Corporate Penalties

In-House News:

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The U.S. Securities and Exchange Commission released the "Statement of the SEC Concerning Financial Penalties" on Jan. 4, 2006, which authorizes the government to impose civil money penalties on public companies.

After the wave of large corporate scandals, the SEC enforced 2002's far-reaching Sarbanes-Oxley Act in an attempt to boost investor confidence. However, this recent amendment to SOX, which publicly reintroduces corporate penalties, has stirred great controversy.

Although the SEC has just released the "Penalties Statement" earlier this year, corporate penalty is nothing new. The Commission gained the power to penalize public companies when Congress passed the Remedies Act in 1990.

Following the Enron debacle, the SEC's high-priced penalties have raised a few eyebrows and questions. In July 2003, WorldCom Inc. settled its lawsuit by paying $750 million in penalties. In March 2005, America Online, Inc. was penalized with $300 million.

The Metropolitan Corporate Counsel commented on the settled enforcement actions, saying that the "Commission's record on assessing penalties is uneven, creating uncertainty in two critical respects, *first*, as to the

circumstances likely to result in the SEC's demand for a significant civil penalty and, *second*, how the Commission determines the amount of a penalty."

The expressed goal of the "Penalties Statement" was to "provide the maximum possible degree of clarity, consistency, and predictability in explaining the way that its corporate penalty authority will be exercised."

To clarify and create consistency, the Commission provided a list of factors that would determine whether a public company would be penalized. The two main provisions include "the presence or absence of a direct benefit to the corporation as a result of the violation" and "the degree to which the penalty will recompense or further harm the injured shareholders."

The SEC shows their principles in action by contrasting the enforcement actions of McAfee Inc. and Applix Inc.

Both companies are alleged with overstating its revenue and keeping fraudulent records.

McAfee must pay $50 million civil penalties while Applix pays nothing.

In a speech to the SEC staff, Linda Chapman Thomsen, Director of SEC's Division of Enforcement, explained the key factors that shaped the two different outcomes.

McAfee's misconduct was pervasive and continued for almost three years whereas Applix's misconduct was more limited. McAfee's scandal resulted in inflated revenues of $622 million and understated losses of $353 million while

Applix's scheme resulted in the improper recognition of $1,239,000.

McAfee can afford to pay its penalty without inflicting undue hardship to its shareholders; Applix can't.

Furthermore, the sum of McAfee's penalty is large enough to provide economical distribution without incurring undue hardship on its shareholders. The bottom line: Applix's penalty, if any were imposed, would be more detrimental than beneficial for its shareholders.

Although the Commission has drawn out guidelines on when to impose corporate penalties, how the Commission will evaluate a corporation's potential benefit and its shareholder's potential harm still remains ambiguous.

Sidley Austin, an international law firm, noted in their scholarly report, "In a typical public company financial fraud, [] the shareholders who benefited from the fraud most likely sold their stock long ago—at the inflated prices driven by the company's misrepresentations.

"The current shareholders generally are innocent—either the ones who remained as the stock price plummeted after the announcement of a restatement, or who bought later at a depressed value."

Sidley Austin continued, "Thus, to some extent, a civil penalty typically will harm current shareholders or, at best, amount to a wash if the SEC sets up a Fair Fund to allocate the penalty to victims."

Despite the SEC's attempt to deter corporate malfeasance and encourage the

establishment of good compliance programs, many in the Commission itself—contrary to Chairman Christopher Cox's claim of having "unanimous agreement"—are split over the issue of corporate penalty.

Commissioner Paul Atkins and Cynthia Glassman have openly criticized SEC's corporate penalties. Glassman said, in a June 2005 speech, that "there has been disagreement among us on the appropriateness of imposing corporate penalties, which, at the end of the day, are paid by shareholders."

Glassman continued, "I cannot justify imposing penalties indirectly on shareholders whose investments have already lost value as a result of the fraud."

Although SOX's Fair Funds provision allows the Commission to disgorge corporate penalty moneys to compensate negatively afflicted investors, there have been unforeseen complications to the money's distribution.

The Government Accountability Office reported in Aug. 2005 that the SEC has "designated over $4.8 billion in [civil money penalties] and disgorgements to be returned to harmed investors" in April 2005.

However, very little of that collection has been disgorged to defrauded investors. The GAO said, "At the time of our review, although SEC has collected money for 73 of the 75 cases they identified, approximately $60 million from only three cases have been distributed to harmed investors, and funds totaling about $25 million from only one other case were being readied for distribution." The rest of that money is kept in the Treasury.

The distribution of money has been impeded by the fact that the SEC did not have a method to systematically track their orders, collections, and distributions.

The GAO report continued, "The SEC does not have a formal mechanism to assess whether the increased collection resources are being used effectively. [] Without a formal process for determining the effectiveness of the increased resources, SEC cannot validate these benefits."