

**House of Representatives Committee on Financial Services
Subcommittee on Investor Protection, Entrepreneurship and Capital Markets**

***“Putting Investors First: Examining Proposals to Strengthen
Enforcement Against Securities Law Violators”***

**Wednesday, June 19, 2019, 2 pm
2128 Rayburn House Office Building**

Testimony of Stephen J. Crimmins

(Mr. Crimmins was Deputy Chief Litigation Counsel and a senior officer of the SEC’s Enforcement Division until 2001, and since then has defended clients in SEC enforcement matters. He served as Chair of the Federal Bar Association’s Securities Law Section and as Chair of the DC Bar’s Corporation, Finance and Securities Law Section. He is a partner in the Murphy & McGonigle PC law firm in New York and Washington.)

Chair Maloney, Ranking Member Huizenga, and Members of the Subcommittee: Thank you for the opportunity to appear today to express my views on pending proposals to assure that the SEC’s enforcement staff has the tools to assure that our securities markets remain the cleanest and fairest in the world, and strong magnets drawing the capital needed to build American prosperity.

I. An Emergency That Needs to Be Addressed

Before addressing specific proposals, let me briefly urge you to support your House colleagues in boosting the SEC’s budget at least to the presently proposed \$1.85 billion. Giving the SEC the funding it desperately needs is the most important thing anybody can do to deliver on our goal of putting investors first and strengthening securities enforcement.

The SEC’s budget has been essentially frozen around \$1.6 billion for years, resulting in a multi-year hiring freeze, and a reduction of about 400 professional staff through attrition. Yet the SEC is now dealing with bigger and more complex trading markets, more complicated products, huge datasets, cross-border scams, etc. It now oversees \$97 trillion in annual securities trading, the activities of 27,000 registered market participants, filings and disclosures by 8,000 reporting companies (4,300 exchange-listed), and the activities of 22 national securities exchanges, 10 credit rating agencies, 7 active registered clearing agencies, plus the PCAOB, FINRA, MSRB, SIPC, FASB, etc.¹ And in just the last year, it authorized “a diverse mix of 821 enforcement actions”; presided over 984 pending administrative proceedings; and directed the management and settlement of 1,777 pending federal court actions.²

¹ SEC Congressional Budget Justification, https://www.sec.gov/files/secfy20congbudgjust_0.pdf, p. 3 (3/18/2019).

² *Id.*, p. 23, 25

Everybody forgets that the SEC spends no tax dollars. And that it entirely supports itself. Since bipartisan legislation in 1996, the SEC has run entirely on filing fees that are so small that nobody has ever complained about them. Interestingly, Dodd-Frank wrote into law that the SEC's authorized (not appropriated) budget needed to grow to \$2.25 billion by 2015 and implicitly should be well above \$2.25 billion today, yet in 2019 it's still stuck around \$1.6 billion. It is just plain wrong to go cheap on investor protection, fair and orderly trading markets, and capital formation in the world's largest and most important economy. Particularly when abundant filing fee money is available at no cost to taxpayers from willing market participants and issuers who benefit from a strong and effective SEC.³

II. Statute of Limitations for Commission Actions

The SEC's claims for civil monetary penalties (often substantial in amount) and for professional bars (of brokers, accountants, corporate officers, directors, and others) have long been subject to the 5-year statute of limitations in 28 U.S.C. §2462. However in 2017, the Supreme Court's *Kokesh* decision extended the application of this 5-year limitation statute to SEC "disgorgement" claims that seek to recover a violator's illegal profits.⁴ Before 2017, it had been understood that SEC claims for disgorgement of illegal profits were not subject to any statute of limitations.

Responding to this new imposition of a 5-year statute of limitations on SEC disgorgement claims, the SEC Enforcement Division's 2018 Annual Report noted, in view of the multi-year character of many securities violations, that the ruling "has limited our ability to obtain disgorgement in certain long-running frauds." The SEC estimated that the ruling "may cause us to forego up to approximately \$900 million in disgorgement, of which a substantial amount likely could have been returned to retail investors."⁵

Need for Uniform Limitations Period for SEC Claims. The present bill proposal would extend the statute of limitations for civil monetary "penalty" claims from the present 5 years to 10 years. But the proposal would leave at 5 years the statute of limitations for SEC claims for professional bars and certain other SEC claims. Importantly, by not specifying an appropriate limitation for disgorgement claims, the proposal may have the unintended consequence of leaving some or perhaps all SEC disgorgement claims still subject to a 5-year limitation period – that is, still stuck in the problem created by *Kokesh*.

A companion bill proposal attempts, through a "rule of construction" clause, to restore the SEC to a world where its disgorgement claims would not be subject to any limitations period

³ In Dodd-Frank Congress "authorized to be appropriated to carry out the functions, powers, and duties of the Commission – for fiscal year 2015, \$2,250,000,000." Now codified at 15 U.S.C. §35(5).

⁴ *Kokesh v. SEC*, 137 S.Ct. 1635 (2017).

⁵ SEC Enforcement Division 2018 Annual Report, p. 5 (Nov. 2, 2018): <https://www.sec.gov/files/enforcement-annual-report-2018.pdf>.

at all, as was the case before the 2017 *Kokesh* decision. However this rule of construction provision only applies to SEC claims for what it calls the “equitable relief” of “disgorgement in the amount of any unjust enrichment obtained,” apparently by the violator. No problem if such “equitable disgorgement” were all that the SEC claimed. But defense counsel will cite *Kokesh* itself to argue that the SEC claims much more – that, in substance, the SEC claims a “penalty disgorgement” that remains subject to a “penalty” statute of limitations, far different and much larger than simple equitable disgorgement.

Writing for a unanimous Supreme Court in *Kokesh*, Justice Sotomayor said that SEC disgorgement differs considerably in character from traditional forms of “equitable disgorgement.” Among other things, she found that disgorgement “as it is applied in SEC enforcement proceedings, operates as a penalty,” citing the following: (i) When victims are too dispersed, SEC disgorgement is simply paid into the U.S. Treasury, and is thus “not compensatory.” (ii) SEC disgorgement “sometimes exceeds the profits gained” by the violator, who may be required to disgorge gains obtained by “third parties,” in some cases where the violator personally “never received any profits.” (iii) SEC disgorgement may include gross gains, “without consideration of a defendant’s expenses that reduced the amount of illegal profits.” (iv) SEC disgorgement does “not simply restore the status quo; it leaves the defendant worse off.” (v) Overall “disgorgement in this context is punitive, rather than a remedial, sanction,” and designed “not only to ‘prevent the wrongdoer’s unjust enrichment’ but also ‘to deter others’ violations of the securities laws.’”⁶

Defense counsel would likely rely on this unanimous Supreme Court language to show that SEC disgorgement is very different from the “equitable disgorgement” covered by the present bill proposal’s rule of construction. In so doing, defense counsel will likely convince at least some judges that the SEC’s “penalty disgorgement” remains subject to the penalty statute of limitations – thus resulting in potentially years of litigation uncertainty for the SEC, regardless of the ultimate outcome after appeals. Nor is it feasible to try to craft a substitute rule of construction that would attempt to treat “penalty disgorgement” as different from other “penalties,” a definitional nightmare that likewise would only spawn confusion and again years of litigation attempting to sort it out.

The realistic and effective approach here is to take the present opportunity to simply legislate a statute of limitations – but an appropriate statute of limitations – for all SEC disgorgement claims. Additionally, considering the full range of SEC remedies – not just disgorgement – the inconsistency of having some SEC claims subject to a 5-year limitation period and other SEC claims subject to a 10-year limitation period makes no sense. The unfortunate reality is that this disparity would have the effect of forcing the SEC to continue to have to bring all of its claims within 5 years, as the SEC would not want to have to explain why it waited until it became time barred on all of its other claims (at the 5-year threshold) before filing a claim against a violator for just civil monetary penalties. So whether Congress ultimately

⁶ *Kokesh v. SEC*, 137 S.Ct. 1635, 1644-45 (2017).

decides that the statute of limitations for SEC claims should be 5 years or 10 years or something else, the statute of limitations period should be the same for all SEC claims – a uniform statute of limitations applying across the board.

Hybrid Approach to Assure Reliable Testimony. Separately, there can be a serious policy question whether it is in the public interest to stretch any statute of limitations beyond 5 years. Across the full range of federal and state law, statutes of limitations generally range, depending on the claim, between 1 and 6 years, and it is rare to find a limitations period beyond 6 years. The reason for this is that it can be very hard for witnesses to give reliable testimony many years after the events in question. Beyond 5 or 6 years, experience shows that witnesses can remember situations generally, but not particular events, meetings and conversations. And memory may turn on the significance of an event to them personally. So litigants on both sides of a case may through passage of time lose the ability to question a witness who originally had important testimony to give, but who now is at best hazy in recalling the events.

So how do we accommodate the competing considerations of giving the SEC enough time to find and pursue violators, while at the same time giving our courts and juries testimony from witnesses who can reliably recall events and accurately provide sworn testimony? In answering this question, we can take a lesson from the approach Congress chose in setting the statute of limitations for private securities cases, where legal claims are similar but do not involve the SEC. In the Sarbanes-Oxley Act of 2002, Congress provided that such actions must be brought “not later than the earlier of – (1) 2 years after the discovery of the facts constituting the violation; or (2) 5 years after such violation.” 28 U.S.C. §1658(b). Interpreting this “2-and-5” provision, the Supreme Court clarified that the limitations period “begins to run once the plaintiff did discover or a reasonably diligent plaintiff would have ‘discovered[ed] the facts constituting the violation’ – whichever comes first,” but “irrespective of whether the actual plaintiff undertook a reasonably diligent investigation.”⁷

Acting in the public interest, the SEC should get more time than private plaintiffs. But the same hybrid structure can still be applied – perhaps by adopting a “3-and-10” approach in SEC cases. Thus, the SEC would have to file its action “not later than the earlier of – (1) 3 years after the discovery of the facts constituting the violation; or (2) 10 years after such violation.” This 3-and-10 structure would give the SEC potentially as long as a generous 10 years after the violation to act against concealed violations, but still require it to complete its investigation and file suit within 3 years from reasonable discovery of the violation. In this way, the SEC would be assured of having sufficient time to file suit where facts are hidden, but it would still have to work diligently to be able to responsibly present witnesses who had some recollection of the events. If Congress sees a need to further accommodate the SEC, such a provision could also explicitly provide that, where a violation involves a continuing course of related conduct, the statute of limitations for the entire course of conduct would only begin to run at the conclusion of the course of conduct.

⁷ *Merck & Co. v. Reynolds*, 559 U.S. 633, 653 (2010) (quoting 28 U.S.C. §1658(b)(1)).

Safety Valve. Experience shows that generally the SEC can complete an investigation within 3 years of discovering the misconduct, so such a 3-and-10 approach is reasonable. In the rare case where the SEC needs more than 3 years to complete an investigation, it can ask the subjects of its investigation, who will after 3 years of investigating be known, to consent to a routine “tolling agreement” voluntarily extending the statute of limitations, a request that is virtually always agreed to in SEC investigations. Alternatively, the SEC can simply file litigation based on what it knows after investigating the matter for 3 years. If it gets additional information during the course of its litigation (for example through pretrial depositions), it can ask the court to allow it leave to amend its complaint, and the relevant procedural rule provides that the court “should freely give leave when justice so requires.”⁸

III. Equitable Relief in Commission Actions

Need to Confirm SEC Ability to Compel Disgorgement of Illegal Gains. As enacted in the 1930s, the securities laws allowed the SEC to seek injunctions against securities violations and other limited relief, but they did not specifically authorize the SEC to obtain a monetary recovery. Beginning around 1970, the SEC persuaded courts that their equitable jurisdiction to grant injunctive relief inherently allowed them to decree that wrongdoers must “disgorge” any ill-gotten gains they received from their violations.⁹ More recently, Congress has confirmed that the SEC has the power to seek “equitable” remedies, but without specifically enumerating disgorgement as among those remedies.¹⁰ In 1990, Congress gave the SEC authority to seek civil monetary “penalties” to punish wrongdoing, but the SEC also continued to seek and obtain “disgorgement” of illegal gains.¹¹

Two years ago, in ruling for the first time that SEC disgorgement claims should be subject to a 5-year statute of limitations, as discussed above, a unanimous Supreme Court startled many observers by also raising fundamental doubts about the SEC’s long-accepted power to obtain disgorgement at all. The Court left the answer to this question for a future day, noting that its ruling was limited simply to the statute of limitations question, and that the opinion should not be interpreted as ruling, in Justice Sotomayor’s words, “on whether courts possess authority to order disgorgement in SEC enforcement proceedings or on whether courts have properly applied disgorgement principles in this context.”¹²

Demanding that violators surrender their illegal profits with interest has for many decades been at the core of the SEC’s enforcement program, and rightly so. But now, the Supreme Court’s unanswered question has left the SEC’s disgorgement remedy in limbo. Congress

⁸ Rule 15(a)(2), Federal Rules of Civil Procedure.

⁹ *Kokesh v. SEC*, 137 S.Ct. 1635, 1640 (2017), citing *SEC v. Texas Gulf Sulphur Co.*, 312 F. Supp. 77, 91 (S.D.N.Y. 1970), *aff’d in part and rev’d in part*, 446 F.2d 1301 (2d Cir. 1971).

¹⁰ Securities Exchange Act §21(d)(5), 15 U.S.C. §78u(d)(5).

¹¹ *Kokesh*, 134 S.Ct. at 1640, citing 104 Stat. 932, codified at 15 U.S.C. §77t(d).

¹² *Id.* at 1642, n. 3.

should not allow this uncertainty to persist. It is time to explicitly state in legislation that the SEC may seek full disgorgement of violators' profits.

The present bill proposal would do this. However, for the reasons discussed above, there is the problem of how the proposal describes "disgorgement." A better and clearer approach may be to slightly modify the proposal's description of the disgorgement that the SEC would be formally authorized to seek so that it would read as follows: "(ii) disgorgement, *including without limitation* the amount of any unjust enrichment obtained through the act or practice with respect to which the Commission is bringing such action or proceeding, *and without regard to whether any such amount may be construed to be a penalty*" (italicized material added).

Challenges of Adding a Restitution Remedy. The present bill proposal would separately give the SEC the ability to seek the additional remedy of restitution – something the SEC has not previously done over its 85-year history. This proposal would be viable only with a substantial increase in the SEC's budget. At current flatlined budget levels and seriously reduced staffing levels, the SEC has difficulty managing a docket of cases that seek simply findings of securities law violations, disgorgement of the violator's profits, additional monetary penalties, injunctions (or cease-and-desist orders), and professional bars.

Restitution is very different and would get the SEC into the business of doing far more labor-intensive cases. Restitution is the functional equivalent of a class action "damages" claim because restitution requires the violator not just to refund illegal profits and pay a penalty, but additionally to compensate each and every investor who may have suffered a monetary loss flowing from the violation. To illustrate, a violator may have earned no personal profit as a member of a company's executive group during a period when it failed to disclose a material fact, but ultimate disclosure of the omitted fact may wipe out \$500 million or more in market cap, and result in hundreds of millions in losses to investors who bought or sold the company's securities over the time the material fact was illegally concealed.

Proving restitution claims would require the SEC to prove causation of investor losses with reasonable precision, in far more labor-intensive and prolonged litigation than it presently handles, followed by collection efforts to try to get the defendant company (effectively its current shareholders) and defendant present or former executives to pay the restitution ordered into a distribution fund, and then a prolonged claims process to carry out the distribution to shareholders impacted by varying loss levels, including fair proration if the full loss amount could not realistically be collected. Class action lawyers quickly file such claims following a stock drop, but then after initial court motions and discovery, some (not all) may seek to quickly negotiate settlements in amounts that cover attorneys' fees and "pragmatic" additional relief that may simply involve improved corporate governance provisions without actual monetary payments (or with amounts comfortably with D&O policy limits). However as a public agency, the SEC could not conveniently wrap up its restitution (essentially damages) cases so quickly and easily, and would be charged by Congress and the public to seek the full relief its lawsuit demanded and not settle cheap for attorneys' fees and small actual recoveries.

So how could the SEC handle this different and far more labor-intensive kind of litigation? At present funding levels, the SEC could radically cut back on the number of cases it brings, meaning that many frauds would never be exposed, investors would continue to suffer, and violators would go free. This obviously makes no sense. The alternative is to radically increase the SEC's budget from its present \$1.6 billion level to something more like \$4-5 billion, and substantially grow its enforcement staff and infrastructure to handle this heavier litigation load. There's no question that the SEC needs a much bigger budget, but increasing it this much and this fast is probably not realistic.

Finally, there is the question of the interplay between disgorgement and restitution. Would the SEC seek both disgorgement of the violators' profits and restitution of victims' losses, or would it choose disgorgement or restitution? If a choice, what would be the basis for decision between them? If both, defense counsel may raise Constitutional fairness and other objections that would send the SEC down the road of years of unproductive litigation.

IV. Stronger Enforcement of SEC Civil Penalties

The bill proposal increases by roughly 25% to 33% the dollar amount of each penalty "tier" in the penalty structure that has been in place for the last 30 years in the federal securities laws. For serious violations (Third Tier), it alternatively allows the penalty to equal "gross pecuniary gain" obtained by the violator if that is higher, or the "amount of losses incurred by victims" if that is still higher. And it allows the penalty amount to be trebled (a new Fourth Tier) if within the five years before the conduct the entity or individual had resolved an unrelated securities fraud case. And due to an ambiguity already existing in the statute, such penalty amount could be imposed for each act or transaction over a course of dealing,¹³ resulting in a maximum penalty calculation easily in the trillions of dollars, as discussed below.

Issues Presented. While nobody wants to go light on fraudsters, this overall approach creates some problems. First, the proposal again requires us to consider the restitution issues discussed above. Setting penalty amounts, in the alternative, at a level equal to "the amount of losses incurred by victims as a result of the violation" is another way of setting the SEC on the course of seeking restitution (damages), discussed above. As presently drafted, the proposal would have the SEC make an equitable claim for restitution (damages) and then additionally seek a penalty amount equal to the restitution amount. So in the example given above, the defendant executive serving during a nondisclosure and the defendant company's current shareholders (as the company's equity owners) would be on the hook to pay those who were

¹³ Law 360 recently reported that a brokerage firm charged with filing defective suspicious activity reports over an extended period was found to have committed 2,720 "violations," one for each defective report, and that the SEC then multiplied this number by the penalty amount to demand \$22.7 million, an amount that the firm said would put it out of business. "Brokerage Firm Fights 'Draconian' SEC Bid For \$23M Penalty," Securities Law 360 (6/11/2019), reporting on *SEC v. Alpine Securities Corp.*, Case No. 17-CV-4179 (S.D.N.Y.).

shareholders back at the time of the nondisclosure an amount up to twice the full stock drop (the loss in market cap), once as restitution and a second time as penalty.

And the “recidivist” provision in the penalty proposal would increase this substantially if the individual or the entity had resolved another SEC case within the previous five years (which would likely have involved conduct 8 to 10 years ago, given the time needed for investigation and litigation), even if the previous SEC resolution was a no-admit settlement of one of the negligence-based antifraud provision. In such a case, the defendant corporation could be ordered to pay restitution, and then pay a penalty equal to three times the restitution amount, for a total of four times the stock drop amount to be paid by current shareholders to shareholders during the stock drop period, with some shareholders overlapping and others not.

And if the individual or entity had ever settled an earlier SEC court or administrative case with an injunction or cease-and-desist order – provisions found in virtually all SEC settlements – the penalty amounts for the second case would get astronomically higher. Even if the earlier settlement was for a technical charge not involving fraud and without an admission, the penalty in the new case would be imposed for “each day” during the period of the new violation. So if the events involved in the nondisclosure hypothetical discussed above stretched over six months, then the penalty equal to the restitution amount (or three times the restitution amount) could be imposed for each of the 180 days over the six month period, for a total penalty amount of 540 times (three times 180) the amount of the stock drop (loss in market cap).

Effective But Measured Alternative. This is certainly talking tough, but it’s not realistic and may cause the law (and the SEC) to lose credibility. With a sky’s-the-limit approach and no guidance from Congress, the SEC will wonder, on a case-by-case basis, whether to ask the court for thousands or for trillions. This will build in opportunities for defense counsel to raise a range of due process and equal protection Constitutional and other challenges that risk tying up the SEC in litigation for years – a replay of the Constitutional litigation the SEC is presently working its way through over the process for appointing and removing its administrative law judges. This is not something the SEC needs.

To make a meaningful difference, a more measured approach to enhancing the toughness of SEC penalties is what’s needed here. One such alternative would be the following: (i) Increase the specific dollar amounts for each penalty tier as stated in the proposal. (ii) Provide that alternatively penalties could equal gross pecuniary gain, if greater than the specific dollar amounts in the tier calculation, also as stated in the proposal. (iii) Provide that each “course of action” – essentially each type of misconduct in a case, but not each individual transaction – shall constitute a separate act for purposes of assessing penalties. Such an approach has been used by the SEC and its administrative law judges, and it typically results in a single-digit and thus credible number of penalties for purposes of penalty calculation.¹⁴

¹⁴ See *Matter of J.S. Oliver Capital Management, LP*, 2016 WL 3361166 at *15 and n. 106, 108 (June 17, 2016).

Finally, provide that once the penalty amount has been determined by using this approach, the federal court judge or SEC administrative law judge must then make an overall assessment of the fairness, for Constitutional and other purposes, of the resulting amount by applying certain specifically enumerated factors that Congress has previously directed must be applied in setting penalties in the SEC's administrative proceedings.¹⁵ But do not additionally include a restitution measure of penalty, a treble penalty provision, or a separate Tier Four recidivist calculation, as these additional measures will create unintended problems for the SEC without actually resulting in additional collectible monetary recoveries for investors or meaningful additional deterrent effect for law enforcement purposes.

V. PCAOB Enforcement Reforms

Public Hearings at the PCAOB: The proposal for public PCAOB hearings has been recommended for some time by persons within and outside the PCAOB. The administration of justice generally should be public, and to assure clean markets and build investor confidence, there is a particular need for “public” hearings when the PCAOB evaluates “public” accountants working for “public” companies. The argument on the other side is that, by having proceedings conducted in secret, the PCAOB preserves the reputation of those charged in the event that some or all of the claims are ultimately not proven. While this concern is understandable, it would apply equally to all of the SEC's litigation in federal court and in administrative proceedings, but these SEC proceedings have been public for the SEC's entire 85-year history, and no one has argued this should be changed.

Disclosure of Use of Firm That PCAOB Cannot Inspect: The PCAOB and the SEC have had continuing difficulty obtaining records and information from accounting firms in certain foreign jurisdictions in recent years. Companies raising capital in the U.S. that use such firms beyond a reasonable period should have their access to U.S. markets limited.

Whistleblower Program at the PCAOB: The whistleblower program has been a big success at the SEC, and it would undoubtedly also help the PCAOB carry out its mission. The only concern is that it would require a very small agency to use limited staff positions to staff a whistleblower office to receive complaints and process bounty claims. An alternative would be for the PCAOB to refer whistleblower bounty claims to the SEC's whistleblower office, which has overlapping jurisdiction over accounting matters and which already has in place the staff and other infrastructure needed to effectively run a whistleblower program. In short, there may be a way for the SEC and the PCAOB to partner on this for greater efficiency.

¹⁵ For example, in Securities Exchange Act §21B(c), Congress directed the SEC to apply a variety of enumerated “public interest” factors in assessing penalties, along with “such other matters as justice may require.” And in §21B(d), Congress provided for an assessment of ability to pay in making a penalty determination.

Conclusion

I will conclude by thanking the Subcommittee and its staff for their careful consideration of these important issues at the heart of SEC enforcement. I am ready to respond to any questions Members may have concerning my testimony today.

(The views above are solely those of the author, and may or may not reflect the views of the author's professional colleagues, clients or others as to particular items discussed.)