (CA-40)
26 February 2003
"It's only FAIR: Returning Money to Defrauded Investors"

Thank you, Chairman Oxley and Chairman Baker, for calling this hearing today to investigate what further measures Congress and the Securities and Exchange Commission (SEC) can take to uphold the spirit of the FAIR (Federal Account for Investor Restitution) language that was a fundamental part of the Corporate Accountability bill passed by this Committee during the last Congress. I commend the Chairman for his stewardship of this issue, and for his ongoing pursuit of investor protections that have been integral in ensuring the soundness of our financial markets.

Last Congress, as a member of the Conference Committee for the Sarbanes-Oxley Act, I had the opportunity to explore with my colleagues a number of ways to guarantee that investors who are exploited and defrauded by corporate malfeasance are offered a process to recoup their financial losses. Of the competing methodologies for accomplishing this task that were debated during the conference, the FAIR language proposed by Mr Baker proved to be the most practical.

Under the FAIR statute (Section 308 of the Sarbanes-Oxley Act of 2002), the SEC is authorized to take civil penalties collected in enforcement cases and add them to disgorgement funds for the benefit of victims of those securities laws violations. However, in the subsequent study conducted by the SEC to assess its ability to implement this Congressional prerogative, it found that three additional legislative changes are necessary to allow it to accomplish its goal of returning ill-gotten gains to investors.

First, the SEC has recommended that the Fair Fund be amended to permit the Commission to add penalty monies to the distribution fund even when disgorgement is not ordered. Second, the SEC has asked Congress to give the SEC express authority to hire private collection attorneys for the litigation necessary to collect disgorgement and penalty sums. Third, the SEC has stated that Congressional intent would be served if relevant securities fraud cases falling under the FAIR language were exempted from State law property exemptions, such as homestead exemptions.

I believe that the SEC's proposed changes are common sense and necessary if we wish to uphold the spirit of the Sarbanes-Oxley Act. The SEC should be given all of the tools that it needs to disgorge corporate criminals of their stolen riches, and the recipients of these funds should be the victims of the crime itself. I look forward to hearing from our witness about his views on the FAIR language, and on any other feedback that they can provide to this committee about what legislative action can be taken to protect investors and America's capital markets. I thank the Chairman and I yield back the balance of my time.

TESTIMONY
OF
STEPHEN M. CUTLER
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U.S. SECURITIES AND EXCHANGE COMMISSION

CONCERNING
RETURNING MONEY TO DEFRAUDED INVESTORS

BEFORE THE SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE, AND GOVERNMENT SPONSORED ENTERPRISES

COMMITTEE ON FINANCIAL SERVICES

U.S. HOUSE OF REPRESENTATIVES

FEBRUARY 26, 2003

U.S. Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549

Testimony
of
Stephen M. Cutler
Director, Division of Enforcement
U.S. Securities and Exchange Commission
Concerning Returning Funds to Defrauded Investors

Before the House Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises, Committee on Financial Services

February 26, 2003

Chairman Baker, Ranking Member Kanjorski, and Members of the Subcommittee:

On behalf of the Securities and Exchange Commission, I am pleased to be here to testify before you. In inviting me here today you have asked me to discuss the following matters:

- The principal findings and legislative recommendations in the Commission's report pursuant to Section 308(c) of the Sarbanes-Oxley Act of 2002 ("Sarbanes-Oxley Act" or the "Act");
- The Fair Fund provision in the Sarbanes-Oxley Act;
- The difficulties the Commission encounters in collecting disgorgement; and
- The Commission's efforts to improve the effectiveness of its collection program and return more money to defrauded investors.

I. Background

On July 30, 2002, President Bush signed into law the Sarbanes-Oxley Act of 2002, which some observers have called the most significant and far-reaching securities legislation since the 1930s. Among other things, the Act created the Public Company Accounting Oversight Board, a new oversight board for the accounting profession charged with establishing standards and rules relating to the preparation of audit reports, periodically inspecting the operations of public accounting firms, and investigating and bringing disciplinary actions against public accounting firms and their associated persons.

Among the Act's many other provisions are ones:

- adding new substantive and procedural requirements intended to enhance auditor independence;
- imposing new obligations on corporate audit committees;
- establishing new disclosure and certification requirements for companies and their CEOs and CFOs;
- accelerating the reporting of certain executive officer and director transactions;
- imposing new rules of conduct and professional responsibility on attorneys and securities analysts; and
- criminalizing certain behavior and enhancing a variety of criminal penalties for securities-related offenses.

The Commission has engaged in a number of rulemakings to implement many of these provisions.

Of particular importance to the Commission's enforcement program, the Act also adds a number of new weapons to the Commission's enforcement arsenal, including:

- authority to seek officer-and-director bars in federal court and administrative cease-and-desist proceedings under a new, lower standard;
- the ability to freeze certain extraordinary payments before bringing an action;
- a provision on Commission access to foreign audit work papers; and
- authority to seek penny stock bars in federal court.

A particularly novel provision that should benefit investors significantly is the Fair Fund provision, Section 308(a). In short, this provision allows the Commission, in appropriate cases, to distribute civil money penalties to harmed investors. The Commission receives payments from wrongdoers in the form of disgorgement as well as civil money penalties. Disgorgement is a well-established, equitable remedy applied by federal district courts and is designed to deprive defendants of ill-gotten gains. The Commission may distribute payments of disgorgement to harmed investors in appropriate circumstances. The Commission also obtains orders imposing civil monetary penalties against defendants. Prior to the Act, when the Commission received payment of a penalty, it was required to transmit the funds to the Department of the Treasury. Penalty amounts could not be paid to harmed investors.

Section 308(a) of the Act provides that in Commission actions where both disgorgement and penalties are obtained against a defendant or respondent, the amount of the penalty may be added to the disgorgement fund for the benefit of victims of the violation. Within the first six months of enactment of the Act, the Commission already has authorized the Division of Enforcement to seek federal court approval of Fair Fund distributions on at least a dozen occasions.

II. Commission Report Pursuant to Section 308(c) of the Sarbanes-Oxley Act

Section 308(c) of the Act required the Commission to review and analyze its enforcement actions over the previous five years to determine how such proceedings may best be utilized to provide recompense to injured investors. The principal findings of the Commission's study were set forth in a report submitted to Congress on January 24, 2003. The report found that:

- Significant payments, or the failure to make such payments, by a small number of defendants has a disproportionate impact on the Commission's overall collection success;
- Emergency enforcement actions (seeking temporary restraining orders and asset freezes), where appropriate, can limit investor losses and increase the chances of returning funds to investors in almost all types of cases, particularly when the Commission receives early notice of the misconduct;

- The appointment of a receiver, where appropriate, enhances the Commission's ability to maximize investor recovery; and
- The Commission's historic practice of allocating defendants' payments first to disgorgement and last to penalties has produced results, within prior statutory restrictions, consistent with the principle on which the Fair Fund provision is based – that all monies recovered in Commission actions be made available first to compensate the victims of securities fraud.

The next section describes the collection process and the difficulties the Commission encounters in collecting disgorgement and penalties. These points are also embodied in the report mandated by Section 308(c) of the Act.

A. The Collection Process

The collection process is initiated when an SEC defendant or respondent fails to pay disgorgement or penalty amounts owed in a timely manner. There are two primary means by which the Commission's staff collects judgments: (1) through the efforts of Commission enforcement attorneys ("in-house" collection), and (2) through referrals to the Department of the Treasury ("Treasury").

In-house collection may involve litigation or non-litigation efforts. With respect to in-house litigation to collect <u>disgorgement</u>, the Commission may avail itself of the following alternatives:

- file a civil contempt motion in federal district court (requesting the court to hold the defendant in contempt for failure to pay);
- execute on the judgment in federal district court using state law procedures such as:
    - levying on and liquidating real and personal property (the physical seizure and forced sale of a defendant's property);
    - requesting the courts to issue various writs, such as writs of garnishment to obtain payment from a defendant's wages or other income; and
- request that the Commission garnish a defendant's wages.

With respect to in-house litigation to collect penalties, the Commission, like other agencies, is limited to the methods available in the Federal Debt Collection Procedures Act. These methods include:

- levying on and liquidating real and personal property;
- requesting courts to issue writs of garnishment;
- requesting courts to impose installment payment orders; and
- filing fraudulent transfer actions when defendants transfer their assets in an attempt to hide them.

Treasury administers two collection programs, available to all agencies, in which the Commission participates. The first program, the Treasury Offset Program, is a centralized process that matches certain federal payments to debts owed to the government. When a match occurs, the federal payment is offset to collect the debt. For example, if a Commission defendant has failed to pay disgorgement and is due an income tax refund, the tax refund is offset by the amount the defendant owes.

The other program is Treasury's collection services program. With this program, Treasury employs traditional collection agency services, such as skip tracing, sending demand letters, and making phone calls to the defendant. Treasury cannot conduct litigation to collect the debt. If Treasury is unsuccessful in collecting the debt, it employs private collection agencies to attempt to collect. Treasury sends the debt to up to three private collection agencies. If their efforts are unsuccessful, Treasury will return the debt to the Commission as uncollectable. A private collection agency receives at least 25 percent of any recovery it makes.

B. Difficulties in the Collection Process

A variety of factors hinder the Commission's ability to collect money judgments owed by securities law violators. Unfortunately, many of these difficulties stem from factors outside the Commission's control.[1]

First, in a typical fraudulent securities offering case, substantial recovery of the fraudulent proceeds is often not possible because the violators have spent investors'

[1] See U.S. General Accounting Office, SEC Enforcement: More Actions Needed to Improve Oversight of Disgorgement Collections, at 12-14, GAO-02-771 (Washington, D.C.: July 2002) (discussing factors beyond SEC's control that make it unlikely the SEC will collect all disgorgement).

money to bring in more investor money. Thus, even when the Commission successfully sues the wrongdoers and obtains sizable judgments, these individuals lack sufficient funds to pay any judgment or to compensate investors.

In addition, wrongdoers often hide assets to hinder collection efforts. In the appropriate circumstances, the Commission expends significant resources tracking down assets and compelling defendants to satisfy monetary judgments. One example cited in the Commission's Section 308(c) report is the "Crazy Eddie" matter, in which the staff conducted a worldwide search for, and extensive litigation over, Eddie Antar's assets.[2] Even though the Commission and Crazy Eddie's trustee brought actions in six countries to recover approximately $64 million, millions of dollars remain unaccounted for.

In many cases, some of the Commission's most effective investor protection remedies may contribute to defendants' or respondents' inability to pay amounts owed. For example, to help prevent future violations, the Commission can obtain orders barring wrongdoers from the securities industry, from service as officers or directors, or in other capacities. Such bars, however, limit an individual's employment opportunities, and thus may reduce defendants' ability to pay. Furthermore, state or federal criminal authorities may also prosecute securities law violators. As a result, these individuals may be incarcerated and unable to earn money with which to pay their disgorgement or penalty orders.

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

Legal restrictions applicable to in-house litigation also may make collecting unpaid judgments difficult. As described above, the legal procedures that the staff may employ to collect disgorgement judgments are different from those the staff may use to collect penalty judgments. Consequently, collection litigation against a single defendant may be bifurcated into one proceeding to collect disgorgement and another proceeding to collect penalties. Some of these procedural issues may be resolved as a result of Section 308(a) of the Act – the Fair Fund provision.

Prior to the Fair Fund provision, the Commission pursued the collection of disgorgement before penalties in order to maximize the amount of money that could be returned to defrauded investors. Since enactment of the Sarbanes-Oxley Act, although different types of proceedings to collect penalties and disgorgement are still necessary, those proceedings can now be initiated simultaneously, or an action to recover penalties could be initiated first. Because, under the Fair Fund provision, all monies recovered from either a disgorgement or penalty proceeding can be returned to investors, the Commission has greater flexibility to choose the most advantageous collections venue. The Fair Fund provision, however, cannot address another difficulty in collecting disgorgement judgments. To execute on disgorgement judgments, the Commission must employ state law procedures, requiring the staff to become proficient in the law and procedures of multiple jurisdictions. Developing such proficiency takes staff time away from investigating and stopping other violations of the federal securities laws. As discussed further below, to conserve staff resources, the Commission recommended in its Section 308(c) report to Congress that it be given the authority to hire private collection attorneys located in the relevant states. Local counsel would have the necessary expertise readily available.

Because the Commission wants to improve in-house collection and historically has received relatively low returns through the Treasury programs, the Commission has been examining how to improve collection methods.

III. New Methods to Return More Money to Investors

Using the Sarbanes-Oxley Act provisions, bringing enforcement actions as quickly as possible, and revising internal collection procedures are the most important changes the Commission has made in striving to increase its collections and return more funds to investors. The Commission has also recommended several amendments to current law that it believes will assist its collection program, strengthen its enforcement efforts generally, and provide more compensation for defrauded investors.

A. Using the New Sarbanes-Oxley Act Provisions

Section 308(a) of the Act – the Fair Fund provision -- is an important step in helping the Commission return more money to defrauded investors. The Commission has already granted authority to the staff to file at least a dozen motions in court to apply the Fair Fund provision in a wide range of enforcement actions.[3] The Commission

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[3] E.g., SEC v. John Giesecke, Jr., et al., Lit Rel. 17745 (Sept. 25, 2002), SEC v. Tel-One, Inc., et al., Lit Rel. 17337 (Jan. 24, 2002).

intends to use the Fair Fund provision whenever economically feasible, consistent with its mission to protect investors.

Section 803 of the Act should also help the Commission's collection efforts. Section 803 amended federal bankruptcy laws to make non-dischargeable certain debts, including judgments and settlements that result from a violation of federal or state securities laws. This provision makes it harder for securities violators to avoid Commission judgments, and as a result may make more of their assets available to compensate defrauded investors.

B. Improving Collection Guidelines and Tracking

Last year, the Commission took several steps to enhance its collection program: it developed written guidelines for staff on how to pursue collections; established a collection tracking system; and designated collection monitors to oversee the collection program in each Commission regional and district office. Additionally, the Commission created and filled a position for an attorney dedicated solely to collections. We believe that these measures are improving the Commission's ability to collect on judgments and to monitor the effectiveness of the collection program.

C. Recommendations for Legislation

The Act required the Commission to conduct three studies related to its enforcement program. Section 308(c) required a study regarding Commission proceedings to obtain civil penalties and disgorgement, and methods to provide more effective recompense to injured investors. Section 703 required a study to determine the number of securities professionals who had violated, or aided and abetted violations of, the federal securities laws. Section 704 required a study of Commission enforcement actions involving reporting violations and accounting restatements.

The Commission provided its reports on these studies to Congress on January 24, 2003.[4] The Commission's reports included a number of recommendations for amendments to the securities laws. As discussed below, some of these recommendations directly address the Commission's ability to collect money from wrongdoers and return it to injured investors; others are designed more generally to improve the effectiveness of the Commission's enforcement program, and thus indirectly assist the Commission's ability to prosecute, and collect judgments from, securities law violators.

1. Fair Fund Amendment to Increase Payments to Investors

The Fair Fund provision created a significant change in the law to provide for greater return of moneys to investors victimized by securities law violations. The Fair Fund provision changed the law to permit penalty amounts collected to be added to

[4] Report of the Securities and Exchange Commission Pursuant to Section 308(c) of the Sarbanes-Oxley Act of 2002, Jan. 24, 2003; Report of the Securities and Exchange Commission Pursuant to Section 703 of the Sarbanes-Oxley Act of 2002, Study and Report on Violations by Securities Professionals, Jan. 24, 2003; Report of the Securities and Exchange Commission Pursuant to Section 704 of the Sarbanes-Oxley Act of 2002, Jan. 24, 2003. (Available at http://www.sec.gov/news/studies.shtml)

disgorgement funds in certain circumstances. This expanded the pool of funds available to compensate investors for their losses.

As noted, the Commission has already begun to use the Fair Fund provision, and has asked courts to add penalty amounts collected from defendants to disgorgement funds. However, as discussed in the Commission's 308(c) report, there is a technical limitation in the wording of the Fair Fund provision that limits its utility in some circumstances. As enacted, the provision only permits the Commission to add penalty amounts to disgorgement funds when a penalty is collected from the *same defendant* that has been ordered to pay disgorgement. There are cases, however, where some defendants may not be ordered to pay disgorgement and it would be beneficial if the Commission could distribute penalties collected from these defendants (as well as from defendants who are paying disgorgement) to harmed investors in that case. Indeed, in some cases, the Commission may not obtain disgorgement from any defendant, but may obtain civil money penalties. In such cases, it might nevertheless be feasible to create a distribution fund for the benefit of victims in that case. We recommend making technical amendments to the Fair Fund provision to permit the Commission to use penalty moneys for distribution funds in these additional circumstances.

2. Exclude Securities Cases from State Law Property Exemptions

As discussed above, section 803 of the Sarbanes-Oxley Act assisted the Commission's collection efforts by making certain securities law judgments non-dischargeable in bankruptcy. Even with this change, however, the Commission still encounters cases where securities law violators can rely on state law homestead exemptions and other protections to shield their assets from collection. All states have statutes that exempt certain property from collection by creditors, including the Commission. Some defendants use these exemptions to shelter their assets from collection. For example, in certain states, defendants can shelter millions of dollars in their primary residences -- the "homestead" exemption -- that might otherwise be available for collection by the Commission. Currently, when trying to collect disgorgement, the Commission's staff usually must engage in protracted litigation to avoid state law exemptions.

Accordingly, the Commission recommends that Congress enact legislation to remove state law impediments to the Commission's collection of judgments and administrative orders. By excluding Commission securities fraud judgments from state law property exemptions, Congress can increase the deterrent value of Commission enforcement actions against wrongdoers, and also make more assets available for recovery by the Commission and return to investors.

3. Empower the Commission to Contract with Private Collection Attorneys

Any successful collection program must have a strong litigation component. Current authority allows the Commission to contract for non-litigation collection services. If a private attorney does not have the direct and timely ability to invoke litigation during the collection process, however, it dramatically lowers the opportunity for success. Accordingly, in its Section 308(c) report, the Commission recommended legislation to expressly authorize the Commission to hire private attorneys to conduct litigation to collect its judgments. This proposal is modeled after the Department of Justice's ("DOJ") current authority to hire private counsel to collect judgments. DOJ has used its authority to hire private attorneys to employ Federal Debt Collection Procedures Act ("FDCPA") methods to collect judgments. The Commission's proposal also contemplates that private attorneys it hires would have the ability to conduct litigation under FDCPA. However, the private attorneys would also be expected to conduct litigation tailored to the collection of disgorgement, including filing contempt motions and executing on judgments using state law procedures, so as to undertake the most extensive collection efforts possible.

Specifically, the private attorneys hired by the Commission would be required not only to file contempt proceedings, but also to be proficient in state law procedures required to execute on disgorgement judgments. They would also appear in court proceedings where they would be expected to file liens and other papers, and would represent the Commission in settlement and compromise negotiations. Authority to approve any settlement would remain with the Commission, however.

Currently, collection litigation diverts staff resources from investigating and stopping other violations of the federal securities laws. Contracting-out this function would conserve staff resources for major mission functions, while increasing amounts available to recompense injured investors. Further, local attorney expertise should provide quicker and more efficient returns.

4. Expanded Access to Grand Jury Materials

In its report to Congress under Section 704 of the Act, the Commission made several recommendations designed to enhance the effectiveness of the enforcement program generally. One of these recommendations was to authorize the Department of Justice, subject to judicial approval in each case, to share grand jury information with the Commission staff in more circumstances and at an earlier stage than is currently permissible. This proposed modification of the "grand jury secrecy rule" would be modeled on the law that currently applies to bank and thrift regulators.

Under existing criminal procedure law applicable to the Commission, in most cases the Commission's staff will not receive access to grand jury information, and therefore the staff must conduct a separate, duplicative investigation to obtain the same information already in the hands of federal criminal authorities. The "grand jury secrecy rule" results in an inefficient use of government resources, and places additional burdens on private persons who must provide essentially the same documents and testimony in multiple investigations.

5. Nationwide Service of Trial Subpoenas

In its Section 704 report, the Commission also recommended legislation to make nationwide service of trial subpoenas available in the Commission's civil actions filed in federal district court. Under current law, the Commission may issue trial subpoenas in federal court actions only within the judicial district where the trial takes place or within a "100-mile bulge" from the courthouse. When witnesses are located outside of the district court's subpoena range and fail to volunteer to appear at trial, the staff must take the witnesses' depositions, and then use those depositions at trial. Such deposition testimony is more expensive and less effective than live testimony.

The Commission currently has authority for nationwide service in administrative proceedings. The Commission staff's favorable experience in the administrative forum supports extending those provisions to civil actions filed in federal district courts. Moreover, other federal agencies with comparable missions have long had such nationwide service authority.

Granting the Commission authority to serve trial subpoenas nationwide would provide substantial advantages. The Commission would save significantly on the costs of creating and presenting videotaped deposition testimony, on travel costs, and on staff time due to the elimination of unnecessary depositions. It would also provide the benefit of more frequent live witness testimony before trial courts in Commission cases.

6. Shield the Production of Privileged Information

In its Section 704 report, the Commission also recommended that Congress amend the Securities Exchange Act of 1934 to allow persons or entities who produce privileged or otherwise protected material to the Commission, such as a report of an internal investigation conducted by attorneys, to do so without fear that, by virtue of such production alone, they will be deemed to have waived privilege or protection as to anyone else.

Voluntary production of information that is protected by the attorney-client privilege, other privileges, or the attorney work product doctrine greatly enhances the Commission's investigative efforts, and in some cases makes them more efficient. In many cases, persons or entities would be willing to share privileged information with the Commission's staff if they could otherwise maintain the privileged and confidential nature of the information. Currently, a person who produces privileged or otherwise protected material to the Commission runs a risk that a third party, such as an adversary in private litigation, could obtain that information by successfully arguing that the production to the Commission constituted a waiver of the privilege or protection. This situation creates a substantial disincentive for anyone who might otherwise consider providing protected information.

This proposal would help the Commission's enforcement staff gather information in a more efficient manner. More expeditious investigations could lead to more prompt enforcement actions, with a greater likelihood of recovery of assets to return to investors.

7. Money Penalties in Administrative Cease-and-Desist Proceedings

Although not discussed in the Commission's reports to Congress, the Commission also recommends that Congress amend the federal securities laws to authorize the Commission to impose civil money penalties in additional cease-and-desist proceedings. The Commission is already empowered to seek civil money penalties against all persons and entities in the actions that the staff files in district court.

Currently, the Commission has two primary means of seeking civil penalties: in administrative proceedings against entities and persons directly regulated by the Commission, such as broker-dealers or registered representatives; or in federal court actions against any entity or person. The Commission also has authority to seek remedies other than civil penalties against any entity or person in an administrative proceeding. The result of this patchwork is that in some circumstances the Commission must file two separate actions against the same entity or individual to obtain the appropriate array of relief. For example, if the Commission finds cause to order a company or a corporate officer to cease and desist from violating the securities laws but also seeks to impose a civil money penalty, two separate actions concerning the same facts must be filed. Similarly, if the Commission wished to employ its new authority to seek an officer and director bar administratively, and also wished to seek a money penalty from the corporate officer, it would have to file two separate actions. Moreover, under current law, if the

Commission charges a respondent with "causing" another party's violation of the securities laws (a concept similar to aiding and abetting) in an administrative cease-and-desist proceeding, the Commission can impose a monetary penalty only in very limited circumstances.[5]

By granting the Commission additional authority to seek penalties in cease-and-desist proceedings, Congress would eliminate inefficiency, give the Commission added flexibility to proceed administratively, and strengthen the Commission's ability to hold those who assist in violating the securities laws financially accountable for their actions. This proposal also would provide appropriate due process protections for subjects of administrative penalty proceedings by making imposition of a civil penalty in an administrative cease-and-desist proceeding appealable to a federal court of appeals.

IV. Conclusion

The Commission is dedicated to improving its collection success and providing greater recovery to defrauded investors. We look forward to working with this subcommittee on additional measures to further these important goals.

[5] The Commission may in some circumstances seek a penalty in a cease-and-desist proceeding against anyone who was a cause of a violation of certain provisions of Section 10A of the Securities Exchange Act of 1934.

Question by Congressman Fossella:

As we have all had the unfortunate experience of watching the market decline in response to, among other factors, the irresponsibility of a small group of untrustworthy executives in high positions, I particularly have been keeping a watchful eye on how the enforcement process would unfold.

I have sat in this committee room many times listening to political leaders, CEOs, and regulators as they have explained to this committee the need to move to a nationalized market. In the Securities Exchange Act of 1934, Congress created a regulatory body that would act as the national enforcement body of the U.S. markets.

Realizing that I have the ability to look at the recent string of events regarding the enforcement of the market place due to the actions of some of America's senior level executives, I believe that this process is not over. For this reason, I would like to get your thoughts about the power of the State Attorneys General have played in the enforcement process that we have seen of late, and what, if anything, should be done to ensure that our markets are in fact operated and enforced on a nationalized scale by the regulators that Congress delegated these powers to in the 1934 Securities Exchange Act?

Answer:

State securities regulators and attorneys general have played -- and, in my view, should continue to play -- a significant role in making our securities markets the most respected and trusted in the world. The more resources -- federal and state -- we can bring to the cause of maintaining this status, the better off we are. Active state enforcement programs can only benefit investors. At the same time, however, we must be mindful of the Congress' vision -- indeed, its mandate -- of a "national market system." As SEC Chairman William Donaldson observed in his confirmation testimony, "one of the great strengths of our market system is that it *is* a national market system and has not been Balkanized." In a global economy, in which U.S. competitors are taking dramatic steps to integrate their markets and eliminate barriers, a national market is more important than ever. Thus, in my view, it is critical that there be a single dominant regulator, and that the SEC be that regulator. The SEC is able to bring to its consideration of matters affecting our markets a broader perspective -- one informed by national economic and international policy developments -- than can any one state.

I recently delivered a speech on the subject of our dual federal/state regulatory system. A copy of the speech is attached.

Speech by SEC Staff: Remarks at the F. Hodge O'Neal Corporate and Securities Law Symposium

by

Stephen M. Cutler

Director, Division of Enforcement
U.S. Securities & Exchange Commission

Washington University School of Law
February 21, 2003

Good afternoon. It's a pleasure to be here. The description of this panel suggests numerous tempting topics, but I thought I would use my time to address one that for me has left the realm of the theoretical and entered the very real world of my daily life as head of the SEC's enforcement program. Specifically, I'd like to share with you my views, and they are only my views and not those of the Commission or its staff, on the appropriate roles and responsibilities of the federal government and the states in the regulation of our securities markets.

It's an issue that's received a lot of attention as of late. Indeed, at the Senate Banking Committee hearing held last week to consider his nomination as SEC Chairman, Bill Donaldson was asked by a member of the Committee for his thoughts on this subject. Chairman Donaldson observed that "one of the great strengths of our market system is that it is a national market system and has not been Balkanized."

During the last 12 months, the overlapping responsibilities of federal and state securities agencies have been vividly illustrated by the joint investigations of research analyst practices undertaken by the SEC, the self-regulatory organizations, and the states. On December 20 of last year, the Commission, along with the NASD, New York Stock Exchange, New York Attorney General Eliot Spitzer, and other state regulators, announced a settlement-in-principle with the nation's top investment firms to address issues of conflict of interest between investment banking and research analyst activities at major brokerage firms. The "global settlement," if finalized, would address firm (but not individual) liability.

The announcement of the global settlement was preceded by the New York

Attorney General's action against Merrill Lynch, and then an extensive joint investigation among the SEC, the self-regulatory organizations and the states. Although this process has by no means come to a close - indeed, until the Commission authorizes the global settlement-in-principle, not even that aspect of the matter will be final - I view this effort as having been instructive for regulators as well as beneficial to investors.

The investigation of research analyst practices has been a singular one not only for the breadth and importance of the issues being examined, but for the number of different regulators who have actively participated. Perhaps for these reasons, it has been, and continues to be, particularly effective at highlighting important questions concerning the roles of the SEC and state agencies in effecting change in the securities markets. As I've grappled with these questions, it has occurred to me that there may exist certain common principles discernible from the history of the securities laws that should guide federal and state securities regulators alike. After all, we are all public servants doing our best to give life to the dual regulatory system that Congress created. Moreover, keeping our eyes firmly on these principles might, in fact, guide us more effectively in dealing with issues of state/federal cooperation than would any bright-line rules we might struggle to articulate. Today's forum provides me an opportunity to explore these principles in a deliberate fashion.

Indeed, in preparing for this panel, I've found that pursuit of a fairly limited number of central principles animated the lawmakers who created, and subsequently revised, the dual regulatory system in which we operate. With that in mind, I'd like to use my time, first, to identify and discuss these historically important goals, and then to consider the implications of these priorities for contemporary federal/state cooperation in the securities regulation arena.

A Brief Survey of the History of the Securities Laws

Policy makers have been debating the roles of the federal and state governments in protecting investors since before the 1933 and 1934 Acts and the creation of the SEC. Decades before the first federal securities law was adopted, states had begun to implement the so-called blue sky laws. These statutes were enacted in response to the ever-increasing prevalence of overvalued, speculative, and fraudulent securities.[1] Such legislation was very popular, and between 1911, when Kansas adopted the first blue sky law, and 1933, when the first federal securities statute was adopted, all states, except Nevada, implemented such laws.[2]

Despite this blanket of state regulation, by the 1930s there was widespread demand for the federal government to assume a role in policing the markets. According to a Department of Commerce Report, "notwithstanding ... protective state laws, there has never been a period in history when the public has been so grossly mulcted of accumulated savings by shrewd and conscienceless 'securities' manipulators, as during recent years."[3]

This is not to say that Congress questioned the commitment of the states to investor protection. Instead, lawmakers attributed the shortcomings of state-only enforcement to securities fraudsters' ability to operate in the more lightly (or un-) regulated states or by conducting sales on an interstate basis. Thus, two important goals of the federal legislation were to provide uniform standards for offering securities to the public[4] and to eliminate the ability of scammers to "tak[e] advantage of State boundaries."[5]

While there were occasional nods toward the need to avoid too many, or inconsistent, regulations, the single-minded preoccupation of lawmakers appears to have been protecting investors and preventing fraud. Indeed, the 1933 and 1934 Acts included explicit provisions preserving existing state authority to regulate intrastate activities. In sum, Congress' apparent intent at this early stage was to "supplement and strengthen" the existing state regimes,[6] rather than replace them with a single federal regime.

While in 1933 lawmakers thought of federal standards as essential to achieving investor protection, decades later, Congress came to view federal standards as the key to a new priority - efficiency. Congress' first clear articulation of this new priority was in 1980, when it adopted the Small Business Investment Incentive Act, adding Section 19(c) to the Securities Act. Section 19(c) (now Section 19(d)) mandated greater federal/state cooperation in order to, among other things, maximize uniformity in federal and state standards and minimize "interference" with capital formation.[7] Like the 1933 and 1934 Acts, however, it explicitly preserved existing state authority.[8]

By 1996, Congress was moved to address the more practical difficulties arising from the patchwork quilt of state regulation.[9] In the National Securities Markets Improvement Act ("NSMIA"), in contrast to the prior federal securities laws, Congress explicitly pre-empted vast areas of state regulation.[10] The Conference Committee that approved NSMIA explained in its joint statement: "[T]he system of dual Federal and state securities regulation has resulted in a degree of duplicative and unnecessary regulation...that, in many instances, is redundant, costly, and ineffective."[11] In short, Congress could hardly have been clearer in articulating its intent that our dual regulatory system promote efficiency and competitiveness whenever possible.

Congress worried that our dual system of regulation had become *dueling* systems, burdening capital formation, job creation, and commercial innovation.

At the same time, the drafters of NSMIA were careful to explain that while eliminating regulatory burdens, the Act "preserve[ed] important investor protections by reallocating responsibility over the regulation of the nation's securities markets in a more logical fashion between the Federal government and the states."[12] Specifically, under the legislation, the states were to "continue to exercise their police power to prevent fraud and broker-dealer sales practice abuses," but abstain from regulation of "the securities registration and offering process."[13] Moreover, Congress was explicit that the prohibitions on state authority "applied both to direct and indirect State action."[14] That is, states were not to use the regulatory authority they retained to exercise the sort of authority that had been preempted.

Lessons of the Legislative History of the Securities Laws

Let me pause here to summarize what I believe is evident from even this brief discussion of the history of the securities laws. First, aggressively protecting investors and instilling in them confidence in the fairness of our markets is critical to Congress' vision of oversight of our capital markets. Second, especially in recent years, Congress has likewise emphasized the goals of efficiency and competitiveness in our capital markets, and has concluded that uniformity in regulation is a pre-requisite to achieving these goals. Third, Congress continues to believe in the efficacy of a dual regulatory system in which both federal and state agencies serve specific, valuable functions.

In my view, these broad principles can provide helpful guidance to federal and state securities regulators as we carry out our separate and overlapping duties. Indeed, these general principles can have very specific implications in practice. I'll use the remainder of my time to discuss these implications.

Applying the Lessons to Federal/State Cooperation

First, there is no question in my mind that the imperative to achieve consistent regulation of the U.S. securities markets, and of the vast majority of domestic securities offerings, regardless of locale, dictates the need for a single, dominant regulator. Coordinated efforts to achieve uniformity among the states, and between the states as a group and the federal system, have fallen short, even after decades of trying. In adopting NSMIA, Congress expressed its intent to "further advance the development of national securities markets" by establishing the SEC as "the exclusive regulator of national offerings of securities."[15] In a global economy, in which U.S. competitors are taking dramatic steps to integrate their markets and eliminate barriers, a national market is more important than ever.

Moreover, the SEC is able to bring to its consideration of matters affecting our markets a broader perspective -- one informed by national economic and international policy developments -- than can any one state. Accordingly, when confronted with circumstances requiring cooperation or coordination, federal and state securities regulators should keep Congress' command firmly in mind. Our *mutual* goal should be to avoid re-balkanizing (to paraphrase Chairman Donaldson) the securities markets, and effectively, undoing the work Congress has done. We, as public servants and policy makers, should ask ourselves how the actions we contemplate taking as federal or state actors would promote or detract from Congress' vision of a truly national market system.

This is not meant to suggest, however, that I believe the states should be relegated to the backseat of our regulatory system. Let me be clear: state securities agencies have played - and should continue to play -- a significant role in making our securities markets the most respected and trusted in the world. The more resources - federal and state -- we can bring to the cause of maintaining this status, the better off we are. By working together, state and federal regulators can help to ensure that our markets remain the envy of the world.

That brings me to the next or second guiding principle. It is clear that protecting investors from fraud must always remain central to our missions. The *primary* goal of the lawmakers who drafted and adopted the first federal securities statutes was, undoubtedly, investor protection. They were coming to the aid of the many "investors [who] were induced to exchange hard-earned savings of a lifetime for 'securities' which were not worth the paper on which they were engraved or printed." According to the legislative record the members took pains to create, Congress was moved to action by "[r]ecent disclosures in financial circles [that shook] public confidence to its very foundations.'"[16] Perhaps not coincidentally, these concerns have a surprisingly contemporary sound to them.

The Congress that considered NSMIA some 60 years later was not so single-minded, but still unquestionably viewed protection of investors as a high priority. Although the legislation focused on the need to streamline the dual securities regulatory system, the exhortations to enhance competitiveness and efficiency consistently were qualified by the need to preserve aggressive and vigorous investor protection mechanisms.

Thus, lawmakers made clear that the legislation "preserved the authority of the states to protect investors through application of state antifraud laws... [and] to exercise their police power to prevent fraud and broker-dealer sales practice abuses."[17] The state enforcement agencies were characterized as the "local cop[s] on the beat" who were best positioned to quickly detect and address the needs of individual investors. And, of course, the states have proven themselves highly effective in investigating and charging those who defraud their residents, and continue to be committed to doing so.[18]

This alignment of Congressional intent and state regulators' agendas suggests another or third principle that should inform the judgments of securities regulators. We should expect state agencies - and respect the right of state agencies -- to pursue fraudulent conduct within their jurisdictions. State regulators are an important part of the arsenal needed to combat securities law misconduct. The SEC will never have resources sufficient to investigate every allegation of fraud, particularly those affecting a small number of geographically-concentrated investors. Active state enforcement programs can only benefit such investors.

Moreover, a visible and aggressive *state* enforcement machine may motivate *federal* regulators, like me, to respond more quickly to potential securities-related misconduct. Of course, if we in the federal government want to be the dominant securities enforcement authority, we must be vigilant in protecting the investing public. And I think I can safely say that Chairman Donaldson, as well as the Commission and its staff, are single-minded in our determination to do just that.

Such competition among regulators, to be the first on the scene, if tempered by the other principles I've identified, will help ensure that investors' needs are addressed promptly. As public servants, we must admit to ourselves, however, the possibility that a contest to be the most *responsive* regulator could too easily become a contest to be the most *popular* but most *irresponsible* regulator. This in turn can have untold costs - to investors, to issuers, to financial institutions, to the capital markets, to the justice system, and, ultimately, to our credibility as regulators. Federal and state securities agencies must bear this in mind at all times and exercise our judgment and discretion accordingly. As Supreme Court Justice Robert H. Jackson eloquently cautioned in a speech he made as Attorney

General: "While the prosecutor at his best is one of the most beneficent forces in our society, when he acts from malice or other base motives, he is one of the worst."[19]

In sum, as federal regulators, we must acknowledge the value of the states' enforcement firepower, and, in return, prevail upon our state counterparts to recognize that when a state enforcement matter implicates a competing federal regulatory interest, consultation and cooperation with the Commission may be critical.

That brings me to the fourth and *final* guiding principle: adherence to Congress' particular vision of what our dual regulatory system should be. As I've already discussed, lawmakers were quite explicit that those areas of regulation reserved to the federal system should be immune not just from the direct exercise of state authority, but also from the indirect. In my view, this command creates important considerations for the exercise of state enforcement authority. Let me explain.

As an enforcement lawyer, I am quite familiar with the complaint, often raised by defendants or respondents, and even by an occasional SEC Commissioner, that a proposed settlement amounts to rulemaking by enforcement. While I'm confident that we hear that argument far more often than warranted, it points up that an enforcement proceeding can, in fact, realign an industry standard. That is, when faced with the risks and costs of litigating an enforcement action, some parties may agree in settlement to change or restrict their future conduct in significant and far-reaching ways. So what does this have to do with NSMIA and dual regulation?

Consider that, though varying in their breadth, state securities fraud statutes are commonly enforceable through criminal sanctions and civil remedies that, for regulated entities, can be as extreme as the loss of a license. As has been vividly demonstrated, in some circumstances, the prospect of being charged with fraud, even *civilly*, creates very high stakes for securities-industry participants -- indeed, so high, that state regulators may find themselves in a position to dictate dramatic changes in conduct to settling parties. In short, they will have the leverage to effect rule changes through enforcement. Why is this a particular problem in the context of the dual regulatory system? It's a problem because Congress clearly intended, when it adopted NSMIA, that the *federal* government, not the states, establish the rules and policies governing the securities markets, and that it do so on a national, rather than piecemeal, basis. Moreover, Congress specifically warned that the states should not rely on their residual power to set regulatory standards for the national markets. As state and federal regulators navigate the waters of our dual regulatory system, this Congressional command should guide our decisions. Otherwise, we may destroy the balance Congress struck in its effort to strengthen and streamline our national market system.

Conclusion

The question of the appropriate roles of the federal and state governments in our dual securities regulatory system has arisen continually for 70 years, and it's not likely to go away anytime soon. Although some may question the value of legislative history generally, on this subject I believe it can provide federal and state securities regulators with a useful roadmap. The lawmakers who created the dual regulatory system, and those who have maintained it, clearly expressed the belief that regulatory uniformity imposed at the national level, coupled with aggressive and overlapping enforcement authority would best foster fair and efficient markets. And frankly, it's hard to argue with their results to date. But with today's increasingly complex and international securities markets, we need to proceed carefully. As we exercise the discretion with which Congress entrusted us, it is important that both federal and state securities regulators bear in mind the balance Congress sought to strike.

Footnotes

1 Joel Seligman, The Historical Need for A Mandatory Corporate Disclosure System, 9 J. Corp. L. 1, 19 (Fall 1983); Jonathan R. Macey and Geoffrey P. Miller, Origin of the Blue Sky Laws, 70 Tex. L. Rev. 347, 353-360 (Dec. 1991).

2 Hearing on the Federal Securities Act, 73rd Cong., 1st Sess., A Study of the Economic and Legal Aspects of the Proposed Federal Securities Act (submitted for the record by the Department of Commerce), at 93-94 (1933) [hereinafter "Economic Study"].

3 Economic Study at 99.

4 It is worth noting that the desire for - and recognition of the importance of - national uniformity in securities laws did not first arise from adoption of the federal securities laws. In fact, the first significant effort to achieve a more uniform approach to securities regulation occurred several years earlier, in 1929, with the development of the Uniform Sale of Securities Act by the National Conference of Commissioners on Uniform State Laws. This model state statute was adopted by only seven states. Dennis C. Hensley, The Development of a Revised Uniform Securities Act, 40 Bus. Law. 721, 722 (Feb. 1985).

5 Economic Study at 101.

6 Economic Study at 101.

7 Securities Uniformity; Annual Conference on Uniformity of Securities Laws, Release No. 8072, at 1-2 (March 20, 2002).

8 Securities Act, Section 19(c)(3)(C).

9 The effort to encourage nationwide uniformity through creation of a model state securities law had been renewed in 1947. During that period, no two blue sky laws were identical, and the 47 statutes altogether contained a whopping 2800 exemptions. Hensley, 40 Bus. Law. at 721. Nine years later, in 1956, a model act was approved by the relevant drafting bodies. *Id.* The Uniform Standards Act of 1956, or variations thereon, subsequently was adopted in 39 jurisdictions. The Uniform Securities Act was revised in 1985, but adopted in that form by only a few states. It was again redrafted in 2002. Joel Seligman, The New Uniform Securities Act at 1 (2002). These dogged, long-running (and thus far fruitless) efforts to develop a consensus model-act evidence the value legal experts have placed on attaining greater uniformity in securities regulation.

10 Kevin A. Jones, The National Securities Markets Improvement Act of 1996: A New Model for Efficient Capital Formation, 53 Ark. L. Rev. 153, 154 (2000).

11 Joint Expl... of the Committee of Conference Conference

11 Joint Explanatory Statement of the Committee of Conference, Conference Report - National Securities Markets Improvement Act of 1996, HR 3005, House Conf. Rep. No. 104-864 (Sept. 28, 1996).

12 Joint Explanatory Statement of the Committee of Conference, Conference Report - National Securities Markets Improvement Act of 1996, HR 3005, House Conf. Rep. No. 104-864 (Sept. 28, 1996).

13 Joint Explanatory Statement of the Committee of Conference, Conference Report - National Securities Markets Improvement Act of 1996, HR 3005, House Conf. Rep. No. 104-864 (Sept. 28, 1996).

14 National Securities Markets Improvement Act of 1996, H.R. Rep. No. 104-622, 30 (June 17, 1996) [hereinafter "House Report"].

15 House Report at 16.

16 Economic Study at 92.

17 Joint Explanatory Statement of the Committee of Conference, Conference Report - National Securities Markets Improvement Act of 1996, HR 3005, at 40.

18 See NASAA President Christine Bruenn's Speech to Annual Conference of the North American Securities Administrators Association, Philadelphia, PA, Oct. 1, 2002 (available at http://www.nasaa.org/nasaa/Files/File_Uploads/Bruennspeech.37528-49824.doc)

19 The Federal Prosecutor, An Address by Robert H. Jackson, Attorney General of the United States, Delivered at The Second Annual Conference of United States Attorneys, April 1, 1940.

http://www.sec.gov/news/speech/spch022103smc.htm

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