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The Stronger Enforcement Of Civil Penalties Act; A Push For Higher SEC Penalties

The following is written by Laura Anthony, Esq., a going public attorney focused on OTC listing requirements, direct public offerings, going public transactions, reverse mergers, Form 10 and Form S-1 registration statements, SEC compliance and OTC Market reporting requirements.

In July a Democratic senator and a Republican senator together introduced the Stronger Enforcement of Civil Penalties Act of 2015 (SEC Penalties Act), which would give the SEC the ability to levy much heftier penalties for securities fraud, and against recidivists. The Act was referred to the Senate Baking, Housing and Urban Affairs Committee for review and further action. The proposed SEC Penalties Act would increase the limits on civil monetary penalties and directly link the size of the penalty to the scope of harm and associated investor losses, and substantially increase the penalties for repeat offenders.

Background: A Trend Towards Increased Enforcement

The SEC Penalties Act continues a trend to deter securities law violations through regulations and stronger enforcement including the SEC Broken Windows policy, increased Dodd-Frank whistleblower activity and reward payments, and increased bad actor prohibitions. See my prior blog on bad actor prohibitions HERE.

The SEC Broken Windows policy is one in which the SEC is committed to pursue infractions big and small; where they are committed to investigate, review and monitor all activities and not just wait for someone to call and complain or just wait for the big cases. The idea is that small infractions lead to bigger infractions, and the securities markets have had the reputation that minor violations are overlooked, creating a culture where laws are treated as meaningless guidelines. So the SEC thinks it is important to pursue all types of wrongdoings, not just big frauds, but negligence-based cases and the enforcement of prophylactic measures as well.

In a speech by Mary Jo White back in October 2013, she announced the policy and the SEC's enforcement initiative. The policy is modeled after one pursued by the NYPD back in the nineties under Mayor Rudy Giuliani, which resulted in helping to clean up the streets of New York. The analogy is that if a window is broken and someone fixes it, it is a sign that disorder will not be tolerated, but if no one fixes it, the thought is that no one cares and no one is watching so why not break more windows.

In a future blog I will cover the whistleblower rules in depth, but as a precursor, the Dodd-Frank Act, enacted in July 2010, added Section 21F, "Whistleblower Incentives and Protection," to the Securities Exchange Act of 1934 ("Exchange Act"). As stated in the original rule release, the purpose of the rule was "to encourage whistleblowers to report possible violations of the securities laws by providing financial incentives, prohibiting employment related retaliation, and providing various confidentiality guarantees."

The bulk of the whistleblower statutes relate to the submission of original information leading to successful enforcement actions, and the calculation and payment of awards to the whistleblower. The statute also implements measures to protect the whistleblower from retaliatory actions. The SEC has been actively pursuing actions against entities for such retaliatory conduct. See, for example, my blog HERE.

Current SEC Civil Penalties

Under the current law, penalties differ depending on whether the SEC pursues and resolves an action in an SEC administrative proceeding or through a federal court action. In SEC administrative proceedings, there are three tiers of maximum penalties. For most civil violations, the SEC can impose a first-tier money penalty of no more than $7,500 for an individual and $80,000 for a company for "each act or omission" violating the securities laws. Second-tier violations involving at least reckless misconduct impose a monetary penalty of no more than $80,000 for an individual and $400,000 for a company for each such act or omission. Third-tier violations involving fraud, deceit, manipulation, or deliberate or reckless disregard of a regulatory requirement that resulted in substantial losses to victims or substantial pecuniary gain to the wrongdoer allow for the maximum penalty of no more than $160,000 for an individual and $775,000 for a company for each such act or omission.

The tiers are the same when a proceeding is heard in federal court, except that the SEC also has the option of seeking, instead, a penalty equal to the wrongdoers' "ill-gotten gain" from the violation.

The press and official position related to the bipartisan SEC Penalties Act is that it is addressing a concern that fines levied against Wall Street firms and institutions are meaningless and nothing more than "decimal dust." However, according to a Yale Law Journal article published in October 2014, since 2000 penalties have grown 30% year over year, compared to only a 3% growth in cases filed. The article points out that Xerox's 2002 $10 million civil penalty was then "the largest ever levied in a Commission action against a public company for financial fraud," and that since that time, corporate penalties have skyrocketed. As I've noted in several prior blogs, the SEC is very vocal about its use of penalties as a deterrent and its commitment to increase that trend.

Proposed SEC Penalties Act

The SEC Penalties Act increases the per-violation cap for first-tier violations to the greater of $10,000 for individuals or $100,000 for entities, or the gross pecuniary gain by the wrongdoer. Second-tier penalties are increased to the greater of $100,000 for individuals or $500,000 for entities, or the gross pecuniary gain by the wrongdoer. Third-tier penalties are increased to the greater of (i) $1 million per violation for individuals or $10 million per violation for entities, (ii) three times the gross pecuniary gain, or (iii) the losses incurred by victims as a result of the violation. The SEC Penalties Act also triples the penalty cap for recidivists who have been held criminally or civilly liable for securities fraud in the last five years.

The Act also provides authority to seek civil penalties for violations of previously imposed injunctions or bars with each violation and each day of continuing violation being considered a separate offense. The penalties under the proposed Act would apply in both administrative and federal court proceedings.

Particular Considerations Related to Administrative Proceedings

The SEC Penalties Act, as written in its beginning form, treats administrative court and federal court proceedings equally. However, the administrative court process is not an equal forum, and based on a barrage of negative attacks, including lawsuits, appeals and media coverage, requires review and attention. A recent analysis by the Wall Street Journal indicated that in the last five years, the SEC has won 90% of cases brought in its own administrative courts but only 69% of cases brought in federal court. Part of the disparity can be that the SEC chooses to settle or drop "losing" claims, but that still leaves a large discrepancy.

Moreover, the Dodd-Frank Act enacted in 2010, for the first time granted the SEC the authority to impose civil penalties in administrative proceedings against any person the SEC claims violated the securities laws, regardless of whether that person or firm is in the securities business. In other words, Dodd-Frank opened the doors for the SEC's own administrative proceedings to be just another forum for the pursuit of any securities law violations. Common sense tells us that this change, five years ago, directly relates to the uproar in the defensive bar.

Recently a slew of cases have been filed challenging the SEC's power in administrative actions and the administrative process. In June, in the case Hill vs. SEC, a federal district court in Atlanta granted injunctive relief preventing the SEC from proceeding with an administrative proceeding on the grounds that the proceeding was unconstitutional. Without getting overly complex, Hill argued that the SEC administrative process (i) violated Article I of the constitution by letting the SEC pick the forum in which to pursue claims (administrative court or federal court) and that power is limited to Congress; (ii) violated the Seventh Amendment right to a jury trial (administrative court proceedings are heard by an administrative court judge); and (iii) violated the Article II Appointments Clause.

The federal court rejected the first two arguments but found that the there was enough evidence and support of a violation of the Appointments Clause to support the granting of a temporary injunction. In particular, the SEC administrative law judge was an inferior officer that, under Article II, must be appointed by either the President, a court of law, or a department head. In fact, the judge had not been appointed by the SEC commissioner (department head), the President or a court.

The SEC has appealed the ruling. Clearly this is an easy fix for the SEC. It just needs to have the SEC Commissioner appoint the judge. However, the challenges continue to be filed and the process remains under attack. On August 12, 2015 another federal court reached the same conclusion as the Hill court and similar challenges are mounting.

This firm does not litigate or participate in SEC enforcement proceedings, and so my knowledge of the actual court vs. administrative process and procedures is peripheral. However, as with any good securities attorney, we keep our clients informed of the law so that they can avoid participation in these proceedings.

Liability for Signing SEC Report, Including CEO and CFO Certifications

I am often asked about potential liability for signing SEC reports and, in particular, the CEO and CFO certifications. An officer providing a false certification potentially could be subject to SEC action for violating Section 13(a) or 15(d) of the Exchange Act and to both the SEC and private actions for violating Section 10(b) of the Exchange Act and Exchange Act Rule 10b-5. Each of these violations could be a first-, second- or third-tier violation depending upon the level of scienter by the signing officer or director and the damage resulting from the false report. In practice, courts consider the actual facts, including the signor's involvement or scope of knowledge of the information in the reports, and do not consider the signing of the report itself dispositive. The SEC advocates the view that officers and directors have a proactive responsibility to ensure the accuracy of the reports they sign and have concurrent liability.

As a reminder, a public company with a class of securities registered under Section 12 or which is subject to Section 15(d) of the Exchange Act must file reports with the SEC. The underlying basis of the reporting requirements is to keep shareholders and the markets informed on a regular basis in a transparent manner. Reports filed with the SEC can be viewed by the public on the SEC EDGAR website. The required reports include an annual Form 10-K, quarterly Form 10Q's, and current periodic Form 8-K, as well as proxy reports and certain shareholder and affiliate reporting requirements.

These reports are signed by company officers and directors. A company officer signs a Form 10-Q and all company directors sign a Form 10-K. Moreover, the Sarbanes-Oxley Act of 2002 ("SOX") implemented a requirement that the company's principal executive officer or officers and principal financial officer or officers execute certain personal certifications included with each Form 10-Q and 10-K. Certifications are not required on a periodic Form 8-K.

Although it is the function of the officer that determines the requirement to execute the certifications, for purposes of this blog, I will refer to the principal executive officer as the "CEO" and the principal financial officer as the "CFO." All companies that file reports under the Exchange Act, whether domestic or foreign, small business issuers or well-known seasoned issuers, are required to include the CEO/CFO certifications. Under the CEO/CFO certification requirement, the CEO and CFO must personally certify the accuracy of the information contained in reports filed with the SEC and the procedures established by the company to report disclosures and prepare financial statements.

A company's CEO and CFO must each provide two certifications as part of the company's quarterly Form 10-Q and annual Form 10-K. The certifications are required under Sections 302 and 906 of the SOX. The certifications are executed individually and filed as exhibits to the applicable quarterly and annual filings. Although certifications are not included in reports other than Forms 10-Q and 10-K, the disclosure controls and procedures to which the CEO and CFO certify must ensure full and timely disclosure in all current reports, as well as definitive proxy materials and definitive information statements.

Section 302 Certification

Under Section 302, the CEO and CFO make statements related to the accuracy of the reports filed with the SEC and the controls and procedures established by the company to ensure the accuracy of such reports. The certification must be in the exact form set forth in the rule, and the wording may not be changed in any respect whatsoever. The CEO and CFO must each certify that:

- He or she has reviewed the report;
- Based on his or her knowledge, the report does not contain any untrue statement of a material fact or omit to state a material fact necessary in order to make the statements made, in light of the circumstances, not misleading;
- Based on his or her knowledge, the financial statements and financial information fairly present, in all material respects, the company's financial condition, results of operations and cash flows of the company;
- The certifying officer(s) is/are responsible for: establishing and maintaining disclosure controls and procedures;
- having designed such disclosure controls and procedures to ensure that they are informed of all material information;
- having each evaluated the effectiveness of the disclosure and financial controls and procedures as of the end of each period in which they are making the certification; and
- having disclosed their conclusions regarding the effectiveness of the controls and procedures in the subject Form 10-Q or 10-K;
- He or she has disclosed to the company auditors and to the audit committee any significant deficiencies or material weaknesses in the design or operation of internal controls over financial reporting which could adversely affect the company's ability to record, process, summarize and report financial data;
- He or she has disclosed to the company auditors and to the audit committee any fraud, material or not, that involves employees who have a significant role in internal controls over financial reporting; and

Any changes in the internal controls or financial reporting have been disclosed in the subject Form 10-Q or 10-K, including changes designed to correct deficiencies or material weaknesses.

If a material weakness is uncovered, it must be disclosed in a Form 10-K and, as a result, management cannot conclude that its controls and procedures are effective. The SEC defines a material weakness to be a deficiency, or a combination of deficiencies, in internal control over financial reporting that creates a reasonable possibility that a material misstatement of a company's annual or interim financial statements will not be prevented or detected on a timely basis. The disclosure of a material weakness should include the nature of the weakness, its impact on financial reports and plans or steps and changes made to correct the disclosed material weakness.

Section 906 Certification

Under Section 906, the CEO and CFO must attest that the subject periodic report with financial statements fully complies with the Exchange Act and that information in the report fairly presents, in all material respects, the company's financial condition and results of operations. Like the Section 302 certification, the Section 906 certification must be in the exact form set forth in the rule and the wording may not be changed in any respect whatsoever.

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Securities Law Blog is written by Laura Anthony, Esq., a going public lawyer focused on OTC Listing Requirements, Direct Public Offerings, Going Public Transactions, Reverse Mergers, Form 10 Registration Statements, and Form S-1 Registration Statements. Securities Law Blog covers topics ranging from SEC Compliance, FINRA Compliance, DTC Chills, Going Public on the OTC, and OTCQX and OTCQB Reporting Requirements. Ms. Anthony is also the host of LawCast.com, the securities law network.

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