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An Analysis of the SEC's Prosecution of Financial and Accounting Related Fraud

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By

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Abstract

This paper examines the Securities and Exchange Commission's (SEC) penalties of specifically accounting and financial related frauds. The paper analyzes whether the punishments imposed on companies and individuals appear to be harsh enough compared to the crimes committed. The following topics are analyzed: the SEC's policy of "neither admit nor deny", accountants' suspensions, and disgorgement and civil penalties. The discussion includes information on the SEC's current and proposed rules and procedures regarding these topics. A small sample of data was gathered on individuals and companies related to fraud cases from the SEC's Accounting and Auditing Enforcement Releases (AAER) database and the results are included in the analysis. The fourth quarter of 2010 was chosen as the time period to begin the collection of data after a brief examination of audit suspension periods showed that, on average, the periods ranged from three to seven years. The eight cases that were chosen were related to the first eight releases from the fourth quarter of 2010. The final section of the paper examines current limitations and impediments to the SEC's power that make successful and efficient prosecution more difficult.

<u>Part 1- Background Information</u>

Fraud Defined and Background on Sample Study

The Merriam Webster dictionary defines "fraud" as a "wrongful or criminal deception intended to result in financial or personal gain" ("Fraud", n.d.). Fraud is one of the many forms of "white-collar crime", a term given to a crime that is performed by professionals and is non-violent in nature. Although not violent, this type of crime can lead to devastating financial losses for its victims. In addition, fraud cases are commonly complicated because they often involve a multitude of perpetrators, the individuals have a high level of expertise and knowledge, and they take great care in covering up any possible tracks. Fraud encompasses a wide range of different individuals and scopes. Some examples of fraudulent crimes include credit card fraud, petty cash fraud, healthcare fraud, identity theft, and securities fraud.

The general elements required to prove fraud in a court of law, according to the Legal Information Institute are: a representation was made, the representation was false, the defendant knew that the representation was false or that the defendant made the statement recklessly without knowledge of its truth, the fraudulent misrepresentation was made with the intention that the plaintiff would rely on it, the plaintiff did rely on the fraudulent misrepresentation, and that the plaintiff suffered harm as a result of the fraudulent misrepresentation. (Ryan, 2009, para. 1) A fraud case can be prosecuted criminally, civilly, or both. Whether a case is prosecuted criminally or civilly depends on a variety of factors. One of the main differences between a criminal and civil case is the sanctions available in each and the purpose of these sanctions. In a criminal case, incarceration, probation, community service, and monetary fines are common sanctions with the primary purpose of punishing the defendant for their crime ("Sanction", n.d.).

In a civil court case, the most common sanctions or remedies available are monetary fines, suspending and revoking of licensures, and court orders commanding a person to do or refrain from doing something. The primary purpose of sanctions in a civil case is to provide a penalty for a violation of the law, while remedies are meant to provide relief to the plaintiff and are not punitive in nature ("Sanction", n.d.). Another major difference between choosing whether to pursue a case in criminal or civil court is the burden of proof required in each. In a criminal case, the burden of proving the defendant's guilt is on the prosecution, and they must establish guilt "beyond a reasonable doubt" whereas in a civil court case, the plaintiff has the burden of proving his case by a "preponderance of the evidence" which is a requirement that only more than 50% of the evidence points to wrongdoing (Hashmall, 2017).

This paper specifically focuses on financial and accounting related frauds, as these frauds usually create a great magnitude of losses for victims. According to a study conducted by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) that examined nearly 350 accounting fraud cases investigated by the SEC in the period from 1998-2007, "the median fraud was $12.1 million" while "more than 30 of the fraud cases each involved misstatements/misappropriations of $500 million or more" (McCallum, 2010, para.4). These types of frauds are also investigated heavily by the SEC and are conveniently located in the SEC's Accounting and Auditing Enforcement Releases (AAER) database publicly available on the SEC's website. The analysis in this paper focuses solely on the civil prosecution of these crimes because, although many of these crimes are prosecuted both criminally and civilly, the SEC does not have the authority to prosecute in a criminal forum. The type of accounting fraud focused on in this paper will be financial statement fraud which, according to the Association of Certified Fraud Examiners Brisbane Chapter, is the "manipulation of the information used to prepare financial statements released to the public and financial institutions" ("Common Financial Statement Frauds", 2013, para.3). This deceit can be achieved by manipulating timing through early recognition of revenues or postponing of expenses, or by falsifying entries through fictitious revenues, manipulating liabilities and expenses, and valuing assets ("Common Financial Statement Frauds", 2013). This paper also focuses on a variety of other financial frauds often committed on a large scale such as stock manipulation, insider trading, Ponzi schemes, and options backdating schemes.

SEC's Structure and Enforcement Processes

The Securities and Exchange Commission is an independent government organization that was created with the passage of the Securities Exchange Act of 1934. The SEC was established in response to the stock market crash of 1929 and the ensuing Great Depression in which investors lost great sums of money and confidence in securities markets. Congress created the SEC to incorporate safety, protection, and reliability in capital markets as well as to restore investor faith. To this day, the SEC is the primary regulator of the U.S. securities markets with responsibilities including interpreting and enforcing federal securities laws; issuing new rules and amending existing rules; overseeing the inspection of securities firms, brokers, investment advisers, and ratings agencies; overseeing private regulatory organizations in the securities, accounting, and auditing fields; and coordinating U.S. securities regulation with federal, state, and foreign authorities. (SEC, 2013, Organization of the SEC section, para. 2)

The SEC is structured broadly and organized by both areas of functional responsibility and by region. At the top of the organizational chart are five commissioners, one of which is designated as Chairman of the Commission. Reporting to the Chairman of the Commission are five divisions and twenty-three offices headquartered in Washington, DC and charged with carrying out the main responsibilities of the Commission. There are also eleven regional offices that report to the Division of Enforcement and the Office of Compliance Inspections and Examinations (SEC, 2013).

This paper concentrates on the Division of Enforcement which is responsible for carrying out the Commission's law enforcement function. This Division of Enforcement performs the important task of disciplining publicly traded companies and the people associated with those entities. It also investigates any potential violations of securities laws and can bring about civil penalties for white-collar crimes such as insider trading, accounting fraud, bribery, and others (SEC, 2013).

The Division of Enforcement first begins its investigative process by obtaining tips, complaints, and other forms of notices as possible evidence of a violation of securities law. This possible evidence may come from various sources, including market surveillance activities, investors themselves, Divisions and Offices of the SEC, other self-regulatory organizations, securities industry sources, and media reports (SEC, 2017). These leads may turn into a preliminary investigation formally known as a MUI, or Matter Under Inquiry, or, if the situation is pressing enough, they may be converted directly into an investigation (SEC Division of Enforcement, 2017).

According to the SEC Enforcement Manual, considerations the Division staff take when evaluating whether or not to open an MUI include whether the facts underlying the MUI show that there is potential to address conduct that violates the federal securities laws as well as whether the assignment of a MUI to a particular office will be the best use of resources for the

Division as a whole (2017). During this period, assigned staff look at the potential magnitude of the violation, losses to investors, whether conduct is ongoing, and if other authorities may be better suited to handle the investigation. After a period of no more than 60 days, the MUI is either converted into an investigation or closed based upon the findings (SEC Division of Enforcement, 2017).

The MUI process is converted to a formal investigation if the Division staff believe the investigation will have the potential to “substantively and effectively address violative conduct.” Once converted, facts are developed through “informal inquiry, interviewing witnesses, examining brokerage records, reviewing trading data, and other methods” (SEC Division of Enforcement, 2017, para. 3). Witnesses may be subpoenaed in this process to furnish some of these relevant documents to be evaluated. Formal investigations, as well as MUI’s, are carried out privately (SEC Division of Enforcement, 2017).

After an investigation, the SEC staff present their findings to the Commission for review along with a recommended enforcement action. The Commission can then authorize the staff to file a case in federal court or bring about an administrative action (SEC, 2017). The decision to either litigate in court or bring an administrative action often depends on the remedies available in each, for example, an emergency freezing order is only allowed in federal court cases; whereas barring a broker from securities trading is only allowed in an administrative proceeding (Henning, 2015). Oftentimes, if the misconduct warrants it (if crime is severe enough), the Commission will bring about both an administrative and a civil proceeding. The SEC strongly encourages individuals and companies to cooperate, and many times the Commission and the party charged decide to settle a matter without trial by entering into arrangements such as cooperation agreements, deferred, and non-prosecution agreements (SEC Division of Enforcement, 2017).

An administrative proceeding is conducted by an Administrative Law Judge (ALJ) who is independent of the Commission. The ALJ considers evidence from both division staff and the subject of the proceeding. The ALJ issues an initial decision, which includes findings of fact and legal conclusions as well as a recommended sanction. This decision may be appealed by the division staff or the defendant. The Commission then acts similarly to an appellate court in that it may “affirm the decision of the ALJ, reverse the decision, or remand it for additional hearings” (SEC, 2017, para.6). Under this forum, some of the common sanctions include “cease and desist orders, suspension or revocation of broker-dealer and investment advisor registrations, censures, bars from association with the securities industry, civil monetary penalties, and disgorgement” (SEC, 2017, para.6).

In contrast to the more informal administrative proceeding, a civil action is carried out in a U.S. District Court. The SEC files a complaint in a U.S. District Court and asks the court for a sanction or remedy. A common sanction is an injunction, which prohibits any further acts or practices that violate the law or Commission rules. Other common sanctions include civil monetary penalties, disgorgement, and corporate officer and director bars (SEC, 2017).

Sample Study from AAER Database

A sample study from the SEC's AAER database was conducted noting the following three variables: (1) was the policy of neither admit nor deny used, (2) where there any accountants involved and if so, what was their punishment, and (3) were disgorgement or civil penalties imposed on wrongdoers. The fourth quarter of 2010 was chosen as the time period to collect the data from the AAER database after a brief examination of accountant suspensions periods that showed that, on average, suspension periods ranged from three to seven years. The sample study examined the first eight cases in the AAER database for the fourth quarter of 2010 that involved either accounting or financial related fraudulent wrongdoing.

The releases on the AAER database are often related to many other releases including litigation releases, other accounting and auditing enforcement releases, and SEC complaints. SEC complaints and litigation releases are involved if the SEC prosecuted in a civil court. The accounting and auditing enforcement releases are related to either administrative proceedings or civil proceedings. These releases combined, contained the information needed to examine the three variables to discuss if fraud crimes are punished appropriately.

Release no.	**Defendant (s)**	**Fraudulent wrongdoing**	**Monetary penalties**	**CPA Suspension**
AAER-3196	Michael S. Joseph	Violated antifraud, reporting, and recordkeeping provisions of the federal securities laws, as well as auditor independence standards	N/A	Permanent Suspension with right for reinstatement after 3 years
AAER-3197	LocatePlus Holdings Corp., Jon Latorella and James Fields	Fraudulently inflated the company's publicly-reported revenue by creating a fictitious customer, falsely reporting	Joint and Severable Restitution 4.9 million	N/A

		more than $6 million in revenue		
AAER-3198	Office Depot, Inc., former CEO Stephen A. Odland, and former CFO Patricia A. McKay	Violated Regulation FD by selectively communicating to analysts that it would not meet analysts' quarterly earnings estimates; also, prematurely recognized approximately $30 million in funds received from vendors	Office Depot was ordered to pay a $1 million penalty and Odland and McKay were each ordered to pay $50,000 penalties	N/A
AAER-3214	Delphi Corporation, and former executives Catherine Rozanski, J.T. Battenberg, III, Alan Dawes, Paul Free, John Blahnik, Milan Belans, Judith Kudla, Scot McDonald, and B.N. Bahadur	Hid a $237 million warranty claim asserted by its former parent company and inflated its net income by $202 million, inflated its cash flow from operations by $200 million, engineered $270 million in inventory reductions, and improperly reported $80 million in net income and hid up to $325 million in factoring	In total the executives were ordered to pay $1,284,715 in disgorgement and $669,300 in civil penalties	Rozanski was permanently suspended with right for reinstatement after 5 years and Belans was permanently suspended with right for reinstatement after 3 years
AAER-3215	Comverse Technology, Inc., former CEO Jacob Alexander, former CFO David Kreinberg, and former Director William Sorin	Total actual gains of nearly $138 million from sales of stock underlying the exercises of backdated options	Total disgorgement between the three executives was $51.1 million and total civil penalties were $8.4 million	N/A
AAER-3216	Paul R. Beckwith, former Assistant Controller of Theradoc, Inc.	Illegally moved $13 million out of an operating account he managed and transferred the money to his account to trade stocks on margin.	Ordered to pay $178,880.74 in disgorgement	Permanently suspended
AAER-3217	Vitesse Semiconductor Corporation, former CEO	Accused of materially inflating revenues for 14 quarters, and backdating stock options to officers and employees by failing to record approximately	Vitesse was ordered to pay a $3 million civil penalty, and the total disgorgement	Hovanec was permanently suspended for the right for reinstatement

	Louis Tomasetta, former CFO Eugene Hovanec, former controller Yatin Mody, and former Director of Finance Nicole Kaplan	$184 million in compensation expense	between the four executives was $3,044,184	after 10 years, and Mody and Kaplan were permanently suspended
AAER-3218	Alvin L. Dahl, former CFO of 21st Century Technologies, Inc.’s	Prepared false and misleading Form 10-K and two Forms 10-Q and certified that those filings were complete and accurate, even though they contained material omissions concerning certain reported investments	Ordered to pay a $5,000 civil penalty	Permanently suspended with right for reinstatement after 12 months

Part 2- Are Fraud Crimes Punished Appropriately?

Neither Admit Nor Deny Policy

The SEC settles most of its cases with a consent judgement containing a provision known as “neither admit nor deny”. This settlement provision allows the defendant to agree to penalties outlined by the SEC without admitting to the SEC’s assertions of misconduct and without denying the allegations set forth in the SEC’s complaint. This practice of “neither admit nor deny” has been used by the SEC to settle cases since 1972. A less stringent practice allowing defendants to settle with the SEC without admitting to the facts in the SEC complaint but not requiring the denial provision was in effect before 1972. This less strict practice proved to be unsatisfactory as there were cases in which companies and individuals who had settled with the

SEC under the requirements of not admitting the allegations against them went on "public campaigns denying that they had ever done what the SEC had accused them of doing…" (Sklar, 2012). The "nor deny" part of the provision became required in 1972 when a Rule of Practice titled "Consent Decrees in Judicial or Administrative Proceedings" was adopted that necessitated that a defendant "not take any action or make or permit to be made any public statement denying, directly or indirectly, any allegation in the complaint or creating the impression that the complaint is without factual basis" .(Priyah, 2015, p.539)

The "neither admit nor deny" policy has undergone little criticism until nearly a decade ago. The first case where a federal district court judge challenged the neither admit nor deny policy was in 2011, in the case of the *U.S. Securities and Exchange Commission v. Citigroup Global Markets Inc*. This case was highly publicized because of the monetary loss to investors. According to the SEC, "Citigroup misled investors about the independence of their investment and failed to inform them that Citigroup stood to make millions if the product failed" (Bregant & Robbennolt, 2013, para. 2). The case was settled by Citigroup accepting the SEC's order to relinquish all profits with interest from its collateralized debt obligations, pay a civil penalty, and undergo three years of increased monitoring by the SEC (Bregant & Robbennolt, 2013). As part of the consent decree, the neither admit nor deny policy was used. United States District Court Judge Jed Rakoff of the Southern District of New York rejected the settlement and sharply criticized the SEC's use of its neither admit nor deny policy. He exclaimed in his refusal that the policy "leaves the defrauded investors substantially short-changed" and that there is an "overriding public interest in knowing the truth" which necessitates "cold, hard, solid facts, established either by admissions or by trials" (Bregant & Robbennolt, 2013, para. 3). This challenge brought a wave of other criticisms by district court judges such as Judge Rudolph

Randa of the Eastern District of Wisconsin and Judge Victor Marrero of the Southern District of New York, along with many other prominent individuals.

The SEC and defendants who have chosen to utilize the settling practice of neither admit nor deny have justified the practice on many different grounds. They have defended the practice by explaining that it has been used by the SEC as a popular settling practice for decades, and that the practice is used similarly by other federal agencies. In a statement made in 2012 by Robert Khuzami, the then Director of the Division of Enforcement, he exclaimed that many other federal agencies also resolve cases through negotiated settlements and consent judgments. For example, in recent years, the EEOC resolved 80 percent of its cases and the FTC resolved 80 percent of its antitrust actions by consent judgment. The "vast majority" of civil antitrust cases brought by the Department of Justice are resolved in this fashion. (Khuzami, 2012, para. 10) Khuzami also points out in this statement that the SEC's settlement policy is stricter than some agencies because it does not allow for the denial of wrongdoing under any circumstance and has even "remanded a retraction or correction on those occasions when a defendant's post-settlement statements are tantamount to a denial" (Khuzami, 2012, para. 18). Another popular defense for the neither admit nor deny policy is that it helps the SEC settle as many cases as possible with its limited monetary resources and faculty. The SEC claims that settling rather than going to civil court allows its resources to be spread more appropriately across more investigations. The SEC also notes the greater efficiency of settlement for returning funds to affected investors. Lastly, the SEC has warned that if the neither admit nor deny policy was removed, then most defendants would not attempt to settle cases with the SEC for fear of future litigation. The SEC stated that "many companies likely would refuse to settle cases if they were required to affirmatively admit unlawful conduct or facts related to that conduct" (Khuzami, 2012, para. 18). The SEC cites this refusal for fear of "collateral estoppel" in which a defendant could be relitigated on the same grounds in future lawsuits.

Out of the eight fraud cases examined from the AAER database in the last quarter of 2010, all the companies and all but two of the individuals involved in these cases, utilized the neither admit nor deny policy to settle the charges against them. This outcome is surprising based on the severity of the fraudulent crimes committed in these cases. For example, in the case of the *SEC v. Vitesse Semiconductor Corporation*, four of the former executives were accused of materially inflating revenues from 2001 to 2006. The former CEO and CFO were also accused of backdating stock options to officers and employees by failing to record approximately $184 million in compensation expense from 1995 to 2006. All of the four executives involved in the case and the company itself settled with the SEC without admitting or denying the allegations against them (U.S. Securities and Exchange Commission, 2010). Although monetary penalties were imposed, the lack of admission by the defendants in this case and other high stakes cases reduces the deterrent effect of wrongdoing. Settling out of court with an agreement void of any confessions reduces a company's potential for reputational harm and substantial monetary damages. Settling out of court while using the neither admit nor deny policy also lessens the transparency of the investigation. As explained by Priyah Kaul, "arguments at trial reveal and publicize facts uncovered after thorough discovery by both parties" (Kaul, 2015, p.549). Court hearings are often open to the public so interested or affected persons can read the judicial opinions. The SEC settlement process by contrast, is not as transparent. The consent decree that is decided upon by the negotiating parties is often shrouded from public sight. The only readily available public document about the settlement is the Order Instituting Proceeding, which contains only a small fraction of relevant facts of the trial (Kaul, 2015). Using the neither admit nor deny policy instead of trials on major cases such as the case of Vitesse Semiconductor Corporation, shows that the SEC is focused on speed and efficiency rather than returning the maximum amount of fraudulent funds to those affected investors and imposing harsh penalties on wrongdoers. Although the SEC claims that settlement in cases allows for better use of its resources and more investigations into other fraudulent cases, in doing so it fails to litigate the majority of its cases to their maximum potential.

The SEC modified its neither admit nor deny policy in May of 2012 for special cases where there is a paralleling criminal case. Under the new policy, the SEC eliminated the neither admit nor deny language in settlements where the defendant has been convicted of the same conduct in a criminal prosecution. This was agreed upon by members of the SEC Enforcement Division and the Commission as a whole to ensure consistency of admissions and liability of the defendant. This modification is not particularly relevant for the future use of the neither admit nor deny policy because, as explained by the SEC, "it does not affect our traditional 'neither-admit-nor-deny' approach in settlements that do not involve criminal convictions or admissions of criminal law violations" (Khuzami, 2012, para.26). By only affecting a small fraction of the cases the new policy does little to enhance transparency in the settlement process, increase the deterrence effect of wrongdoing, or impose the maximum penalties possible to help affected third parties.

Accountants Suspensions

Accountants play a vital role in the integrity of financial reporting. Private accountants help businesses with internal controls and safeguards, assist them in making cost/benefit decisions, and keep accurate records about the company's financial position. Public accountants may perform various tax, audit, and other consulting services to their clients. Public accountants that have publicly traded client companies or private accountants who work for a publicly traded company are subject to all rules laid out by the SEC**.** The SEC along with stock market investors rely heavily on accountants to perform their duties with due care and diligence. The SEC has only so many resources that it can exert to ensure financial statements are accurate and present fairly a company's financial position. Therefore, the SEC must have confidence that all public and private accountants are competent and that the auditors are independent providers. Investors utilize financial statements to estimate their risk and return and ultimately to make informed decision about what companies to invest in. If financial numbers are wrong or important disclosures are not made, investors could lose a large amount of money. In addition to the loss of money, a large financial statement error or omission because of an incompetent accountant "can damage the Commission's processes and erode investor confidence… "("Final Rule", 1998, section II, part B, para. 4). In the case that an accountant fails to perform his/her duties, whether intentional or due to negligently, they may be reprimanded by the SEC's enforcement division.

Rule 102(e) in the SEC's rules of practice deals with the suspension and disbarment of professionals. Rule 102 (e)(1) states that generally the" Commission may censure a person or deny, temporarily or permanently, the privilege of appearing or practicing before it in any way to any person who is found by the Commission after notice and opportunity for hearing in the matter…" ("Rules of Practice", 2017). The circumstances for which the Commission may impose these penalties include: not properly possessing the necessary qualifications to represent others, lacking character or integrity or participating in unethical or improper professional conduct, or willfully violating or aiding in the violation of federal securities laws or other rules and regulations set forth by the SEC ("Rules of Practice", 2017). In 1998, an amendment was made to the Rule 102 (e). The amendment was created to clarify what was meant by "improper professional conduct" as applied to accountants. The meaning that was clarified by the SEC is intentional or knowing conduct, including reckless conduct, that results in a violation of applicable professional standards; or either a single instance of highly unreasonable conduct that results in a violation of applicable professional standards in circumstances in which an accountant knows, or should know, that heightened scrutiny is warranted; or repeated instances of unreasonable conduct, each resulting in a violation of applicable professional standards, that indicate a lack of competence to practice before the Commission. ("Final Rule", 1998, section I, para. 4)

If a defendant is charged with violating Rule 102 (e), they may be suspended permanently from practicing before the Commission, suspended permanently with the possibility for reinstatement after a specified period, or temporarily suspended. The difference between a permanent suspension with a possibility for reinstatement and a temporary suspension is that a permanent suspension will continue to be permanent unless the respondent applies for reinstatement whereas a temporary suspension allows the respondent to immediately begin practicing before the commission once the suspension period has ceased. The Commission will allow a reinstatement hearing for individuals who were suspended permanently and whose specified period has lapsed. The individual in question may apply for reinstatement "as a preparer or reviewer, or as a person responsible for the preparation or review, of financial statements of a public company to be filed with the Commission" (SEC Release No. 63061, 2010, para. 1). A reinstatement will be granted "for good cause shown" which is determined on a case by case basis and is determined solely by facts. If the defendant has submitted an application showing compliance with the terms of the original suspension and "no information has come to the attention of the Commission relating to character, integrity, professional conduct or qualifications to practice before the Commission that would be a basis for adverse action," then the Commission will grant reinstatement (SEC Release No. 63061, 2010, para. 5). If "good cause" is not shown, or if an individual does not apply for reinstatement, the permanent suspension will persist.

The data collected on the eight accounting and financial related frauds revealed eight CPA's charged with the violation of Rule 102 (e). All the CPA's charged were either permanently suspended or permanently suspended with the right to apply for reinstatement after a certain period. Three out of the eight CPA's were permanently suspended with no chance for reinstatement and the other five were suspended with the chance for reinstatement after a specified time period. This suspension period ranged between 12 months and 10 years depending on the severity of the crime committed. Two out of the five respondents that were allowed to apply for reinstatement after a specified time period applied for and were ultimately granted reinstatement to practice before the Commission. One case of reinstatement examined was the case of *SEC v. Michael S. Joseph* in 2006. Joseph was accused of violating "certain antifraud, reporting, and recordkeeping provisions of the federal securities laws, as well as auditor independence standards, while he was a partner in the national office of Ernst & Young LLP" (SEC Release No. 63061, 2010, para.3). Joseph developed and marketed a product for one of his E&Y clients, American International Group, Inc. and then worked with an E&Y audit team to advise another E&Y client, PNC, on the accounting treatment on a version of that product. PNC improperly excluded certain assets from its financial statements because of Joseph's advice. As a result of his violations, Joseph was permanently suspended from appearing or practicing before the Commission with the right to apply for reinstatement after three years. In December of 2010, Joseph applied for reinstatement as an accountant responsible for the preparation or review of financial statements to be filed with the SEC. Joseph was granted the reinstatement for “good cause shown” (SEC Release No. 63061, 2010).

Investors’ and the SEC’s reliance on financial statements and on the integrity of accountants is a strong argument for the necessity of harsh penalties on CPA’s who have violated provisions of the federal securities laws or auditors who have violated auditor independence standards. All accountants who have been convicted by the SEC of professional wrongdoing should be permanently suspended with no chance for reinstatement. Imposing harsher penalties on perpetrators have a greater deterrence effect on wrongdoing and, therefore, help to diminish future occurrences of similar misconduct. CPA’s charged by the SEC for any type of violation should never be able to practice before the Commission again because it may erode investor confidence in the reliability of financial statements. The SEC’s mission is to “protect investors, maintain fair, orderly, and efficient markets, and facilitate capital formation” (“What We Do”, 2013, para. 1). If violators are allowed to have their right to practice before the commission reinstated, the SEC is not properly protecting investors from the risk of relying on inaccurate financial statements. CPA’s charged with wrongdoing should not be allowed to have the right for reinstatement to practice before the Commission to ensure they will not perpetrate any additional acts of committing or aiding in fraud.

Disgorgement and Civil Penalties

Public companies and individuals associated with those companies who have committed fraudulent crimes in violation of the laws that govern the securities industry are subject to monetary penalties imposed by the SEC. The monetary penalties imposed on these individuals or public companies are issued in the form of either disgorgement or civil penalties. Disgorgement as defined by the Legal Information Institute is "a remedy requiring a party who profits from illegal or wrongful acts to give up any profits he or she made as a result of his or her illegal or wrongful conduct" (2015). In contrast, a civil monetary penalty is defined in relevant part as any penalty, fine, or other sanction that: (1) is for a specific amount, or has a maximum amount, as provided by federal law; and (2) is assessed or enforced by an agency in an administrative proceeding or by a federal court pursuant to federal law. ("Final Rule: Adjustments to Civil Monetary Penalty Amounts", 2001)

Disgorgement has been used by the SEC as an equitable remedy for criminal wrongdoing since the 1970's. The SEC was never specifically granted the right to impose disgorgement until 1990, but "the SEC and courts justified its use based on courts' inherent 'equity powers'" (Liman, Solomon, & Cleary Gottlieb Steen & Hamilton LLP, 2017, para. 3). In 1990, the SEC was authorized to seek disgorgement in administrative proceedings under the Securities Enforcement Remedies and Penny Stock Reform Act of 1990 (Buckberg & Dunbar, 2008). The doctrine of disgorgement has been subject to two main arguments over the past few decades: whether it should be solely compensative or partially punitive, and how it should be calculated.

The purpose of disgorgement has long been debated with strong arguments on each side. The case for a purely compensative disgorgement has been made with the argument that it has "its roots in the traditional equitable remedies of restitution and recoupment and, therefore, is not intended to punish the defendant" (Buckberg & Dunbar, 2008, p.350). Some district courts have ruled on this side, finding that disgorgement has a remedial purpose and is not a "penalty or forfeiture" (Liman et al., 2017, para. 5). On the other hand, the longstanding argument for disgorgement as a penalty is that it is imposed, in part, as a deterrence from wrongdoing and, therefore, should be seen as being punitive. In 2017, a landmark decision by the U.S. Supreme Court was made that ceased any further disagreement about the purpose of disgorgement. In the case of *Kokesh v. SEC*, Kokesh an investment advisor was accused of misappropriating nearly $35 million between 1995 and 2009. The SEC took Kokesh to trial for the crime in 2014, seeking disgorgement of the full $35 million. Kokesh argued that $30 million was misappropriated more than 5 years before the 2014 lawsuit and, therefore, he was only responsible for the $5 million, citing 28 U.S.C. § 2462 which "imposes a five-year statute of limitations for any action, suit, or proceeding for the enforcement of any civil fine, penalty or forfeiture" (Liman et al., 2017, para. 3). Both the District Court of New Mexico and the Tenth Circuit Court of Appeals ruled in the SEC's favor, concluding that disgorgement is not considered a penalty and therefore is not subject to the statute of limitations.

The case was ultimately brought to the U.S. Supreme Court, where it was determined that SEC's disgorgement is in fact a penalty and so it is subject to the five-year statute of limitations. The Supreme Court Justice Sotomayor, acting for a unanimous court, looked at two factors to determine if the sanction was considered a penalty, "first, whether it redresses harm to individuals or the public at large, and second, whether it deters conduct or compensates victims for their loss" (Liman et al., 2017, para. 9). Considering the first factor, Justice Sotomayor found that the SEC brings lawsuits for the government and their purpose is to "remedy harm to the public at large" (Liman et al., 2017, para. 9). As for the second factor, Justice Sotomayor found that in many cases the disgorgement funds are sent to the U.S. Treasury and not directly to the victims (Liman et al., 2017, para. 9).

As a result of the 2017 *Kokesh v. SEC* ruling, there will be tighter deadlines for the SEC to seek disgorgement funds from fraud perpetrators. If a minimum of five years have passed from the time a crime is committed to when the SEC brings about an administrative proceeding on the issue, disgorgement is no longer allowed.

The second argument regarding how to calculate disgorgement is largely unresolved. The disagreement to be resolved- profits or proceeds theory of unjust enrichment should be used when calculating disgorgement. The profits theory of unjust enrichment allows for the offsetting of applicable expenses from the revenue obtained from the wrongdoing. On the other hand, the proceeds theory disallows any offsetting of revenue illegally obtained. The allowance of offsetting illegal profits by “direct transactional costs” and “general business expenses” has varied greatly between district courts and has been largely determined on a case-by-case basis.

Pro-offsetting cases have been the most successful in the jurisdiction of the second circuit. Many of these courts have held that “direct transactional costs, such as brokerage fees, commissions, or price premiums, are valid offsets” (Kirk, 2015, p.137). The argument to reduce illegally obtained profits by general business expenses has been more unconvincing because of the often extensive and subjective estimates as to how they are allocated to the illegal profits. The anti-offsetting case headed by the SEC has been made with the belief that the offsetting of any expenses incurred in the obtainment of illegal profits should not be allowed. In the case of *SEC v. Kenton Capital, Ltd*. the D.C. district courts ruled that “[defendants] may not escape disgorgement by asserting that expenses associated with this fraud were legitimate” (Kirk, 2015, p.137). Courts have generally held that the SEC is entitled to a disgorgement amount that is based on a “reasonable approximation” of illegal profits (Buckberg & Dunbar, 2008). If the defendant believes that the disgorgement amount stated by the SEC is not reasonable then the burden of proof is on the defendant to prove otherwise (Buckberg & Dunbar, 2008).

The Supreme court ruling on *Kokesh v. SEC*, deciding that disgorgement is punitive in nature, will likely influence the calculation of disgorgement. Since disgorgement is now considered punitive instead of compensative, courts will likely reject many offsets to disgorgement proposed by the defendants. Allowing fewer offsets to disgorgement will increase the amount paid by wrongdoers, therefore increasing the deterrence effect of wrongdoing.

Based on analysis of the SEC’s AAER database from the fourth quarter of 2010, five out of the eight cases examined involved individuals who were ordered to pay disgorgement. These five cases showed that generally disgorgement is significantly less than illegal profits obtained from wrongdoing. For example, in the case of *SEC v. Comverse Technology*, the former CEO, CFO, and directors were accused of “engaging in a decade-long fraudulent scheme to grant in-the-money options to themselves and to others by backdating stock option grants to coincide with historically low closing prices of Comverse common stock”(“SEC Charges Former Comverse Technology, Inc”, 2006, para. 1). The former CEO, Jacob Alexander, was found to have actual gains of almost $138 million from sales of stock underlying the exercises of backdated options. Alexander was charged with disgorgement of only $47.6 million for his crime. Similarly, the former CFO, David Kreinberg, had actual gains of $13 million but was only required to pay approximately $1.8 million in disgorgement (“SEC Settles Options Backdating Case”, 2010).

Civil penalties are another monetary sanction that can be imposed on anyone who violates or aids in the violation of securities laws. Unlike disgorgement, the purpose of civil penalty is not to disgorge profits, but instead to penalize for the wrongdoing. The civil penalty dollar amounts per "each act or omission" of violating securities laws are outlined in penalty statutes that contain "tiers" of violations and the maximum dollar amounts for each tier for both individuals and entities. The tiers are ranked by specificity of wrongdoing. The first tier pertains to any type of violation of securities law, the second tier specifies a violation that involves "fraud, deceit, manipulation or deliberate or reckless disregard of regulatory requirement", and the third tier is a violation that "also involves a substantial risk of loss to others or gain to the violator" (Eisenberg & K&L Gates LLP, 2016). The tier dollar amounts are directly related to the tier numbers. In other words, as tiers increase, the maximum penalty amount increases. The tier dollar amounts are changed each year to account for inflation. The most current amounts posted by the SEC as of January 15th, 2018, range from $8,458 for individuals who have committed a tier one violation and up to $905,353 for entities who have committed a tier 3 violation (Inflation "Adjustments to the Civil Monetary Penalties", 2017).

Although calculation of civil penalties is seemingly straightforward, there are still disagreements on what is considered a separate "act or omission." The maximum civil penalty dollar amounts can be greatly varied if a "separate act or omission" is in one case considered to be appropriate for each misled investor while in another case all of the conduct within the case considered to be one "act or omission." Most cases have been shown to use the latter choice of calculating the maximum monetary penalty. In many cases the number of affected investors, the number of reporting errors, or the number of misleading communications can be excessively large and there may be concern that using these types of multipliers may violate the eighth amendment prohibition against excessive fines; therefore, most cases have used one-to-few multipliers when calculating maximum penalty amounts (Eisenberg & K&L Gates LLP, 2016).

New legislation by bipartisan senate members was proposed in March of 2017 to "increase civil and administrative monetary penalties for securities laws violations" (Congress gov). The proposed act is aptly named "Stronger Enforcement of Civil Penalties Act of 2017" and also proposes adding a fourth tier of civil penalties that would pertain to a person or entity that "(1) was criminally convicted for securities fraud; or (2) became subject to a judgment or order imposing monetary, equitable, or administrative relief in a Securities and Exchange Commission (SEC) action alleging fraud" (U.S. Senate, Banking, Housing, and Urban Affairs, 2017). The act would significantly increase the maximum penalty amounts; the act would increase the highest possible maximum penalty amount for individuals from the existing $181,071 per violation to $1 million and for entities from the current $905,353 to $10 million ("Senators Introduce Bipartisan SEC Penalties Act", 2017).

According to the sample collected from the AAER database of companies accused of accounting and financial related frauds, five~~three~~ of the eight cases examined involved individual and company civil penalties. These five~~three~~ cases showed how comparatively insignificant the civil monetary penalties are to the dollar amount of wrongdoing. In the case of *SEC v. Delphi Corporation*, numerous Delphi executives engaged in fraudulent schemes that spanned from 2000 to 2004. In fiscal year 2000, the executives hid a $237 million warranty claim asserted by its former parent company and ultimately inflated its net income by $202 million. In 2001, the company was accused of improperly accounting for a $20 million loan "as if it was a nonrefundable rebate on past business, rather than a liability" in order to meet forecasted earnings ("SEC Charges Delphi Corporation", 2006, para. 4). The company also hid nearly $325 million in factoring of accounts receivables to materially overstate its "Street Net Liquidity" which was a pro forma measure that was relied upon by numerous investors and analysts from

2003 to 2004. In total, nine executives from the company were charged in the case including prominent top executives like the company's CEO, CFO, and controller. The civil penalties for the individuals ranged from $16,500 to $300,000 with the total civil penalties in the case amounting to a mere $669,300 ("SEC Charges Delphi Corporation", 2006). For four years of fraudulent manipulation involving hundreds of millions of dollars, the dollar amount of civil penalties imposed is quite meager. The modest monetary punishment in this case was reminiscent of the other four ~~two~~ cases examined.

Deterring fraudulent wrongdoing is the foremost reason for imposing civil penalties; therefore, penalties should be harsh enough to accomplish this task. With current guidelines for individual maximum monetary penalties set at $181,071 per act or omission while some fraudulent acts involve hundreds of millions of dollars, a strong deterrence effect may not be achievable. Allowing and encouraging harsher maximum penalties for wrongdoers whose fraudulent acts involve big money is necessary to properly punish companies and individuals while signaling to all that fraudulent crimes will not be taken lightly. Passage of the proposed "Stronger Enforcement of Civil Penalties Act of 2017" would increase maximum penalties nearly ten-fold in some cases, allowing for greater deterrence and more appropriate monetary punishment for big money cases.

Part 3- Current Challenges and Impediments to the SEC Enforcement Process

Lack of Funding

One major issue for the SEC that seems to be an ongoing problem is the lack of resources the Commission has in comparison to the responsibilities the agency carries. The SEC is appropriated a funding amount from Congress each year which the Commission relies upon to sustain and grow its initiatives. In order to receive this funding, the SEC submits a budget request to Congress and the President each year for the following fiscal year's funding. In the request, the Chairman of the Commission discusses the significant obligations of the agency along with what the agency has achieved during the last budget period and what new priorities are expected in the upcoming year.

The SEC is unique when it comes to its funding. The SEC's funding is deficit neutral in that the amount Congress appropriates to the agency does not have an impact on the nation's budget deficit nor does it impact the amount of funding available to other agencies. This situation exists because the collection of fines and penalties received from various securities transactions offset the SEC's funding ("Testimony on the Fiscal Year 2016", 2015). The amount of money provided to the government from the agency exceeds that given to the agency with the excess money allocated to the U.S. Treasury Department. Despite this budgetary neutrality, the SEC has continuously been denied increases in funding as requested in the yearly budgetary requests. For instance, in the yearly budgetary request for 2016, the Commission asked for 1.722 billion dollars in funding for the year but only received $1.605 billion. The Commission has been strained for funding in recent years, and in a comparison of actual obligations versus budget authority after 2010 shows that in four out of seven years, actual obligations exceeded budget authority ("Budget History", 2017).

Former Chairman of the Commission, Mary Jo White, in her budget request testimony for fiscal year 2016, pointed out that since 2001, assets under management of SEC-registered investment advisers increased by approximately 254 percent from $17.5 trillion to approximately $62 trillion and the SEC's responsibilities have also dramatically increased, adding or expanding jurisdiction over securities-based swaps, private fund advisers, credit rating agencies, municipal advisors, and clearing agencies, among others. (“Testimony on the Fiscal Year 2016”, 2015, para. 3) The SEC adopted 67 mandatory rulemaking provisions of the Dodd-Frank Wall Street Reform and Protection Act passed in 2010, established five new offices, and has issued more than 30 studies and reports required under the new act (“Implementing the Dodd-Frank”, n.d.). The Enforcement Division is particularly hampered with enforcing the new market rules of the Dodd Frank Act. In 2013, one of the specific requests in the president's budget for the following fiscal year was for additional trial attorneys. Mary Jo White criticized this request by commenting, “we can't judge at this point how many additional trials we're going to have, but we already don't have enough [lawyers]” (Finkle, 2013, para. 3).

Maintaining adequate resources is crucial for the SEC to pursue companies and individuals that violate securities’ rules. The added workload of responsibilities from new legislation like the Dodd-Frank Act, combined with the inability to hire new staff due to the unsatisfactory budget allocation, poses an extensive limitation for the agency.

Administrative Proceedings

An additional threat to the power of the SEC has increasingly been the scrutinization of the Commissions increased use of, and broadened authority of its administrative proceedings. According to the agency, utilizing administrative proceedings rather than pursuing the more formal route of a civil suit, has some notable advantages. Specifically, the procedures are more streamlined; and, according to former Director of Enforcement, Andrew J. Ceresney, administrative law judges "develop expert knowledge of the securities laws, and the types of entities, instruments, and practices that frequently appear in our cases, and the litigation period is often much shorter and less costly than that of a civil proceeding" (Platt, n.d., p. 6).

The administrative proceedings do lack several protections and advantages that are provided to defendants in civil courts: "there is limited discovery, the Federal Rules of Evidence do not apply, and SEC proceedings arguably do not offer adjudication by a neutral arbiter (or a jury)" (Halper, 2016, para. 4). These disadvantages to defendants; and the fact that the SEC has increased its use of these administrative proceedings due to provisions in the Dodd-Frank Act has initiated a wave of criticisms and constitutional challenges (Platt, n.d.).

As of 2015, twelve different suits have been filed by individuals facing charges in administrative proceedings. These cases attack a multitude of different features of the administrative proceedings process including the "use of ALJs, the comingling of prosecutorial and adjudicative functions, the availability of monetary penalties and other sanctions, and the use of procedures less protective than the Federal Rules of Civil Procedure" (Platt, n.d., p. 11).

One major constitutional challenge generated by defendants is that of Article II under the Appointments Clause which questions the power of the SEC's ALJ's. Under this clause an "Officer" must be appointed by either the president, the Senate, Courts of Law, or Department heads ("The 2nd Article", n.d.). The SEC ALJ's are currently appointed by the SEC's Office of Administrative Law Judges so, if it was determined by the Supreme Court that ALJ's are indeed "Officers," then the use of ALJ's in administrative proceedings would be deemed unconstitutional. Courts have often looked at the ALJ's ability to deliver final decisions as an indicator of the role of an "officer." In the *Lucia* court, it was found that the ALJ's decisions are not final because the SEC commission has the power to overturn their decisions. On the contrary, the Tenth Circuit Court of Appeals in *Bandimere v. SEC* ruled that the ALJ's were in fact inferior officers subject to the appointments clause. This court based its decision on the ALJ's duties rather than their decision-making abilities (Good, Hurtado, & Pillsbury Winthrop Shaw Pittman LLP, 2017*)*. The future of ALJ's is uncertain and will be most likely addressed by the supreme court or in future legislation.

Many other complaints have been cited regarding the perceived unfairness of the administrative proceeding process. One complaint is that there are tight deadlines imposed on ALJ's to issue an initial decision whereas the division investigative process is often very lengthy in comparison. Also, discovery may be more limited for individuals being prosecuted in the administrative forum which may hinder their ability to obtain exculpatory evidence. Another common complaint cited is that depositions, a common part of the discovery process in civil court, are not allowed in an administrative proceeding unless the witness will not be available to testify at the administrative hearing (Choi & Pritchard, 2017, p. 13).

The SEC has responded to these criticisms of its unfairness to defendants in the administrative process by revising some of its Rules of Practice. In 2016, the SEC announced the adoption of several new amendments to its process. The amendments included extending the prehearing period from four months to a maximum of ten months for certain cases, allowing lengthiest trials the right to notice three depositions on each side in single-respondent cases and five depositions per side in multi-respondent cases, and excluding evidence that is irrelevant, immaterial, or unreliable among other changes used to clarify and conform changes to other rules ("SEC Adopts Amendments", 2016).

The numerous criticisms pose a great threat to the public opinion and legitimacy of the administrative proceedings process. The criticisms of the SEC administrative process still largely remain, despite the reforms implemented by the commission to curb them. Many critics of the process say the reforms do not eliminate the inherent biases of the administrative process and still do not make an administrative action equivalent to that of a federal court action (Choi & Pritchard, 2017). Although unable to appease all critics, the SEC has continued to address and respond to complaints appropriately and make reforms where applicable to ensure the fairness and accuracy of its proceedings and attempt to enhance, rather than diminish, the public's perception of the enforcement division. Maintaining a successful and positive reputation is also critical to receiving the funding needed to sustain the Commission.

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