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7

Remedies and Sanctions in SEC Enforcement Actions

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In SEC enforcement actions, the potential sanctions can be both monetary (principally fines and "disgorgement" of ill-gotten profits) and non-monetary (in particular, professional or occupational bars, as well as injunctions or cease-and-desist orders). These remedies can be imposed in federal district court proceedings or in SEC administrative proceedings. Each remedy has its own history and tradition, both in the courts and within the agency. Courts have sometimes struggled with SEC remedies because a number of them, while theoretically justified as purely remedial or "equitable" in nature, seem to function, at least in part, as punishment or general deterrence. Because most cases settle, and the agency has tremendous leverage in negotiating a settlement, the SEC's

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own practices and customs are at least as important as the statutes and case law in determining the remedies imposed in an enforcement action. Should a case proceed to litigation, however, courts often take a very different view from the SEC of the appropriate sanctions.

With respect to monetary remedies, there have been significant developments in recent years. First, two Supreme Court decisions addressed the SEC's power to seek disgorgement: the 2020 decision in *Liu v. SEC*, which announced limitations on disgorgement awards that the SEC can obtain in federal court, and the 2017 decision in *Kokesh v. SEC*, which held that the disgorgement remedy is subject to a five-year statute of limitations. Then, following *Liu* and *Kokesh*, in January 2021 Congress passed the William M. Thornberry National Defense Authorization Act (NDAA), which undid some of those limitations, including by codifying the SEC's ability to seek disgorgement in federal court proceedings and establishing a ten-year statute of limitations for seeking disgorgement with respect to scienter-based fraud claims. Collectively, these developments will substantially impact the disgorgement remedy in the future.

With respect to non-monetary remedies, recent public statements by agency officials have emphasized the importance of prophylactic measures intended to protect the integrity of the markets, such as debarment from the securities industry or tailored undertakings to prevent a recurrence of misconduct. In a similar vein, the SEC in recent years has modified its practice with respect to injunctions. The SEC's traditional core remedy has been an "obey the law" injunction—a court order that commands the defendant not to commit a future violation of the provisions of federal securities law under which the defendant has been charged, but with no additional guidance regarding how to conform one's conduct to the law. In recent years, the agency has increasingly sought "conduct-based injunctions": relatively clear, simple prohibitions on otherwise lawful conduct that are tailored to a particular individual's history of engaging in a specific type of misconduct.

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In all events, counsel negotiating a settlement (or contemplating litigation) with the SEC need to be aware of the potential for so-called collateral, or follow-on, consequences from the imposition of SEC remedies. Issuers and regulated securities intermediaries can lose a range of privileges in the capital markets and the securities industry just from entering into a no-admit settlement with the SEC, let alone losing to the agency in a contested proceeding. These consequences can be severely disabling if not waived by the SEC.

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Remedies and Sanctions in General

Q 7.1 What laws and rules give the SEC authority to impose remedies and sanctions?

The SEC can obtain sanctions in enforcement actions brought in either federal district court or in-house as an administrative proceeding. Cases brought by the SEC in federal court typically seek injunctive relief (in addition to monetary and other equitable relief) and are sometimes referred to as "civil injunctive actions." Sanctions in civil injunctive actions are ordered by a district court judge, even when the case is brought as a settled action, i.e., when the entry of a judicial order has been agreed to by the defendant. In administrative proceedings, an SEC administrative law judge (ALJ) has the role of imposing sanctions only if the proceeding is contested. When the SEC

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brings an administrative proceeding as a settled action, any agreed-upon sanctions are ordered by the Commission, without involvement from an ALJ.

The core statutes authorizing the SEC to seek and obtain remedies and sanctions are the Securities Exchange Act of 1934 ("Exchange Act"), the Securities Act of 1933 ("Securities Act"), the Investment Advisers Act of 1940 ("Advisers Act"), and the Investment Company Act of 1940 ("Company Act"). All four statutes provide for various forms of monetary and non-monetary relief against individuals and entities accused of violating the respective statute or in some cases other provisions of the securities laws.[1] The Exchange Act also authorizes the SEC to issue a report of investigation.[2] The 2002 Sarbanes-Oxley legislation added several provisions relevant to the SEC's remedies in portions of the U.S. Code separate from the four core statutes.[3]

For the first few decades following its creation in 1934, the SEC sought and obtained only *non*-monetary remedies, notably injunctions. In the late 1960s and early 1970s, the SEC began asking courts to order defendants to "disgorge" their ill-gotten gains from activities alleged to violate the securities laws. This remedy was analogous to restitution (which was the name first used for the remedy) and was designed to make securities violations unprofitable. The remedy of disgorgement at first was not expressly conferred by statute but was justified as an exercise of courts' "inherent equity power to grant relief ancillary to an injunction."[4]

The SEC's authority to obtain and impose monetary remedies expanded over time. In 1984, Congress first gave the SEC the authority to seek, and district courts the authority to impose, civil penalties (i.e., fines) for insider trading in an amount up to triple the profit gained or loss avoided.[5] In 1988, among other amendments and refinements, this authority was expanded to create liability for a culpable controlling person of one who commits insider trading violations.[6] The SEC's remedial authority was dramatically expanded by the Securities Enforcement Remedies and Penny Stock Reform Act of 1990 (Remedies Act).[7] The Remedies Act authorized civil penalties in district court for virtually any violation of the federal securities laws and also authorized civil penalties in administrative proceedings against regulated securities intermediaries (notably broker-dealers, investment advisers, and

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their associated individuals) for "willful" violations.[8] The Remedies Act also authorized the SEC to order disgorgement and an accounting in administrative proceedings, created the bar on service as an officer or director of a publicly traded company (officer-or-director bar) as a remedy for certain antifraud violations prosecuted in federal court, and authorized the SEC to impose a bar on penny stock–related activities in an administrative proceeding.[9]

Relatedly, the Remedies Act created the species of administrative action known as a cease-and-desist proceeding—essentially a mechanism to proceed administratively against any actor, even one not directly regulated by the SEC and thus not subject to occupational debarment or formal censure.[10] The cease-and-desist authority is especially significant because it contemplates liability for one who merely "causes" a violation by another—a negligence standard for secondary actors not otherwise found in the securities laws. In 2002, the Sarbanes-Oxley Act (SOX) rounded out the Remedies Act by giving the SEC the authority to impose an officer-or-director bar administratively, and by giving federal courts the authority to impose a penny-stock bar.[11]

In 2010, Congress significantly expanded the SEC's remedial powers in the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank).[12] Among many other amendments to the securities laws, Dodd-Frank gave the SEC the authority to impose civil penalties in cease-and-desist administrative proceedings.[13] The SEC now has the power to impose fines through administrative processes (as opposed to cases prosecuted in federal court) on *any* entity or individual accused of violating the securities laws; previously such authority existed only in certain administrative proceedings against regulated entities like broker-dealers and investment advisers and their associated persons. Most recently, on January 1, 2021, Congress passed the William M. Thornberry National Defense Authorization Act (NDAA), which amended the Exchange Act and established the SEC's express statutory authority to seek disgorgement in "any action or proceeding brought . . . under any provision of the securities laws."[14]

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Q 7.2 Can the SEC bring criminal cases or otherwise seek criminal penalties?

No. The SEC is limited to civil remedies. The SEC, however, can refer cases to the criminal authorities (most often the U.S. Department of Justice), and frequently investigates and files cases in tandem with the DOJ. Such "parallel" enforcement activity is discussed in chapter 5, *supra*.

Q 7.3 What kinds of monetary remedies and sanctions can the SEC impose or obtain?

The most common forms of monetary sanctions are disgorgement and civil penalties.

As noted above, the remedy of disgorgement was developed in enforcement actions brought in federal court as a type of equitable remedy. The theory of disgorgement was that the proceeds of misconduct are a form of unjust enrichment that a defendant as a matter of equity is not entitled to retain.[15] By making fraud unprofitable, disgorgement is also supposed to help deter misconduct.[16]

Traditionally, monies paid by defendants as disgorgement could be, but were not required to be, used to compensate victims, as opposed to being paid into the U.S. Treasury.[17] In *Liu v. SEC*, the Supreme Court held that "the equitable nature" of disgorgement combined with the applicable statutory language (authorizing "equitable relief that may be appropriate or necessary *for the benefit of investors*") "*generally* requires the SEC to return a defendant's gains to wronged investors for their benefit."[18] The Court, however, stopped short of holding that a disgorgement payment must *always* be returned to investors.[19] In practice, pre-*Liu*, the SEC frequently did not attempt a distribution to investors of collected funds when, among other circumstances, the amounts involved were such that the administrative expense outweighed the likely benefits of a distribution, or there simply were not readily identifiable victims of the misconduct.

Since *Liu*, the NDAA amended the Exchange Act to expressly authorize the SEC to seek disgorgement "of any unjust enrichment by the person who received such unjust enrichment as a result of such violation."[20] Notably, the NDAA did not specify that disgorgement must

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be "for the benefit of investors," nor did it classify disgorgement as an "equitable" remedy. Consequently, since its passage, courts have begun to address whether the SEC still is required to return disgorged funds to investors.[21]

Also not entirely clear is whether this aspect of the *Liu* ruling applies in administrative proceedings (as opposed to federal court), where disgorgement already was specifically authorized by statute.[22] In administrative proceedings, the SEC has occasionally elicited an "undertaking" (undertakings generally are discussed further in Q 7.4 below) from a settling party to pay money directly to identified victims—essentially restitution by another name.[23] That approach or variations on it may become more common in the future.[24]

The SEC routinely seeks civil penalties (i.e., monetary fines) in addition to disgorgement. See Q 7.15 and Q 7.16 below for an explanation of how penalties are supposed to be calculated in federal court and administrative proceedings. The 2002 SOX legislation gave the SEC and the courts the authority to establish "fair funds" from penalty payments in order to distribute penalty monies collected to the victims of violations.[25] Such authority was previously assumed to exist for amounts paid as disgorgement.

SOX also authorized so-called "clawbacks" of executive compensation from a public company's chief executive officer and chief financial officer when the company restates financial results. Specifically, section 304(a) of Sarbanes-Oxley provides that "[i]f an issuer is required to prepare an accounting restatement due to the material noncompliance of the issuer, as a result of misconduct, with any financial reporting requirement under the securities laws, the chief executive officer [CEO] and chief financial officer [CFO] of the issuer shall reimburse the issuer for [ ] any bonus or other incentive-based or equity-based compensation received by that person . . . during the 12-month period following the issuance or filing" of the relevant financial document, as well as "any profits realized from the sale of securities of the issuer" during the same time period.[26] Only the SEC, not private litigants, may enforce this provision.[27] Dodd-Frank subsequently required the SEC to implement rules mandating that companies trading on national securities exchanges adopt internal policies with additional clawback provisions.[28] The SEC recently implemented this statutory mandate.[29]

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The SEC has pursued "SOX 304" clawbacks of executive compensation from CEOs and CFOs who were accused of misconduct,[30] and also when CEOs or CFOs were not personally accused of misconduct.[31] The Ninth Circuit has endorsed this approach.[32] There are several questions about the reach of SOX 304 that courts have yet to address. For example, courts have not addressed whether the SEC can bring a claim against a CEO or CFO who already reimbursed the issuer after a restatement due to misconduct, although the SEC has instituted settled proceedings under these circumstances.[33] Courts also have not addressed the breadth of the SOX 304 clawback (whether it applies to all or only some of the incentive compensation), and there may be future litigation concerning the appropriate amount to claw back from CEOs or CFOs.

Q 7.4 What kinds of non-monetary remedies and sanctions can the SEC obtain in general?

Traditionally the standard SEC remedy in federal court is an injunction prohibiting a defendant from engaging in further or future violations. A "cease-and-desist order" is an analogous remedy available in administrative proceedings. Both SEC injunctions and cease-and-desist orders typically prohibit a defendant generically from committing violations of specified provisions of the securities laws—hence the nickname "obey-the-law injunctions." Because defendants already are under an obligation to obey the law, and the SEC rarely tries to enforce obey-the-law injunctions with contempt proceedings (as opposed to bringing new cases for new violations),[34] such generic injunctions on their own terms are comparatively meaningless.[35] What is more, obey-the-law injunctions have come under sharp criticism in certain courts. The Eleventh Circuit, for instance, has questioned their usefulness, and observed that they often fail to comport with Rule 65(d)(1) of the Federal Rules of Civil Procedure, according to which "[e]very order granting an injunction and every restraining order must: (A) state the reasons why it issued; (B) state its terms specifically; and (C) describe in reasonable detail—and not by referring to the complaint or other document—the act or acts restrained or required."[36] The Third Circuit has similarly observed that "obey-the-law injunctions pose a risk of overbreadth, lack of fair notice, unmanageability, and noncompliance with Federal Rule of Civil Procedure 65(d)," and that "in some cases

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