Testimony
of
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Concerning Returning Funds to Defrauded Investors

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

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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 disgorgement, 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.

[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

[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.