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"PERP" WALK OR CAKE WALK?

A STUDY OF THE S.E.C.'S ENFORCEMENT OF THE SECURITIES LAWS THROUGH AGREED SETTLEMENTS

Raymond L. Britton[*] *and N. Kimberly Bohannon*[**]

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I. INTRODUCTION

The financial collapse and inevitable bankruptcy of Enron foreshadowed a torrent of bankrupt companies plagued by corporate scandal.[1] By the year 2003, a multitude of criminal charges and civil suits were filed alleging that Enron officers and officials engaged in misconduct including, but not limited to, securities fraud, insider trading, wire fraud, conspiracy, money laundering, fraudulent market practices, and making false statements to the Securities and Exchange Commission, (hereinafter sometimes referred to as the "Commission" or "SEC") and to the public at large.[2] Additionally, the House-Senate Joint Committee on Taxation found that Enron implemented various multifaceted and "dizzyingly complex schemes" in order to deceive the IRS and improperly claim more than $2 billion in tax and accounting savings.[3]

Former CFO Andrew Fastow's involvement in these nefarious schemes led to his plea of guilty in 2004 to one charge of conspiracy to commit wire fraud and one charge of conspiracy to commit wire and securities fraud.[4] He also agreed to serve 10 years in prison and forfeit millions in personal assets.[5] Similarly, former COO Jeffery Skilling, CAO Richard Causey, and CEO Kenneth Lay face a trial in January of 2006 for numerous alleged criminal violations.[6] Enron's unsavory activities also implicated a lower echelon of officials which includes Paula Rieker, former director of investor relations and secretary to Enron's board of directors, as well as Timothy DeSpain, Enron's former assistant

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1. *See* Marianne Lavelle, *The actions of corporate honchos horrified the nation: So when's the day of reckoning?*, U.S. NEWS & WORLD REPORT, Dec. 30, 2002, *available at* http://www.usnews.com/usnews/biztech/articles/021230/30rogues.htm.
2. Mary Flood et al., *Months after Enron's bankruptcy, ordeal not over*, HOUSTON CHRONICLE, Jun. 27 2003, *available at* http://www.chron.com/cs/CDA/ssistory.mpl/business/1962079.
3. *Report: Enron schemes reaped over $2 billion*, HOUSTON CHRONICLE, Feb. 13, 2003, *available at* http://www.chron.com/cs/CDA/ssistory.mpl/special/enron/1777641.
4. Press Release, Department of Justice, Former Enron Chief Financial Officer Andrew Fastow Pleads Guilty To Conspiracy To Commit Securities and Wire Fraud, Agrees To Cooperate With Enron Investigation (Jan. 14, 2004), *available at* http://www.fbi.gov/dojpressrel/pressrel04/enron011404.htm.
5. *Id*.
6. Second Superseding Indictment, United States v. Causey, No. CRIM. H-04-025 (S.D. Tex. Jul. 7, 2004), *available at* http://www.chron.com/content/news/photos/04/07/08/layindict.pdf; Mary Flood, *Ex-Enron Execs' Trial won't Start until 2006*, HOUSTON CHRONICLE, Feb. 25, 2005, *available at* http://www.chron.com/cs/CDA/ssistory.mpl/special/enron/3056397.

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treasurer.[7] While both settled with the SEC, DeSpain is now permanently barred from acting as an officer or director of a public company.[8]

In the aftermath of the Enron debacle, a number of officers and officials began to face civil suits and criminal charges. Congress found it necessary to inquire through hearings as to how Enron's officers carried out the schemes, and more importantly, why no director or government agency discovered or assessed the egregious managerial activities.[9] Ultimately, the Senate Governmental Affairs Committee concluded that Enron's former board of directors ignored "more than a dozen red flags" concerning its financial dealings.[10] Regrettably, it also found that the SEC was at least partially responsible for Enron's collapse, in that it failed to timely discover and prevent the company's deceptive accounting practices.[11]

Because the Enron schemes totally duped both the IRS and the SEC, thousands of employees and shareholders were affected. While Enron's shares once traded on the New York Stock Exchange for $90 a share during Skilling, Lay, and Fastow's tenancy, its ultimate market value declined dramatically to eight cents a share shortly prior to Enron's filing for bankruptcy in late 2001.[12] As a result of Enron's collapse and subsequent bankruptcy, shareholders and creditors lost billions of dollars. Underlying this financial tragedy is the question of whether the

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7. Consent & Undertaking of Paula H. Rieker, U.S. Sec. & Exch. Comm'n v. Rieker, No. H–04 1994 (S.D. Tex. May 18, 2004), *available at* http://images.chron.com/content/news/photos/04/05/20/judgement.pdf; Cooperation Agreement, U.S. v. Despain, No. CRIM. H–04–449 (S.D. Tex. Oct. 5, 2004), *available at* http://images.chron.com/content/chronicle/special/01/enron/trials/barge/pdf/100504/coopagr.pdf.

8. Press Release, U.S. Securities & Exchange Commission, SEC Charges Timothy A. DeSpain, Former Enron Executive, With Violating Securities Laws (Feb. 8, 2005), *available at* http://www.sec.gov/litigation/litreleases/lr19067.htm.

9. STAFF OF SENATE COMM. ON GOVERNMENTAL AFFAIRS, 107TH CONG., FINANCIAL OVERSIGHT OF ENRON: THE SEC AND PRIVATE–SECTOR WATCHDOGS (Comm. Print 2002) [hereinafter FINANCIAL OVERSIGHT OF ENRON], *available at* http://www.senate.gov/~gov_affairs/100702watchdogsreport.pdf.

10. *Levin's Opening Statement: The Role of the Board of Directors in Enron's Collapse, Permanent Subcomm. on Investigations, Senate Comm. on Governmental Affairs*, 107th Cong. (2002) (opening statement of Carl Levin, Chairman).

11. FINANCIAL OVERSIGHT OF ENRON, *supra* note 9, at 29–40; *SEC, credit agencies lax on fraud, report charges*, Houston Chronicle, Oct. 7 2002, *available at* http://www.chron.com/cs/CDA/ssistory.mpl/special/enron/1606260.

12. *Debtors' Vision: Betting on Chapter 11 Turnarounds*, BUSINESS WEEK, Sep. 1, 2003, *available at* http://www.businessweek.com/magazine/content/03_35/b3847084_mz020.htm.

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Commission's sanctions of those whose conduct effectively wiped out billions of dollars of millions of investors' life savings are adequate and reached the intended result. In short, are the agreed settlements with the SEC severe enough to deter misconduct of a similar nature or are they to be considered, at most, as merely a proverbial slap on the wrist?

Such questions, however, are not restricted to the corporate scandal arena. In 2002, the Commission also reached several settlements with the investment banking community.[13] The magnitude of the sanctions in these settlements literally exceeds hundreds of millions of dollars.[14] Yet some would argue that these sanctions are still not sufficient to blunt the "culture" that from its inception was the wellspring of the misconduct.[15] For example, the Commission recently settled with Environmental Solutions Worldwide, Inc. (ESWW), and its former chairman Bengt Odner for allegedly engaging in a pump-n-dump scheme whereby ESWW stock was artificially inflated about 250% before being sold for approximately $15 million.[16] Both ESWW and Odner were permanently enjoined from future violations, and Odner was fined only $25,000.[17] Finally, the Commission reached a settlement with J.P. Morgan Securities, Inc. for its role in various forms of initial public offerings abuse; the firm was enjoined from future violations and fined $25 million.[18] However, there are those that question whether a $25 million fine is an adequate sanction when J.P. Morgan purportedly set aside a reserve of $1 billion in order to counter the Commission's charges.[19]

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13. *See Unclean slate - The Wall Street Settlement*, THE ECONOMIST, Jan. 4, 2003.

14. *See id.* (noting that as of the date of the article, about $925 million in fines had been assessed).

15. *See id. See also* Louis Aguilar, *Business Year Was Tainted By Big Crimes But Not So Much Punishment*, DENVER POST, Dec. 29, 2002, at K-05 (accusing the Commission of being "asleep at the wheel" during the many investing-related crises of 2002).

16. *See* SEC Files Civil Lawsuit in $15 Million "Pump and Dump" Stock Fraud Case, Litigation Release No. 17673A (August 13, 2002), *available at* http://www.sec.gov/litigation/litreleases/lr17673a.htm.

17. *See* Environmental Solutions Worldwide, Inc. and its Former Chairman and President, Bengt Odner, Consent to Settle SEC Fraud Charges, Litigation Release No. 18,310 (Aug. 26, 2003), *available at* http://www.sec.gov/litigation/litreleases/lr18310.htm.

18. *See* SEC Sues J.P. Morgan Securities, Inc. for Unlawful IPO Allocation Practices: J.P. Morgan Agrees to Settlement Calling for Injunction and Payment of $25 million Penalty, Litigation Release No. 18,385 (Oct. 1, 2003), *available at* http://www.sec.gov/litigation/litreleases/lr18385.htm.

19. H. Bernstein, *SEC Sanctions J.P. Morgan*, *at*

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Paradoxically, the Commission at times appears overzealous in its role as chief enforcer of the securities laws. For example, in addition to seeking administrative sanctions against a number of broker-dealers involved in the stock manipulation of BW Resources Corp., the Commission also sought sanctions against the clients who benefited from the broker-dealers' violations.[20] During the past few years, the country has been witness to an economic upheaval that rivals the most severe depressions, recessions, and panics that occurred in prior years. There are those who maintain that this condition has been brought about by the ruthless behavior of a few individuals whose sole motivation is greed. Their greed, not unlike a disease, wreaks discomfort and pain on the public at large. Investment monies and jobs are lost and pensions decimated. As a result, our capital structure is severely weakened because individuals rightfully become fearful of making positive investment decisions that are critical to an adequate financial infrastructure. Without the necessary capital to build new and expand old operating facilities, jobs decline and employee purchasing power evaporates, causing further pressure on the economy. In the midst of this "parade of horribles" sits the Securities and Exchange Commission confronted with the question of whether it should fully unleash its ample enforcement powers and thereby effectively sanction, punish and deter corporate misbehavior?

How effective the Commission's enforcement activities are is a question that does not readily lend itself to a satisfactory answer. This article will address some of these issues by examining a selected number of the Commission's recent administrative enforcement actions. While it is beyond the scope of this project to determine if the Commission's efforts are sufficient to punish and deter misconduct, the data discussed here reveals the pattern of enforcement followed by the Commission, the range of sanctions it employs, and the consistency with which it employs them.

Part II details the statutory authority of the Commission to enforce the securities laws and describes the typical sanctions it uses. Part III describes the administrative enforcement process as well as the settlement process. Part IV outlines the methodology of the study, both the data collection process and

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http://www.theaxcess.com/money_07_1003.html (last visited Nov. 1, 2003).

20. Cathy Rose A. Garcia, *SEC Drops 66 BWRC-Related Cases, Collects P5 Million in Fines*, BUS. WORLD, July 1, 2002.

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the analytical strategy. Part V describes the data collected, while Part VI presents the findings of the analyses. Parts VII and VIII summarize the findings and their limitations. Finally, Part IX draws some conclusions about the enforcement process as revealed in the data collected.

II. STATUTORY BACKGROUND

In order to facilitate the discussion of the enforcement data collected in this study, it is first necessary to understand the authority by which the Commission acts because that authority differs depending upon the identity of the alleged violator and the manner in which the Commission chooses to pursue enforcement. This section explores the extent of this authority.

Created by the Securities Exchange Act of 1934, the Commission is vested with the authority to adopt rules and to enforce the securities laws.[21] The Commission's enforcement authority has its genesis in several statutory sources including the Securities Act of 1933,[22] the Securities Exchange Act of 1934,[23] the Investment Company Act of 1940,[24] and the Investment Advisers Act of 1940.[25] The Commission's authority was significantly expanded by the Securities Enforcement Remedies and Penny Stock Reform Act of 1990 (the "Remedies Act").[26] This authority can be divided into two basic parts: authority over persons registered with the Commission (for example, brokers, dealers, and investment advisers) and authority over non-regulated persons.[27] In addition, the Commission is authorized to enforce the securities laws through the initiation of one or more of three different procedures: seeking a civil injunction and other remedies in a district court; seeking sanctions via an administrative hearing, which may lead to a settlement or to a hearing before an administrative law

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21. Securities Exchange Act of 1934 § 4(a), 15 U.S.C. § 78d(a) (2002).

22. Securities Act of 1933, 15 U.S.C. §§ 77a-77b-4 (2002). Subsequent notes cite to the original Act's sections rather than the section numbers codified in 15 U.S.C.

23. Securities Exchange Act of 1934, 15 U.S.C. §§ 78a-78ll (2002). Subsequent notes cite to the original Act's sections rather than the section numbers codified in 15 U.S.C.

24. Investment Company Act of 1940, 15 U.S.C. §§ 80a-1 to 80a-64 (2002). Subsequent notes cite to the original Act's sections rather than the section numbers codified in 15 U.S.C.

25. Investment Advisers Act of 1940, 15 U.S.C. §§ 80b-1 to 80b-21 (2002). Subsequent notes cite to the original Act's sections rather than the section numbers codified in 15 U.S.C.

26. The Remedies Act, Pub. L. No. 101-429, 104 Stat. 931 (1990).

27. *See generally* Securities Exchange Act of 1934 § 4(a), 15 U.S.C. 78c (2002).

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judge; or referring the case to the Department of Justice to pursue criminal sanctions.[28]

A. *The Commission's Authority over Non-Regulated Persons*

The Securities Act of 1933 makes it unlawful for "any person" to sell unregistered securities[29] or to engage in fraudulent, interstate transactions in securities.[30] The Commission has the express authority to institute "cease and desist" hearings against "any person" whom the Commission believes is violating, has violated, or will violate any part of the 1933 Act or the rules promulgated thereunder.[31] A cease and desist order is a powerful sanction as is discussed in detail below.[32] The Commission also has the authority to order an accounting and disgorgement of unjust profits plus interest, but does not have the authority to impose civil monetary penalties in a cease and desist hearing under this Act.[33] The Commission has the express authority under the 1933 Act to file suit in a civil district court to obtain an injunction against "any person" whom it believes is violating, has violated, or will violate any part of the 1933 Act or its rules.[34] In such a suit, the Commission is authorized to seek monetary penalties as well as disgorgement.[35]

The Securities and Exchange Act of 1934 also expressly authorizes the Commission to engage in particular types of enforcement activities.[36] Specifically, Section 21 of the 1934 Act authorizes the Commission to investigate alleged violations of the 1934 Act and the rules promulgated thereunder, as well as violations of rules of the national securities exchanges and the Municipal Securities Rulemaking Board.[37] As with the 1933 Act, the Commission also has the authority to seek injunctions,

28. *See, e.g.*, William R. McLucas, J. Lynn Taylor, & Susan A. Mathews, *A Practitioner's Guide to the SEC's Investigative and Enforcement Process*, 70 TEMPLE L. REV. 53, 57 (1997) (outlining the options the Commission has at the conclusion of an investigation).

29. Securities Act of 1933, ch. 38, § 5(a), 48 Stat. 77.

30. *Id*. § 17(a), 48 Stat. 84.

31. *Id*. § 8A(a), 104 Stat. 933.

32. *See infra* Part II-D.

33. Securities Act of 1933, ch. 38, § 8A(e), 104 Stat. 933.

34. *Id*. § 20(b), 48 Stat. 86.

35. § 20(d), 48 Stat. 86.

36. Securities Exchange Act of 1934, ch. 404, §21(a)(1), 48 Stat. 899.

37. *Id*.

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disgorgement, and civil monetary penalties in a district court.[38] The 1934 Act provides for two types of administrative proceedings. The first type is the "cease and desist" hearing in which the Commission may order the respondent to disgorge unjust profits.[39] In this proceeding, the Commission is not authorized to impose a civil monetary penalty.[40] The second proceeding is the administrative hearing in which the Commission may order a civil monetary penalty against the respondent.[41] However, the Commission's authority to assess such monetary penalties is limited to only those administrative hearings brought under sections 15(b)(4), 15(b)(6), 15B, 15C, or 17A of the 1934 Act, all of which involve regulated persons.[42] In sum, the Commission can order an accounting and disgorgement for non-regulated persons, but may not impose civil monetary penalties unless it does so through a district court.

B. *The Commission's Authority over Regulated Persons*

As shown in the above discussion, the Commission's authority to enforce the securities laws against any person in general includes such sanctions as the cease and desist order, the civil injunction, disgorgement, and, in some circumstances, civil monetary penalties. The Commission's arsenal of sanctions is expanded for regulated parties – that is, persons required to register with the Commission.

The Commission's authority over registered brokers, dealers, municipal securities dealers, and government securities broker/dealers includes the following sanctions: censure; limitation of the respondent's activities, functions, or operations; suspension for one year or less; and revocation of registration.[43] For persons associated with any of these entities, the Commission may also use the sanction of barring the person from

38. *Id*. § 21(d)(1)-(3), 48 Stat. 899.
39. 15 U.S.C. § 78u-3(c)(1) (2000).
40. *Id*. § 78u-3(a).
41. *Id*. § 78u-2(a).
42. *Id.* These sections relate to the Commission's authority over registered brokers and dealers, persons associated with registered brokers and dealers, municipal securities brokers and dealers, government securities brokers and dealers, and the National System for Clearance and Settlement of Securities Transactions. 15 U.S.C. §§ 78o(b)(4), (6); 78o-4(a); 78o-5(a); 78q-1(a).
43. 15 U.S.C. §§ 78o(b)(4), 78o-4, 78o-5(c).

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that entity.[44] The Commission has similar authority over persons involved in penny stock offerings,[45] investment advisors,[46] and persons associated with investment advisors.[47]

The Commission may only order civil monetary penalties in administrative proceedings involving brokers, dealers, persons associated with brokers or dealers, or persons involved in penny stock offerings,[48] municipal securities dealers,[49] or government securities dealers.[50] Civil monetary penalties may also be ordered in some proceedings involving a willful violation of the Investment Advisor's Act of 1940 or a failure to reasonably supervise.[51] Whenever the Commission has the authority to order a civil money penalty, it may also order disgorgement.[52]

C. *The District Court's Authority*

There are a few sanctions that only the district court is permitted to impose. The district court may bar a person from acting as an officer or director of a public company.[53] The district court always has the authority to order civil monetary penalties against both regulated and non-regulated persons[54] and to order triple-penalties in insider trading cases.[55] In addition, the district court may impose equitable sanctions such as injunctions and the appointment of a receiver.[56]

D. *The Cease and Desist Order*

The Remedies Act of 1990 extended the Commission's

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44. *Id*. §§ 78o(b)(6), 78o-4, 78o-5.

45. *Id*. § 78o(b)(6).

46. Investment Advisers Act of 1940 § 203(e)-(k), Pub. L. No. 86-750, §§ 8, 9, 74 Stat. 887, 15 U.S.C. § 80b-3(e) (2000).

47. *Id.*

48. 15 U.S.C. § 78o(b)(4) and (6).

49. *Id.* § 78o-4.

50. *Id.* § 78o-5.

51. *Id*. § 80b-3(i).

52. *Id*. §§ 78u-2(e), 80b-3.

53. *Id*. § 78u(d) . With the passage of the Sarbanes-Oxley Act of 2002, the Commission is given the authority to impose officer-director bars itself. Sarbanes-Oxley Act of 2002, Pub. L. 107-204 § 1105, 116 Stat. 745, 809-10 (2002). However, this authority came after the time period covered by the data in this study.

54. 15 U.S.C. § 78u(d)(3) .

55. *Id.* § 78u-1.

56. *See, e.g.*, Steven Amchen, Jessica Cordova, & Paul Cicero, *Securities Fraud*, 39 AM. CRIM. L. REV. 1037, 1089 (2002) (describing the ancillary relief the Commission may seek through the district court).

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authority by granting it the power to issue cease and desist orders against regulated and non-regulated persons.[57] The cease and desist order is similar to an injunction in that it directs a respondent to stop violating securities laws and to not commit future violations.[58] Yet, it may reasonably be argued that there are important differences between the power of the Commission to seek injunctions from a district court and its power to issue cease and desist orders. First, the cease and desist authority extends to all persons, not just regulated persons.[59] Thus, where the only manner of reaching non-regulated persons prior to the Remedies Act of 1990 was through a district court, the Commission can now exercise its authority over such persons in its own administrative proceedings.[60] Second, some would argue that the standards for justifying a cease and desist order are lower than that for an injunction, thus increasing the likelihood of having a cease and desist order imposed.[61] It is necessary to recognize that the language granting cease and desist authority is very broad and grants the Commission wide latitude in crafting orders to not only stop violating conduct but to require future compliant conduct.[62] A sample of the typical language

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57. *See, e.g.*, Committee on Federal Regulation of Securities, *Report of the Task Force on SEC Settlements*, 47 BUS. LAW. 1083, 1093 (1992) [hereinafter *Task Force*] (recognizing that the Commission's new authority permits the Commission to act on its own instead of being required to seek district court sanctions); *id*. at 1105 (calling this new authority "extremely broad"); Thomas C. Newkirk & Ira L. Brandiss, *The Advantages of a Dual System: Parallel Streams of Civil and Criminal Enforcement of the U.S. Securities Laws*, Address Before the 33rd Annual Institute on Securities Regulation (Sept. 19, 1998), *in* PLI Corp. L. & Practice Course, Handbook Series No. B0-0113, 1005-06 (2001) (recognizing that the Commission need no longer "jump the technical and procedural hurdles of bringing an action in federal court"); Daniel J. Morrissey, *SEC Injunctions*, 68 TENN. L. REV. 427, 463 (2001) (calling the new cease and desist authority the "most far-reaching innovation of the Remedies Act").

58. *See, e.g.*, Newkirk & Brandiss, *supra* note 57, at 1006; Dhaivat H. Shah, *The Care and Feeding of an SEC Cease-and-Desist Order: The Commission Defines Its Authority Through in the Matter of KPMG Peat Marwick, LLP*, 25 HAMLINE L. REV. 271, 272 n.3 (2002) (defining the role of the cease and desist order).

59. Securities Enforcement Remedies and Penny Stock Reform Act of 1990 § 203, Pub. L. No. 101-429, 104 Stat. 931 (1990) (codified as amended at 15 U.S.C. § 78u-3(a) (2000)).

60. *Task Force*, *supra* note 57, at 1093; Morrissey, *supra* note 57, at 464.

61. Morrissey, *supra* note 57, at 464 (claiming that the Commission uses "less stringent evidentiary standards" and that it may obtain a cease and desist order upon the showing of a single violation); Shah, *supra* note 58, at 283 (noting that the Commission's requirement of a showing of likelihood of future violation for a cease and desist order is at a lower standard than for civil injunctions). However, there is some disagreement between the standards imposed in an administrative hearing and those imposed by an administrative law judge. Shah, *supra* note 58, at 283 (implying that the Commission and the administrative law judges do not always agree that a cease and desist order is necessary upon the showing of a violation).

62. 15 U.S.C. § 78u-3(a); *see also Task Force*, *supra* note 57, at 1105 (remarking on

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used in a cease and desist order is provided in Appendix A.

Unclear, however, is whether the impact of a cease and desist order is equivalent to that of an injunction.[63] For example, a violation of an injunction leads to a contempt charge while a violation of a cease and desist order leads only to a monetary penalty.[64] In addition, a cease and desist order does not have the collateral effect of an injunction, such as disqualifying an entity for an exemption or subjecting a person to further disciplinary action.[65]

E. *Civil Monetary Penalties*

The 1934 Act controls the amount of civil monetary penalties whether assessed by the Commission[66] or by a district court.[67] For the district court, the statute prescribes a three-tier system of penalties amounts. In the most lenient tier, the maximum penalty is the greater of (1) $5,000 per violation for a natural person, $50,000 per violation for others or (2) the "gross amount of pecuniary gain" to the defendant.[68] In the second tier, the maximum penalty is the greater of (1) $50,000 per violation for a natural person, $250,000 per violation for others or (2) the "gross amount of pecuniary gain" to the defendant.[69] Finally, in tier three, the maximum penalty is the greater of (1) $100,000 per violation for a natural person, $500,000 per violation for others or (2) the "gross amount of pecuniary gain" to the defendant.[70]

Similar dollar amounts are available to the Commission in an administrative hearing. However, the "gross amount of pecuniary gain" option is absent under this section.[71] The maximum dollars per violation, at the same amounts as set for the district court, is the only determinant of penalty amount.[72]

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the Commission's ability to "tailor-make" its remedies).

63. *See* Shah, *supra* note 58, at 292-93 (lamenting the lack of research into the practical effects of cease and desist orders).

64. Newkirk & Brandiss, *supra* note 57, at 1006.

65. Morrissey, *supra* note 57, at 470. *See also* Shah, *supra* note 58, at 280-81 (quoting a former SEC Chairman as describing the cease and desist order as a remedy that would not have the serious collateral consequences that an injunction does). *See also* Newkirk & Brandiss, *supra* note 57, at 1004-05 (describing the negative collateral effects of an injunction).

66. 15 U.S.C. § 78u-2(a) (2000).

67. *Id*. § 78u(d)(3)(A).

68. *Id*. § 78u(d)(3)(B).

69. *Id*.

70. *Id.*

71. *Id*. § 78u-2(b).

72. *See* 15 U.S.C. §§ 78u(d)(3)(B), 78u-2(b)

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Therefore, the district court has a broader range of money penalties available to it than does the Commission.[73] This difference in authority has profound implications with respect to the Commission's ability to impose adequate monetary penalties. Unlike the district court, which is free to set its penalties commensurate with the "gross amount of pecuniary gain" resulting from the violation, the Commission's penalties are capped by the language of the statute.

F. *Suspensions and Bars: Temporary and Permanent*

Suspensions and temporary bars are similar, differing only as to length and the re-instatement process. By statute, a suspension can last no more than one year.[74] There are no requirements for reinstatement upon the termination of the suspension period. A temporary bar, on the other hand, is not capped at one year but may extend for several years.[75] In addition, the temporarily barred party may be required to apply for re-admission to the industry from which he/she was temporarily barred.[76] A permanent bar, however, has all the aspects of being permanent.[77]

III. THE ADMINISTRATIVE ENFORCEMENT PROCEEDING

A. *The Proceeding Timeline*

Commission enforcement proceedings generally begin with an informal investigation by Commission staff.[78] These

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73. The administrative third-tier penalty, in contrast to the judicial version, may be imposed although there has been no substantial loss or risk of loss, as long as the penalized party received a "substantial pecuniary gain." *Task Force*, *supra* note 57, at 1110-11.

74. *See, e.g.*, Securities and Exchange Act of 1934, § 15(b)(4) (authorizing suspensions for brokers and dealers); § 15B(c)(2) (authorizing suspensions for municipal securities dealers); § 15C(c)(1)(A) (authorizing suspensions for government securities brokers and dealers).

75. *See* Securities and Exchange Act of 1934, § 15(b)(6) (authorizing the barring of persons associated with brokers or dealers). *See also* S.E.C. Rules of Practice, 17 C.F.R. § 201.102(e) (permitting the Commission to "deny, temporarily or permanently, the privilege of appearing or practicing before" the Commission).

76. S.E.C. Rules of Practice 201.193 (outlining the procedure for applying for re-admission to practice).

77. Permanency, however, may be in the eye of the beholder. *See Task Force*, *supra* note 57, at 1114-15, n.161 (explaining that though the statute provides only for a permanent bar, the Commission's practice is to permit the dissolution of the bar upon certain showings). *See also* Mitchell E. Herr, *Does the SEC Demand More in Settlement Than It Can get at Trial*?, 33 SEC. REG. & L. REP. (BNA) 607, 608 n.8 (2001) (claiming that the Commission will "entertain a right to reapply after five years even when no such right is specified" in the original sanction).

78. *See* William R. McLucas et al., *A Practitioner's Guide to the SEC's Investigative*

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investigations are usually not made public.[79] The Commission may follow an informal investigation with one that is formal, which vests the Commission with subpoena authority.[80] As with informal investigations, formal investigations are non-public.[81] At the close of the investigation, whether formal or informal, the Commission has at least four options available: terminate the investigation; initiate formal administrative proceedings; seek injunctive relief from a district court; or refer the matter to the Department of Justice for criminal prosecution.[82] The Commission is not limited to only one option as it may seek any combination of remedies, administrative, civil and criminal.[83] For purposes of this section, however, only the administrative proceeding is addressed.

At the close of the investigation, the Commission staff refers its findings to the Commission which then decides whether to initiate formal administrative enforcement proceedings.[84] These proceedings are begun with an Order Instituting Proceedings ("OIP") in which the allegations against the respondent(s) are specified.[85] The OIP also establishes whether the proceeding will be an administrative or a cease and desist hearing.[86] Because OIPs are published as Commission releases, the proceeding becomes public at this stage.[87]

In the event the respondent reaches a settlement with the Commission, the terms of the settlement are published as a

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and Enforcement Process, 70 TEMPLE L. REV. 53, 56 (1997) (noting that informal investigations rely on the cooperation of others to provide information because staff members do not have the authority to issue subpoenas at this stage); Amchen et al., *supra* note 56, at 1084-85 (2002).

79. *See, e.g.*, McLucas et al., *supra* note 78, at 56 (explaining that the investigation stage is non-public).

80. *See id.* at 57 (explaining that a formal investigation may be necessary when witness are not cooperative or when subpoenas are needed to obtain documents from entities such as banks).

81. *See* Amchen et al., *supra* note 56, at 1085-86.

82. *Id.* at 1086-87.

83. *See id.* at 1094 (noting that the Commission may pursue both civil and administrative proceedings at the same time); McLucas et al., *supra* note 78, at 100 (explaining that the Commission can seek both civil and criminal sanctions at the same time).

84. *See* Jonathan C. Dickey et al., *SEC Investigations and Enforcement Actions: An Overview and Discussion of Recent Trends in Accounting Fraud Investigations*, *in* PLI Corp. L. & Practice Course, Handbook Series No. B0-015P 507, 518-19 (2001).

85. *See Task Force*, *supra* note 57, at 1104 (explaining that the Order Instituting Proceedings often contains settlement information as well).

86. S.E.C. Rules of Practice 201.200(a)-(b) (defining the contents of an order instituting proceedings).

87. *Id.* at 201.200(e).

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Commission release. In fact, the settlement terms often appear on the original OIP.[88] If the respondent does not settle, the allegations are then litigated before an administrative law judge ("ALJ") whose findings of fact and conclusions of law will eventually be published in a Commission release.[89]

B. *The Settlement Process*

The majority of administrative enforcement actions are settled rather than litigated.[90] Realistically speaking, both the Commission and the respondent have significant incentives to settle. Litigation is costly and time-consuming for both sides.[91] In order to process its ever-increasing caseload, the Commission must rely heavily upon a high settlement rate.[92] In similar vein, companies under investigation wish to avoid the negative publicity that would attend a trial.[93] According to the Commission's Rules of Practice, a respondent may initiate settlement discussions at any time.[94] The timing of the settlement, however, is important in determining the degree of exposure the respondent will suffer. A respondent who settles early in the process can reduce or even eliminate completely the public record of the investigation.[95]

During either a formal or informal investigation, the party

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88. *See* Arthur B. Laby & W. Hardy Callcott, *Patterns of SEC Enforcement Under the 1990 Remedies Act: Civil Money Penalties*, 58 ALB. L. REV. 5, 38 (1994). *See also Task Force*, *supra* note 57, at 1149 (noting that the settlement is made public).

89. *See* Anne C. Flannery, *Time for a Change: A Re-examination of the Settlement Policies of the Securities and Exchange Commission*, 51 WASH. & LEE L. REV. 1015, 1016 (1994).

90. *See Task Force*, *supra* note 57, at 1104 (noting that the majority of actions settle without an evidentiary hearing); Laby & Callcott, *supra* note 88, at 21, 38 (observing that many enforcement actions settle at the same time as they are begun); Flannery, *supra* note 89, at 1016 (recognizing that the majority of cases settle); Harvey L. Pitt. & Karen L. Shapiro, *Securities Regulation By Enforcement: A Look Ahead at the Next Decade*, 7 YALE J. ON REG. 149, 179 (1990) (observing that the S.E.C. maintains its high rate of efficient case processing by relying on a high rate of settlements).

91. *See, e.g.*, *Task Force*, *supra* note 57, at 1092-93 (describing the high costs of litigation for both parties in terms of money, time, and resources).

92. *See id*. at 1092 ("The effectiveness of the S.E.C.'s enforcement program now depends, more than ever before, on how effectively cases can be settled.").

93. *See, e.g.*, Dickey et al., *supra* note 84, at 519 (listing the reasons why settlements are preferred over litigation in an S.E.C. enforcement action).

94. S.E.C. Rules of Practice, 17 C.F.R. § 201.240(a) (2004). "Any person who is notified that a proceeding may or will be instituted against him or her, or any party to a proceeding already instituted, may, at any time, propose in writing an offer of settlement." *Id.*

95. *See infra* notes 96-107 and accompanying text (describing the Wells submission).

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being investigated may submit a written statement, known as a Wells submission, which outlines the party's position and response to the issues under investigation.[96] Often, the purpose of the submission is to convince the Commission investigators that the party is not involved in the problem under investigation.[97] While there are significant concerns about the practice of the Wells submission, ranging from issues of third-party discovery of the document[98] to questions of how much information to disclose,[99] the practice remains very common.[100]

The Wells submission is made prior to the initiation of a formal administrative proceeding.[101] If successful, the investigation against the respondent may be dropped completely. At this stage, there has been no public record of the investigation, and therefore no public record of the respondent's involvement.[102] Even if not successful in ending the investigation, the Wells submission may lead to a reduced number of allegations or a lowered degree of alleged scienter.[103]

Those investigations which are not settled at this stage are referred to the Commission which decides whether to institute an enforcement proceeding.[104] If so, the Commission publishes an Order Instituting Proceedings ("OIP").[105] However, during the time between the Commission's decision and the actual publication of the OIP, the respondent has another opportunity to reach a settlement.[106] If a settlement is reached at this stage, the terms of the settlement will be published in the same release

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96. *See, e.g.*, Joshua A. Naftalis, Note, *"Wells Submissions" to the SEC as Offers of Settlements Under Federal Rule of Evidence 408 and Their Protection From Third-Party Discovery*, 102 COLUM. L. REV. 1912, 1913 (2002) (reciting the history of the Wells submission practice).

97. *Id*. at 1913 (describing the Wells submission as an attempt to either end the investigation or to initiate early settlement discussion).

98. *Id.* at 1913-14.

99. *See, e.g.*, Mathew Bender, LexisNexis, The SEC Administrative Hearing: Commission Decision to Institute Administrative Proceeding, 6-89 Securities Law Techniques § 89.04 (MB) (2002) (discussing the issues involved in deciding what to disclose in a Wells submission).

100. *See* Dickey et al., *supra* note 84, at 518 (relating that the S.E.C. will contact the respondent "in virtually every case other than those requiring emergency relief," giving the opportunity for a Wells submission to be submitted).

101. *Id*. at 518-19.

102. *Id*. at 518. (stating that the outcome of the Wells submission will determine whether or not action on the case should be commenced).

103. *Id*.

104. *Id*.

105. Securities Exchange Act of 1934 § 15(b).

106. Dickey et al., *supra* note 84, at 519.

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as the OIP. Indeed, many settlements are published in this manner.[107] If a settlement is reached at some point after the OIP is published, the notice and terms of the settlement are published in a second release.[108] If an OIP is filed against multiple parties, those parties may reach settlements at different times, thus generating separate releases for each settlement.[109] With each release comes public exposure for the respondent; therefore, the respondent has great incentive to settle as early in the process as possible.

IV. DATA COLLECTION PROCEDURE

A. *Identifying the Cases*

Commission enforcement activities occur in three spheres: in Commission-based administrative actions, in civil suits filed by the Commission in district courts, and in criminal suits filed by the Department of Justice upon Commission recommendation.[110] Because the initiation of a criminal suit is ultimately determined by the Department of Justice[111] rather than the Commission, this project does not focus upon the initiation of those suits. However, sanctions from criminal proceedings are included if they are specified in the settlement release.[112]

Each administrative enforcement proceeding is documented in a "release" which is published on the Commission's website[113] as well as gathered by traditional legal resources such as Westlaw[114] and Lexis-Nexis.[115] Many of the administrative proceeding releases refer to companion civil litigation – civil injunction suits initiated for the same conduct that is the subject of the administrative proceeding. The Commission publishes "litigation releases" on its web site that document these civil cases as well as any criminal cases by the Department of Justice.

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107. *See Task Force*, *supra* note 57, at 1104 (citing that many OIPs are published for the sole purpose of publishing the settlement terms).

108. *See* Laby & Callcott, *supra* note 88, at 21-22 (recognizing that settlements can sometimes take up to two years after the OIP is published).

109. *Id.*

110. Securities Enforcement Remedies and Penny Stock Reform Act of 1990 (the Remedies Act), Pub. L. No. 101-429, 104 Stat. 931 (1990).

111. *Id.*

112. *See* Investment Advisor Act of 1940, Exchange Act Release No. 2050 (Aug. 30, 2002), *at* http://www.sec.gov/litigation/admin/ia-2050.htm.

113. *See* http://www.sec.gov/rules/final/33-8530.htm.

114. *See also* http://www.westlaw.com/

115. *See also* http://www.lexis.com/

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It is these releases, both administrative and "litigation", that provide the data in this study.

Over 800 administrative releases, published from January 1, 1999 through January 24, 2002, were collected from Lexis-Nexis.[116] An initial pilot study using approximately sixty-seven non-randomly chosen releases was conducted to develop the data gathering instrument used in the larger study. The pilot study is not discussed here. From the pool of releases (excluding those used in the pilot study), 200 releases were randomly selected for inclusion in this study.[117] For ease of discussion, the 200 releases will be referred to as "cases."

Two of the 200 cases contained findings of fact and conclusions of law from hearings before an administrative law judge. An additional eight cases concerned activity that was not related to an enforcement proceeding. These cases were eliminated. The final data set consisted of 190 cases which chronicled the agreed settlements of 260 respondents.

B. *Collecting the Data*

In addition to collecting data from each of the 190 cases in the sample, data from litigation releases were also gathered when the case provided the litigation release number. If published court opinions were available, data were also collected from them. The final data set for this study includes data from the Commission's administrative proceedings releases (the cases), its "litigation" releases, and published court opinions. The data collected from each case fall into three general categories: party data, violation data, and sanction data. Each category is described separately below.

1. Party-Related Data

Each respondent was identified as either an individual or an organization (i.e., brokerage house, corporation). In addition, each respondent is classified as one of five party types. The five types and examples of parties in each type are given in Table 1.

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116. The actual search criteria used were: administrative proceeding and caps (offer settlement) and date bef 1/24/2002. These criteria exclude administrative law judges' decisions.

117. Using the computer program Microsoft Excel, each release was assigned a random number between 0 and 1. The releases were then sorted by random number, and the first 200 releases with the lowest random number were chosen. The approximately 67 releases used in the pilot study were excluded from selection.

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Table 1. Examples of Respondents in Each Party Type

Accounting Related:	Accounting Firm, CPA
Broker-Dealer Related:	Broker, Dealer, Municipal Securities Dealer, Trader, Market Maker, Transfer Agent
Investment Advisor Related:	Fund Manager, Investment Advisor, Investment Company
Issuer Related:	Accounting Manager, Accounts Receivable Clerk, CEO, President
Outside the System:	Business Owner, Computer Programmer

The "Accounting Related" group included CPAs and auditors who were not associated with an issuer. CPAs within an issuer were classified as "Issuer Related." The "Outside the System" category contained parties who are not otherwise related to the securities industry and who did not fit another classification. It also included persons who were acting as brokers, dealers, or investment advisors but who were not registered with the Commission as such. Appendix B lists the most common roles of respondents in each party type category.

This grouping scheme is similar to the scheme the Commission uses in its annual reports. In those reports, the Commission breaks its cases out into groups that represent a combination of party and activity type. For example, in the appendices of the annual reports for fiscal years 1999, 2000, and 2001, the following are a few of the categories the Commission uses: Securities Offerings; Broker-Dealer Cases; Issuer Financial Statement and Reporting Cases; Other Regulated Entity Cases (Investment Advisors, Investment Companies, Transfer Agents, Self Regulatory Organizations); Insider trading; and Market Manipulation.[118]

118. Sec. Exch. Comm'n, *Annual Report of the Securities and Exchange Commission for Fiscal Year 1999*, app. table 1, *available at* http://www.sec.gov/pdf/annrep99/appxa.pdf (2002); Sec. Exch. Comm'n, *Annual Report of the Securities and Exchange Commission for Fiscal Year 2000*, app. table 1, *available at* http://www.sec.gov/pdf/annrep00/appx.pdf (2002); Sec. Exch. Comm'n, *Annual Report of the Securities and Exchange Commission for Fiscal Year 2001*, app. table 1, *available at* http://www.sec.gov/pdf/annrep01/ar01appendix.pdf (2002).

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2. Violation-Related Data

Each case in the study was carefully examined for specific allegations of violations. The alleged violations were roughly sorted into twenty-four violation types. Table 2 provides the complete list of violation types. An additional violation type was added to indicate whether any of the allegations included an allegation of violation of Rule 10b-5.[119] Table 2 violations that could be named in an allegation of a Rule 10b-5 violation are indicated by "[R10b-5]" in brackets. Appendix C contains a list of all violations in the "Other Violation" category.

Table 2. Violation Types.

1. Bribery (of registered representatives to sell stock)
2. Failure to Reasonably Supervise
3. Failure to File Required Reports
4. Failure to Follow GAAP (Generally Accepted Accounting Procedures) (i.e., improper revenue recognition, improper accounting technique)
5. Failure to Follow GAAS (Generally Accepted Auditing Standards) (i.e., undue reliance on officer-provided information)
6. Fraudulent Sales Practices (i.e., churning)
7. Inaccurate Books and Records (i.e., recording inaccurate revenue, failing to keep records accurate, doctoring records to cover improper activity)
8. Lack of Insider Trading
9. Appropriate Internal Controls (i.e., not having procedures in place to discover fraudulent activity by traders)
10. Manipulation of Market Prices (i.e., fraudulent coordination of quotes, best execution violations)

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119. Rule 10b5-1 addresses the issue of when insider trading liability arises in connection with a trader's "use" or "knowing possession" of material nonpublic information. The rule provides that a person trades "on the basis of" material nonpublic information when the person purchases or sells securities while aware of the information. However, the rule also sets forth several affirmative defenses, which the SEC has modified in response to comments, in order to permit persons to trade in certain circumstances where it is clear that the information was not a factor in the decision to trade. *See* http://www.sec.gov/rules/final/33-7881.htm.

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11. Material Misrepresentation in Advertising [R10b-5] (i.e., promoting a future loan as incoming capital)
12. Material Misrepresentation in Advising [R10b-5] (i.e., misrepresenting the actual risk level of investments, misrepresenting the performance of investment)
13. Material Misrepresentation in New Sales of Securities [R10b-5]
14. Material Misrepresentation in Registration Statement [R10b-5]
15. Material Misrepresentation in Reporting [R10b-5] (i.e., filing inaccurate reports with the SEC or other regulatory bodies)
16. Material Misrepresentation in Trading of Securities [R10b-5]
17. Misappropriation of Funds (i.e., theft)
18. Sale of unregistered securities [R10b-5]
19. Undisclosed Compensation [R10b-5]
20. Unregistered Broker-Dealer
21. Unregistered Investment Advisor
22. Violation of Advisor's Act
23. Other Violations (i.e., violate Regulation T, bid-rigging, aiding and betting in fraud, improper documentation of loans, pre-solicitation of after-market purchases)
24. 10b-5 Fraud Allegation Flag

3. Sanction-Related Data

Data relating to sanctions were also collected from each case. Each type of sanction is described in Table 3.

Table 3. Sanction Categories

Sanction	**Description**
CD	A cease and desist order has been imposed.
Injunction	A district court has permanently enjoined the respondent.
Censure	The Commission censures the respondent.
Penalty/Fine	This includes monetary penalties

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	imposed by the Commission or by a district court, and fines imposed in a criminal case.
Suspension	The right to practice in the industry may be suspended up to one year.
Temporary Bar	The right to practice may be barred for any time period. Respondent must re-apply for admission to practice at the end of the period.
Permanent Bar	Respondent is permanently barred from practice.
Develop Policies	Respondent must develop internal policies to guard against violations.
Independent Consultant	Respondent must develop policies using an independent consultant.
Notify Clients	Respondent must notify existing and/or prospective clients of the current order against the respondent.
Revoke Registration	Respondent's registration (not a registration statement) is revoked.
Other Sanctions	Any sanction that does not fit another category.

According to information provided in the releases, seventy-nine of the 260 respondents were the subject of additional civil suits by the Commission. Twenty-one respondents also faced criminal suits (eight respondents had both civil and criminal suits filed against them). Each suit was located in the Commission's archives of litigation releases on the Commission web site; however, not all suits had reached final disposition at the time of data collection (very few of these cases have published court opinions). Because of the complexity of the data, the sanctions from the civil suits, criminal trials, and administrative hearings were combined. It is important to note, however, that sanctions from civil or criminal courts were imposed prior to the agreed settlement and were referenced in the Commission's release. Therefore, it is reasonable to assume that the sanctions were considered in the settlement and thus should be considered in the present analysis.

C. *Additional Data*

Additional data collected included: whether the proceeding

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was an administrative or a cease and desist proceeding, whether the alleged violations occurred once or more than once, whether the alleged violations occurred in less than or over one year's time, the dollar amount lost to victims, the dollar amount of unjust gain, the dollar amount of the monies involved, and the presence of remedial conduct. However, this additional information was so infrequently available that only the duration of the alleged violation could be included as a variable in the analysis.

D. *Analysis Strategy*

The basic goals of this analysis are threefold: 1) describe the violations the Commission prosecutes and the sanctions it employs; 2) identify any patterns in the imposition of sanctions; and 3) evaluate the relationship between severity of violation and severity of sanction.

Though the securities laws and rules do not establish a hierarchy of severity for securities violations, some indices of severity were nonetheless derived from the data collected. Specifically, the analysis focuses on three measures of severity. The first measure is the number of violation types alleged. The presumption is that the more types of violations alleged against a respondent, the more egregious the respondent's conduct. The second measure is the presence of an allegation of a Rule 10b-5 violation. A Rule 10b-5 violation raises the specter of fraud and the possibility of more severe punishment. Finally, the duration of the alleged violating conduct is the third measure of severity. The presumption in this measure is that the longer a violation continues, the more damage is done, and therefore, the more egregious the conduct becomes.

The severity of the sanctions imposed is also assessed. The first measure of sanction severity is the number of sanctions imposed overall. In addition, severity of sanction is measured by the presence or absence of a specific sanction. Finally, some sanctions permit measurement along a scale. For example, the penalty/fine sanction is measured in dollar amount and the higher the amount imposed, the more severe the sanction. Similarly, the suspension/temporary bar sanction is measured in time: the longer the suspension/temporary bar, the more severe the sanction.

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Given these measures of violation and sanction severity, the analyses are organized to address these specific questions:

Which of these factors?	Predicts which of these outcomes?
Number of alleged violations	Number of sanctions
Duration of violation	Likelihood of penalty/fine
Whether 10b-5 allegation	Amount of penalty/fine
Likelihood of suspension/ temporary bar	Length of suspension/temporary bar
Likelihood of permanent bar	

E. *Statistical Procedures Used*

Complex analyses such as multiple regression or categorical modeling are beyond the scope of this project. Instead, the analyses of these data involved very basic statistical procedures. There are two classes of procedures used: descriptive and inferential. Descriptive statistics such as frequencies, averages, and correlation analysis[120] are limited in that their results cannot be extrapolated beyond the current sample. Thus, these processes merely describe the sample of cases in the study.

The two inferential statistics used are "analysis of variance" or ANOVA and chi-square analysis. Inferential statistics reveal characteristics of the population as a whole, and thus are not limited to describing only the current sample. The ANOVA

120. *See* Statsoft website (Mar. 22, 2005), *available at* http://www.statsoft.com/textbook/stathome.html. A correlation coefficient ("correlation r") can be calculated for two variables when both variables are numeric rather than categorical. *See* http://mathworld.wolfram.com/SpearmanRankCorrelationCoefficient.html. The correlation coefficient ranges from –1 to 1 and will be indicated as, for example, "correlation r = 0.25". *Id*. A positive coefficient greater than zero indicates that as the value of one variable increases or decreases, the value of the second variable also increases or decreases in the same direction as the first variable (i.e., as outside temperatures rise, beach attendance also rises). A negative, non-zero correlation coefficient indicates that as the value of one variable changes, the second variable also changes but in the opposite direction (i.e., as outdoor temperatures drop, indoor heating bills rise). *Id*. The correlation between the two variables is stronger as the coefficient approaches 1 or –1. *Id*. A coefficient of zero indicates that a change in the value of one variable is not predictive of any change in the second variable. *Id*. It is important to keep in mind, however, that a correlation between two variables does not necessarily mean that changes in one variable *cause* changes in the other. Changes in both variables may be caused by an unknown third factor. Therefore, correlations cannot be used to indicate causality. *Id*.

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procedure is used when comparing outcomes for different groups; however, the outcome being measured must be a numeric variable such as amount of penalty/fine or length of suspension/bar. When the outcome being measured is categorical such as whether or not a penalty/fine was imposed, chi-square analysis is used. Each analysis is briefly described below.

The result of the ANOVA indicates whether or not the grouping variable is causally related to the outcome measure.[121] In other words, are the outcomes for the different groups statistically different from each other? Unlike correlational analysis, a significant ANOVA result does indicate a causal relationship between the groups and the outcomes. In addition, if the ANOVA result is significant, the effect of the grouping variable on the outcome variable can be extended to the population as a whole. For example, a simple experiment may compare bar exam scores for two groups of law students: students in the first group enrolled in a commercial bar preparation course while students in the second group did self-study only. Assuming there are no other differences between the groups (such as intelligence level, law school attended, GPA, etc.), an ANOVA procedure would reveal whether the average bar exam scores for each group are significantly different from each other. A significant result would not only show a difference between the two groups actually studied, but could be extended to permit general conclusions about which study method is better at producing higher scores for all students.[122]

In comparison, if the experiment on bar preparation methods focused on how many students in each group passed the bar,

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121. *See* http://mathworld.wolfram.com/ANOVA.html. The ANOVA produces a value "F" and a probability, or "p," for the "F" value. *Id*. In most social sciences, a probability of 0.05 or less is interpreted to mean that the grouping variable had a statistically significant impact on the outcome variable. More specifically, such a low probability means that the obtained difference in the groups would occur by chance fewer than 5 times out of a 100. If the probability that the outcome is due to chance is that low, we conclude that the groups are not different by chance alone. A probability of greater than 0.05 is generally interpreted to mean that no relationship between the grouping variable and the outcome variable was found in the sample. *Id*. However, the absence of a statistically significant result does not mean that there absolutely is no relationship – it only means that one was not found in the sample. An ANOVA result is indicated as F("df") = X, p = Y ("df" refers to degrees of freedom). *Id*.

122. This study uses the p-value of 0.01 rather than 0.05 to indicate significant results. Because this study involves multiple variables and multiple analyses, the probability that some of the significant results obtained in this study are actually due to chance alone increases. By using a lower p-value cutoff, the probability of false-positive results (results that look significant but are actually due to chance alone) is reduced. Under this stricter standard, a result is significant only if the probability that it was caused by chance is less than 1 in 100, rather than 5 in 100. *Id*.

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rather than the score each student earned, the proper analysis would be chi-square analysis.[123] A chi-square analysis would compare the number of students passing the bar in each category with the number of students expected to pass the bar if there were no difference between study methods. A significant result, indicating that the frequency of passing students is significantly different from what was expected, would support the conclusion that the type of preparation does affect likelihood of passing the bar.

V. DATA DESCRIPTION

A. Party Description

Each respondent was identified by party type. Table 4 shows the number of respondents in each party type broken down by individual and organizational categories.

Table 4. Number of Respondents in Each Party Type.

Party Type	**Individual**	**Organizational**	**Total Respondents**
Accounting	7	1	8
Broker-Dealer	93	28	121
Investment Advisor	29	7	36
Issuer	47	26	73
Outside the System	19	3	22

123. *See* Professor Jeff Connor-Linton, *Chi-Square Tutorial* (Mar. 22, 2003), *available at* http://www.georgetown.edu/faculty/ballc/webtools/web_chi_tut.html. Chi-square analysis starts with the assumption that the grouping variable (i.e., type of bar preparation) is unrelated to the outcome variable (whether or not the student passes the bar). The expected numbers of subjects in each outcome group (passed the bar, did not bass the bar) are calculated based on this assumption of no relationship between grouping and outcome variables. *Id*. The actual frequencies of students in each outcome group are then compared to the expected frequencies. A significant chi-square result means that the actual frequencies of students in each outcome group are different from what would be expected if there were no relationship between grouping and outcome variables. As with the ANOVA procedure, if the likelihood of obtaining such a difference between expected and actual frequencies by chance alone is less than 1 in 100, we conclude that the difference is not due to chance and that the grouping variable is related to the outcome variable. *Id*. A chi-square result will be notated as: Chi-square ("df")= X, p = Y, where the value of "p" is the probability of the chi-square result.

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Total	**195**	**65**	**260**

The ratio of individuals to organizations is about 3:1. For both the individual and the organizational categories, the most frequent type of party is the Broker-Dealer, followed by the Issuer. Respondents in the Broker-Dealer and the Issuer groups account for 75% of the sample. The remaining party types include too few respondents to permit any statistically reliable conclusions to be drawn. Therefore, the remaining analyses address only the 194 respondents in the Broker-Dealer and the Issuer party types. Reducing the party types in this manner also eliminates noise in the data caused by the extra party types by permitting greater focus on the two party types for whom solid analytical conclusions may be drawn.

B. Violations Description

Table 5 shows by party type the five most frequently alleged types of violations. As explained above, several types of violations may also be characterized by an additional allegation of a Rule 10b-5 violation. The determination of the five most frequently alleged violations excludes these Rule 10b-5 allegations. As the table shows, the most frequent violations were not limited to any one type of party. The allegations are distributed across the Broker-Dealer and the Issuer groups, as well as appearing in both the individual and the organizational categories.

Table 5. Breakdown of Respondents for the Five Most Frequently Alleged Offenses (Excluding Rule 10b-5 Allegations)

Party Type	**Material Misrep. In Reporting**	**Material Misrep. In New Sale**	**Material Misrep. In Trading**	**Sale of Unregistered Securities**	**Inaccurate Records and Books**
Individual Broker-Dealers	9	24	28	15	13
Individual Issuers	19	6	1	11	10
Organizational Broker-Dealers	3	4	3	3	7
Organizational Issuers	10	1		7	9
Total Respondents (out of 194)	**41**	**35**	**32**	**36**	**39**

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Table 6 lists the most frequently alleged violations within each party type category. As the table reflects, there is a great deal of overlap among the party types.

Table 6. Most Frequently Alleged Violation Types for Each Party Type (Accounting for 50% or More of All Allegations within a Party Type).

Ind. Broker-Dealers (65% of allegations)	**Org. Broker-Dealers (66% of allegations)**
Material Misrep. In Trading Material Misrep. In Trading-R10b-5 Material Misrep. In New Sale Material Misrep. In New Sale-R10b-5 Other Violation Manipulate Market Sell Unregistered Security	Other Violation Fail to Reasonably Supervise Inaccurate Books and Records Fail to File Reports Material Misrep. In New Sale Lack Internal Controls
Ind. Issuer (65% of allegations)	**Org. Issuer (62% of allegations)**
Material Misrep. In Reporting Sell Unregistered Security Material Misrep. In Advertising Inaccurate Books and Records Violate GAAP Material Misrep. In Advertising – R10b-5	Material Misrep. In Reporting Material Misrep. In Advertising Inaccurate Books and Records Sell Unregistered Security Material Misrep. In Advertising –R10b-5

In Table 7, the average, minimum, and maximum numbers of alleged violations are listed for each party type category. At least one allegation of a Rule 10b-5 violation was made for 90 of the 194 respondents (46% of sample).

Table 7. Range of Violations Alleged for Each Party Type Category.

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Party Type	**Total # Respondents**	**Average # Violation Types**	**Minimum # Violation Types**	**Maximum # Violation Types**	**# With At Least One Rule 10b-5 Allegation**
Individual Broker-Dealers	93	2.68	1	7	56 (60%)
Individual Issuers	47	2.32	1	5	17 (36%)
Organizational Broker-Dealers	28	2.29	1	6	7 (25%)
Organizational Issuers	26	2.81	1	8	10 (38%)
Total Respondents	**194**	**2.56**	**1**	**8**	**90 (46%)**

C. Sanctions Description

Table 8 shows the range of sanctions imposed on respondents in this study. The data for the penalty/fine sanction reflect only those respondents who were ordered to pay a sum greater than zero, regardless of whether the amount was later waived due to the respondent's inability to pay. The suspension and the temporary bar sanctions are combined into one sanction which is measured in number of years. The sanction of hiring an independent consultant occurs only when the respondent is also ordered to develop new policies. Appendix D lists the sanctions that fall into the "Other Sanctions" category.

Table 8. Range of Sanctions Imposed Overall.

Sanction	**Imposed on # of Respondents**	**Imposed on % of Respondents (out of 194)**
Cease and Desist Order (CD)	112	58%
Injunction	53	27%
Censure	25	13%
Penalty/Fine (civil and criminal)	83	43%
Suspension/Temporary Bar	42	22%
Permanent Bar	54	28%

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Develop Policies	10	5%
Independent Consultant	9	5%
Revoke Registration	9	5%
Other Sanctions	12	6%

Table 9 shows the distribution of sanctions across the different party types. To facilitate readability, this table omits the "Independent Consultant" and the "Other Sanctions" categories. As the table shows, the "Develop Policies" and "Revoke Registration" sanctions are applied to organizational respondents rather than to individual respondents. In contrast, suspensions, temporary bars, and permanent bars are more often imposed on individual respondents rather than organizational ones.

Table 9. Number of Respondents Receiving Each Type of Sanction.

Party Type	**CD Order**	**Injunc-tion**	**Censure**	**Pen/ Fine**	**Sus/ Bar**	**Perm Bar**	**Dev Pol**	**Rev Reg**	**Total Resp.**
Individual Broker-Dealers	39	39	7	49	37	46			**93**
Individual Issuers	35	11	2	12	4	8			**47**
Organization Broker-Dealers	14	3	14	20	1		9	7	**28**
Organization Issuers	24	0	2	2			1	2	**26**
Total Respondents	**112**	**53**	**25**	**83**	**42**	**54**	**10**	**9**	**194**

Because most respondents received multiple sanctions, Table 10 shows the number and percentage of respondents receiving different sanction combinations. Note that almost 27% of the respondents received only a "CD/Injunction" or "Censure" sanction (52 out of 194). The top three combinations account for over half (54%) of the respondents.

Table 10. Number of Respondents in Each Sanction Combination.

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% Respondents	**# Respondents**	**Sanction Combination**
27%	52	CD/Injunction and/or Censure
14%	27	CD/Injunction and/or Censure, Permanent Bar
13%	26	CD/Injunction and/or Censure, Pen/Fine
12%	24	CD/Injunction and/or Censure, Pen/Fine, Suspension/Temp. Bar
6%	12	CD/Injunction and/or Censure, Suspension/Temp. Bar
5%	10	Permanent Bar
6%	11	CD/Injunction and/or Censure, Pen/Fine, Permanent Bar
3%	5	CD/Injunction and/or Censure, Pen/Fine, Develop Policies/Ind. Consultant
2%	4	CD/Injunction and/or Censure, Pen/Fine, Permanent Bar, Other
2%	4	CD/Injunction and/or Censure, Revoke Registration
2%	3	Revoke Registration
2%	3	Pen/Fine, Suspension/Temp. Bar
1%	2	Pen/Fine, Suspension/Temp. Bar, Other
2%	4	CD/Injunction and/or Censure, Pen/Fine, Develop Policies/Ind. Consultant, Other
<1%	1	CD/Injunction and/or Censure, Pen/Fine, Suspension/Temp. Bar, Other
<1%	1	CD/Injunction and/or Censure, Pen/Fine, Revoke Registration
<1%	1	CD/Injunction and/or Censure, Permanent Bar, Other
<1%	1	CD/Injunction and/or Censure, Other
<1%	1	Pen/Fine, Permanent Bar
<1%	1	Pen/Fine, Revoke Registration
<1%	1	Develop Policies/Ind. Consultant, Other
100%	**194**	**Total Respondents**

Table 11 breaks down the top seven combinations (representing 162 respondents) according to party types.

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Table 11. Sanctions Combinations in Each Party Type.

Party Types	**CD/Inj/ Censure**	**CD/Inj/Cen, Perm Bar**	**CD/Inj/Cen, Pen/Fine**	**CD/Inj/Cen, Pen/Fine, Sus/Bar**	**CD/Inj/Cen, Sus/bar**	**Perm Bar**	**CD/Inj/Cen, Pen/Fine, Perm Bar**
Ind-BD	1	24	9	22	10	9	10
Ind-Issuer	29	3	6	2	1	1	1
Org-BD	1		10		1		
Org-Issuer	21		1				
Total Resp.	**52**	**27**	**26**	**24**	**12**	**10**	**11**

As Table 11 reveals, the respondents most likely to receive only a cease-and-desist order/injunction and/or censure sanction are the individual and organizational issuers. Together, they account for fifty of the fifty-two respondents in that sanction combination (96%). Eighty-nine percent of the respondents receiving the "CD/Inj/Censure, Permanent Bar" combination are individual broker-dealers (twenty-four out of twenty-seven). The third most frequent combination is distributed somewhat evenly across the party type categories with the exception of organizational issuers.

The data permit the following observations. First, of the ninety-three individual broker-dealer respondents, only one received the "CD/Injunction" sanction. The remaining individual broker-dealer respondents received at least one of the following sanctions in addition to the "CD/Injunction" sanction: penalty/fine, suspension/temporary bar, or permanent bar. Of the twenty-eight organizational broker-dealers, again, only one respondent was sanctioned solely with a cease-and-desist order. Twenty of the twenty-eight organizational broker-dealers respondents also received civil penalties/fines. Of the eight respondents who did not receive civil penalties, five had their broker-dealer registrations revoked.

In stark contrast, over half of the individual issuers received only a cease-and-desist order or injunction (twenty-nine out of forty-seven). Eighty-one percent (twenty-one out of twenty-six) of organizational issuers received a cease-and-desist order or injunction only.

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VI. ANALYSIS OF THE RELATIONSHIP BETWEEN VIOLATION AND SANCTION

A. Comparison of Sanctions for Broker-Dealers and Issuers

1. Number and Type of Violations Alleged for Broker-Dealers and Issuers

The typical violations named for broker-dealers are different than those named for issuers. Individual broker-dealers tended to have allegations concerning violations in trading or selling securities as well as market manipulation. Organizational broker-dealers had varied allegations including failing to reasonably supervise, failing to file reports, and inaccurate books and records. Individual and organizational issuers, on the other hand, tended to have allegations concerning misleading reporting and advertising, sale of unregistered securities, and inaccurate books and records. While these violations differ in kind, no one type of violation is inherently more or less severe than another.

The number of alleged violations does not differ for broker-dealer and issuer respondents. Overall, broker-dealers averaged approximately 2.59 violation types, and issuers averaged 2.51 violation types. This difference is not statistically significant.[124]

2. Number of Sanctions for Broker-Dealers and Issuers

The maximum number of sanctions that could be imposed upon a single respondent is nine: cease and desist order/injunction, censure, penalty/fine, suspension/temporary bar, permanent bar, revocation of registration, order to develop policies, order to hire independent consultant, and "other" sanctions.

On average, broker-dealer respondents were given more sanctions than were issuer respondents. Specifically, the average number of sanctions for individual broker-dealer respondents was 2.8 compared to only 1.7 for Individual Issuers. Organizational broker-dealers averaged 3.04 sanctions while organizational issuers only averaged 1.3 sanctions. Both differences are statistically significant.[125]

124. $F(1,192) = 0.14$, $p = 0.71$, not significant.

125. For individual respondents: $F(1,138) = 38.8$, $p < 0.01$, significant. For organizational respondents: $F(1,52) = 32.1$, $p < 0.01$, significant.

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3. Money Penalties for Broker-Dealers and Issuers

Table 12 displays the proportion of respondents with a penalty/fine imposed and the range of penalty/fines imposed in each party type group. As Table 12 shows, the majority of respondents (57%) did not receive a penalty/fine sanction. Sixty-nine of the 83 (83%) respondents who did receive a penalty/fine were broker-dealers, but broker-dealers made up only 62% (121 of 194) of the total sample. On the other hand, issuers made up 38% of the total sample, but only 17% of the respondents sanctioned with a penalty/fine were issuers. Chi-square analysis reveals that significantly more individual broker-dealer respondents received a penalty/fine sanction than expected (forty-nine compared to an expected 40.52), but fewer individual issuer respondents received a penalty/fine sanction than expected (twelve compared to an expected 20.48).[126]

The data clearly shows that the Commission was most likely to impose a penalty/fine on a broker-dealer. Fifty-seven percent of broker-dealers received a penalty/fine (both individual and organizational). In comparison, only 19% of individual and organizational issuers received penalty/fines.

Table 12. Range of Penalty/Fines Imposed.

Party Type	# Respondents Receiving Penalty/Fine	Min. Penalty/ Fine	Max. Penalty/ Fine	Average Penalty/ Fine	% w/ Penalty/ Fine
Individual Broker-Dealers	49 of 93 (53%)	$500	$1,000,000	$50,659	59%
Individual Issuers	12 of 47 (26%)	$5,000	$150,000	$40,417	14%
Organizational Broker-Dealers	20 of 28 (71%)	$5,000	$735,000	$125,500	24%
Organizational Issuers	2 of 26 (8%)	$10,000	$100,000	$55,000	2%
Total Respondents	**83 of 194 (43%)**	**$500**	**$1,000,000**	**$67,317**	**100% (83)**

126. Chi-square (1) = 9.36, $p < 0.01$, significant.

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However, the analysis showed, however, no significant difference in the amount of the penalty/fine sanction when imposed on respondents in the individual categories (there are too few respondents to permit analysis of the organizational categories). While the average penalty/fine of $50,659 for the individual broker-dealer group is higher than the average of $40,417 for the individual issuers group, the difference between the two values is not statistically significant.[127]

4. Suspensions and Temporary Bars for Broker-Dealers and Issuers

About 40% of individual broker-dealers (thirty-seven of ninety-three) were suspended or received a temporary bar while only 9% of individual issuers (four of forty-seven) received a similar sanction. Broker-dealer respondents were usually suspended or temporarily barred from working in the broker-dealer field. The four issuer respondents were temporarily barred or suspended from practicing as accountants before the Commission. Chi-square analysis shows that, again, significantly more individual broker-dealer respondents received a suspension/temporary bar sanction than expected (thirty-seven compared to an expected 27.24) but that fewer individual issuer respondents received a suspension/temporary bar sanction than expected (four compared to an expected 13.76).[128]

5. Permanent Bars for Broker-Dealers and Issuers

Almost half (forty-six of ninety-three) of the individual broker-dealers were permanently barred from the securities industry. Most were permanently barred from the broker-dealer arena, but many were also collaterally barred from investment advisors, investment companies, and penny stocks as well. On the other hand, only 17% (eight of forty-seven) of individual issuers received permanent bars. Three were permanently barred from practicing as accountants before the Commission, and five were permanently barred from participating in penny stocks. Again, significantly more individual broker-dealer respondents than expected were permanently barred (forty-six compared to an expected 35.87); significantly fewer individual issuers than expected were similarly barred (eight compared to

127. $F(1,59) = 0.16$, $p = 0.81$, not significant.

128. Chi-square $(1) = 14.75$, $p < 0.01$, significant.

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an expected 18.13).[129]

B. *Relationship between Number of Violations Alleged and the Sanctions Imposed*

1. Is the Number of Violations Alleged Related to the Number of Sanctions Imposed?

The prediction is that the greater the number of alleged violations, the greater the number of sanctions imposed. This section used the correlation analysis which is a solely a descriptive procedure. A correlation coefficient of zero would indicate no relationship between number of alleged violations and the number of sanctions imposed; a positive coefficient would indicate that as the number of alleged violations increases, the number of imposed sanctions increases; and a negative coefficient would indicate that as the number of alleged violations increases, the number of imposed sanctions decreases. Overall, there was a moderate correlation between the number of alleged violations and the number of sanctions imposed (correlation r = 0.17). Table 13 shows the average number of violations and sanctions for each party type category as well as the correlations for each.

Table 13. Correlation Between Average Number of Violations and Sanctions.

Party Type	**Total # Respondents**	**Average # Violation Types Per Respondent**	**Average # Sanctions Per Respondent**	Correlation Coefficient (-1 to +1)
Individual Broker-Dealers	93	2.68	2.77	0.01
Individual Issuers	47	2.34	1.72	0.50
Organizational Broker-Dealers	28	2.29	3.04	0.25
Organizational Issuers	26	2.81	1.27	0.32
Total Respondents	**194**	**2.56**	**2.35**	**0.17**

129. Chi-square (1) = 13.87, $p < 0.01$, significant.

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For most of the party type categories, the correlation between number of violations alleged and number of sanctions imposed is positive. For the individual broker-dealer, however, the correlation is near zero. The positive correlations indicate that, in general, the number of sanctions imposed increased as the number of alleged violations increased.

2. Is the Number of Violations Alleged Related to Whether a Penalty/Fine is Imposed?

This section addresses the relationship between the number of alleged violations and the likelihood of a civil money penalty or a criminal fine being imposed. This analysis is only descriptive – the results cannot be extended beyond the current sample.

The prediction is that the respondents with more violations alleged against them are more likely to be given a money sanction. Thus, we would expect to see that respondents who received a penalty/fine sanction have more violations alleged against them than respondents without such a sanction. However, this prediction is not borne out by the data. Table 14 lists the average number of alleged violation types for each party type. Overall, respondents with penalty/fine sanctions had an average of 2.47 violation types alleged against them, while respondents with no penalty/fine sanction had an average of 2.62 violation types alleged.

The results are mixed for the different party types. For both the individual and the organizational broker-dealer groups, respondents with penalty/fines averaged fewer violation types alleged than those with no penalty/fine. The opposite occurs with the issuer groups: those respondents with penalty/fines averaged more allegations than respondents without penalty/fines. The number of violation types alleged does not seem to be consistently related to whether or not a respondent received a penalty/fine.

Table 14. Average Number of Alleged Violation Types For Respondents With and Without Penalty/Fine Sanctions (Number of Respondents is in Parentheses)

Party Type	**Avg. Violations With Penalty/Fine**	**Avg. Violations Without Penalty/Fine**

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Individual Broker-Dealers	2.37 (49)	3.02 (44)
Individual Issuers	3.25 (12)	2.03 (35)
Organizational Broker-Dealers	2.15 (20)	2.63 (8)
Organizational Issuers	3.50 (2)	2.75 (24)
Total Respondents	**2.47 (83)**	**2.62 (111)**

3. Is the Number of Violations Alleged Related to the Amount of Penalty/Fine Imposed?

This prediction is that the more violations alleged, the greater the amount of the penalty/fine sanction when imposed. This section uses correlation analysis based only on those respondents for whom a penalty/fine was imposed. Table 15 shows the correlation coefficients for number of alleged violations and penalty/fine amount for each party type.

Table 15. Correlation Between Number of Alleged Violations and Penalty/Fine Amount

Party Type	**Correlation (-1 to +1)**	**# Respondents**
Individual Broker-Dealers	0.19	49
Individual Issuers	0.19	12
Organizational Broker-Dealers	0.05	20
Organizational Issuers	n/a	2
Total Respondents	**0.09**	**83**

Overall, there is a small-to-moderate correlation between number of alleged violation types and amount of penalty/fine (correlation r = 0.09). This correlation is stronger for the individual broker-dealers and individual issuers groups, indicating that the amount of the penalty/fine imposed tended to increase as the number of allegations against a respondent increased. The correlation for the individual broker-dealer group, however, is influenced by an outlier – one respondent for whom the penalty/fine of $1 million was far greater than all the other penalties imposed in the group. If this one respondent is removed from the sample, the correlation for the individual broker-dealer group drops to near zero (correlation r = 0.02).

It is important to recognize that the sample sizes in each of

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these groups is fairly small. In addition, the range of values for number of violation types (from one to seven) is much narrower than the range of values for penalty/fines (from $500 to $1,000,000). Both of these factors limit the likelihood of finding a strong correlation between the two measures. Consequently, correlations coefficients were not calculated for groups where fewer than ten respondents received a penalty/fine.

4. Is the Number of Violations Alleged Related to Whether a Suspension/Bar is Imposed?

As in the previous analyses, the prediction is that respondents with more violations alleged against them are more likely to receive a suspend/bar sanction; therefore, respondents receiving such a sanction should have a greater number of allegations against them than respondents not receiving such a sanction. This analysis describes only what was obtained in the current sample.

Only forty-two individual respondents overall received a suspension/bar sanction (the one respondent in the organizational broker-dealer group does not provide sufficient data for analysis). The length of the sanction ranged from 0.13 years (forty-nine days) to five years. The data shown in Table 16 tend to reflect the pattern predicted, but the evidence is not very strong. Those individual respondents receiving the suspend/bar sanction tended to have more violations alleged against them (average 2.71 violations) than respondents without the sanction (average 2.51 violations). However, this pattern held only for the individual issuers; the opposite result was obtained for the individual broker-dealers. Thus, while the current sample is somewhat consistent with the prediction, it does not provide strong support for the hypothesis that a suspension/bar is more likely when more violations are alleged.

Table 16. Breakdown of Respondents Who Were Suspended or Temporarily Barred.

Party Type	**# Suspend/ Bar**	**% Suspend/ Bar**	**Average # Violations with Suspend/Bar**	**Average # Violations with no Suspend/ Bar**
Individual Broker-Dealers	37 of 93	40%	2.59	2.73

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Individual Issuers	4 of 47	9%	3.75	2.21
Organizational Broker-Dealers	1 of 28	4%		
Organizational Issuers	0 of 26	0		
Total Respondents	**42**	**22%**	**2.71**	**2.51**

5. Is the Number of Violations Alleged Related to the Length of the Suspension/Bar?

The prediction is that as the number of alleged violations increases, the length of a suspend/bar sanction increases. This correlation analysis is descriptive only of the current sample.

Table 17. Correlation Between Alleged Violations and Length of Suspend/Bar Sanctions for Individual Respondents.

Party Type	Respondents w/Sanction	Correlation (-1 to +1)
Individual Broker-Dealers	37	0.38
Individual Issuers	4	-0.58
Total Individual Respondents	**41**	**0.42**

Overall, Table 17 shows a strong correlation between the length of the suspend/bar sanction and the number of violations alleged: as the number of violations increases, the length of the sanction increases. This result is primarily due to the strong presence of the individual broker-dealer group. The apparently strong but opposite relationship obtained in the individual issuer group is based on only four respondents.

6. Is the Number of Violations Alleged Related to Whether a Permanent Bar is Imposed?

The assumption is that the greater the number of alleged violations, the more likely a permanent bar will be imposed. Thus, the prediction is that respondents who are permanently barred will have more allegations against them than respondents who are not permanently barred. This analysis is descriptive of only the current sample. As the table below shows, respondents who were permanently barred tended to have more violations

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alleged against them (average 3.0 violations) than did respondents who were not permanently barred (average 2.29 violations). This is consistent with the prediction.

Table 18. Breakdown of Respondents Receiving a Permanent Bar Sanction.

Party Type	**# Permanent Bar**	**% Permanent Bar**	**Average # Allegations w/ Permanent Bar**	**Average # Allegations with No Permanent Bar**
Individual Broker-Dealers	46 of 93	49%	2.98	2.38
Individual Issuers	8 of 47	17%	3.13	2.18
Total Respondents	**54 of 140**	**39%**	**3.0**	**2.29**

C. *Relationship between Rule 10b-5 Allegations and the Sanctions Imposed*

1. Do Respondents With Allegations of Rule 10b-5 Fraud Receive More Sanctions?

The assumption is that the presence of a Rule 10b-5 violation allegation indicates a more serious violation of the securities laws, and thus a respondent may have more sanctions imposed. Table 19 shows the average number of sanctions for respondents with and without Rule 10b-5 allegations.

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Table 19. Average Number of Sanctions With and Without Rule 10b-5 Allegations.

Party Type	**Average Sanctions With Rule 10b-5 Allegation**		**Average Sanctions Without Rule 10b-5 Allegation**	
	# Respondents	Average # Sanctions	# Respondents	Average # Sanctions
Individual Broker-Dealers	56	2.80	37	2.70
Individual Issuers	17	2.12	30	1.50
Organizational Broker-Dealers	7	2.29	21	3.29
Organizational Issuers	10	1.10	16	1.38
Total Respondents	**90**	**2.44**	**104**	**2.27**

ANOVA results show that there is no significant difference between the number of sanctions imposed overall when a Rule 10b-5 allegation is present and when it is not. Thus the prediction is not supported: respondents with Rule 10b-5 allegations did not receive significantly more sanctions (average 2.44) than respondents without Rule 10b-5 allegations (average 2.27).[130]

2. Are Respondents With Allegations of Rule 10b-5 Fraud More Likely to Receive a Penalty/Fine?

The assumption is that the presence of an allegation of violation of Rule 10b-5 indicates a more serious violation of the securities laws, and thus the respondent should be more likely to receive a penalty/fine sanction. Table 20 shows the distribution of respondents with and without Rule 10b-5 allegations and with and without penalty/fines. Overall, ninety of the 194 respondents had a Rule 10b-5 allegation alleged against them (46%). However, the proportion of respondents receiving a penalty/fine appears to be lower when a Rule 10b-5 allegation is present (31%) than when there is no such allegation (53%). In fact, chi-square analysis of the number of penalty/fine sanctions given in each group showed a significant difference from expected

130. $F(1,192) = 1.07$, $p = 0.3$, not significant.

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frequencies but in the opposite direction from that predicted. Fewer penalty/fines than expected were given when a Rule 10b-5 allegation was present (twenty-eight compared to an expected 38.5), and more penalty/fine sanctions than expected were given when there was no such allegation (fifty-five compared to an expected 44.49).[131] Thus, there is no evidence that the presence of a Rule 10b-5 increases the likelihood of the imposition of a penalty/fine.

Table 20. Distribution of Rule 10b-5 Allegations and Penalty/Fines Imposed.

	Rule 10b-5 Allegation Absent			**Rule 10b-5 Allegation Present**		
Party Type	**No Penalty / Fine**	**Penalty/ Fine**	**% Penalty/ Fine**	**No Penalty/ Fine**	**Penalty/ Fine**	**% Penalty/ Fine**
Individual Broker-Dealers	11	26	70%	33	23	41%
Individual Issuers	22	8	27%	13	4	24%
Organizational Broker-Dealers	2	19	90%	6	1	14%
Organizational Issuers	14	2	13%	10	0	0%
Total Respondents	**49**	**55**	**53%**	**62**	**28**	**31%**

3. Do Respondents With Allegations of Rule 10b-5 Fraud Receive Greater Penalty/Fines?

The prediction is that when a penalty/fine is imposed, respondents with a Rule 10b-5 allegation will be given higher penalty/fines than those without a Rule 10b-5 allegation. The data does not confirm this prediction. The ANOVA results indicate that the difference between the average penalty/fine imposed on respondents with a Rule 10b-5 allegation (average $77,189) and those without (average $62,291) is not statistically significant.[132]

4. Are Respondents With Allegations of Rule 10b-5

131. Chi-square (1) = 9.34, p = 0.01, significant.

132. F(1,81) = 0.20, p = 0.66, not significant.

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Fraud More Likely to Receive a Suspension/Bar?

The prediction is that the presence of a Rule 10b-5 violation allegation is related to the imposition of a suspend/bar sanction.

Table 21. Distribution of Rule 10b-5 Allegations and Suspend/Bar Sanctions.

	Rule 10b-5 Allegation Absent			Rule 10b-5 Allegation Present		
Party Type	No Suspend/ Bar	Suspend/ Bar	% Suspend/ Bar	No Suspend/ Bar	Suspend/ Bar	% Suspend/ Bar
Individual Broker-Dealers	21	16	43%	35	21	38%
Individual Issuers	29	1	3%	14	3	18%
Total Individual Respondents	50	17	25%	49	24	33%

Table 21 shows that the frequency of suspend/bar sanctions changes somewhat depending on whether or not a Rule 10b-5 allegation is present. When the allegation is absent, only 25% (seventeen of sixty-seven) individual respondents receive a suspend/bar sanction; when the allegation is present, about 33% (twenty-four of seventy-three) receive the sanction. However, this pattern reverses for the individual broker-dealer group where the frequency of suspend/bar sanctions was higher when the Rule 10b-5 allegation was absent (43%) than when it was present (38%). Chi-square analysis confirms that, overall, the frequency of suspension/bar sanctions is not significantly different from that expected if there were no relationship between the presence of a Rule 10b-5 allegation and the imposition of the sanction.[133]

5. Do Respondents With Allegations of Rule 10b-5 Fraud Receive Longer Suspension/Bar Sanctions?

The prediction is that when a suspend/bar sanction is imposed, respondents with a Rule 10b-5 allegation will be given

133. Chi-square (1) = 0.95, p = 0.33, not significant.

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longer terms than those without a Rule 10b-5 allegation. The analyses proved significant. The presence of a Rule 10b-5 allegation led to significantly longer suspend/bar sanctions (average length 2.87 years) compared to suspension/bar sanctions when there was no such allegation (average 0.64 years).[134]

6. Are Respondents With Allegations of Rule 10b-5 Fraud More Likely to Receive a Permanent Bar?

The prediction is that the presence of a Rule 10b-5 violation allegation is related to the imposition of a permanent bar sanction. Table 22 shows the number of individual respondents receiving such a sanction when a Rule 10b-5 allegation was present and when it was absent.

Table 22. Distribution of Rule 10b-5 Allegations and Permanent Bar Sanctions.

	Rule 10b-5 Allegation Absent			**Rule 10b-5 Allegation Present**		
Party Type	**No Perm. Bar**	**Perm. Bar**	**% Perm. Bar**	**No Perm. Bar**	**Perm. Bar**	**% Perm. Bar**
Individual Broker-Dealers	24	13	35%	23	33	59%
Individual Issuers	28	2	7%	11	6	35%
Total Individual Respondents	**52**	**15**	**22%**	**34**	**39**	**53%**

As the table shows, a permanent bar was imposed more frequently for respondents who had an allegation of Rule 10b-5 violation (53%) than for respondents who did not have such an allegation (22%). This pattern holds true for each party type group. Chi-square analysis confirms that more permanent bar sanctions were imposed than expected when a Rule 10b-5 allegation was present (thirty-nine compared to an expected 28.16) and fewer such sanctions were imposed than expected in

134. $F(1,39)=25.8$, $p < 0.01$, significant.

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the absence of the allegation (fifteen compared to an expected 25.84).[135]

D. Relationship between Duration of Alleged Violations and the Sanctions Imposed

1. Do Respondents With Alleged Violations of More Than One Year Receive More Sanctions?

The assumption in this analysis is that respondents whose alleged violations lasted longer than a year receive more sanctions than respondents whose alleged violations had a duration of one year or less. Table 23 shows the average number of sanctions for respondents according to the duration of their alleged violations.

Again, ANOVA results show that there is no significant difference between the number of sanctions imposed overall regardless of the duration of the alleged violation. Thus, the prediction is not supported: respondents with long-term violations alleged do not receive more sanctions (average 2.36) than respondents with short-term violations alleged (average 2.34).[136]

Table 23. Average Number of Sanctions for Respondents According to Violation Duration.

Party Type	**Average Sanctions Where Violations of 1 Year or Less**		**Average Sanctions Where Violations of Over 1 Year**	
	# Respondents	Average # Sanctions	# Respondents	Average # Sanctions
Individual Broker-Dealers	53	2.74	40	2.80
Individual Issuers	21	1.57	26	1.85
Organizational Broker-Dealers	12	3.58	16	2.63

135. Chi-square (1) = 14.2, $p < 0.01$, significant.
136. $F(1,192) = 0.09$, $p = 0.93$, not significant.

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Organizational Issuers	16	1.13	10	1.50
Total Respondents	**102**	**2.34**	**92**	**2.36**

2. Are Respondents With Alleged Violations of More Than One Year More Likely to Receive a Penalty/Fine?

The assumption in this analysis is that respondents whose alleged violations lasted longer than a year are more likely to receive a penalty/fine than respondents whose alleged violations had a duration of one year or less. Table 24 shows the breakdown of respondents receiving penalty/fines according to the duration of their alleged violations.

Overall, a penalty/fine was assessed for 48% of respondents whose alleged violations lasted over a year (forty-four out of ninety-two). Comparatively, a penalty/fine was assessed for only 38% of respondents whose alleged violations lasted one year or less (thirty-nine out of 102). However, these frequencies do not differ significantly from those expected if there were no relationship between duration of violation and the imposition of a penalty/fine sanction.[137]

Table 24. Number of Respondents With Penalty/Fines Imposed According to Duration of Alleged Violation.

	Duration 1 Year or Less			**Duration More Than 1 Year**		
Party Type	**No Penalty/ Fine**	**Penalty/ Fine**	**% Penalty/ Fine**	**No Penalty/ Fine**	**Penalty/ Fine**	**% Penalty/ Fine**
Individual Broker-Dealers	27	26	49%	17	23	58%
Individual Issuers	18	3	14%	17	9	35%
Organizational Broker-Dealers	3	9	75%	5	11	69%
Organizationa	15	1	6%	9	1	10%

137. Chi-square (1) = 1.82, p = 0.18, not significant.

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l Issuers						
Total Respondents	**63**	**39**	**38%**	**48**	**44**	**48%**

3. Do Respondents With Alleged Violations of More Than One Year Receive Greater Penalty/Fines?

The prediction is that the longer the alleged violation lasted, the higher the amount of any penalty/fine. The analysis shows a significant effect of duration of alleged violation on the amount of a penalty/fine; however, the effect opposite than the prediction. Specifically, respondents with alleged violations of one year or less duration received significantly higher penalty/fines (average $111,700) than did respondents whose violations lasted over a year (average $27,977).[138]

When the party types are examined separately, the only significant result obtained, for the organizational broker-dealer group, is similar to that of the overall analysis. Higher penalty/fines were imposed on respondents with shorter violation durations (average $237,778) than on respondents with longer violations (average $33,636).[139]

4. Are Respondents With Alleged Violations of More Than One Year More Likely to Receive a Suspension/Bar?

The prediction is that the length of time that alleged violations continued is related to the imposition of a suspend/bar sanction. Table 25 shows the number of individual respondents receiving such a sanction when the alleged violations continued for one year or less and when the alleged violations lasted more than one year.

Table 25. Number of Individual Respondents Receiving Suspend/Bar Sanction According to Violation Duration.

138. $F(1,81)=7.7$, $p <0.01$, significant.
139. $F(1,18)=9.4$, $p <0.01$, significant.

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	Duration of 1 Year or Less			**Duration More Than 1 Year**		
Party Type	**No Suspend/ Bar**	**Suspend/ Bar**	**% Suspend/ Bar**	**No Suspend/ Bar**	**Suspend/ Bar**	**% Suspend/ Bar**
Individual Broker-Dealers	35	18	34%	21	19	48%
Individual Issuers	20	1	5%	23	3	12%
Total Individual Respondents	**55**	**19**	**26%**	**44**	**22**	**33%**

The results in Table 25 appear consistent with the prediction; however, these frequencies are not statistically different from what would be expected if there were no relationship between violation duration and the imposition of a suspension/temporary bar sanction.[140]

5. Do Respondents With Alleged Violations of More Than One Year Receive Longer Suspension/Bar Sanctions?

The prediction is that when a suspend/bar sanction is imposed, respondents with longer alleged violations will be given longer terms than those with shorter alleged violations. The data show that the length of the suspend/bar sanction was not significantly affected by the length of the alleged violation. The average suspension/bar length for individual respondents with shorter alleged violations was 1.91 years; for those with alleged violations extending over a year, the average suspension/bar length was 1.98 years.[141]

6. Are Respondents With Alleged Violations of More Than One Year More Likely to Receive a Permanent Bar?

The prediction is that the duration of the alleged violations is related to the imposition of a permanent bar sanction. Table 26 shows the number of individual respondents receiving such a sanction when the alleged violations lasted one year or less

140. Chi-square (1) = 0.99, p = 0.32, not significant.
141. F(1,39)=0.02, p = 0.89, not significant.

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compared to those lasting more than one year.

Table 26. Number of Respondents With Permanent Bar Sanctions According to Duration of Alleged Violation.

	Duration of 1 Year or Less			**Duration More Than 1 Year**		
Party Type	**No Perm. Bar**	**Perm. Bar**	**% Perm. Bar**	**No Perm. Bar**	**Perm. Bar**	**% Perm. Bar**
Individual Broker-Dealers	24	29	55%	23	17	43%
Individual Issuers	18	3	14%	21	5	19%
Total Individual Respondents	**42**	**32**	**43%**	**44**	**22**	**33%**

Table 26 shows that there is no consistent pattern in the relationship between violation duration and frequency of permanent bars. Overall, 43% of respondents with violations of one year or less and 33% of respondents with violations over a year received the sanction. The individual broker-dealer group shows more respondents receiving the sanction when the violation was alleged to be one year or less. Again, analysis confirms that these frequencies are not statistically different from what would be expected if there were no relationship between violation duration and the imposition of a permanent bar sanction.[142]

VII. SUMMARY OF FINDINGS

A. Inconsistent Sanctions for Broker-Dealers and Issuers

The primary focus of this study concerns the consistency of the Commission's enforcement proceedings. An effective enforcement program should be consistent in the punishment of violations. For example, a violation should be punished the same

142. Chi-square (1) = 1.45, p = 0.23, not significant.

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regardless of the identity of the violator. An enforcement program that punishes only selected violators and lets others "off easy" is neither fair nor effective. The respondents in this study tended to be subjected to multiple allegations; as a consequence, it was not possible to link specific sanctions with specific violations. However, when we examine the data as to the types of parties involved, the disparity of the sanctions imposed becomes obvious.

1. Penalty/Fine Sanctions For Broker-Dealers and Issuers

Primarily, penalty/fine sanctions were clearly imposed more frequently on broker-dealers than on issuers. This disparity in the application of penalty/fine sanctions may stem from two causes. First, the Commission's authority to impose civil penalties/fines in an administrative proceeding is limited to specific entities named in the statute (such as brokers, dealers, and other registered parties), and issuers are not among those named.[143]

Second, the Commission is not authorized to issue civil penalties/fines in the cease and desist proceeding.[144] In the sample, fourteen of the forty-seven Individual Issuers were prosecuted via cease and desist proceedings; eleven of the twenty-six Organizational Issuers were prosecuted via cease and desist proceedings.

While the Commission may have been unable to impose civil money penalties directly on issuers, the district court is always able to do so.[145] As of the time this data was collected, nine of the Individual Broker-Dealer respondents and one Individual Issuer respondent still faced pending civil suits by the Commission. Overall, the Commission filed civil suits against thirty-eight of the ninety-three Individual Broker-Dealers (41%) but only against fifteen of the forty-seven Individual Issuers (32%). The Commission could have sought civil money penalties against issuers via the district court as it did against broker-dealers. Why it was less likely to do so against issuers is not clear.

2. Other Sanctions for Broker-Dealers and Issuers

Statistically more sanctions overall were imposed on broker-dealer respondents than were issuer respondents. In addition,

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143. *See supra,* Part II. B., "The Commission's Authority over Regulated Persons."
144. *See supra* Part II.D., "The Cease and Desist Order."
145. *See supra* Part II.C., "The District Court's Authority."

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more individual broker-dealers were suspended or received a temporary bar (40%) than expected while fewer individual issuers were so sanctioned (9%). Similarly, 49% of individual broker-dealers, compared to 17% of individual issuers, received a permanent bar. Nine of the twenty-eight organizational broker-dealers (32%) were ordered to develop policies to prevent future violations but only one organizational issuer was given a similar sanction (4%). Finally, 25% of organizational broker-dealers had their registrations revoked; only 8% of organizational issuers were treated in a similar fashion.

3. Sanction Combinations for Broker-Dealers and Issuers

When sanction combinations are examined, the same pattern emerges: broker-dealers are sanctioned more severely than issuers. Specifically, 62% (twenty-nine out of forty-seven) of individual issuers were sanctioned with the censure and either a cease-and-desist order or injunction only. No other sanction was imposed. In contrast, only one of the ninety-three individual broker-dealers was sanctioned this lightly. For organizational issuers, 81% (twenty-one out of twenty-six) received only these sanctions compared to only 4% of organizational broker-dealers (one out of twenty-eight).

B. No Major Differences in Violations for Broker-Dealers and Issuers

Differences in sanction patterns may reflect differences in the nature of the violations alleged against the parties. As discussed previously, there is no significant difference in the number of violations alleged against broker-dealers and issuers. In addition, there is a great deal of overlap in the types of violations in each party type. However, there are differences between the groups on allegations involving Rule 10b-5 violations. As Table 27 shows, a greater proportion of individual broker-dealers had Rule 10b-5 allegations than did individual issuers; the opposite relationship holds for the organizational groups where the proportion of organizational issuers with 10b-5 allegations was greater than for organization broker-dealers. Overall, however, broker-dealers respondents were more likely to have a Rule 10b-5 allegation (52%) than were issuer respondents (37%). This variance may reflect some underlying differences in

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the nature of the broker-dealer violations and issuer violations.

Nonetheless, these differences between broker-dealer and issuer violations are not enough to account for the divergence in sanction severity for these groups. The violation-related variables do not consistently distinguish between the broker-dealer and the issuer groups and do not fully explain the strong pattern of differing sanctions for the groups.

Table 27. Comparing Alleged Violations for Broker-Dealers and Issuers.

Party Type	**# Respondents**	**# 10b-5 allegations**	**% 10b-5 allegations**	**# Violations 1 Year or Less**	**% Violations 1 Year or Less**
Individual Broker-Dealers	93	56	60%	53	57%
Individual Issuers	47	17	36%	21	45%
Organizational Broker-Dealers	28	7	25%	12	43%
Organizational Issuers	26	10	39%	16	62%

C. Other Differences between Broker-Dealers and Issuers

While broker-dealers and issuers may not differ in number of violations in this study, there are other differences that may play a role in how each type of respondent was sanctioned. For example, broker-dealers and issuers are very different players in the field of securities. Broker-dealers tend to work with individual investors more, both as individual broker-dealers and as organizations. This close relationship to the investor allows the broker-dealer to offer personalized service to the investor, but it creates the opportunity to take advantage of the investor as well. Offenses such as churning and the misappropriation of money reflect this intimacy. Broker-dealers who are paid commissions on trades have an incentive to increase trading activity at the expense of the investors who trust them. Similarly, broker-dealers are intimately involved with their clients' money. This intimacy implies a sense of trust between

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the broker-dealer and the client. Perhaps it is the violation of this trust that warrants the relatively harsh sanctions given by the Commission.

Issuers, on the other hand, are somewhat more divorced from the individual investor. The violations most common to the issuer group are not of the individualized nature that the broker-dealer violations tend to be. Issuers violate securities laws in their reporting and their advertising. Sometimes they violate the securities laws in failing to register securities. These types of offenses do not involve the personal, intimate relationship with an investor characteristic of broker-dealers and therefore may not justify sanctions of a similar degree.

D. Some Measures of Violation Severity Do Predict Sanction Severity

For an enforcement practice to be effective, there must be a relationship between the "crime" and the "punishment." The more egregious the crime committed, the worse the punishment should be. The current study reveals some evidence of this principle in the settlements the Commission reaches with alleged violators.

This study examined three measures of violation severity to determine if any predicted the severity of sanctions imposed. The first measure is the number of violations alleged against a respondent. There was a small, positive correlation between the number of alleged violations and the number of sanctions imposed indicating that the more violations alleged, the more sanctions imposed. Higher numbers of alleged violations were also slightly associated with the imposition of a suspension or temporary bar sanction. There was also a tendency for respondents with higher numbers of alleged violations to receive longer suspension or temporary bars, but this effect appeared limited to the individual broker-dealer group. Finally, respondents who received the permanent bar sanction tended to have higher numbers of alleged violations than respondent who did not receive this sanction. In contrast, the number of allegations was not associated with the imposition or the amount of a money penalty/fine. Overall, these descriptive analyses show that the more violations alleged against the respondent in this study, the more the respondent is sanctioned; however, these results are descriptive only and may not be extended beyond the scope of the current study.

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The second predictor of sanctions was the presence of an allegation of a Rule 10b-5 violation. Contrary to expectations, the presence of a Rule 10b-5 allegation was not associated with a higher number of sanctions imposed. It was not associated with an increased likelihood of a money penalty sanction. Neither did the presence of such an allegation lead to higher money penalties. While the suspension or temporary bar sanction was not imposed significantly more often when a Rule 10b-5 allegation was present, any suspensions or temporary bars that were imposed were significantly longer for respondents with a Rule 10b-5 allegation than for respondents without such an allegation. Finally, the permanent bar sanction was imposed statistically more frequently on respondents with a Rule 10b-5 allegation than on those respondents without. Thus, with respect to suspensions and bars, a Rule 10b-5 allegation is determinative of the severity of the sanction. Unlike the analyses involving the number of alleged violations, these latter two significant results can be extended beyond the scope of the present study.

The final predictor of sanction severity was the duration of the alleged violation. Respondents with longer alleged violations did not receive more sanctions than respondents with shorter alleged violations. Longer violations were not associated more with the imposition of a money penalty/fine. Surprisingly, though, respondents with shorter violations received significantly greater penalty/fines than did respondents with longer violations. This relationship is the opposite of what was expected. Duration of violation was not related to the likelihood of receiving a suspension or temporary bar sanction, nor was it related to the imposition of a permanent bar. This last measure of violation severity, therefore, does not consistently predict sanction severity.

VIII. LIMITATIONS OF ANALYSIS

A. Availability of Data

There are several significant limitations to the preceding analysis. The foremost limitation is presented by the very limited nature of the data available on Commission settlements in enforcement proceedings. The releases published by the Commission vary widely as to the amount of information relative to the violations being alleged, the parties involved, and the range of sanctions imposed. In addition, sanctions may be

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imposed via Commission administrative proceedings or by a district court. Though every effort was made to locate concurrent district court proceedings for the releases in this sample, it is possible that not all such proceedings were found. Finally, even when district court proceedings were documented, approximately nineteen such proceedings were not yet final so no sanctions had yet been imposed.

In its 1992 report on Commission settlements, the Committee on Federal Regulation of Securities remarked on similar problems it had encountered in collecting data for its review.[146] The researchers in that study, as here, relied upon the "hit-or-miss" manner of accessing the data via computerized tools such as Lexis-Nexis and Westlaw.[147] Among its recommendations to the Commission, the Committee called for the creation of a database of settlements so that relevant "facts, circumstances, and sanctions" in each agreed settlement could be better tracked.[148] It also called for the Commission to identify the criteria involved in deciding which sanctions to impose.[149] As it recognized in its report, there were no published guidelines to determine which types of violations should merit which types of sanctions.[150]

Ten years later, however, such recommendations have not been fulfilled. While accessing Commission releases, both administrative and litigation, is relatively easy through the Commission's web site, there is still no organized database of settlement agreements. There is still no consistency in the presentation of facts in a release. Similarly, there are still no published guidelines on the relevant criteria used in sanctioning decisions.

B. Semi-Random Selection of Respondents

A second limitation relates more to the sampling process used in this study. The 190 releases in this study were randomly selected as described above. However, forty-six of those releases documented settlements for more than one respondent (totaling 116 of the 260 respondents in the sample). This analysis was

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146. *Task Force*, *supra* note 57, at 1124 (classifying the then current database of settlement orders as "not 'user friendly'").
147. *Id*.
148. *Id*. at 1090.
149. *Id*.
150. *Id*. at 1122.

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based on respondents, but the multiple respondents in those forty-six releases were not randomly selected. Thus, there is a possible confound in the study in that the settlements of some of the respondents were reported on the same releases. The main concern of this possible confound is the question of what impact the settlement of one respondent may have on the settlement of another respondent in the same release. In other words, are the settlements different when more than one respondent in a case settles at the same time as compared to individual settlements for the same case but at different times?

While this question cannot be answered with the data collected here, the difficulties posed by concurrent settlements should not affect the utility of the analyses. First, the lone actor scenario is a rarity. For example, in the current sample, 124 of the 190 releases describe violations that involved multiple parties, though the release may document the settlement of only one party. Second, of the 46 releases that do contain multiple settlements, 45 of them documented settlements for all the parties named in the release.

The respondents in the forty-six releases with multiple settlements fall into certain patterns of party categories. For twenty-nine of the forty-six releases, the settling respondents were of the same party type but some were individuals and some were organizations. In thirteen of the forty-six releases, the multiple parties were all of the same party type. Finally, four releases involved a mixed variety of respondent party types. Thus, many of the settlements in this study occurred in the context of multiple parties and/or multiple settlements. Nonetheless, the unavailability of complete data on all respondents to a case makes it impossible to determine what effect, if any, concurrent settlements have on Commission sanctions.

C. Limitations of Violation Data

Additional problems concern the violation data. The primary difficulty stems from the manner in which securities violations are described in the releases: information on the securities violations is poorly organized and the elements of each violation are poorly defined. A comparison to the description of criminal violations in most penal codes illustrates the problems. For example, the Texas Penal Code codifies violations into

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specific, uniform categories such as "Robbery."[151] The Penal Code also defines the elements that comprise each violation.[152] In addition, the Code establishes a hierarchy of severity wherein the most severe offenses, such as capital murder, are punished by the most severe sanctions, such as the death penalty, while less severe offenses such as misdemeanor assault may receive much milder sanctions.[153] Finally, when criminal violations are prosecuted, the record clearly states what violation is alleged, what elements must be proven, how many incidents of the violation occurred, and whether or not the conduct involved is ultimately proven to be criminal.[154]

In contrast, securities violations occur when any of the many statutes and rules regarding securities is violated.[155] There is no specific taxonomy in the releases with respect to the description of these violations other than a reference to the specific statute section or the specific rule allegedly violated. Few elements of these violations are defined; most sections of the statutes simply describe the violation without specifying distinct elements.[156] Securities violations do not fall into a hierarchy of severity such as is established in a penal code. There is nothing in the statutes that define any one type of violation as more egregious or more deserving of punishment than any other. As a result, there may be great variety in the types of conduct that fit any one violation category.

For example, if the Commission is alleging the manipulation of market prices, the release alleges a violation of Section 9 of the Securities and Exchange Act of 1934. Section Nine prohibits, in part, activity that creates "a false or misleading appearance of active trading in any security registered on a national securities exchange."[157] There are many types of conduct that fit this

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151. TEX. PENAL CODE ANN. § 29.02 (Vernon 2003).

152. *See id*. (defining one variation of the offense of robbery as including, in part, the elements of "committing theft . . . with intent to obtain or maintain control of the property" where the offender "intentionally, knowingly, or recklessly causes bodily injury to another").

153. *See id*. § 12.02-12.51 (classifying offense degree and range of punishment available at each degree level).

154. *See, e.g.*, TEX. R. APP. P. 34.5(a)(2) (requiring the criminal record on appeal to contain, *inter alia*, the indictment which names the specific offense/conduct alleged, the findings of fact and conclusions of law, and the judgment).

155. *See infra* Part IV.B.2., "Table 2."

156. *See, e.g.*, 17 C.F.R. § 240.10b-5(a) (prohibiting the employment of deceptive devices, but vaguely stating, "[i]t shall be unlawful for any person. . .to employ any device, scheme, or artifice to defraud").

157. Securities Exchange Act of 1934 § 9(a)(1).

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violation. In the current sample, the general violation of "market manipulation" includes allegations of a variety of conduct such as manipulating the national best bid or offer rule,[158] using wash trades and matched orders,[159] collusion with other traders to use prearranged stock quotations,[160] using bribery to control stock prices,[161] and "pump-and-dump" schemes to manipulate prices.[162] Not only is the array of conduct that is called "market manipulation" broad and varied, in many cases the conduct alleged also fits other categories of violations such as Section 17 of the Securities Act of 1933 which prohibits fraudulent interstate transactions involving securities.[163]

Continuing the analogy to the Texas Penal Code, criminal charges are usually very clear in defining the number of violations involved. If multiple violations arise from the "same criminal episode," then the violations may be listed in a single indictment as multiple counts.[164] Even then, however, each violation must be detailed separately. Whether as the sole violation or as one of many counts, each violation in an indictment must be described in sufficient detail to establish the court's jurisdiction,[165] to defeat any statute of limitations,[166] and to state whatever elements are "necessary to be proved."[167] Thus, violations, whether as counts or cases, can be readily enumerated.

In contrast, the violation descriptions in the Commission's releases are often presented in narrative form. The description will cite the statute or rule that is allegedly violated, but there is no consistent manner of indicating the discrete number of violations. For example, Case 22 describes violations alleged

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158. In the Matter of Blackwell, Administrative Proceeding File No. 3-10632, Exchange Act Release No. 45,018 (Nov. 5, 2001), *available at* http://www.sec.gov/litigation/admin/33-8030.htm.

159. In the Matter of Romano, Administrative Proceeding File No. 3-10463, Exchange Act Release No. 44,241 (May 1, 2001), *available at* http://www.sec.gov/litigation/admin/34-44241.htm.

160. In the Matter of Shamrock Partners, Ltd., James T. Kelly, John R. Doyle, and Stephen J. Fischer, Administrative Proceeding File No. 3-10344, Exchange Act Release No. 44,196 (Apr. 18, 2001), 2001 SEC LEXIS 710.

161. In the Matter of Reuben D. Peters, Administrative Proceeding File No. 3-10241, Exchange Act Release No. 42,977 (June 23, 2000), 2000 SEC LEXIS 1339.

162. In the Matter of Dominic Scacci, Administrative Proceeding File No. 3-10012, Exchange Act Release No. 41,873 (Sep. 14, 1999), 1999 SEC LEXIS 1848.

163. Securities Act of 1933 § 17.

164. TEX. CRIM. PROC. CODE ANN. § 21.24 (Vernon 1998).

165. *Id.* § 21.02(5).

166. *Id.* § 21.02(6).

167. *Id.* § 21.03.

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against Respondent Irwin for his participation in the sale of unregistered securities over a period of several years.[168] The Commission also alleged that Irwin made material misrepresentations to the persons to whom he sold these securities. Many of such sales were made over an extended period of time.[169] Yet, the Commission's release only identifies the statutes being violated: it states that Irwin violated Section 5 of the 1933 Act (sale of unregistered securities), Section 17 of the 1933 Act (material misrepresentation in the sale of a security), Section 10b of the 1934 Act (fraud), Rule 10b-5 under the 1934 Act (fraud), Section 15(a)(1) of the 1934 Act (being an unregistered broker-dealer), and Section 15(c)(1) of the 1934 Act (using manipulative or deceptive devices).[170] The release does not count the different acts or establish how many instances of each type of violation occurred. It also does not specify when one type of conduct gives rise to more than one violation. In this example, the conduct that is cited as violating Sections 5 and 17 of the 1933 Act is the same conduct that is cited as violating Section 10b and Rule 10b-5 of the 1934 Act.[171] This case illustrates the difficulty, for the purposes of this project, in determining how many violations have been alleged against a respondent.

Another difficulty in organizing the violation data is that the Commission's releases are not consistent in the amount of detail in which they describe the violations. Unlike the records of criminal prosecutions, the Commission's releases vary substantially in the amount of information they provide. For some cases, the only violation-related data provided was the statute or rule allegedly violated. For these cases, details about the violations were often found in the separate civil proceedings that the Commission had instituted in district court.

D. Reliability of Violation Data

A final, and the most significant, limitation of this study concerns the very reliability of the violation data itself. It is well established that the agreed settlement is the Commission's

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168. SEC v. Lawrence B. Irwin, James D. Cooper, III and Burton Financial Management Associates, Inc., Litigation Release No. 16740 (Sept. 29, 2000), 2000 SEC LEXIS 2099.

169. *Id.*

170. *Id.*

171. *Id.*

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preferred method of resolving enforcement actions.[172] Former S.E.C. Chairman Harvey Pitt once described the settlement process as a necessary part of keeping the Commission's "enforcement program efficient and vigorous."[173] The Commission is therefore willing to negotiate most of the actual terms of a settlement, including the terms of the allegations as they appear in the releases themselves.[174] According to Pitt, negotiating these terms is one means by which the Commission encourages settlements.[175] In other words, by negotiating a settlement, the respondent has the opportunity to craft the wording of the allegations that will be published in the Commission's release.

The possibility that the allegation descriptions in the releases have been tampered with in this manner seriously undermines their reliability. Consider the fact that a respondent's goal in such negotiations will be to minimize the seriousness of the allegations against it.[176] In fact, this is exactly the advice given to practitioners who expect to defend clients before the Commission.[177] Bender advises practitioners to seek wording of the settlement so that the client's conduct "is cast in the light most favorable to the respondent" in order to "reduce adverse publicity" when the release is published.[178] In addition, practitioners are advised to "influence the language in the settlement documents to minimize any collateral uses thereof."[179] Thus, if true, the alleged violations of securities laws described in the Commission's releases have been "softened" or tempered in the direction of describing less severe misconduct. If this negotiation practice is common, then the only source of data for securities law violations that do not proceed to an administrative law hearing or to a trial before a district court is not an accurate record of those alleged violations.

This study seeks to determine the relationship between the severity of securities violations and the severity of imposed sanctions. A practice which "waters down" the only written

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172. Pitt & Shapiro, *supra* note 90, at 179.

173. *Id*. *See also*, Flannery, *supra* note 89, at 1015 (recognizing that "the vast majority" of enforcement cases initiated by the Commission settle).

174. *See* Pitt & Shapiro, *supra* note 90, at 180.

175. *Id*.

176. *See Task Force*, *supra* note 57, at 1092 ("The respondent also will seek the elimination of any inflammatory language from the release. . . .").

177. *See, e.g.*, The SEC Administrative Hearing: Settlement Negotiations, 6-89 Securities Law Techniques § 89.05 (2002) (stating that "[i]n many cases the language [of the proposed settlement] can be negotiated").

178. *Id*.

179. *See Task Force*, *supra* note 57, at 1100.

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record of the violations involved seriously impairs the reliability of the information gathered.

IX. CONCLUSION

A. Commission's Over-reliance Upon and Under-utilization of the Cease and Desist Order

The Commission relies heavily upon the cease and desist order; in fact, it is the only sanction imposed in 62% of the Individual Issuer and 81% of the Organizational Issuer cases.[180] It imposed the cease and desist order in 58% of the respondents overall on the study. Another 27% of the respondents received an injunction. It appears that when a respondent has already been enjoined by a district court, the Commission does not also impose a cease and desist order as well.[181] Is a cease and desist order simply an administrative version of an injunction?[182] While the Commission may treat it as such, there are significant differences between the two sanctions indicating that the injunction remains the more severe of the two. For example, when brokers or dealers are enjoined, they may be censured, suspended, or have their registration revoked, solely as a result of being enjoined.[183] Such consequences do not arise as a result of a cease and desist order.[184] Similarly, an enjoined issuer may lose some exemptions from the registration requirements of the 1933 Act but an issuer under a cease and desist order does not.[185] In fact, it is not clear what, if any, collateral consequences result following a cease and desist order.[186]

Perhaps the most surprising data in this study concerning

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180. Overall, the cease and desist order was imposed on 112 of the 194 respondents in the study. Of the remaining respondents, 52 were enjoined by a district court, and 30 received neither an injunction nor cease and desist order.

181. One respondent, an individual broker-dealer, received both an injunction and a cease and desist order.

182. *See* Morrissey, *supra* note 57, at 463 ("With its procedural flexibility and easier standards of proof, that action [the cease and desist order] appeared to even have the potential to supplant the injunction as the Commission's principle enforcement tool."). *See also*, SEC Administrative Proceedings, 6-87 Securities Law Techniques § 87.06 (2002) (likening the cease and desist order to an injunction).

183. *See, e.g.*, *Task Force*, *supra* note 57, at 1151.

184. *Id.*

185. *Id.* at 1152-53.

186. *See* Shah, *supra* note 58, at 293 (acknowledging that respondents protest negative consequences of cease and desist orders but that there is no evidence that such consequences are true).

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the cease and desist order is how rarely its potential was fully exercised. The cease and desist order can be used not only to prohibit violating conduct but also to compel complying conduct; thus, a cease and desist order can be customized to the needs of the individual wrong-doer.[187] However, in the cases studied here, the cease and desist order strayed from rote, prohibitory language in only a few instances. In those cases, the Commission usually ordered a respondent to develop new and improved policies that would be designed to prevent future violations.[188] For example, of the fifty-three broker-dealer respondents who received a cease and desist order, only six were given a proactive "undertaking" in addition to the prohibition against violating the securities laws. Of these six undertakings, five were orders to retain an independent consultant to review and modify internals procedures, controls, and policies. The sixth undertaking included the independent consultant as well as the mandate to review the computational formula the firm used in its business. Similarly, of the fifty-nine issuers receiving a cease and desist order, only three were given an undertaking. However, these three undertakings were different from those seen in the broker-dealer group. One issuer was commanded to provide a copy of the Commission's order to the firm's CEO and Board of Directors. The remaining two issuers were ordered to retain an independent consultant and an independent CPA, as well as to submit to four semi-annual reviews by the independent CPA. These three cases notwithstanding, the Commission used this form of creative sanctioning sparingly.

Why then does the Commission rely so heavily upon a less stringent sanction? There are several possible reasons for such reliance. First, the Commission's cease and desist authority allows the Commission to reach subjects such as issuers without the necessity of going to court.[189] In the data collected here, the Commission sought remedies in the district court less often for issuer respondents than for broker-dealer respondents. Other reasons for the preference include the relaxed evidentiary

187. Securities Exchange Act of 1934 § 21C(a) (granting the Commission authority to compel a person to "comply, or to take steps to effect compliance, with such provision, rule, or regulation, upon such terms and conditions and within such time as the Commission may specify"). *See also Task Force*, *supra* note 57, at 1093 (recognizing that the power of the cease and desist order reaches the types of equitable relief the Commission formerly had to seek from a district court).

188. *See Task Force*, *supra* note 57, at 1128-29 (reporting that similar orders to review and revamp procedures were the most common form of "creative" sanctioning the Task Force found).

189. *See* Shah, *supra* note 58, at 280.

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standard of the cease and desist hearing and the fact that the Commission itself designed the procedure to be followed.[190] In fact, the advantages are so heavily weighted in favor of the Commission when it seeks a cease and desist order that several authors have expressed concern at the broad range of authority the order gives the Commission.[191]

In addition, there is some evidence that injunctions are not as easily obtained as they once were.[192] In fact, even cease and desist orders are harder to obtain outside the context of a settlement. When no settlement is involved and the action is brought before an administrative law judge (ALJ), the Commission is not always assured of obtaining the cease and desist order it requests.[193] In contrast, the cease and desist order is almost always present in an agreed settlement. Interestingly, there is evidence that the Commission is also less successful in obtaining suspensions and temporary bars from its ALJs than it is in imposing such sanctions in a settlement.[194] Thus, whether before a district judge or an ALJ, the Commission is not guaranteed the relief it seeks. Given these advantages, it is not surprising that the Commission chooses to rely on the cease and desist order, a sanction that is easy to obtain but does not have the requisite "bite" to be as effective as an injunction. The Commission's deference to the cease and desist order is evidence of an overall reluctance to seek the more powerful sanctions that are only available through judicial proceedings such as injunctions, officer and director bars (before the Sarbanes-Oxley Act), and civil money penalties against non-regulated entities.

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190. *See, e.g.*, Morrissey, *supra* note 57, at 464.

191. *See id.* at 465 (reporting that the "potentially sweeping nature" of the cease and desist authority was downplayed in its statutory history, supposedly to placate concerns at how far-reaching that authority could be construed); Pitt & Shapiro, *supra* note 90, at 246-47 (expressing concern that the cease and desist authority's ability to bypass the district court may curtail the protections that the court traditionally grants respondents).

192. *See* Morrissey, *supra* note 57, at 467-68 (discussing one view that the advent of the cease and desist order has made injunctions harder to obtain).

193. During the same time period as the cases covered in this study, the Commission disposed of 49 cases before an ALJ. Out of those 49 cases (involving more than 49 respondents), the Commission was given all the sanctions it requested at the levels requested only 31 times (63%).

194. *See* Herr, *supra* note 77, at 607 n.2 (reporting an analysis of suspensions and bar sanctions in fraud cases where the Commission imposed longer sanctions in its settlements than it was awarded by ALJs).

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B. Ineffective Enforcement

The effective enforcement of our securities laws at the earliest stages can act as a deterrent to violators who do not hesitate to engage in fraudulent behavior to achieve their own selfish ends. There are two functions that such an effective enforcement program must satisfy: first, it must adequately punish past wrong-doers, and second, it must deter future wrong-doers, both repeat offenders and new offenders. The ability to do so effectively is founded upon the consistency between the violations it prosecutes and the sanctions it imposes.

1. Inconsistent Use of Sanctions

This study presents some evidence that Commission's administrative enforcement activities lack that consistency needed to run an effective enforcement program. A closer look at some of the cases examined in this study makes this point crystal-clear. For example, consider the following individual and organizational respondents, all of which were sanctioned with only a cease and desist order. Both individual respondents in Case #822 were involved in violations involving millions of dollars.[195] Lefere (Case #664) raised $1.3 million in the sale of unregistered securities.[196] Organizational respondents such as Peritus Software Services, Inc. overstated its income by millions of dollars (Case #469).[197] Finally, Fastlane Footware (Case #664) raised approximately $1.3 million in the sale of unregistered securities.[198]

Compare then the cases of individual respondents such as Kirkland (Case #73) who committed fraud in trading by, among other activities, misrepresenting the manner of calculating net asset value.[199] He was sanctioned with a cease and desist order, penalized $30,000, and temporarily barred from associating with a broker-dealer for three years.[200] McKinney (Case #231) accepted $5,225 in fees from a stock promoter but did not disclose

195. Leifer Capital, Inc., Administrative Proceeding No. 3-9810, Securities Act Release No. 7630 (Jan. 14, 1999), 1999 SEC LEXIS 98.

196. Fastlane Footwear, Inc., Administrative Proceeding No.3-9950, Securities Act Release No. 7729 (Aug. 30, 1999), 1999 SEC LEXIS 1733.

197. Peritus Software Services, Inc., Administrative Proceeding No.3-10186, Exchange Act Release No. 42,673 (Apr. 13, 2000), 2000 SEC LEXIS 724.

198. *Fastlane*, Securities Act Release No. 7729.

199. Kyle R. Kirkland, Administrative Proceeding No.3-10602, Exchange Act Release No. 44,876 (Sep. 28, 2001), 2001 SEC LEXIS 2030.

200. *Id*.

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the payments to her clients.[201] She was permanently barred from associating with broker-dealers.[202] This sanction followed criminal sanctions of 366 days in federal prison, three years probation, and $49,160 in restitution.[203] Bertsch (Case #317) failed to reasonably supervise an employee who defrauded clients of over $2 million.[204] For his negligence, Bertsch was penalized $10,000, suspended for three months, and temporarily barred from acting in a supervisory role in a broker-dealer relationship for two years.[205]

As these examples show, there is a remarkable lack of consistency in the Commission's treatment of different respondents and different violations. Such inconsistency reduces the effectiveness of the Commission's enforcement program in adequately punishing wrong-doers. For some respondents, sanctions consist of little more than an order to obey the securities laws. For others, sanctions include monetary penalties, suspensions, and even permanent bars from the industry.

2. Lack of Deterrence

To evaluate the deterrent effect of the Commission's enforcement program, we must reconsider the role of the agreed settlement. As discussed above, there is much negotiation of the terms of the settlement. But one feature that is present in all settlements is the clause stating that the entity under investigation neither admits nor denies any wrongdoing.[206] What exactly does this clause mean? If there was no wrongdoing, then one might ask why there is a need for a settlement. By including language neither admitting nor denying any wrongdoing, violators are not only willing, but also eager, to agree to a settlement as such language removes them from the role of the wrong-doer and shields them from future civil liability. Perhaps, as is suggested by others discussed above, the short answer is

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201. Shirley A. McKinney, Administrative Proceeding No.3-10295, Exchange Act Release No. 44,069 (Mar. 13, 2001), 2001 SEC LEXIS 457.

202. *Id*. at 2.

203. *Id*.

204. Asif Ameen and Bruce W. Bertsch, Administrative Proceeding No.3-9906, Exchange Act Release No. 43,450 (Oct. 17, 2000), 2000 SEC LEXIS 2205.

205. *Id*. at 5-6.

206. Kevin Drawbaugh, *US SEC recasts "neither admit nor deny" agreements*, Reuters (Aug. 4, 2003) ("The 'neither admit nor deny' convention has long been employed in SEC settlements."), *available at* http://www.forbes.com/newswire/2003/08/04/rtr1048316.html .

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that of expediency.[207] It is more expedient for the Commission to encourage settlement than to proceed with costly and time-consuming litigation.

At what cost to deterrence, and at what cost to the investor, does this expediency come? The wrongdoer casts its misdeeds in the most favorable light by artfully constructing the terms of the settlement so as to minimize their serious nature as much as possible, thus distancing the identity of the wrongdoer from the offense(s) committed. For example, every effort is made to avoid the word "fraud" in the settlement as this connotes behavior that not only besmirches the business reputation of the "fraudster" but opens the door to the filing of multiple law suits against the wrongdoer by the victims.[208] By watering down the consequences of the offenses, in order to encourage a high settlement rate, is the Commission deterring future misbehavior by those it settles with? The answer is a resounding "No."

Witness the noncompliance by some members of the Wall Street community with the 1.4 billion dollar settlement recently entered into by the Commission and ten broker-dealer firms and two individuals.[209] The settlement sought to resolve the conflicts of interest existing between the financial analysts and investment bankers.[210] The ink on the settlement had hardly dried before one of the members violated the agreement by improperly using the influence of one of its analysts as a participant in the "road show" leading to the distribution of securities.[211] This was clearly a violation of the settlement agreement.[212] Apparently the sanctions imposed in this settlement agreement could not even deter repeat offenses by those receiving the sanctions.[213] Sanctions of this nature are considered by many on Wall Street to be little more than a "pat on the wrist."[214] Rather than deter, such settlements actually promote recidivistic behavior because there are simply no substantial consequences to discourage the wrongdoer from continuing to violate the securities laws at the expense of the

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207. *See supra* Part III.B.

208. *See supra* Part VIII.D. *See also Task Force*, *supra* note 57, at 1092.

209. Ben White, *Bear Stearns IPO Effort Draws Fire: Video Said to Violate Spirit of Settlement*, WASH. POST, May 13, 2003, at E03, *available at* http://www.washingtonpost.com.

210. *Id*.

211. *Id*.

212. *Id*.

213. *Id*.

214. *See* Robert Trigaux, *$1.4-Billion settlement just a slap on Wall Street's wrist*, ST. PETERSBURG TIMES, May 5, 2003, at 1E, *available at* http://www.sptimes.com.

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investing community. The Commission's argument that the "neither admit nor deny" language is necessary in order to encourage settlements falls of its own weight. While settlements may be encouraged by such language, so too is recidivism.

C. Sarbanes-Oxley: The Icing on the Cake-Walk?

As the data in the current study reflect, the Commission pursues a broad range of securities violations, from the sale of unregistered securities to market manipulation to failing to file required reports. The Commission also imposes the full range of statutory sanctions for which it is authorized. There is some evidence that the more severe the alleged violation, the more stringent the sanction imposed. This evidence is speculative, however, given the reliability issues of the data concerned. There is also evidence of non-uniform application of sanctions where some violators appear to be sanctioned much less severely than others. Finally, the evidence clearly establishes that the Commission does not sanction broker-dealers in the same manner as it does issuers. While the nature of the violations may differ between broker-dealers and issuers, the potential injury to the investing public is the same. Where broker-dealers may misappropriate tens of thousands of dollars from their clients, issuers who publish materially false information about a corporation may potentially cost the investing public millions. In fact, as the Enron and related corporate scandals of the past few years have proven, some issuer misconduct can cost the investing public considerably more.

Neither Congress nor the Commission has been idle in addressing the public concerns about the reliability of the securities industry. In response to these million-dollar scandals such as Enron, Congress passed the Sarbanes-Oxley Act of 2002.[215] Interestingly enough, the Act ordered the Commission to conduct a study of its enforcement activities over a four year period.[216] That report is published on the Commission's web site and very simply lists the types of offenses that were the subject of Commission injunctive or settlement actions, the types of parties involved, and the types of sanctions imposed. [217]

215. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (2002).

216. Sarbanes-Oxley Act § 703.

217. Report of the Securities and Exchange Commission: Section 703 of the Sarbanes-Oxley Act of 2002: Study and Report on Violations by Securities Professionals, *available at* http://www.sec.gov/special_studies (last visited June 1, 2003).

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However, the report presents no analysis of the data. It does not examine whether the same sanctions were imposed for the same offenses or whether the sanctions reflected the severity of the offenses. The report provides a straightforward description of who, what, and how much, but does nothing to address the question of whether the enforcement activity was effective, adequate, or sufficient.

Though the bulk of the Act addressed concerns in the area of corporate governance, the Act also gave the Commission authority to impose corporate officer and director bars directly, instead of requiring a district court order.[218] However, considering the effect of granting the Commission cease and desist authority, one must seriously consider how the Commission will apply this new sanction. With this power, the Commission will have even less incentive to seek out the judicial process. Civil monetary penalties against non-regulated persons such as issuers still require a district court order, but if the Commission does not file for injunctive relief, it will not be able to impose civil monetary penalties against issuers. Will the ability to impose officer and director bars further decrease the likelihood that issuers who violate the laws will actually pay for their violations? Probably. Given the Commission's track record with the cease and desist order, the less incentive there is to use the courts, the less likely severe sanctions such as injunctions and civil money penalties will be imposed against non-regulated entities.

Although a major component of the Sarbanes-Oxley Act addressed new and improved criminal offenses and criminal sanctions for corporate wrong-doings, there is little in the Act that will impact the agreed settlement.[219] Even the new requirements of corporate officers to certify their company's financial reports carry criminal penalties, not administrative penalties.[220] While Section 3 of the Act specifically extends the Commission's existing enforcement authority to include violations of the Sarbanes-Oxley Act, it does not increase that authority in terms of sanctions.[221] It remains to be seen, therefore, what impact the Act will have on the Commission's administrative enforcement practices. If, as one author contends, the Commission only seeks criminal prosecutions in the most

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218. Sarbanes-Oxley Act § 1105.

219. *See, e.g.*, William S. Duffey, Jr., *Corporate Fraud and Accountability: A Primer on Sarbanes-Oxley Act of 2002*, 54 S.C. L. REV. 405 (2002) (summarizing the Act).

220. *Id*. at 411.

221. Sarbanes-Oxley Act § 3.

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"flagrant" cases, then the Sarbanes-Oxley Act will have little to no impact on administrative enforcement activities at all.[222]

D. Suggestions for the Future

This project began with the question of whether the Commission effectively and consistently enforced the securities laws through its administrative settlements. In other words, is the popular press right in claiming that some violators "get off easy"? Unfortunately, the data analyzed here cannot refute that impression. The Commission is armed with significant power in both its administrative arsenal and via the district courts. Nonetheless, the cases studied here do not reflect a strong, consistent response to securities violations. If anything, the cases show a consistent under-utilization of authority in that the Commission does not take advantage of the broad powers of the cease and desist order and does not make as much use of the district court's powers as it could. As a result, for many violators, facing the Commission in an administrative proceeding is indeed a cake walk.

The Commission itself appears to recognize the need for change. Recent news indicates that the Commission is considering ways to "beef up" its settlements agreements, apparently in light of new information that settlements do not carry the punitive or deterrent weight that should be achieved.[223] However, as the Commission acknowledges, making settlement terms stricter increases the likelihood that entities under investigation will choose to litigate rather than settle.[224] The reality is the Commission walks a narrow line. It must take efficiency into consideration when setting the stage for the settlement process. At the same time, it cannot impose such draconian penalties that the enforcement process snuffs out the creation of capital that is the life blood of our economy.

In light of the foregoing analyses, we make the following recommendations for improving the efficiency of the settlement

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222. *Recent Legislation: Corporate Law – Congress Passes Corporate and Accounting Fraud Legislation – Sarbanes-Oxley Act of 2002*, 116 HARV. L. REV. 728, 733 (2002).

223. Deborah Solomon, *SEC Considers Stronger Sanctions: Applying Stiffer Penalties in Coming Cases is Seen as Having Deterrent Value*, WALL ST. J., June 16, 2003, at A2 (reporting that the Commission is considering stricter terms such as requiring settling entities to admit guilt and prohibiting use of insurance to pay settlement fines and disgorgement orders).

224. *Id*. (noting that defendants are more likely to "balk" at stricter settlement terms).

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process. First, any system that has as its goal the deterrence of repeat behavior simply must keep adequate records of offenders. The Task Force, in their 1992 report on settlement agreements,[225] also called on the Commission to keep a more complete record of the entities it chooses to prosecute. The primary function of such a database is to better identify and track "repeat offenders." Better record keeping in this area will accomplish three important functions. First, the database would provide the investing public with a means of verifying a company's violation history with the Commission so that more informed investment decisions can be made. Second, under the current system, the Commission is seemingly unaware of any pattern of repeated violations when negotiating a settlement with a habitual wrongdoer. It is only logical that such historical information would be invaluable during the settlement process; thus a proper database identifying the prior history of violations and sanctions is a prerequisite for the Commission to effectively sanction repeat offenders. Third, by having information on prior violations and sanctions available, the Commission could sanction more effectively by sanctioning repeat offenders more severely. For example, the Commission could consider a "three strikes" type of rule where sanctions increase when an entity is prosecuted repeatedly.

The second recommendation for an effective enforcement program is for the Commission to establish consistency by imposing specific sanctions for specific offenses. At this time, it is anyone's guess which sanctions a respondent may receive for any given offense. The Commission should organize a schedule of sanctions in order that several important goals can be met. First, all respondents accused of the same type of offense will face the same type and same degree of sanctions. Thus, potential violators will have notice of the specific sanctions they risk if they engage in securities violations. Second, the more severe sanctions can be reserved for the more egregious offenses. This consistency in sanctioning materially strengthens the deterrent effect of the sanctions. As the system now functions, if one entity is severely sanctioned for wrongdoing, it does not necessarily follow that another entity will be sanctioned in the same manner for the same type of violation. However, if the range of sanctions for wrongdoing is established *a priori* and is consistently enforced, then the potential wrongdoer may think twice before violating the rules.

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225. *See Task Force*, *supra* note 57, at 1091.

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In addition, by laying a framework for which specific sanctions will be considered for particular offenses, the process of negotiating the settlement can be facilitated. For example, if violations and sanctions are organized in this manner, the range of the issues on the negotiation table will be clearly defined: the wrong-doer will know which sanctions the Commission will be presenting. Further, the Commission should find sanctions easier to justify if there are pre-existing guidelines on the types of sanctions which are appropriate for different types of violations. An appropriate analogy is to the federal sentencing guidelines. By having such guidelines in place, defendants and their attorneys know in advance exactly what is on the line when they negotiate with the prosecutor. Similarly, such guidelines would streamline the settlement process for the Commission by establishing at the outset the risk to the respondent.

The third recommendation is for the Commission to limit the use of the "neither admit nor deny" language in its settlements. The Commission has taken a step in this direction by issuing an order in July, 2003,[226] that a violator that has consented to be enjoined from an illegal activity may not later deny the facts underlying the injunction, even though the "neither admit nor deny" language is used in the settlement agreement.[227] In other words, if a wrong-doer settles in a civil injunction case and thereby consents to the injunction, the wrong-doer may not re-litigate the relevant facts if the Commission brings a subsequent administrative proceeding against the wrong-doer. In its order, the Commission acknowledges that in some cases, the facts underlying the injunction may be dispositive in the administrative proceeding, especially since the respondent is no longer permitted to contest them.[228] However, this new approach does not include cease and desist orders as it only specifies injunctions. Further, it only applies to administrative proceedings that follow district court proceedings; thus the order does not reach the many respondents for whom no civil injunctive proceeding was initiated. Finally, the order only addresses how the Commission will treat the "neither admit nor deny" language in its settlements. It does not eliminate the language altogether,

226. *Commission Bars Marshall Melton from Association in all Capacities and Revokes Investment Adviser Registration of Asset Management & Research, Inc.*, SEC NEWS DIGEST, Issue 2003-143 (Jul. 28, 2003) [hereinafter *Commission Bars*], *available at* http://www.sec.gov (last visited Sep. 1, 2003).

227. Drawbaugh, *supra* note 206.

228. *Commission Bars*, *supra* note 226, *Enforcement Proceedings*.

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nor does it address how other entities such as the Department of Justice or individual investors should treat the language. As a consequence, these words become a shield protecting the wrongdoer from the legal repercussions of his violations. Considering that settlements are about as likely to involve a cease and desist order as an injunction, the Commission should, at a minimum, extend its new approach to include cease and desist orders as well.

The fourth recommendation concerns the Commission's ability to impose civil money penalties on non-regulated persons. At this time, the Commission must seek a district court order to impose such fines. As we have seen, however, the Commission is unwilling to seek such authority. If the Commission will not go to the authority, let the authority come to the Commission. The Commission should have the authority to fine non-regulated persons, specifically issuers, in its administrative proceedings.

The final recommendation is that the Commission make more effective and creative use of the cease and desist order. For example, the Commission should employ such techniques as the use of independent monitors and periodic reporting to the Commission thereby customizing the settlement agreement so that the sanctions imposed carry more punitive and deterrent force. When the violator is an individual, the Commission should, for example, impose educational or training requirements aimed at deterring future misconduct. Borrowing yet again from the criminal context, violators could perform "community service" such as working in a mentoring program focused on educating new entrants in the industry about the securities laws or providing *pro bono* services to low income persons.

The Commission is charged under the Securities Act of 1933 and the Securities Exchange Act of 1934 with using the powers granted to it by Congress to protect the ordinary investor and to safeguard the interests of the public. The mandate of its Division of Enforcement is to protect investors.[229] Other goals of the Commission's enforcement activities include the deterrence of future violations[230] and the punishment of violators.[231] Regardless which goal one might consider dominant, it is clear that the securities laws have a prophylactic bent; that is, they are

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229. *See About the Division of Enforcement, at* http://www.sec.gov/divisions/enforce/about.htm (last visited July 26, 2002).

230. *See Task Force*, *supra* note 57, at 1091.

231. *See* Flannery, *supra* note 89, at 1015, 1020-21 (claiming the Commission's prosecutions of securities violations are no longer remedial but reflect a philosophy that seeks maximum punishment for violations).

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designed primarily to prevent and not to punish. The goal is to protect the ordinary investor. Sophisticated investors can protect themselves; theoretically, at least, they do not require the protection of the securities laws. In the past, the Commission has approached its task of protecting the investor by enforcing the securities laws in a piecemeal fashion, one respondent at a time. That approach no longer satisfies the needs of the industry to identify and track repeat offenders, to impose sanctions in an evenhanded fashion, and to effectively punish and deter wrongdoing. Now is the time for the Commission to make significant changes in its enforcement strategies.

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Appendix A

Excerpt from Cease and Desist Order

From a standard agreed settlement involving the order to retain independent review of internal policies and procedures:

Accordingly, IT IS HEREBY ORDERED that:

. . .

C. Legg Mason cease and desist from committing or causing any violations and any future violations of MSRB Rules G-27(b), (c)(i), (c)(iv), (c)(v), (e), and G-36(b)(I) and (ii), as well as Rule G-27(a) as it relates to Rule G-36;

. . .

G. Legg Mason shall, within one year of the date of this Order, comply with its undertaking to retain, at Legg Mason's expense, an independent consultant, not unacceptable to the Commission's staff who shall, among other things, conduct a comprehensive review of Legg Mason's policies, procedures and practices relating to the prevention or detection of the improper conduct described in §II.C., above. Within 30 days of retention, the independent consultant shall review such policies, procedures and practices with respect to the improper conduct described in § II.C. with a view to determining if all such policies, procedures and practices have been implemented or require supplementation. Legg Mason shall cooperate with the independent consultant's review of Legg Mason's policies, procedures and practices, and shall provide the independent consultant with any and all requested documents that the independent consultant reasonably requests (other than materials or information protected by a valid claim of attorney-client privilege or attorney work product).

See In the Matter of Legg Mason Wood Walker, Incorporated, Thomas M. Daly, Jr., and Joseph A. Sullivan, Administrative Proceeding No.3-10068, Securities Exchange Act of 1934 Release No. 44407 (June 11, 2001), 2001 SEC LEXIS 1120.

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Appendix B:
Respondent Roles in Each Party Type

Individual Accounting Firm/CPA
- CPA
- Auditor

Organizational Accounting Firm/CPA
- Accounting firm

Individual Broker-Dealer
- Persons associated with broker-dealers
- Broker-dealers, registered representatives of broker-dealers
- Broker-dealer officers, directors, employees, owner
- Compliance Officer
- Broker-dealer Financial Advisor
- Underwriter officer
- Market Maker
- Municipal securities dealer
- Trader

Organizational Broker-Dealer
- Broker-dealers
- Municipal securities dealer
- Underwriter
- Day-trader
- New York Stock Exchange

Individual Inv. Adv. or Fund Manager
- Persons associated with investment advisor
- Officer, directors of investment advisor
- Financial Group CEO
- Fund Manager, Fund Manager CEO
- Investment advisor
- Investment advisor general employee, insider, owner
- Inv. advisor website owner
- Inv. Relations firm Employee
- Investment dealer
- Trader at Inv. Advisor

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Organizational Inv. Adv. or Fund Manager
- Fund Manager
- Investment advisor
- Investment company

Individual Issuer
- Accounting manager of issuer
- Accounting operations at issuer
- Accounts receivable clerk
- Officers, directors of issuer
- Issuer controller
- Issuer Direct Marketing
- Issuer Financial Consultant
- Issuer Inventory Clerk, Sales Manager
- Marketer President, Vice-President
- Securities Attorney
- Transfer agency owner, President

Organizational Issuer
- Development Company
- Direct Marketing firm
- Holding Company
- Issuer
- Transfer agency

Individual Outside the System
- Business owner
- Officer of corporation
- Person associated with unregistered entity
- Persons unregistered but acting as broker-dealers or investment advisors

Organizational Outside the System
- Unregistered broker-dealer
- Unregistered investment company

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Appendix C
Violations in the "Other Violation" Category

Aided in violation of the Investment Company Act
Aiding and abetting other company's fraud
Became a creditor of another company against the rules
Bid-rigging, 10b-5 fraud
Credit violations on sales
Did not document loans properly
Fail to enforce section 11(a) rules
Fail to give notice of its assumption or termination of business
Fail to keep minimum balances in reserve accounts
Fail to meet net capital rule
Fail to monitor representatives' presentations
Fail to produce required statements concerning customer loans/credit
Fail to respond adequately to a licensing inquiry from the state
Fail to review accounts and ensure compliance
Failed to monitor representative who had customers complaining about them
Gave false information to auditor's
Helped cover violation of net capital rules
Misleading statements to auditors
No established procedures for signature guarantees
Pre-solicited after market purchases
Purchased and sold at artificially inflated prices
Reporting violations
Selling shares at improper prices
Used unlicensed traders with another company
Used wrong formula in balancing the day's trades
Violate duty to client
Violate fingerprinting rule
Violate Investment Company Act by false NAV pricing
Violate Investment Company Act by fraudulent reporting of fund documents
Violate marginal account loan rules of the Fed Reserve
Violate MSRB reporting requirements
Violate MSRB rule of fair dealing

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Violate MSRB Rule on disclosure
Violate Regulation M for aftermarket purchases
Violate Regulation T and section 7(d) by wrongly extending credit to cover margin call
Violate Regulation T by the Federal Reserve
Violate tender offer rule 10b-13
Violate turnaround rules

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Appendix D
Sanctions in the "Other Sanctions" Category

Individual Broker-Dealer
- Forego any income tax return and all unused income tax.
- Six months suspension from supervisory position.
- In another agreement, respondent to pay Office of the Comptroller $15,000 penalty and is barred from working with insured depository institutions.
- In a Department of Justice investigation, respondent will be personally liable for $500,00 of the fine against the organization.

Organizational Broker-Dealer
- Establish a committee to review reserve formula computation.
- Mandatory education for all independent floor brokers.

Individual Investment Advisor
- Nine month suspension from being in supervisory position.

Organizational Investment Advisor
- Annual audits by independent CPA for 5 years.
- Independent CPA to review all publications, policies, and procedures.

Individual Issuer
- Barred permanently from being director or officer of a public company.
- Barred from being director or officer of public company for 10 years.
- Limits on re-applying to practice before the S.E.C. after a temporary bar.

Organizational Issuer
- Order to correct deficiencies.
- Independent CPA for 4 semi-annual reviews