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Enforcement

'Penalty' Undertakings in SEC Administrative Settlements Deserve a Closer Look

BY RUSSELL G. RYAN

When is a ''penalty'' not really a penalty? This is not a trick question in today's SEC enforcement environment.

Statutory Limits on SEC Penalty Authority. Ever since Congress passed the Securities Enforcement Remedies and Penny Stock Reform Act of 1990, the Securities and Exchange Commission has enjoyed broad statutory power to seek monetary penalties in federal court lawsuits against all types of securities law violators.[1] By contrast, Congress has carefully limited the SEC's power to levy such penalties in the agency's own administrative proceedings. Generally, the Commission may impose monetary penalties in administrative proceedings only when the violator is an entity directly regulated by the SEC—e.g., a brokerage firm, mutual fund, investment adviser, or stock exchange—or someone employed by or otherwise associated with such an entity.[2] In 1995, Congress also empowered the Commission to impose administrative penalties against public accounting firms in very limited circumstances, but the Commission thus far does not appear to have ever exercised that power.[3]

The SEC has periodically asked Congress for expanded authority to impose penalties in administrative proceedings against other securities law violators, but thus far Congress has demurred. Notably, Congress left such authority out of even its sweeping Sarbanes-Oxley corporate reform legislation in 2002, which did expand the Commission's remedial powers in other respects. This year, legislation that would broadly empower the SEC to impose administrative penalties is again winding its way through Congress with the agency's support, but the fate of that legislation (H.R. 2179) is uncertain.

Grant Thornton's 'Penalty.' If the SEC's recent settlement with accounting firm Grant Thornton is any indication, the agency may be running out of patience with Congress. The settlement, which the Commission announced in August 2004, resolved a pending administrative proceeding that accused Grant Thornton of conducting a deficient audit of the 1998 financial statements of MCA Financial Corporation. In addition to being censured and ordered to disgorge nearly $60,000 in audit fees, Grant Thornton agreed to several undertakings that included the payment of $1.5 million as a ''penalty.'' The firm also undertook to spend at least an-

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[1] Pub. L. No. 101-429, 104 Stat. 93, codified in relevant part at 15 U.S.C. §§ 77t, 78u(d), 78u-1(a), 80a-41(e), and 80b-9(e); *see generally* Russell G. Ryan, *Civil Penalties in SEC Enforcement Cases: A Rising Tide*, INSIGHTS, Vol. 17, No. 6, pp. 17-22 (June 2003).

[2] *See* 15 U.S.C. §§ 78u-2, 80a-9(d), and 80b-3(i).

[3] *See* 15 U.S.C. § 78j-1(d).

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other $1 million on fraud-detection training for its audit staff and to refrain from certain joint audit arrangements with other firms for a period of five years. As is typical with SEC settlements, Grant Thornton neither admitted nor denied the Commission's findings.[4]

Although the *Grant Thornton* settlement received a modest level of attention in the press and the defense bar, its primary significance was largely overlooked. Among other oddities, the case stands out because Grant Thornton agreed to pay a monetary penalty in settling an administrative proceeding in which it could not have been ordered to pay one, even if the firm had lost after a hearing on the merits. Grant Thornton surely is not an SEC-regulated entity, and it was not even charged with either of the unique types of violations for which the Commission is statutorily empowered to penalize public accounting firms in administrative proceedings.[5] Indeed, the SEC's order essentially acknowledged the agency's inability to require payment of a penalty by mentioning it only under the heading ''Undertakings by Grant Thornton,'' rather than including it ''below the line'' in the section setting forth the relief actually ordered by the Commission.

Textually, the *Grant Thornton* order is highly unusual—if not unprecedented—in at least two other respects. First, its caption indicates that it was issued in part pursuant to the SEC's cease-and-desist powers under Section 21C of the Securities Exchange Act of 1934,[6] yet the order ultimately does not require any of the respondents to cease and desist from any violations. Second, as discussed later, Grant Thornton's essentially voluntary penalty appears to have been added to a ''fair fund'' pursuant to Section 308 of the Sarbanes-Oxley Act of 2002, yet the order curiously doesn't cite Section 308 as authority for this feature of the settlement.

Intriguing Issues. The *Grant Thornton* settlement raises at least two obvious questions: First, why would Grant Thornton agree to pay a penalty that it could not have been ordered to pay? And second, what's the big deal anyway?

On the first question, it is impossible to know all of the specific factors that led Grant Thornton to agree to the settlement. Of course, settlement generally stems the cost and negative publicity of an otherwise protracted litigation with the SEC, while bringing finality to the process without any admission of wrongdoing. Equally important, settlement eliminates the risk that contested litigation would result in an outcome far worse than paying a modest but certain penalty. In this regard, Grant Thornton was no doubt keenly aware that another accounting firm recently lost a litigated SEC administrative proceeding and—although no monetary penalty could be imposed—was ordered to disgorge $1.6 million in audit fees, hire an independent consultant, and forego new public company audit engagements for six months, in addition to being censured and required to cease and desist from future violations.[7] Moreover, a comparison of the settlement order with the SEC's original order instituting the proceeding reflects that the settlement allowed Grant Thornton to avoid a potential Commission finding that it ''caused and willfully aided and abetted'' a fraud committed by its audit client, as well as a Commission order that it cease and desist from doing so in the future.[8]

The remaining question—What's the big deal?—raises more complicated legal and policy issues. On the one hand, a settlement is essentially a contractual agreement, with each settling party free to accept or reject the demands made by the other. On the other hand, the SEC is a creature of statute, deriving all of its regulatory and enforcement authority from laws passed by Congress. As previously noted, Congress thus far has authorized the Commission to impose monetary penalties in administrative proceedings only against SEC-regulated entities and people associated with them, and against pubic accounting firms for a limited category of violations not charged against Grant Thornton. In all other cases, Congress has statutorily required the Commission to convince a federal judge that a monetary penalty is warranted.

Yet in *Grant Thornton* and a small handful of prior cases,[9] the SEC has devised a creative means of circumventing the statutory limitations on its authority with settlements in which respondents sign ''voluntary'' contractual undertakings to pay penalties. This development is especially significant in the SEC enforcement context because, as a practical matter, the SEC staff generally views Commission settlements as solid precedent in charging and resolving subsequent cases. (In the interest of full disclosure, as a former member of the SEC's enforcement staff, I helped negotiate two of the Commission's previous administrative settlements featuring penalty undertakings, so I'm hardly in a position to criticize the agency's creative approach now.)

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[4] *In the Matter of Grant Thornton LLP, et al.*, SEC Rel. Nos. 34-50148 and AAER-2076 (Aug. 5, 2004) (available at www.sec.gov/litigation/admin/34-50148.htm).

[5] As previously noted, in 1995 Congress empowered the SEC to impose administrative penalties against public accounting firms in very limited circumstances—specifically, only when such a firm willfully fails to resign from an audit engagement and/or to furnish to the SEC a report concerning an ''illegal act'' report in accordance with Section 10A(b)(3) or 10A(b)(4) of the Securities Exchange Act of 1934. *See* 15 U.S.C. § 78j-1(d). Perhaps with deliberate vagueness, the SEC's order did charge Grant Thornton with willfully violating Section 10A, but based only on the firm's failure to assure that the audit committee or the board of directors of its client MCA Financial was ''adequately informed with respect to illegal acts.'' Such a failure violates only Section 10A(b)(1)—not Section 10A(b)(3) or 10A(b)(4)—and thus provides no statutory basis for an administrative penalty against a public accounting firm, even if willful.

[6] 15 U.S.C. § 78u-3.

[7] *In the Matter of Ernst & Young LLP*, SEC Initial Decision Rel. No. 249 (April 16, 2004) (available at www.sec.gov/litigation/aljdec/id249bpm.pdf).

[8] *See In the Matter of Grant Thornton LLP, et al.*, Admin. Proc. No. 3-11377 (Jan. 20, 2004) (order instituting proceedings) (available www.sec.gov/litigation/admin/33-8355-o.htm).

[9] *See, e.g.*, *In the Matter of Schering-Plough Corp., et al.*, SEC Rel. No. 34-48461 (Sept. 9, 2003) (penalty undertaking by company's former chairman and chief executive) (available at www.sec.gov/litigation/admin/34-48461.htm); *In the Matter of Moret Ernst & Young Accountants*, SEC Rel. Nos. 34-46130 and AAER-1584 (June 27, 2002) (available at www.sec.gov/litigation/admin/34-46130.htm). In at least two other settlements, an accounting firm agreed to make payments to the U.S. Treasury, but the payments were not explicitly characterized as a ''penalty.'' *See PricewaterhouseCoopers LLP*, SEC Rel. Nos. 34-47900 and AAER-1787 (May 2, 2003) (available at www.sec.gov/litigation/admin/34-47900.htm); *PricewaterhouseCoopers LLP, et al.*, SEC Rel. Nos. 34-46216 and AAER-1596 (July 17, 2002) (available at www.sec.gov/litigation/admin/34-46216.htm).

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To be sure, this is not the first time the SEC has discovered a means of obtaining relief that Congress had not yet authorized. During the 1970s and 1980s, the Commission devised a similarly creative approach to disqualifying securities violators from service as directors or officers of public companies. Congress didn't explicitly authorize the SEC to seek officer-director bars until 1990,[10] but by that time the Commission was already demanding and obtaining them in settlements for at least 15 years.[11] Notably, in passing Sarbanes-Oxley, Congress further extended the SEC's authority in this area by empowering the Commission to impose officer-director bars in administrative proceedings, something it conspicuously failed to do with respect to the imposition of monetary penalties.

The *Grant Thornton* settlement also raises a novel and intriguing legal issue involving the ''fair fund'' provision of Sarbanes-Oxley. Section 308 of the Act provides that whenever the SEC obtains disgorgement in an enforcement proceeding and creates a fund for distribution to putative victims, the agency can add to that fund any monetary penalty it obtains in the same case ''pursuant to'' the federal securities laws.[12] Prior to Sarbanes-Oxley, whenever the Commission received payment of a penalty, it was required to transmit such money to the U.S. Treasury, a requirement that presumably still applies whenever Section 308 is inapplicable or unavailable.[13]

[10] *See* 15 U.S.C. §§ 77t(e) and 78u(d)(2).

[11] *See, e.g., SEC v. Anshen*, SEC Litigation Rel. No. 11618, 1987 SEC LEXIS 3094 (D. Nev. Dec. 2, 1987) (5-year bar); *SEC v. Gulf Resources, Inc.*, SEC Litigation Rel. No. 1029, 1984 SEC LEXIS 2168 (N.D.Tex. Feb. 21, 1984) (permanent bar absent SEC permission); *SEC v. Nelson*, SEC Litigation Rel. No. 7347, 1976 SEC LEXIS 1912 (E.D.N.Y. April 12, 1976). For a full discussion and additional case citations, see Jayne W. Barnard, *The Securities Law Enforcement Remedies Act of 1989: Disenfranchising Shareholders in Order to Protect Them*, 65 N.D. L. Rev. 32, 54-55 (1989).

[12] Sarbanes-Oxley Act of 2002, § 308(a).

[13] *See, e.g., SEC Report Pursuant to Section 308(c) of the Sarbanes-Oxley Act of 2002* at 5 and 14 n.47 (Jan. 24, 2003) (available at www.sec.gov/news/studies/sox308creport.pdf).

Although the SEC didn't address this issue in its *Grant Thornton* order, a strong argument could be made that the penalty in that case was paid pursuant to a voluntary contractual undertaking rather than the federal securities laws. If that argument prevailed, Section 308 would not authorize the SEC to add the ''penalty'' to a distribution fund, and thus the money would rightly belong to the U.S. Treasury. Perhaps in recognition of this issue, although the Commission's order directs its staff to combine Grant Thornton's penalty with the firm's disgorgement payment for eventual distribution to certain victims, the order conspicuously does not mention Sarbanes-Oxley Section 308 as authority for that distribution.

Conclusion. The SEC deserves credit for continuing its long tradition of finding innovative remedies in the face of perceived statutory inadequacies. Likewise, counsel for parties that have agreed to penalty undertakings were undoubtedly acting in their clients' best interests. Ultimately, neither party to such settlements has much incentive to insist upon punctilious fidelity to statutory limitations on the SEC's authority. Given that reality, it is incumbent upon the rest of the securities bar to apply disinterested and thoughtful scrutiny to the broader issues raised by such settlements.

Note to Readers

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