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**The Second International Roundtable on
Securities Markets in China**

Session 3

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*Protecting Investors in the United States Through Multiple
Enforcement Mechanisms*

**Shanghai, China
6-7 June 2002**

Protecting Investors in the United States Through Multiple Enforcement Mechanisms

By

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I. Overview

Since the enactment of the U.S. securities laws, investor protection has been dependent upon public and private enforcement efforts by 1) the Securities and Exchange Commission (SEC), 2) various self regulatory organizations, such as the National Association of Securities Dealers and the New York Stock Exchange, 3) each of the state securities administrators, and 4) suits brought by private investors.

II. Enforcement by the Securities and Exchange Commission

The SEC was created in 1934 with broad rule making power to protect investors and assure the efficient and fair operation of U.S. securities markets. Among its operating divisions is the Division of Enforcement, whose Director reports directly to the Chairman of the SEC. Although the largest number of the Division of Enforcement's staff is located in its offices in Washington, D.C., there are substantial numbers of staff in the SEC's regional offices throughout the U.S.

Investigations are carried out by the staff of the SEC. If the object of an investigation does not respond to the investigator's request for information, the staff has the power to subpoena testimony and records. Failure to respond to a subpoena request is enforceable in the federal courts. The federal courts have consistently recognized that the SEC staff can obtain through subpoena any evidence relevant to determining whether a violation of the securities laws has occurred. As discussed below, a range of "administrative sanctions" can be imposed by the SEC.

In most instances, an administrative sanction can be imposed only after a hearing before an administrative law judge. An administrative law judge is not a judge of a federal court, but is an agency employee who presides at a hearing between the SEC and the respondent. The administrative law judge not only presides over the conduct of the hearing at which evidence and

testimony is introduced by both the SEC and the respondent, but also makes findings of fact and conclusions of law. To prevail, the SEC must establish by a preponderance of the evidence that the respondent has engaged or is about to engage in a violation. A decision by the administrative law judge can be appealed to the five SEC commissioners; a decision that a violation has occurred reached (reached by a majority of the commissioners) can then be reviewed in an appeal to an appropriate federal Court of Appeals.

The effectiveness of the SEC in protecting investors is facilitated greatly by its having a wide range of enforcement mechanisms and remedies. The following is a brief overview of the sanctions that the SEC may invoke when it believes there has been a violation or that a violation will occur.

1. Report of Results of Investigation. The mildest among the SEC's arsenal of possible sanctions is the publication of a report regarding its investigation (a so-called "21(a) Report."). The report may do nothing more than simply announce that the SEC has commenced an investigation. But more frequently a 21(a) Report sets forth the important facts found in the SEC's investigation and includes a statement by the respondent concurring in the facts so represented. Sometimes the report includes an undertaking by the respondent not in the future to engage in the practices or conduct that was the focus of the report. The SEC selectively uses the 21(a) Report to identify practices or acts it believes violate the securities laws. Thus, the 21(a) Report serves a useful educational function to everyone engaged in securities activities because a report further identifies what is likely to be seen by the SEC as a violation of the securities laws.

2. Cease and Desist Authority. The SEC staff, with the approval of the commissioners, can file a complaint against the respondent, alleging a violation. Such a formal enforcement proceeding sets the matter for a hearing that, as described above, is before an administrative law judge. A common sanction sought in such a hearing is a "cease and desist order" which not only commands the respondent to stop the conduct or practice that is found to be a violation, but also the cease and desist order can require the respondent to take certain steps to assure that he does not violate the securities laws in the future. Among the steps sometimes required by a cease and desist order is circulating notice among the respondent's past and future clients that the respondent has been found to have violated the securities laws and what his violations were.

The SEC also has the power to issue "temporary" cease and desist orders against certain market professionals (specifically, brokers, dealers, investment advisers, investment companies, and transfer agents). The temporary cease and desist order can be issued without a hearing when the SEC believes the respondent is engaging or about to engage in a violation that is likely to result in significant dissipation of assets, conversion of property, or significant harm to investors or the public interest. The temporary cease and desist order is an extraordinary remedy that is invoked only in those instances when the SEC reasonably believes that giving prior notice to the respondent and affording the respondent a hearing is likely, because it entails so much time, that investors or the public interest will be gravely harmed if relief is not immediately forthcoming. Situations where a temporary cease and desist authority is appropriate include where any delay in SEC action is likely to result in the respondent's flight from prosecution, destruction or

tampering with evidence, transfer of assets or records, improper conversion of assets, or impeding the SEC's ability to trace or identify the source or disposition of funds.

3. Administrative Fines. The SEC can in an administrative proceeding (i.e., before an administrative law judge) impose civil fines against brokers, dealers, investment advisers, investment companies, and clearing agents. There are three tiers of penalties authorized, with penalties beginning at \$5,000 per violation for the most minor offenses and largest penalty \$100,000 for natural persons (\$500,000 for other violators) for fraudulent or deceitful conduct that causes substantial loss to others.

4. Disgorgement Sanction. The SEC can, when it finds a violation, obtain an order from an administrative law judge compelling the respondent to disgorge any gains the respondent has acquired as a consequence of the violation. The SEC can thereafter distribute or arrange for the distribution of these funds to be directed to investors who were injured as a consequence of the respondent's violation.

5. Trading Suspensions. The SEC can summarily, without a hearing, suspend trading in a publicly traded company's securities for ten days when it believes cessation of trading is in the public interest and necessary for the protection of investors. Following a hearing, the SEC can permanently prevent trading in a security. It is rare that the SEC suspends trading in a security because to do so destroys the security's liquidity and, thereby, harms investors who own the affected security.

6. Disciplining Those Who Practice Before the SEC. Under Rule 102(e) of the SEC's Rule of Practice, the SEC can discipline individuals who, after a hearing, are found in their practice before the SEC to lack the "requisite qualifications" or "character or integrity" or who "have engaged in unethical or improper professional conduct," or who have willfully violated or assisted another in violating the securities laws. Practice before the SEC is broadly defined to include not just appearing before the SEC, but the filing of any matter with the SEC. The typical sanction imposed by the SEC is to suspend for a stated time, or even indefinitely, the violator's ability to practice before the SEC.

7. Injunctive Actions. The most serious offenses are customarily prosecuted in the federal courts, not before an administrative law judge. In the federal court the SEC can seek several possible sanctions. Foremost among the sanctions is the court's order that the defendant cease the conduct that constitutes a violation. To be successful in such an enforcement action, the SEC must establish by a preponderance of the evidence that the respondent has committed a violation or is about to commit a violation of the securities laws. The order customarily also orders the defendant not to violate the securities laws in the future and to engage in certain practices that are likely to prevent a recurrence of the violation. Violation of such a court order itself gives rise to a separate offense, the offense of contempt of court, and can be separately prosecuted. The court can also order other relief, such as requiring the defendant to disgorge any profits or funds he obtained as a consequence of the violation. Orders have also included requirements that the respondent place a certain number of independent directors on its board of directors and that it conduct a thorough investigation of certain activities and culminating in a report on the results of

its investigation.

Before a final disposition of a case before the federal court, the SEC can obtain from the presiding court a preliminary injunction. The purpose of a preliminary injunction is to preserve the status quo, and frequently is sought to assure that evidence or funds from being removed, dissipated, etc. before a final disposition of the case. The court will grant such relief upon a showing that the SEC will “likely” be successful on the merits of the case following a full trial.

8. Officer and Director Bars. The SEC can request the court to bar a person from ever serving as an officer or director of a public company. To obtain this relief, the SEC must prove that the person to be so barred has engaged in fraudulent conduct in connection with a securities transaction.

9. Civil Fines. The federal court can impose much larger fines than the administrative fines discussed above in Item 3 can be imposed against any. There is a schedule of the amount a court can fine securities violator, but the amount can be even larger than the schedule; the court can impose a penalty equal to the gross amount of the gain the defendant derived from its violation when that amount is greater than the scheduled penalty. Use of the latter sanction does not prevent the court from also ordering the defendant to also disgorge any amount the court finds the defendant obtained at the expense of investors. For insider trading violations, the SEC can obtain up to treble the profits the insider has garnered as a result of his violation.

II. Criminal Enforcement

Criminal enforcement proceedings are not the responsibility of the SEC, but is carried out on the federal level by the Department of Justice (DOJ), part of the executive wing of the U.S. government. Each of the U.S. securities laws provides that a “knowing” violation of the statute or SEC rule can be prosecuted as a criminal offense. In such an action, the government has the burden of proving a knowing violation “beyond a reasonable doubt.” The DOJ can, and frequently does prosecute securities violations under the Mail Fraud Statute and also can be sanctioned under the Racketeer Influenced and Corrupt Organizations Act (RICO). The latter has serious forfeiture provisions that allow the government to confiscate any assets used in carrying out the violation. It is, therefore, possible that a defendant in a single criminal action will be charged with criminal violations under the Securities Act, Mail Fraud Statute, and RICO. Also, such criminal actions can accompany enforcement actions by the SEC so that the defendant may well face parallel criminal and civil enforcement actions for the same misconduct.

III. Enforcement by State Administrators

The U.S. is a federal system of government in which the central federal government coexists with the sovereign governments of the fifty states and the District of Columbia. Each of the states (and the District of Columbia) have securities law provisions that complement, but cannot conflict with, the federal securities laws. As such, their state administrators, customarily working through the state’s attorney general, can bring civil and criminal enforcement actions when there is a violation of a provision of that state’s securities laws. Following the long-

established choice of law principle, a state's securities laws only applies to conduct carried out within that state's borders (e.g., offers or sales made within the state of California are the subject of the California's laws, but not those of Nevada). When there is a conflict between state and federal law, the federal law prevails.

IV. Self Regulatory Organizations

Self regulatory organizations (SRO) are an important feature of the U.S. regulatory and enforcement efforts. The two major SRO's are the National Association of Securities Dealers and the New York Stock Exchange. There are SRO's for clearing agents, government securities dealers and each of the regional exchanges. The Securities Exchange Act imposes substantial undertakings that each SRO must fulfill and mandates that broker-dealers belong to an appropriate SRO. Also, no exchange can enjoy the benefits of a licensed exchange unless it fulfills its obligations as an SRO.

Among the undertakings of each SRO is that it must have rules designed to prevent fraudulent and deceptive practices. For exchanges, this undertaking requires it to have rules designed to assure the fair and efficient operation of the market. Each SRO must be prepared to enforce within its disciplinary proceeding a violation of the SRO's rules, but also any violation of the securities laws that is committed by a member of the SRO. Furthermore, the SRO's disciplinary procedures must be fair, assure a minimum level of due process and entail appropriate sanctions. There is also the explicit requirement that the SRO must have the financial resources and the personnel to fulfill each of these undertakings.

SRO's impose sanctions that include suspension or expulsion of a member, restitution to customers for any losses caused by the sanctioned member's violation, and fines. Violations are prosecuted by full-time staff members in an informal administrative tribunal within the SRO that is customarily presided over by a member of the SRO. A person sanctioned by an SRO can appeal the sanction to the SEC.

SRO's effectively conscript into the protection of the investors market professionals and their organizations. Under the watchful eye of the SEC, SRO's adopt and enforce important rules that regulate the operation of exchanges, the obligations of brokers with respect to one another and their respective clients, and otherwise introduce high professional standards to the profession. The public obtains the benefits of these self regulatory functions without the necessity of spending scarce public funds. Selectively, and wisely, the SEC periodically finds it necessary to stimulate regulatory action by the SRO's. The SEC's oversight is also designed to assure that the SRO does not disproportionately focus its regulatory efforts to the systematic disadvantage of the smaller brokerage firms.

In the U.S., there is a good deal of sharing of investigative information between the SEC and the SRO's. It is not uncommon to find that an enforcement action that has been brought by the SEC also prompts a disciplinary proceeding by the SRO against the same person.

V. Private Enforcement Actions

The Federal Securities Act of 1933 (Securities Act) and the Securities Exchange Act of 1934 (Exchange Act) each provide express causes of action for investors who have suffered losses as a consequence of a violation of the securities laws.

The most important express liability provisions of the Securities Act are Sections 11 and 12(a)(1). Section 11 permits investors to recover damages from the issuer, underwriters, accountants, senior officers and directors if when the registration statement (i.e., prospectus) for a public offering contained a material misrepresentation when it became effective. Everyone but the issuer can, however, successfully defend in such a suit if he proves he engaged in a reasonable investigation, had a reasonable basis to believe and did believe the registration statement was free of material omissions or misstatements. Hence, the overall goal of Section 11 is to force certain parties, the defendants in such a suit, to engage in non trivial efforts to assure themselves that the prospectus was not materially misleading. Section 12(a)(1) provides a right to investors to rescind their purchase of a security that was sold without registration with the SEC and for which there was no available exemption from registration. Liability under this provision is absolute; there is no good faith defense. The objective of this express remedy is to increase the penalty for those who fail to register a security with the SEC. The fear of Section 12 liability stimulates compliance with the registration and exemptive provisions of the Securities Act.

There are several express liability provisions in the Exchange Act: some directed toward manipulation of the price of publically traded securities, a provision permitting actions by those who purchased their securities in reliance upon misleading documents on file with the SEC, and a provision that permits investors trading contemporaneously when an insider is trading while in possession of material non public information.

By far the most significant private remedies are not those that are expressly authorized in the Exchange Act, but which the courts have recognized as “implied causes of action.” Courts selectively have held there exists within the Exchange Act implied causes of action in instances where they saw private enforcement was so inherent in the regulatory structure approved by the Congress that private enforcement was believed by the courts to be a necessary and desirable feature to assure compliance with the securities laws. Such private enforcement is recognized for knowingly or recklessly made material misrepresentations in connection with proxy solicitations, press releases, financial reports, filings with the SEC, face-to-face negotiations, and takeover bids.

A person can sue to recover only for the losses they have suffered individually. To justify such an individual suit, the losses to be recovered must be large enough cover the expenses to be incurred in prosecuting the claim. The most significant expense is that of the plaintiff’s attorney. Many potential securities claimants do not suffer losses sufficient by themselves to justify such a suit. In such a situation, procedural developments for class action suits and contingency fee awards play an important role in assuring compliance with the securities laws. U.S. class action procedures permit numerous, indeed thousands, of individuals who have been harmed by the same securities violation to pool their claims together into a single suit. Though no individual claim would have made the suit financially practical, when combined together the combined

expected recovery is sufficiently great to make the suit financially viable. Moreover, the ability in the U.S. for attorneys to be compensated only if the suit is successful (i.e., a contingency fee) enables the class of plaintiffs to attract counsel to represent the suit. Thus, the availability of class action procedures and a contingency fee arrangement empower private litigation under either express or implied causes of action to provide an important deterrence to violations of the securities laws.