PUBLIC COMPENSATION FOR PRIVATE HARM: EVIDENCE FROM THE SEC'S FAIR FUND DISTRIBUTIONS

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The SEC's primary goal is enforcing compliance with securities laws. Almost as important but less visible is the SEC's rise as a source of compensation for defrauded investors. The Sarbanes-Oxley Act in 2002 expanded the SEC's ability to compensate investors by allowing the agency to distribute collected civil fines through fair funds.

Based on a couple of well-known cases, fair fund distributions have been derided as a smaller, feebler version of private securities litigation—a waste of the SEC's resources on repetitive cases. This is the first empirical study to examine the population of 236 fair funds created between 2002 and 2013, through which the SEC will distribute $14.33 billion to defrauded investors. Contrary to conventional wisdom, the study finds that the SEC's distributions are neither small nor, for the most part, an inefficiently circular transfer from shareholder victims to themselves. Two-thirds of fair funds compensate investors for what can best be described as consumer fraud or anticompetitive behavior by financial intermediaries.

Importantly, the study also reveals that private and public compensation for securities fraud are not coextensive. More than half of the time, the SEC compensates investors for losses where a private lawsuit is either unavailable or impractical. The Article thus exposes the limits of private securities litigation as an investors' remedy. The rise of public compensation, such as the SEC's distribution funds, fills a void in securities laws, which leaves many victims with no private remedy.

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TABLE OF CONTENTS

INTRODUCTION

The SEC's success is conventionally measured by the number of enforcement actions it brings, the multimillion-dollar fines it secures, and the high-impact trials it wins.[1] But the SEC does not just punish wrongdoing.

1. *See e.g.*, Jean Eaglesham, *SEC Pads Case Tally With Easy Prey*, WALL ST. J., Oct. 17, 2013, at C1 (explaining that enforcement "numbers matter to the agency"); Joshua Gallu, *Tourre Case Buoys SEC as Congress Weighs Funding*, BLOOMBERG, Aug. 5, 2013, http://www.bloomberg.com/news/2013–08–05/sec–gets–shot–in–the–arm–with–victory–in–tourre–

Over the last twelve years, the SEC has quietly become an important source of compensation for defrauded investors.[2] Since 2002, the SEC has distributed $14.33 billion[3] to defrauded investors through 236 distribution funds, usually called "fair funds" after the statute that authorizes them.[4] To put the figure into context: the aggregate amount distributed through fair funds over the past decade is substantially larger than the SEC's budget over the same period,[5] and greater than the combined budgets of Congress and the federal judiciary for the fiscal year 2013.[6]

The fair fund provision allows the Commission to distribute civil fines and disgorgements of ill-gotten profits collected from defendants it prosecutes. Other federal agencies also distribute to victims the funds they collect from defendants;[7] the Commodity Futures Trading Commission,[8] the

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case.html.

2. *See* 2009 SEC PERFORMANCE AND ACCOUNTABILITY REPORT 11 (2010); 2011 SEC PERFORMANCE AND ACCOUNTABILITY REPORT 2 (2012) [hereinafter SEC 2011 PAR]; U.S. SECURITIES & EXCH'N COMM., FISCAL YEAR 2012 AGENCY FINANCIAL REPORT 41 & tbl.1.10 (2013).

3. Unless otherwise specified, all figures are in 2013 dollars.

4. The Federal Account for Investor Restitution (FAIR) Fund Act is included in section 308 of the Sarbanes–Oxley Act of 2002. 15 U.S.C. § 7246. The SEC compensates investors in a variety of ways, not just through fair funds, though fair fund distributions are the largest public source of investor compensation. Other ways in which the SEC compensates investors include disgorgement funds, receiverships, coordinated prosecutions, and clawback actions. Disgorgement funds are SEC–administered distribution funds where the defendant is assessed no civil fine, does not pay the fine imposed, or is ordered to pay the fine to the U.S. Treasury. The SEC also pursues emergency actions in court to stop offering frauds and Ponzi schemes. These cases are usually resolved and recovered funds distributed through bankruptcy or quasi–bankruptcy proceedings, including equity receivership. The entity used to perpetuate the fraud is always deeply insolvent, and so most funds are ordinarily recovered from "relief defendants," persons who are not wrongdoers but received ill–gotten funds without legitimate claim to those funds. *See* Andrew Kull, *Common–Law Restitution and the Madoff Liquidation*, 92 B.U.L. REV. 939, 950 & n.42 (2012). Finally, the SEC frequently coordinates its enforcement actions with other agencies, including the Department of Justice, state securities regulators and prosecutors, and FINRA (formerly NASD), which sometimes result in a distribution in the parallel action, but not in the SEC enforcement action. For instance, in the case against Bernard L. Madoff Investment Securities LLC alone, the DOJ will return $2.4 billion to defrauded investors recovered in criminal actions against perpetrators, with another $9 billion recovered from relief defendants in a SIPA–administered receivership. *See* Madoff Victim Fund, Frequently Asked Questions, Q26, http://www.madoffvictimfund.com/FAQ.shtml/ (explaining the difference between recoveries in receivership from Madoff's entity and the DOJ's forfeiture).

5. The SEC's budgets between 2003 and 2013 amounted to $12.04 billion (in 2013 dollars). *See* U.S. Sec. & Exch. Comm'n, Frequently Requested FOIA Document: Budget History – BA vs. Actual Obligations, http://www.sec.gov/foia/docs/budgetact.htm.

6. In addition to funding the House and the Senate, congressional spending includes the Library of Congress, the Government Accountability Office, U.S Tax Court and the not insignificant Capitol Police. *See* U.S. TREASURY, BUREAU OF THE FISCAL SERVICE, FINAL MONTHLY TREASURY STATEMENT OF RECEIPTS AND OUTLAYS OF THE UNITED STATES GOVERNMENT 7 (2013), *available at* http://www.fms.treas.gov/mts/mts0913.pdf.

7. Unlike other federal agencies, the SEC is authorized to distribute civil fines in addition to disgorged assets to injured investors through fair funds, increasing the aggregate dollar amount available for victim compensation. *See* Barbara Black, *Should the SEC Be a Collection Agency for*

Federal Trade Commission,[9] and the Department of Justice,[10] among others, have the authority to distribute ill-gotten gains recovered from defendants to their victims (but not civil fines).[11] But the SEC's distributions are of particular interest because they are the most extensive and sustained effort by a public agency to compensate the victims of misconduct.[12]

Despite the SEC's enthusiasm for the fair funds provision,[13] the high aggregate dollar amount distributed, and the number of funds, the SEC's compensation efforts have been neglected by scholars, policy-makers, and the press.[14] At best, commentators have derided the SEC's contribution off-hand as an insignificant supplement to private securities litigation, and just as flawed: a socially wasteful transfer of funds from one set of innocent shareholders to another.[15] At worst, they have criticized the SEC for

Defrauded Investors?, 63 BUS. LAW. 317, 319 (2008). The Miscellaneous Receipts Act requires agencies to deposit any money they receive, including civil fines they collect, "in the Treasury as soon as practicable without deduction for any charge or claim." 31 U.S.C. § 3302(b). That does not necessarily preclude an agency from structuring its settlement with the defendant in such a way to compensate the victims. The Office of the Comptroller of the Currency (OCC) reached a settlement with large mortgage servicers for widespread deficiencies in foreclosure practices and imposed a $394 million civil fine. By law, the OCC could not itself distribute the civil fine to injured borrowers. Instead, the OCC agreed to hold those penalties in abeyance to the extent the servicers compensated borrowers as much as the civil fine amounts that the OCC would otherwise assess. OFFICE OF THE COMPTROLLER OF THE CURRENCY, INTERIM STATUS REPORT: FORECLOSURE–RELATED CONSENT ORDERS 6 (2012), *available at* http://www.occ.gov/news–issuances/news–releases/2012/2012–95a.pdf.

8. See 7 U.S.C. § 18 (2006); Rules Relating to Reparations, 17 C.F.R. part 12 (2008) (describing the CFTC Reparations Program).

9. *See* FTC v. Mylan Lab Inc., 62 F. Supp. 2d 25, 36–37 (D.D.C. 1999) (holding that FTC is able to "pursue monetary relief" in civil actions); Stipulated Final Judgment and Order for Permanent Injunction and Other Equitable Relief as to Defendants Lifelock and Davis, FTC v. LifeLock, 2:10–cv–00530–MHM (D. Ariz. Mar. 15, 2010) (final judgment and order awarding $11 million to consumers).

10. The Mandatory Victims Restitution Act of 1996 mandates restitution to (1) victims of violent crimes of a crime of violence, as defined in 18 U.S.C. § 16; (2) victims of an offense against property under title 18, including any offenses committed by fraud or deceit; and (3) victims of offenses defined in 18 U.S.C. § 1365, relating to tampering with consumer products. *See* 18 U.S.C. § 3663A(c)(1)(A)–(B).

11. *See* Black, *supra* note 7, at 319 n.13; Adam S. Zimmerman, *Distributing Justice*, 86 NYU L. REV. 500, 527 (2011).

12. A back–of–the–envelope comparison of collections and fair fund distributions between 2004 and 2012 suggests that the SEC distributed between 75 and 90% of all collected sanctions.

13. The SEC's enforcement director has described the Fair Funds Act as "one of the most frequently used tools" created by the Sarbanes–Oxley Act. Linda C. Thomsen & Donna Norman, *Sarbanes–Oxley Turns Six: An Enforcement Perspective*, 3 J. BUS. & TECH. L. 393, 411 (2008).

14. The two exceptions include articles by Professors Barbara Black and Verity Winship. Black, *supra* note 7; Verity Winship, *Fair Funds and the SEC's Compensation of Injured Investors*, 60 FLA. L. REV. 1103, 1127 (2008).

15. *See e.g.*, Black, *supra* note 7, at 335; William W. Bratton & Michael L. Wachter, *The Political Economy of Fraud on the Market*, 160 U. PA. L. REV. 69, 139 (2011); John C. Coffee, Jr., *Reforming the Securities Class Action: An Essay on Deterrence and Its Implementation,* 106 COLUM. L. REV. 1534, 1538 (2006); Roberta S. Karmel, *When Should Reliance Be Presumed in*

"wast[ing] resources on repetitive cases,"[16] lacking a "coherent policy" regarding distributions,[17] burdening courts with "tortured restructuring and embarrassing consequences" of poorly drafted distribution plans,[18] and frustrating remedies available to creditors in bankruptcy.[19]

Until this study, there has been no inquiry into how the SEC has exercised its fair fund authority.[20] Relying on an analysis of all fair funds created to date, the Article provides the first comprehensive assessment of the SEC's compensation efforts, supplying the missing empirical foundation to inform the debate about administrative compensation programs like the SEC's fair funds. The study's findings suggest that a couple of controversial fair fund cases animate the scholarly and popular critiques, but these selected anecdotes are not representative of the class.[21]

In addition to the primary observation that the SEC distributes a surprisingly large amount of money to harmed investors through fair funds, often making defrauded investors whole, the study mostly disproves the conventional wisdom.[22] Specifically, the study refutes the widespread assumption that public and private enforcement of securities laws target and compensate investors for the same misconduct.[23] Overwhelmingly, the SEC compensates harmed investors for losses where a private lawsuit is either unavailable or impractical. Relatedly, the study finds that most fair fund distributions are not inefficiently circular transfers of money from shareholders to themselves.[24] In contrast with private securities litigation,

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Securities Class Actions, 63 BUS. LAW. 25, 52 (2007).

16. Michael D. Sant'Ambrogio & Adam S. Zimmerman, *Agency Class Action*, 112 COLUM. L. REV. 1992, 1992 (2012).

17. Black, *supra* note 7, at 335.

18. Sec. & Exch. Comm'n v. Bear Stearns & Co., Inc., 626 F. Supp. 2d 402, 402 (S.D.N.Y. 2009).

19. *See* Zimmerman, *supra* note 11, at 533.

20. In fact, the author is not aware of any other empirical study of public compensation efforts by any agency.

21. *See e.g.*, Black, *supra* note 7, at 331–35 (concluding, on the basis of four case studies, that the SEC lacks a "any coherent policy" and underappreciates the consequences of large penalties, followed by fair fund distributions); Sant'Ambrogio & Zimmerman, *supra* note 15, at 2013–14 (using the Global Research Analyst fair fund as illustration of deep problems with SEC distributions); Zimmerman, *supra* note 11, at 530, 547–48 (relying on case studies of fair funds in WorldCom, AIG, Fannie Mae and the Global Research Analyst Settlement as basis for policy proposals that would govern all fair fund distributions); Winship, *supra* note 14, at 1127–28 (relying on three fair fund distributions to suggest the existence of a class–wide problem).

22. See discussion infra in Part III.A.2. *But see Harmed Investors Got Tiny Fraction of SEC Fair Funds*, WALL ST. J., Oct. 4, 2005, at D2.

23. *See e.g.*, Bratton & Wachter, *supra* note 14, at 139–40 (arguing that fair fund distributions "mimic" class actions); Sant'Ambrogio & Zimmerman, *supra* note 15, at 1992 (suggesting that agencies "waste resources on repetitive cases").

24. See discussion *infra* in Parts I.B and III.B.1. *See also* Andrew Ross Sorkin, *As JP Morgan Settles Up, Shareholders Are Hit Anew*, N.Y. TIMES DEALBOOK (Sept. 23, 2013, 8:58 PM), http://dealbook.nytimes.com/2013/09/23/as–jpmorgan–settles–up–shareholders–are–hit–

which largely targets firms for material misrepresentations, the majority of fair funds compensate defrauded investors for what can best be described as consumer fraud or anticompetitive behavior by securities intermediaries. For example, fair funds have compensated the victims of interest rate fixing,[25] undisclosed fees and false advertising,[26] collusive arrangements between investment funds and broker-dealers,[27] bribing brokers to sell overpriced investments to municipalities,[28] embezzlement,[29] mutual fund market

anew/?_r=1&; Jennifer H. Arlen & William J. Carney, *Vicarious Liability for Fraud on Securities Markets: Theory and Evidence,* 1992 U. ILL. L. REV. 691, 694–95 (1992); Coffee, *supra* note 14, at 1556–66; Merritt B. Fox, *Civil Liability and Mandatory Disclosure*, 109 COLUM. L. REV. 237, 280–81 (2009) (describing the circularity problem); Donald C. Langevoort, *Capping Damages for Open–Market Securities Fraud,* 38 ARIZ. L. REV. 639, 649 (1996). *But see* Jill E. Fisch, *Confronting the Circularity Problem in Private Securities Litigation*, 2009 WISC. L. REV. 333 (2009) (suggesting that compensation is necessary to reward traders); James J. Park, *Shareholder Compensation as Dividend*, 108 MICH. L. REV. 323 (2009) (suggesting that damages for securities fraud are no more circular than dividends); Alicia J. Davis, Are Investors' Gains and Losses from Securities Fraud Equal Over Time? Some Preliminary Evidence 31–32 (Univ. of Mich. L. Sch., Empirical Leg. Stud. Ctr., Working Paper No. 09–002, 2009), *available at* http://ssrn.com/abstract=1121198 (suggesting that many diversified investors suffer considerable losses from fraud, "not just a few outliers").

25. The SEC recently settled several actions against investment banks for fixing interest rates offered to municipalities to reinvest municipal bond proceeds. When municipalities sell bonds, they do not spend the entire amount at once because projects take years to complete. Municipalities put the balance of the bond sale into a bank account. To preserve favorable tax treatment, municipalities are required to hold competitive public auctions, for which they hire a broker and invite investment banks to bid what interest rates they are willing to pay for the funds. *See* Complaint at 5–6, Sec. & Exch. Comm'n v. Wachovia Bank, N.A., Complaint, No. 11–cv–7135 (D.N.J. Dec. 8, 2011). Instead of competing for municipalities' business, the banks agreed in advance which one would win the contract and exchanged details about competitors' bids before submitting their final bids. *See id.* at 7–8. This meant that municipalities received lower interest rates than they would in a market unaffected by price fixing, and financial institutions avoided having to pay higher interest rates. The financial institutions' shareholders who ultimately bear the cost of the sanction were the ones who benefitted from the cartel, along with insiders.

26. *See e.g.*, In the Matter of Franklin Advisers, Inc. & Franklin/Templeton Distributors, Inc., Securities Exchange Act Rel. No. 50841, Dec. 13, 2004 (finding that Franklin Templeton Investments, a mutual fund investment complex, used $52 million of fund assets to compensate broker–dealers for marketing those funds).

27. *See e.g.*, In the Matter of Edward D. Jones & Co., L.P., Securities Act Rel. No. 8520, Dec. 22, 2004 (finding that Edward D. Jones LP, a broker–dealer whose primary business is selling mutual funds and college savings plans, promoted to its customers only those funds that agreed to share advisory fees they charged to clients with Edward D. Jones, basing its promotions not on quality but on kickbacks, and failing to disclose its conflict to its customers).

28. *See e.g.*, In the Matter of J.P. Morgan Securities, Inc., Securities Act Rel. No. 9078, Nov. 4, 2009 (finding that J.P. Morgan's managers paid $8.2 million in bribes to brokers associated with Jefferson County Commissioners in exchange for contracts to underwrite $5 billion of bonds and interest rate swaps). Jefferson County, which is the most populous county in Alabama, filed for bankruptcy protection in 2011.

29. *See e.g.*, In the Matter of Raymond James Financial Services, Inc. et al., at 52, Initial Dec. Rel. No. 296, Admin. Proc. File 3–11692, Sept. 15, 2005 (finding that Raymond James Financial Services, Inc., a broker–dealer and investment advisory firm, allowed its broker to embezzle $16.4 million from clients by failing to take adequate steps despite multiple red flags).

timing[30] and late trading,[31] pump-and-dump and other market manipulation schemes,[32] and blatant self-dealing.[33] The prosecution of these violations forces violators to disgorge illicit gains obtained through misconduct, while the subsequent distribution of collected monetary sanctions to defrauded investors reverses the wrongful transfer. Moreover, individual and secondary defendants contribute to fair funds much more often than they pay damages to settle private securities litigation. Unlike in private litigation, targeted individuals cannot shift the SEC's sanction to the firm through indemnification and directors' and officers' ("D&O") insurance. Forcing individual defendants to pay out of pocket increases the deterrent effect of the SEC's enforcement action compared to private litigation and eliminates the concern that their payment is a circular transfer from shareholder victims to themselves.[34]

This Article makes an important contribution to two different literatures: the literature on private and public enforcement of securities laws, and the burgeoning literature on large-scale compensation efforts by public agents, including federal prosecutors, administrative agencies, and state attorneys' general.[35] The securities enforcement literature largely concludes that

30. *See e.g.*, In the Matter of Bear, Stearns & Co., Inc. & Bear, Stearns Securities Corp., Securities Act Rel. 8668, Mar. 16, 2006. Market timing includes frequent buying and selling of shares of the same mutual fund, or buying or selling mutual fund shares in order to exploit inefficiencies in mutual fund pricing. Market timing can harm other mutual fund shareholders because it can dilute the value of their shares. While the practice is not illegal per se, it disrupts the management of the mutual fund's investment portfolio and causes the targeted mutual fund to incur extra costs associated with excessive trading and, as a result, cause damage to other shareholders in the fund. Most mutual funds prohibit frequent transactions, but many firms, including Bear, Stearns, helped those who wanted to engage in market timing conceal their identity to avoid detection.

31. *See id*. (finding that Bear, Stearns touted its "late trading capabilities"). In contrast with market timing, late trading is clearly illegal. *See* 17 C.F.R. § 270.22c–1(a). Late trading is the practice of placing orders to buy mutual fund shares after when mutual funds calculate their net asset value ("NAV"), typically 4 p.m. Late trading enables the trader improperly to obtain profits from market events that occur after 4 p.m., such as earnings announcements and futures trading, that are not reflected in that day's NAV. Several investment banks not only allowed, but facilitated late trading.

32. In most pump–and–dump schemes, an individual acquires stock in a company with a small market capitalization. She then pays broker–dealers to promote that stock to their clients, without disclosing the payments, and sells her stock to those investors at prices considerably above the purchase price. *See e.g.*, Complaint, Sec. & Exch. Comm'n, v. B. Roland Frasier, III & Richard A. May, No. 03–cv–01958 (S.D. Ca. Oct. 2, 2003).

33. Three fair funds were created in enforcement actions for "cherry picking"—allocating cheaply bought securities to the firm's own account and more expensive ones to customers' accounts. *See e.g.*, Complaint, Sec. & Exch. Comm'n v. K.W. Brown & Co. et al., No. 05–cv–80367–JOHNSON (S.D. Fla. Apr. 28. 2005).

34. See discussion *infra* in Part III.B.3.

35. *See* David F. Engstrom, *Agencies as Litigation Gatekeepers*, 123 YALE L.J. 616 (2013); Margaret H. Lemos & Max Minzner, *For–Profit Public Enforcement*, 127 HARV. L. REV. (forthcoming) (2014); Margaret H. Lemos, *Aggregate Litigation Goes Public: Representative Suits by State Attorneys General*, 126 HARV. L. REV. 486 (2012); Sant'Ambrogio & Zimmerman, *supra*

compensation for securities violations is circular and thus futile.[36] This Article challenges that consensus by showing that compensation for abuses by financial intermediaries is both possible and desirable. Private litigation for this sort of misconduct is rarely successful, and the SEC is often the only possible source of investor compensation.[37] Because the SEC punishes individual wrongdoers, who largely avoid liability in private lawsuits, its enforcement deters misconduct more effectively. Finally, the SEC is more flexible than private plaintiffs in selecting enforcement targets and adjusting its enforcement and distributions after missteps.

The large, and generally critical, body of literature on public compensation that has grown over the last few years has used the SEC's compensation effort as one of its primary examples.[38] The main critiques of the literature are procedural: public agencies fail to consult victims when they settle enforcement actions,[39] judges are too deferential when they review public agencies' compensation plans,[40] and agencies fail to police potential conflicts of interest between public agents and private victims.[41] These critiques are factually correct, but mostly inconsequential. This Article contends that the literature has missed the forest for the trees. The commentators have overemphasized relatively minor procedural concerns in public compensation, and downplayed what the rise of public compensation reveals about the failure of more traditional compensation schemes, in particular private litigation. The Article concludes that public compensation, in large part, replaces private litigation where private lawsuits do not serve their compensatory role. The collateral benefit of the shift towards public compensation is better deterrence, but both benefits are vulnerable to congressional control over the SEC's and other agencies' budget, which threatens to undermine the deterrent and compensation functions of public enforcement.

Fundamentally, the Article urges caution before implementing policy changes based on anecdotal evidence. Part I provides the background on the SEC's compensation approach and concludes with a brief summary of limited prior research. Part II describes the data, explains the methodology for collecting and analyzing the information, and provides an overview of fair fund distributions, including details about the size of fair funds, the

note 15; Zimmerman, *supra* note 11, at 563–68; Adam S. Zimmerman & David M. Jaros, *The Criminal Class Action*, 159 U. PA. L. REV. 185 (2011).

36. *See* sources *supra* note 23.

37. See discussion *infra* in Part III.A.3.

38. *See e.g.*, Lemos & Minzner, *supra* note 34, at 2; Sant'Ambrogio & Zimmerman, *supra* note 15, at 2006, 2009–10, 2013–14, 2016; Zimmerman, *supra* note 11, at 507.

39. Sant'Ambrogio & Zimmerman, *supra* note 15, at 2009–10; Zimmerman, *supra* note 11, at 507.

40. *See e.g.*, Zimmerman, *supra* note 11, at 549.

41. *See e.g.*, Lemos & Minzner, *supra* note 34, at 3.

measures of the central tendency, the types of securities violations, the ebb and flow of distributions over time, and the processes used to distribute fair funds. Part III discusses in depth the most serious critiques levied against fair funds specifically and against compensation for securities fraud more generally: small recoveries relative to investors' losses, the circularity of compensation for securities fraud, and duplicative enforcement. Both, Part II and III refute many of the conventional assumptions about fair fund distributions. The Article concludes in Part IV by offering some reflections on what this study reveals specifically about fair fund distributions, and more generally about securities enforcement and public compensation schemes. Beside the already stated observations that SEC's distributions are neither small nor, for the most part, circular or duplicative, the Article concludes that the SEC is responsive to critiques and flexible about changing its approach when possible. Looking beyond the fair funds, the Article exposes the limits of private causes of action for securities fraud as investors' remedy. It predicts that public compensation will persist, as the availability of private litigation declines.[42]

I. BACKGROUND ON THE SEC'S COMPENSATION OF DEFRAUDED INVESTORS

Fair funds are little known outside of a small universe of securities lawyers. This Part begins by explaining the legal authority and context of securities enforcement proceedings, which are a prerequisite for ordering, collecting, and distributing monetary sanctions. The SEC's authority to distribute to injured investors monies collected in enforcement actions has expanded considerably over time, and continues to expand, most recently in 2010 with an amendment enacted by the Dodd-Frank Act. This Part also reviews the existing literature regarding the SEC's fair fund distributions, which has been overwhelmingly critical, despite the lack of empirical work.

A. The Commission's Fair Fund Authority

The SEC's primary goal is to protect investors and to safeguard the public interest by ensuring that capital markets are "fair, orderly, and efficient."[43] To further these goals, the SEC prosecutes violations of

42. Two cases are currently pending before the U.S. Supreme Court that could make private securities litigation unavailable for several classes of securities fraud. *See* Roland v. Green, 675 F.3d 503 (5th Cir. 2012), *cert. granted* (U.S. Jan. 18, 2013) (Nos. 12–79, 12–86 & 12–88) (asking the Court to decide whether SLUSA precludes class actions under state law when defrauded investors purchase instruments that are not covered securities, but derive some of their value from covered securities); Erica P. John Fund, Inc. v. Halliburton, 718 F.3d 423 (5th Cir. 2013), *cert. granted* (U.S. Nov. 15, 2013) (No. 13–317) (asking the Court to overrule or substantially modify the presumption of class–wide reliance derived from the fraud–on–the–market theory).

43. U.S. SEC. & EXCH. COMM., STRATEGIC PLAN: FISCAL YEARS 2010–2015, at 1 (2009).

securities laws and sanctions violators using a variety of tools, including cease-and-desist orders, injunctions, bars to individuals serving as officers and directors of public companies, trading suspensions, and monetary sanctions—civil fines, disgorgements of ill-gotten gains, and compensation clawbacks.

The laws regulating the Commission's enforcement proceedings are complicated, perhaps unnecessarily so. The federal securities laws empower the Commission to adjudicate certain matters in administrative proceedings, and resolve others in judicial proceedings. Until very recently, the SEC's authority to impose civil fines in an administrative proceeding was limited to actions against broker-dealers,[44] investment advisers,[45] and clearing agencies.[46] To force other securities violators, in particular issuers[47] and parties associated with them, to pay civil fines, the SEC had to sue in federal court.[48] The Dodd-Frank Act expanded the SEC's authority to impose civil fines in administrative proceedings against all persons, not just regulated industries.[49]

In addition to imposing civil fines, the SEC can order defendants to disgorge any "tangible benefit causally connected" to the securities violation.[50] Until 1990, the SEC had no express authority to order securities violators to pay disgorgement. The SEC sometimes asked courts to exercise

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44. A broker–dealer is an individual or a firm that is engaged in the business of buying and selling securities either on behalf of the person's customers (a broker) or for the person's own account (a dealer), and is subject to regulation as such under the Securities Exchange Act of 1934. *See* 15 U.S.C. § 78c(a)(4)(A) (2012) (defining "broker"); *id.* at § 78c(a)(5)(A) (defining "dealer"); *id.* § 78i(j) (prohibiting broker's or dealer's use of mails or other instrumentalities of interstate commerce "to effect any transactions in, or to induce or attempt to induce the purchase or sale of, any" security unless broker or dealer is registered with SEC as "broker–dealer" under Exchange Act).

45. The term investment adviser includes money managers, investment consultants and financial planners. Advisers that manage more than $100 million in assets must register with the SEC. Investment adviser regulation governs investment advisers to investment vehicles, such as mutual funds and hedge funds, as well as to other types of advisory clients, such as individuals and endowments. Advisory services for mutual funds, for example, include buying and selling assets that are in the fund's portfolio, processing mutual fund investors' deposits and withdrawals, in exchange for an advisory and performance fee. *See* STAFF OF THE INV. ADVISER REGULATION OFFICE, DIV. OF INV. MGMT., SEC, REGULATION OF INVESTMENT ADVISERS BY THE U.S. SECURITIES AND EXCHANGE COMMISSION 8–9, 50 (2013).

46. 15 U.S.C. § 78u–2.

47. Issuers are persons who issue securities, usually firms. Most important among them are public companies, whose stock is traded on national exchanges, such as the New York Stock Exchange and Nasdaq. *See* Securities Act, § 2(a)(4), 15 U.S.C. § 77b(a)(4).

48. 15 U.S.C. § 77t(d); 15 U.S.C. § 78u(d)(3). Until 1990, the SEC could impose civil fines in actions brought under the Foreign Corrupt Practices Act and for insider trading. *See* Winship, *supra* note 14, at 1114–15.

49. Section 929P of Dodd–Frank Act of 2010, 15 U.S.C. §§ 77h-1, 78u-2.

50. *See* U.S. SEC. & EXCH. COMM'N, REPORT PURSUANT TO SECTION 308(C) OF THE SARBANES–OXLEY ACT OF 2002, at 33 n.103 (citing Sec. & Exch. Comm'n v. David C. Guenthner, et al., Lit. Rel. 17297 (January 8, 2002)) [hereinafter SEC 308(C) REPORT].

equitable powers and order "ancillary relief," including disgorgement, to bolster its enforcement efforts.[51] In 1971, in *SEC v. Texas Gulf Sulphur Co.*, an appellate court recognized that the SEC had equitable power to require corporate insiders who traded on material nonpublic information to disgorge their illegal trading profits.[52] The measure of the disgorgement remedy is the ill-gotten gain from the victims (similar to restitution),[53] but the SEC views disgorgement as an enforcement tool, and not primarily a means to compensate defrauded investors.[54]

The SEC for a long time did not believe that compensating investors was part of its mission, and took the position "that it is not a collection agency for victims of securities fraud."[55] Private litigation was perceived as the appropriate mechanism to compensate defrauded investors.[56] That changed when the Securities Enforcement Remedies and Penny Stock Reform Act of 1990[57] expressly authorized the SEC to order disgorgement in administrative proceedings, and to distribute disgorgement funds to investors,[58] but not civil fines—the SEC continued to remit those to the U.S. Treasury as required by statute.[59]

Between 1990 and 2002, the Commission ordered disgorgement and distribution of disgorged funds in two types of cases. The first were cases where individuals made identifiable profits from the fraud, most commonly from insider trading.[60] The second type were securities offering frauds and Ponzi schemes where the entity had no business purpose beyond the fraud.[61] The SEC routinely sought emergency relief to shut down the scheme and

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51. *See generally* George W. Dent, Jr., *Ancillary Relief in Federal Securities Law: A Study in Federal Remedies,* 67 MINN. L. REV. 865 (1983); James R. Farrand, *Ancillary Remedies in SEC Civil Enforcement Suits*, 89 HARV. L. REV. 1779 (1976); James C. Treadway, Jr., *SEC Enforcement Techniques: Expanding and Exotic Forms of Ancillary Relief,* 32 WASH. & LEE L. REV. 637 (1975).

52. 446 F.2d 1301, 1307–08 (2d Cir.), *cert. denied,* 404 U.S. 1005 (1971).

53. Similar, though not coextensive. The SEC can hold one party liable in disgorgement for the improper profits of another. *See* Sec. & Exch. Comm'n v. First Jersey Sec., Inc., 101 F.3d 1450, 1475 (2d Cir. 1996), cert. denied 522 U.S. 812 (1997).

54. *See* SEC 308(C) REPORT, *supra* note 48, at 3 n.2 ("Restitution is intended to make investors whole, and disgorgement is meant to deprive the wrongdoer of their ill–gotten gain."). *See also*, Sec. & Exch. Comm'n v. Blavin, 760 F.2d 706, 713 (6th Cir. 1985) ("The purpose of disgorgement is to force 'a defendant to give up the amount by which he was unjustly enriched' rather than to compensate the victims of fraud.").

55. Jayne W. Barnard, *Evolutionary Enforcement at the Securities and Exchange Commission*, 71 U. PITT. L. REV. 403, 416 (2010).

56. *See* Zimmerman, *supra* note 11, at 527.

57. Pub. L. No. 101–429, 104 Stat. 931 (codified as amended in scattered sections of 15 U.S.C.).

58. §§ 202(a), 203, 104 Stat. at 937–40 (codified at 15 U.S.C. §§ 78u–2(e), 78u–3(e). Drafters assumed that the SEC could obtain disgorgement in court proceedings. *See* Black, *supra* note 7, at 321 (citing to legislative history S. REP. No. 101–337, at 8 (1990)).

59. *See* Section 21(d)(3)(C)(i) of the Exchange Act, 15 U.S.C. 78u(d)(3)(c)(i).

60. *See* SEC 308(C) REPORT, *supra* note 48, at 6–8.

61. *See id*. at 9.

appoint a receiver to recover any remaining funds for defrauded investors.[62]

The accounting scandals in 2001 and 2002 produced unprecedented investor losses.[63] In their wake, Congress enacted the Sarbanes-Oxley Act, which, among other things, expanded the SEC's power to compensate defrauded investors.[64] Section 308(a) of the Act authorized the SEC to add civil fines paid in enforcement actions to disgorgement funds—called "fair funds"—and distribute them to the victims of securities violations.[65] The power to distribute civil fines to the victims is unique among federal agencies.[66]

While the fair funds provision considerably expanded the SEC's authority to compensate defrauded investors, there were obvious limits. Most importantly, the SEC could distribute civil fines only when it also ordered *that* defendant to pay disgorgement. To order disgorgement, the SEC had to show that the particular defendant profited from the securities violation.[67] The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 removed this restriction. In section 929B, the Dodd-Frank Act authorizes the SEC to distribute civil penalties to victims of securities violations even in cases where no disgorgement is ordered.[68]

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62. *See* Black, *supra* note 7, at 322.

63. WorldCom fraud wiped out almost $200 billion in investors equity. Sec. & Exch. Comm'n v. WorldCom, Inc., 273 F. Supp. 2d 431, 431 (S.D.N.Y. 2003).

64. *See* Black, *supra* note 7, at 327 (describing the significance of the change in SEC's compensation authority by the Sarbanes–Oxley Act).

65. Section 308(a) of the Sarbanes–Oxley Act of 2002 provided:

> If in any judicial or administrative action brought by the Commission under the securities laws (as such term is defined in section 3(a)(47) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(47)) the Commission obtains an order requiring disgorgement against any person for a violation of such laws or the rules or regulations thereunder, or such person agrees in settlement of any such action to such disgorgement, and the Commission also obtains pursuant to such laws a civil penalty against such person, *the amount of such civil penalty shall*, on the motion or at the direction of the Commission, *be added to and become part of the disgorgement fund for the benefit of the victims* of such violation.

(emphasis added)

66. Black, *supra* note 7, at 319 n.13. The fair funds provision is an exception to the general rule that all civil penalties be paid to the U.S. Treasury. *See* Section 21(d)(3)(C)(i) of the Exchange Act, 15 U.S.C. 78u(d)(3)(c)(i).

67. SEC 308(C) REPORT, *supra* note 48, at 33 n.103 (citing Sec. & Exch. Comm'n v. David C. Guenthner, et al., Lit. Rel. 17297 (January 8, 2002). The Commission tried to get around the restriction by adding $1 disgorgements to sizeable civil fines in order to create a fair fund, but it was criticized for doing so. *See* U.S. GOV'T ACCOUNTABILITY OFFICE, SEC AND CFTC PENALTIES: CONTINUED PROGRESS MADE IN COLLECTION EFFORTS, BUT GREATER SEC MANAGEMENT ATTENTION IS NEEDED 28 (2005), *available at* http://www.gao.gov/products/GAO–05–670 [hereinafter "GAO, SEC PENALTIES"] (reporting that the SEC issued guidance to its staff in which it explained that $1 disgorgement "can qualify a case as a Fair Fund case and made [civil money penalties] eligible for distribution"); Black, *supra* note 7, at 331–33 (chiding the SEC for "evading" the Act's limitation by ordering $1 disgorgements in order to create a fair fund).

68. Section 929B of Dodd–Frank Act of 2010, codified as 15 U.S.C. § 7246(a):

The decision to distribute funds to investors is at the discretion of the SEC or, upon the SEC's motion, the court, in cases where the SEC pursues the defendant in a judicial proceeding.[69] The enforcement staff considers whether to propose a distribution when it proposes that the Commission approve a negotiated settlement or initiate litigation.[70] The Commission's ultimate decision to distribute collected funds depends largely on two factors: whether there is an identifiable class of investor victims who suffered identifiable harm, and whether the amount of money likely to be collected from the defendant is large enough to justify a distribution given the number of potential victims.[71] The SEC has explained that compensating investors "is not always economically feasible," though it tries to "return funds to harmed investors" whenever possible.[72] Unlike institutions and agencies that are funded by fees and sanctions they collect,[73] the SEC must by statutory

> If, in any judicial or administrative action brought by the Commission under the securities laws, the Commission obtains a civil penalty against any person for a violation of such laws, or such person agrees, in settlement of any such action, to such civil penalty, the amount of such civil penalty shall, on the motion or at the direction of the Commission, be added to and become part of a disgorgement fund or other fund established for the benefit of the victims of such violation.

69. *See id*.

70. The Office of Distributions conducts a feasibility study to determine the likelihood of distribution based on thirty different factors. Interview with Nichola Timmons, Assistant Director of the SEC Office of Distributions, Dec. 24, 2013.

71. *Id.* The U.S. District Court for the Southern District of New York has explained that disgorged proceeds may "very well end up in the United States Treasury, for example, (1) where numerous victims suffered relatively small amounts thereby making distribution of the disgorged proceeds to them impractical; (2) where victims cannot be identified; and (3) where there are no victims entitled to damages." Sec. & Exch. Comm'n v. Lorin, 869 F.Supp. 1117, 1129 (S.D.N.Y. 1994).

72. U.S. SEC. & EXCH. COMM'N, 2005 PERFORMANCE AND ACCOUNTABILITY REPORT 5 (2005). The Commission's track record is consistent with its statement. Between 2007 and 2012, the SEC secured $13.83 billion in civil fines and disgorgements but was able to collect only $7.29 billion, despite considerable efforts. *See* U.S. SEC. & EXCH. COMM'N, FY 2014 CONGRESSIONAL BUDGET JUSTIFICATION 32, 36 (2013) (reporting that the SEC either collected the debt or initiated collection efforts within 6 months of due date for 92% of owed amounts) [hereinafter SEC 2014 BUDGET JUSTIFICATION]. Of that amount, the SEC distributed more than $4.75 billion through fair funds.

The SEC's collection record is considerably better than those of its peer enforcement institutions, including the Department of Justice which collected only 4% of criminal fines imposed between 2000 and 2002, and the number declined to 3.3% in 2006. Ezra Ross & Martin Pritkin, *The Collection Gap: Underenforcement of Corporate and White–Collar Fines and Penalties*, 29 YALE L. & POL'Y REV. 453, 477 (2011).

73. The Federal Reserve is funded entirely from proceeds from its vast assets and fees it charges banks for managing the payment system. *See* Peter Conti–Brown, *The Institutions of Federal Reserve Independence*, at 22, Rock Ctr. For Corp. Gov., Working Paper No. 139, *available at* http://ssrn.com/abstract=2275759. In addition, the Health Insurance Portability and Accountability Act of 1996 (HIPAA) allows the Department of Health and Human Services, the Department of Justice, and the FBI to use fines and forfeited assets recovered in cases involving federal health care offenses for further enforcement of health care fraud. *See* 42 U.S.C. § 1395i(k).

default remit all payments it collects to the U.S. Treasury unless it distributes them to defrauded investors.[74]

After the SEC settles a case, it can distribute collected funds to investors. In rare cases the order imposing sanctions or the final consent judgment itself directs the defendant to pay disgorgement and civil fines to identified victims,[75] usually where the victims and their losses are known, where the risk that the defendant will file for bankruptcy is low, and where the defendant can be trusted to distribute the funds as ordered.[76] In other cases, the SEC creates and oversees a distribution fund. This includes developing a plan to administer and distribute the funds, and overseeing the distribution.[77]

The SEC currently does not have the resources to administer distribution plans in-house, except for the simplest plans where a notice and claims process is unnecessary.[78] In most cases, the SEC's Office of Distributions hires a distribution consultant to develop the plan of distribution, and a fund administrator to publish notices, send information packets to eligible participants, process claims, prepare accountings, file tax returns, and make distributions from the fund to eligible defrauded investors.[79] During the early

74. *See* U.S. SEC. & EXCH. COMM'N, FISCAL YEAR 2013 AGENCY FINANCIAL REPORT 147 (2013). The Dodd–Frank Act of 2010 created the Investor Protection Fund to fund whistleblower awards. The SEC is authorized to place in the fund civil fines and disgorgements that it does not distribute to defrauded investors under the fair fund provision, unless the balance in the Fund exceeds $300 million. *See* Section 922(g)(3) of the Dodd–Frank Act (codified as 15 U.S.C. 78u–6(g)(3)). In 2011, the SEC deposited more than $450 million into the Investor Protection Fund. *See* SEC 2011 PAR, *supra* note 2, at 9.

75. See discussion *infra* in Part II.A.3.

76. Interview with Nichola Timmons, Assistant Director of the SEC Office of Distributions, Dec. 24, 2013. Nearly all enforcement actions settle without defendants' admission of guilt. A few judges have recently refused to approve such settlements, and it remains to be seen whether the Commission will be forced to try more cases against defendants reluctant to confess. *See* Jean Eaglesham & Chad Bray, *Citi Ruling Could Chill SEC, Street Legal Pacts*, WALL ST. J., Nov. 29, 2011, at C1.

77. The plan must develop the methodology for identifying eligible participants, for approving their claims and handling disputed claims, for sending out checks, and keeping track of whether checks have been cashed, and for receiving additional funds. In addition, the SEC must deposit the funds in an interest–bearing account and pay quarterly taxes on the interest, provide accounting, and procedures for appointment of the plan administrator, including indemnification. *See* SEC. EXCH. COMM., RULES OF PRACTICE AND RULES ON FAIR FUND AND DISGORGEMENT PLANS, RULE 1101 (2006) [hereinafter SEC RULES].

78. Interview with Nichola Timmons, Assistant Director of the SEC Office of Distributions, Dec. 24, 2013.

79. *See* SEC RULES, *supra* note 77, at 104 (Rule 1101(b)(6)). The SEC's enforcement attorneys used to manage collections and distributions in cases that they prosecuted. As a result, distributions were scattered among 11 regional offices and somewhat haphazard. In 2007, the SEC created the Office of Collections and Distributions to administer distribution funds, yet as of July 2010, the SEC did not have a centralized database for monitoring the administration of distribution funds. *See* U.S. GOV'T ACCOUNTABILITY OFFICE, SECURITIES AND EXCHANGE COMMISSION: GREATER ATTENTION NEEDED TO ENHANCE COMMUNICATION AND UTILIZATION OF RESOURCES IN THE DIVISION OF ENFORCEMENT 4 (2009), *available at* http://www.gao.gov/new.items/d09358.pdf. In July 2011, the Office of Collections and

years of the program, the SEC often hired distribution consultants to create customized distribution plans, even in cases with parallel securities class actions, leading some commentators to describe the fair funds provision as a "logistical and administrative nightmare."[80]

B. Problems with Investor Compensation

The purpose of securities litigation and the SEC's distributions is compensation, but most academics believe that trying to compensate defrauded investors is a pointless exercise. First, damages in securities cases are small compared to aggregate investor losses.[81] And second, a large majority of securities class actions alleges that plaintiffs purchased stock at prices that were artificially inflated by public company's fraudulent disclosures. The company generally does not benefit from the misrepresentation, but pays damages to settle litigation.[82] At least some of the shareholders who bear the cost of damages are among those harmed by the misrepresentation. As a result, investor compensation for securities fraud is widely perceived as an inefficiently circular transfer of money from shareholders to themselves, minus sizeable transaction costs.

The fair funds provision has been criticized on both counts. The fair fund provision was adopted to augment the pool of funds available to compensate harmed investors.[83] However, sanctions that the SEC obtained in several high-profile accounting fraud cases were tiny compared to the class action settlements.[84] WorldCom paid a record-breaking $750 million civil fine to settle the SEC's enforcement action, yet the WorldCom class action settled for $6.15 billion; Lucent paid $25 million to the SEC, but $517 million to settle the parallel securities class action.[85] Because securities class action

Distributions was reorganized and divided into three distinct units: the Office of Collections, the Office of Distributions, both within the Division of Enforcement, and Enforcement Audit and Data Integrity Branch within the Office of Financial Management. *See* SEC 2014 BUDGET JUSTIFICATION, *supra* note 71, at 33.

80. Geoffrey C. Rapp, *Beyond Protection: Invigorating Incentives for Sarbanes–Oxley Corporate and Securities Fraud Whistleblowers*, 87 B.U.L. REV. 81, 147 (2007).

81. *See* Coffee, *supra* note 14, at 1545–47 (showing that securities cases "recover only a very small share of investor losses"); Fisch, *supra* note 23, at 337 n.16 (explaining that Supreme Court precedent limits damages that investors can recover in private litigation).

82. Firms manipulating their financial reports often engage in acquisitions, borrow cheaply, and hire superior talent, thus directly benefitting from their misconduct. But the primary beneficiaries of accounting fraud are managers and lucky shareholders who sold at inflated prices. *See generally* Urska Velikonja, *The Cost of Securities Fraud*, 54 WM. & MARY L. REV. 1887 (2013).

83. *See* Winship, *supra* note 14, at 1121–22.

84. *See* James D. Cox & Randall S. Thomas, *SEC Enforcement Heuristics: An Empirical Inquiry*, 53 DUKE L.J. 737, 779 (2003) (expressing concern that compensation through fair funds would be small).

85. *See* Coffee, *supra* note 14, at 1543.

damages "dwarf" the SEC's monetary sanctions,[86] commentators have wondered whether it ever makes sense for the SEC to spend its limited resources to compensate investors.[87]

Moreover, there is widespread agreement that the SEC's compensation efforts "mimic" and duplicate private securities class actions.[88] Fair fund distributions have been described as "every bit as much an exercise in pocket shifting as is payment of a [class action] settlement."[89] They "take corporate funds away from one group of investors, the current shareholders, and pay it to another group of investors, those who traded in the securities during the class damages period."[90] Fair fund distributions could only be justified in the small subset cases where a private cause of action is not available,[91] and where the SEC targets defendants that private litigants cannot reach, including auditors, investment banks, and consultants, for aiding and abetting as well as for unprofessional conduct.[92] The widely-shared perception, however, is that fair funds merely duplicate private litigation, and so are largely a waste of resources.[93]

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86. Coffee, *supra* note 14, at 1543.

87. *See* Black, *supra* note 7, at 345 (arguing that the SEC has "sacrifice[d] legal principles and consistency in its zeal to create large Fair Fund distributions"); Winship, *supra* note 14, at 1136, 1139 (reporting that the SEC brought fewer enforcement actions in 2007 because "the SEC has had to divert resources to the distribution function").

88. Black, *supra* note 7, at 335; Bratton & Wachter, *supra* note 14, at 139; Coffee, *supra* note 14, at 1534.

89. Bratton & Wachter, *supra* note 14, at 139–40.

90. Black, *supra* note 7, at 331. Professor Black acknowledged that disgorgements from third parties, such as accountants and investment banks, are true ill–gotten gains that, if distributed to defrauded shareholders, do not merely shift money from one pocket to another. *See id.* at 329.

91. *See e.g.*, Securities Exchange Act of 1934 § 13(b)(2), 15 U.S.C. § 78m(b)(2)(A) (2006)(requiring registered companies to maintain adequate books and records); *see also* 17 C.F.R. § 240.15c3–1 (2008) (outlining net capital requirements of brokers); Regulation FD. *See generally* Cox & Thomas, *supra* note 81, at 744; Winship, *supra* note 14, at 1132.

92. Central Bank of Denver v. First Interstate Bank of Denver, 511 U.S. 164 (1994) (holding that private plaintiffs cannot maintain aiding and abetting suits under section 10(b) of the Securities Exchange Act); SEC RULES, Rule 102(e), *supra* note 77, at 5–9.

93. *See e.g.*, Paul S. Atkins & Bradley J. Bondi, *Evaluating the Mission: A Critical Review of the History and Evolution of the SEC Enforcement Program*, 13 FORDHAM J. CORP. & FIN. L. 367, 399 & n.171 (2008) (arguing that fair fund distributions create "a circular situation: the Commission penalizes a corporation to put the money into a fund to reimburse the shareholders who were themselves just indirectly penalized"); Cynthia A. Glassman, Comm'r, U.S. Sec. & Exch. Comm'n, Speech by SEC Commissioner: SEC in Transition: What We've Done and What's Ahead (June 15, 2005), http://www.sec.gov/news/speech/spch061505cag.htm ("I cannot justify imposing penalties indirectly on shareholders whose investments have already lost value as a result of the fraud. Our use of so–called Fair Funds . . . leads to the anomalous result that we have shareholders paying corporate penalties that end up being returned to them through a Fair Fund–minus distribution expenses."). Not surprisingly, management groups also agree. COMMISSION ON REGULATION OF U.S. CAPITAL MARKETS IN THE 21ST CENTURY, REPORT AND RECOMMENDATIONS 89, http://www.uschamber.com/sites/default/files/reports/0703capmarkets_full.pdf (criticizing the fair funds because they "inappropriate[ly] burden . . . innocent shareholders" and proposing that the SEC offset damages paid in private litigation against the civil fines and disgorgements it imposes).

C. The Paucity of Prior Research

Beyond a handful of critical off-hand remarks, the SEC's compensation efforts have received remarkably little scholarly attention.[94] The only two empirical studies of the SEC's distributions to date have been limited studies conducted by federal agencies. The first is a self-study of a sample of disgorgement funds created between 1997 and 2002 that the SEC conducted as instructed by section 308(c) of the Sarbanes-Oxley Act.[95] The study revealed that the SEC often failed to collect ordered disgorgements and civil fines.[96] The costs to create and administer distribution plans were high, so the SEC exercised its authority sparingly.[97] Between 1997 and 2002, the SEC distributed a little over $1 billion to defrauded investors in 34 disgorgement funds created in judicial actions[98] and 16 disgorgement funds created in administrative proceedings.[99] The study suggested that even before the Fair Funds Act, the Commission tried to compensate investors where possible, but collection obstacles often made such compensation difficult.

The second is a limited study that the U.S. Government Accountability Office ("GAO") conducted in 2010 to examine concerns about fair fund distribution delays.[100] Earlier GAO reports suggested that the SEC processed

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94. By one simple measure, mentions in law review articles, securities class actions are almost 35–times as interesting as SEC's fair funds. In Westlaw's Journals & Law Reviews' database from August 1, 2002 onwards, the term "fair fund*" appears in the title of 4 articles and is mentioned in 205. By contrast, "securities class action" or "private securities litigation" appear in the title of 138 articles and in the text of 3247 articles.

The SEC's fair fund distributions are not an exception, but the rule. There is very limited empirical scholarship on public litigation on behalf of large numbers of victims. Despite the lack of empirical work, the volume of theoretical scholarship on public litigation and enforcement is now quite large. *See e.g.*, Deborah R. Hensler, Response, *Goldilocks and the Class Action*, 126 HARV. L. REV. F. (2013), http://www.harvardlawreview.org/issues/126/december12/forum_984.php (responding to Margaret H. Lemos, *Aggregate Litigation Goes Public: Representative Suits by State Attorneys General*, 126 HARV. L. REV. 486 (2012)) ("Lemos's analysis is similarly heavy on theory and light on empirics—indeed, her article does not contain any empirical data about the nature and frequency of the litigation that concerns her.") and sources cited *supra* note 34.

95. 15 U.S.C. § 7246(c) (providing that the SEC "shall review and analyze enforcement actions by the Commission over the five years preceding July 30, 2002, that have included proceedings to obtain civil penalties or disgorgements to identify areas where such proceedings may be utilized to efficiently, effectively, and fairly provide restitution for injured investors").

96. *See* SEC 308(C) REPORT, *supra* note 48, at 1, 6–8.

97. *See id.* at 1.

98. *See id*. at 10.

99. *See id*. at 15–16.

100. U.S. GOV'T ACCOUNTABILITY OFFICE, SECURITIES AND EXCHANGE COMMISSION: INFORMATION ON FAIR FUND COLLECTIONS AND DISTRIBUTIONS (2010), *available at* http://www.gao.gov/products/GAO–10–448R/ [hereinafter "GAO STUDY"]. The GAO study is the only source of information about fair funds cited in NERA's review of the first ten years of fair funds published in early 2013, suggesting that it is the only such study to date. *See* DR. ELAINE BUCKBERG, DR. JAMES A. OVERDAHL, AND JORGE BAEZ, SEC SETTLEMENT TRENDS: 2H12 UPDATE 17 (2013) [hereinafter 2012 SEC SETTLEMENTS].

fair fund distributions very slowly, often taking years to return collected funds to harmed investors.[101] The 2010 GAO study reviewed fair funds created between 2001 and 2010. It reported that the SEC initially eagerly used its fair fund authority, but scaled back its efforts after May 2007.[102] The GAO study also included some general information on the number of fair funds created, total amounts ordered, collected, and distributed, and a comparison with 2007 data.[103] It noted that while distribution delays were common, the SEC had picked up the pace since 2007. Through February 2010, the SEC collected $9.1 billion or 96% of $9.6 billion in monetary sanctions earmarked for distribution through a fair fund, and distributed $6.9 billion or 75.5%.[104] Beyond that, the study did not provide information about the cases in which fair fund distributions were ordered.

Neither study supplies sufficiently detailed information about fair funds to inform the debate about the value of public compensation for securities fraud. The goal for this study is to examine the population of fair funds to shed light on whether and to what extent the critiques are justified. The following Part presents the sources of the data, the methodology used to evaluate the data, and an overview of fair funds.

II. DATA, METHODOLOGY, AND OVERVIEW

A. Data and Methodology

The data set consists of all fair funds created to date, which includes 236 fair funds created between July 25, 2002, when the Sarbanes-Oxley Act authorized the distribution of civil fines to harmed investors, and December

101. *See* GAO, SEC PENALTIES, *supra* note 66, at 29 (reporting that the SEC had collected almost $4.8 billion between 2002 and April 2005, but distributed only $60 million to defrauded investors); U.S. GOV'T ACCOUNTABILITY OFFICE, SECURITIES AND EXCHANGE COMMISSION: ADDITIONAL ACTIONS NEEDED TO ENSURE PLANNED IMPROVEMENTS ADDRESS LIMITATIONS IN ENFORCEMENT DIVISION OPERATIONS (2007), *available at* http://www.gao.gov/products/GAO–07–830 [hereinafter "GAO, IMPROVEMENTS"] (reporting that the SEC collected $8.4 billion between 2002 and June 2007, and distributed 21% or $1.8 billion);

102. The study reported that after 2006, the SEC reduced monetary sanctions against defendants and determined that fair funds were "not appropriate for certain types of cases." GAO STUDY, *supra* note 98, at 14–15.

103. *Id.* at 19.

104. *Id.* at 13. The SEC may have sped up distributions, but delays remain quite common. *See* Bruce Carton, *Mississippi Faults SEC for Delays in $100 Million Morgan Keegan Settlement Distribution*, COMPLIANCE WEEK (Aug. 14, 2013), http://www.complianceweek.com/mississippi–faults–sec–for–delays–in–100–million–morgan–keegan–settlement–distribution/article/307428 (reporting that the State of Mississippi filed an amicus brief in a lawsuit that Mississippi victims filed against the SEC for delays in administering the $100 million Morgan Keegan fair fund).

31, 2013.[105] The information was drawn from and verified using a variety of sources. The SEC has made available on its website information about many distribution funds.[106] The author supplemented the lists with research in LexisNexis, Westlaw and SEC's Litigation Releases database for SEC-overseen funds, and in Bloomberg Law and the Public Access to Court Electronic Records ("PACER") databases for court-overseen funds.[107] To ensure that the study did not miss any fair fund distributions, the author also verified the data for completeness using research reports issued by the National Economic Research Associates, Cornerstone Research, Stanford Securities Class Action Clearinghouse, and corporate annual reports.

For each fair fund, the author reviewed the order imposing sanctions, the order to create a fair fund, the proposed and approved distribution plan, distribution agent status reports, and, where available, orders disbursing funds and terminating the fair fund. The study also collected information about type of securities violation involved using the SEC's own classification published in the *Select SEC and Market Data* reports for the relevant period,[108] the size of the fund, amounts paid in civil penalties and disgorgements, amounts paid by individuals and secondary defendants, such as audit firms and investment banks, and whether those amounts were added to the fair fund, whether the firm filed for bankruptcy within 2 years of the enforcement action (using PACER and news searches), detailed information about parallel securities class actions using the Stanford Securities Class Action Clearinghouse and PACER, and whether the fair fund was distributed pursuant to a separate plan or added to the class action settlement.

The goal of the study is to examine the SEC's use of its newly expanded authority to distribute to harmed investors civil fines collected from securities violators through fair funds. Unlike fair funds, distributions of disgorged profits were never criticized for being small and circular, and for duplicating securities litigation. For this reason, the data set does not include disgorgement funds, where either no civil fine was assessed, the SEC remitted the civil fine to the U.S. Treasury or could not collect the civil

105. The SEC often files multiple enforcement actions against corporate and individual defendants on the basis of the same set of facts. Where fines and disgorgements from multiple actions were paid into a single distribution fund, it was counted as one fair fund.

106. *See* U.S. Sec. & Exch'n Comm., Distributions in Commission Administrative Proceedings: Notices and Orders Pertaining to Disgorgement and Fair Funds, http://www.sec.gov/litigation/fairfundlist.htm/; U.S. Sec. & Exch'n Comm., Investor Claims Funds, http://www.sec.gov/divisions/enforce/claims.htm/.

107. I reviewed dockets including references to "308(a)," "fair fund," "distribution fund," and "distribution plan."

108. U.S. Sec. & Exch. Comm'n, About the SEC, http://www.sec.gov/about.shtml (listing reports from 2004 until 2013).

fine,[109] or because a fair fund distribution otherwise proved infeasible.[110] This screen required careful sorting because the SEC and courts sometimes use the term "fair fund" as a synonym for a distribution fund and use it to refer to a fund were only disgorgement is distributed.[111] For the same reason, the study also excluded enforcement actions where the defendant "voluntarily" set up a distribution plan, and the SEC only censured the defendant, without ordering monetary sanctions.[112]

The data set also excludes cases where the SEC originally considered a fair fund but later abandoned the plan, usually because restitution was ordered in a parallel proceeding.[113] Parallel proceedings include criminal actions, receivership, and bankruptcy. Unlike fair funds, those funds are distributed pursuant to court-directed procedures, are managed by a trustee or

109. This screen excluded virtually all receivership cases, including Ponzi schemes and offering frauds. In particular in Ponzi scheme cases, investors ordinarily receive little more than a few percent of their claims. The SEC always pursues individuals associated with the scheme in a parallel proceeding, securing disgorgement as well as civil money penalties, and requesting that the receiver distribute those funds pursuant to its fair fund authority. Despite the order to distribute the penalty, that penalty is virtually never collected. I reviewed receivership cases and the dataset includes one such case where a civil money penalty was collected and distributed. *See* Decl. of Pamela Chattoo, Sec. & Exch. Comm'n v. Credit First Fund et al., No. 2:05–cv–8741 (C.D. Cal. July 22, 2009) (reporting that the individual defendant paid $32,000 of the $120,000 civil penalty ordered).

110. *See e.g.*, EC v. Peter C. Lybrand, et al., Lit. Rel. 16448 (February 24, 2000).

111. *See e.g.*, Motion to Approve Proposed Distribution Plan, Sec. & Exch. Comm'n v. Poirier et al., No. CV–96–2243–PHX–EHC (D. Az.) (explaining that the Court ordered defendant to disgorge over $2 million and pay $100,000 civil penalty, and subsequently agreed to accept $850,000; since disgorgement was not paid in full, no civil fine could be paid, and the fund cannot be described as a "fair fund"). The 2003 self–study lists 8 enforcement actions in which the SEC filed motions to apply the fair fund provision, but only three of those resulted in a fair fund distribution. Of the remaining five, three were Ponzi schemes where the civil fines were ordered but not collected, one was a market manipulation case where the fine and disgorgement were paid to the U.S. Treasury in 2008 (Lybrand), and one ordered the defendant to pay the civil fine to the U.S. Treasury in the settlement and distributed only the disgorgement. *See* SEC 308(C) REPORT, *supra* note 48, at 22.

112. In addition, because the SEC does not issue an order creating the distribution fund in these circumstances, it is much more likely that a study would miss many such funds, undermining its validity. *See e.g.*, In the Matter of Claymore Advisors, LLC, at 9 (reporting that the defendant had established a distribution plan to distribute $45,396,878 and noting that the fund is "not a Commission–ordered distribution plan"); Final Consent Judgment, Sec. & Exch. Comm'n v. State Street Bank and Trust Co., 1:10–cv–10172 (D. Mass. Feb. 4, 2010) (giving defendant credit for reimbursing investors, and ordering additional compensation).

113. *See e.g.*, Final Judgment as to Defendant David J. Hernandez, Sec. & Exch. Comm'n v. David J. Hernandez, d/b/a NextStep Financial Services, Inc., Civil Action No. 09–cv–3587, Jan. 26, 2012 (not ordering disgorgement or a civil penalty in light of the criminal case in which defendant was ordered to pay restitution and was sentenced to jail); Unopposed Motion to Dismiss Monetary Claims Against Defendants C. Keith LaMonda and Jesse W. Lamonda, Jr., Sec. & Exch. Comm'n v. ABC Viaticals, Inc. et al., No. 3:06–cv–2136 (N.D. Tex. Sept. 3, 2009) (moving to dismiss fines and disgorgement because of restitution ordered and prison sentences imposed in a parallel criminal proceeding); U.S. Sec. & Exch'n Comm., William A. Huber Sentenced to 20 Years in Prison and Ordered to Pay $23.6 Million in Restitution for Securities Fraud, Litig. Rel. 21777, Dec. 13, 2010.

similar individual, and generally allow victim participation. Moreover, parallel proceedings generally are not accompanied by private litigation, and only distribute restitution and recovered illicit profits, not civil fines. And so, they do not face the same criticism as fair funds. As a result of this screen, the study does not include well-known victim compensation funds established in parallel proceedings, including securities class actions and criminal actions. For example, Adelphia and the Rigas family signed a non-prosecution agreement with the U.S. Department of Justice, settling the criminal case against the firm and the officers. The Rigas family turned over $1.5 billion in assets to the firm, and the firm agreed to pay $715 million to compensate defrauded investors.[114] The SEC participated in the settlement and, in light of the payment in the criminal proceeding, agreed not to seek disgorgement or civil penalties against the Rigas family members or Adelphia.[115]

Finally, the data set does not include clawback actions for bonuses paid to top executives under sections 304 of the Sarbanes-Oxley Act and 954 of the Dodd-Frank Act.[116] These actions are similar to disgorgements because executives must reimburse the company for any performance-based compensation they received based on financial results that were later restated, but these disgorgements do not require executive wrongdoing.[117]

B. Overview of Fair Funds

This section provides summary data on fair funds, followed by a review of the SEC's distribution activity over time, by type of securities violation, and by the process for distributing the funds. The findings refute several of the critiques levied against fair fund distributions, specifically the assertions that fair funds mimic and duplicate private securities litigation.

114. *See* Press Release, SEC and U.S. Attorney Settle Massive Financial Fraud Case Against Adelphia and Rigas Family for $715 Million, http://www.sec.gov/news/press/2005–63.htm.

115. *See* Notice of Motion for Order Authorizing Distribution of Funds Held in Court Registry to Victims of Adelphia Fraud in Accordance With Procedure Adopted by U.S. Department of Justice Wither Respect to Adelphia Victim Fund, Sec. & Exch. Comm'n v. Adelphia, NO. 1:02–cv–5776 (S.D.N.Y. Oct. 30, 2008). *See also* Consent Judgment, Sec. & Exch. Comm'n v. Bernard L. Madoff & Bernard L. Madoff Investment Securities, No. 08–cv–10791 (S.D.N.Y.) (waiving the civil fine because of restitution ordered as part of defendants' criminal plea); Final Consent Judgment, Sec. & Exch. Comm'n v. Computer Associates International, Inc., No. 04–cv–4088 (E.D.N.Y. Oct. 1, 2004) (settling the enforcement action for accounting fraud against Computer Associates International, Inc. without disgorgement or civil fines, acknowledging that the firm agreed to pay $225 million in restitution pursuant to a deferred prosecution agreement entered with the U.S. Attorney's Office for the Eastern District of New York).

116. For a review of recent clawback actions, see Lawrence J. Trautman & Kara Altenbaumer–Price, *D&O Insurance: A Primer*, 1 AM. U. BUS. L. REV., at 33–38 (2012).

117. *See* 15 U.S.C. § 78j–4.

1. When are Fair Funds Created and What Do They Look Like

Between 2002 and 2013, the SEC ordered $14.33 billion distributed through 236 fair funds, of which 141 were created in judicial proceedings and 95 in administrative proceedings. All fair funds but two include both civil money penalties and disgorgements.[118] Of the aggregate amount, $5.40 billion of the funds were disgorgements and (some) prejudgment interest, and $8.93 billion were civil fines. Without section 308(a), civil fines could not be distributed to investors and would be remitted to the U.S. Treasury's general fund.

Whether the SEC moves to distribute monetary sanctions collected in an enforcement action depends on a variety of factors. Cost-effectiveness is the most serious limitation: the SEC cannot distribute funds when the amount in the fund is small relative to the number of victims.[119] The mean amount deposited in the fair fund was $60.72 million while the median fund was smaller at $16.96 million. By comparison, during the fiscal year 2011, the mean SEC enforcement action settled for $4.30 million (the median settlement was $332,163).[120]

118. The exceptions are fair funds created in the SEC's enforcement actions against British Petroleum, Inc. and J.P. Morgan that were brought in 2012 and 2013, after the Dodd–Frank Act authorized distributions of fines unaccompanied by disgorgement orders. *See* Final Consent Judgment, Sec. & Exch. Comm'n, No. 2:12–cv–02774 (E.D. La. Nov. 15, 2012); Order Instituting Cease–and–Desist and Administrative Proceedings, In the Matter of JPMorgan Chase & Co., Admin. Proc. File No. 3–15507 (Sept. 13, 2013).

119. *See* Securities and Exchange Commission v. Dennis A. Bakal et al., Motion to Pay Funds in Registry to Treasury, 2008 WL 515530 (N.D.Ga.), Jan. 29, 2008 (suggesting that distribution would not be "practicable" given the small amount of funds available and the costs of setting up a claims process).

120. *See* MAX GULKER, ELAINE BUCKBERG &JAMES OVERDAHL, SEC SETTLEMENT TRENDS: 2H11 UPDATE 25 (2012) [hereinafter 2011 SEC SETTLEMENTS]. Average settlements with individual defendants are smaller than settlements with entity defendants, $2.09 million versus $7.35 million. *See id*. Median settlements are considerably smaller at $175,000 for individuals and $1.47 for entities. *See id*. The difference between SEC settlements and fair fund cases is statistically significant at the 1 percent confidence level.

SUMMARY DATA ON FAIR FUND DISTRIBUTIONS IN SEC- AND COURT-OVERSEEN FUNDS (2002-2013)

	SEC-overseen funds	Court-overseen funds	Overall
No. of plans	95	141	236
Total amount (in $M)	5,427.2	8,902.9	14,330.1
Disgorgements	3,129.0	2,269.1	5,398.0
Civil Fines	2,298.2	6,633.8	8,932.1
Mean plan (in $M)	57.13	63.14	60.72
Median plan (in $M)	$22.37	$10.62	16.96
Maximum (in $M)*	$375.34	$816.5	$816.5
Minimum*	$109,330	$24,959	$24,959
Most common category	Investment Adviser (52 of 95)	Issuer reporting (66 of 141)	Issuer reporting (70 of 236)

* All figures, except for those followed by an asterisk, are reported in 2013 dollars.

The largest fair fund, created in the AIG accounting fraud case, included $816.5 million, while the smallest fair fund was $24,959 for insider trading.[121] Ten largest fair funds distributed, or are in the process of distributing, $5.35 billion or 37.4% of the total amount.[122]

SEC-overseen fair funds ordered a total of $5.43 billion distributed to defrauded investors, while court-overseen funds ordered $8.90 billion to be distributed. As explained above, until 2010 the SEC could only impose civil fines in administrative proceedings against market professionals. Not surprisingly, of 95 SEC-administered fair funds, 52 are associated with investment adviser violations and 31 with broker-dealer violations. Judicial enforcement actions are the default statutory category and thus more diverse, so court-overseen fair funds also tend to be more diverse. Nonetheless, the

121. In nominal dollars.

122. They include AIG, WorldCom, British Petroleum, Enron, Invesco Funds, Banc of America Capital Management, Fannie Mae, State Street, Time Warner, and J.P.Morgan. The distribution is less left–skewed now than it was in 1997–2002, when only disgorgements could be distributed. *See* Cox & Thomas, *supra* note 81, at 755 ("Specifically, of the 35 financial fraud actions in the SEC study, two separate actions account for over 70 percent of the disgorgement funds ordered.").

plurality of court-overseen fair funds, 66 of 141, are associated with issuer disclosure and reporting violations (i.e., accounting fraud).

Despite the somewhat greater diversity of court-overseen funds by type of securities violation and size, the mean size of SEC- and court-overseen fair funds is similar, about $60 million.[123] The median SEC-overseen fund is $22.37 million, compared with the median for court-overseen funds of $10.62 million. The size of court-overseen cases is more variable than the size of SEC-overseen cases, but that difference in the variability itself between the two subsamples is not statistically significant.[124]

There are other differences between the two subsamples that are statistically significant. Almost 57.65% of the amounts deposited in SEC-overseen fair funds were disgorgements, while 25.5% of the aggregate amount distributed in court-overseen fair funds were disgorgements. Conversely, mean civil fines ordered in court-overseen cases are considerably larger than in the SEC-overseen cases, $47 million compared with $25.2 million.[125] The difference is attributable to the different types of enforcement actions that the SEC can resolve administratively. Many enforcement actions against investment advisers and broker-dealers, which are usually within the jurisdiction of the administrative judge or the Commission itself, prosecute securities violations in which broker-dealers and investment advisory firms obtained ill-gotten profits by defrauding their customers. By contrast, enforcement actions for issuer reporting and disclosure violations are almost exclusively resolved in judicial proceedings. Because issuers rarely receive ill-gotten gains attributable to the fraudulent disclosure, average disgorgement amounts for issuer reporting and disclosure violations, and thus court cases overall, are correspondingly smaller.

123. The difference between subsample means is not statistically significant.

124. Levene's test for equality of variances between total fund amounts in the two subsamples produced a p–value of 0.18, which is not significant at the 5 percent confidence level. In other words, court–overseen funds and SEC–overseen funds are statistically similar in size.

125. Both differences are statistically significant at the 5 percent confidence level.

FAIR FUNDS BY SEC CLASSIFICATION (2002-2013)

SEC Classification	Number of Funds (n=236)	Amount in Fund (in $M)	Median Fund (in $M)	Mean Fund (in $M)	Percent of Fair Funds	% of Enforcement Actions[126]
Broker Dealer	49	2,152.8	19.10	43.93	20.8	17.2
Insider Trading	15	100.9	2.62	6.73	6.4	8.5
Investment Adviser/Company	62	3,868.3	21.58	62.39	26.3	16.6
Issuer Reporting and Disclosure	70	6,322.5	23.83	90.32	29.7	25.8
Market Manipulation	9	25.7	1.35	2.85	3.8	6.5
Securities Offering	21	1,451.4	4.87	69.11	8.9	16.8
Municipal	7	240.2	34.32	31.48	3.0	n/a
Total	236	14,330.1	16.96	60.72	n/a	n/a

Unlike private securities litigation which predominantly targets fraudulent disclosure by public companies,[127] the SEC targets a wide variety of securities violations, including fraudulent disclosure in primary and secondary markets, sale of unregistered securities, Ponzi and related schemes, insider trading, market manipulation, investment company and investment advisory improprieties, broker-dealer violations, foreign bribery and corruption.[128] The cases in which a fair fund distribution is ordered are similarly varied.

Enforcement actions for some categories of securities violations generally result in smaller monetary sanctions, either because defendants are individuals, who pay smaller fines than firms, or because defendants are more likely to be bankrupt.[129] The size of the settlement fund is an important

126. The percentage is calculated using annual percentage of cases over the 10–year period, excluding delinquent filing enforcement actions and FCPA cases. Enforcement actions in the former category result in censure or delisting and impose only very modest monetary sanctions. *See* 2011 SEC SETTLEMENTS, *supra* note 118, at 25.

127. More than 60% of class action settlements and more than 90% of all damages paid in class actions are for accounting fraud. *See* CORNERSTONE RESEARCH, ACCOUNTING CLASS ACTION FILINGS AND SETTLEMENTS: 2011 REVIEW AND ANALYSIS 1, 11–12 (2012).

128. *See e.g.*, U.S. SEC. & EXCH. COMM'N, SELECT SEC AND MARKET DATA 3 & tbl.2 (2013) (listing enforcement actions by type of securities violation).

129. *See id*. at 25 (showing different mean and median settlements by category of securities violation); 15 U.S.C. § 78u–2(d) (authorizing the SEC to consider defendant's ability to pay in setting penalties).

determinant of whether a distribution is possible, so one would expect some types of cases to be underrepresented in the fair funds sample relative to the number of enforcement actions, and others to be overrepresented.

Market manipulation and insider trading enforcement actions tend to target individuals, and yield smaller fines and disgorgements. As a result, there are relatively fewer fair fund distributions related to market manipulation than there are enforcement actions. By contrast, enforcement actions against investment advisers and against issuers for reporting and disclosure violations (i.e., accounting fraud) often result in large monetary settlements, and are overrepresented in the study relative to the number of enforcement actions. Securities offering cases are underrepresented in the fair funds population because in many, if not most, such cases involve sales of unregistered securities, where the SEC seeks to freeze the defendants' funds and appoint a receiver. Any recovered funds and disgorgements are then distributed by the receiver, not the SEC, and are thus excluded from the fair funds census. Finally, the SEC has declined to distribute fair fund assets to non-investor victims.[130] As a result, although the Commission has collected large fines in FCPA enforcement actions, it has remitted those funds to the U.S. Treasury.

The survey of all fair funds thus refutes the critique that the SEC compensates harmed investors for the same type of misconduct as securities litigation. While issuer reporting and disclosure cases are an important category of cases in which fair funds are distributed, but they are a minority of fair fund distributions.

2. Do Fair Fund Distributions Change Over Time

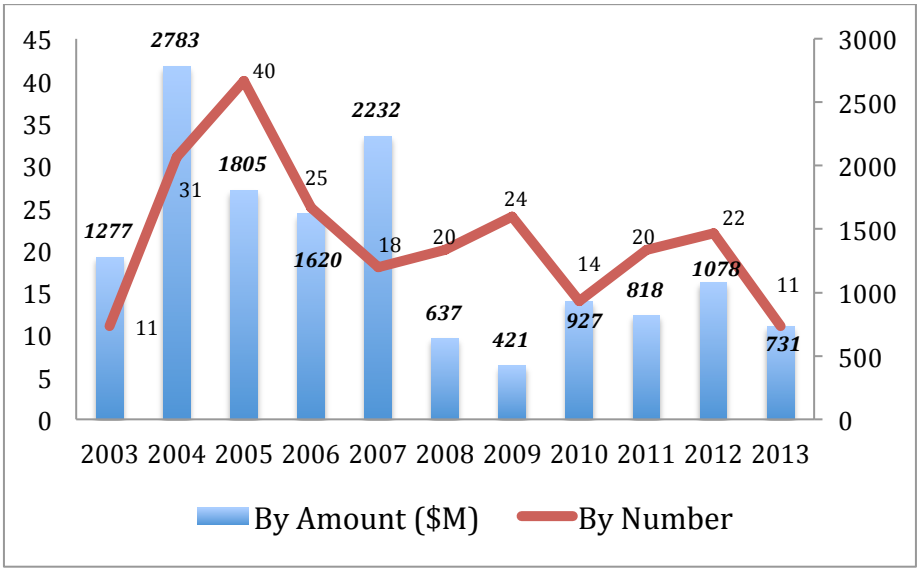
The SEC's distribution activity has varied over time, tracking market developments and enforcement actions that were brought during the preceding years. Mutual fund market timing scandals erupted in 2003, and the SEC pursued and quickly settled more than two dozen enforcement actions with investment advisors and broker-dealers. As a result, almost half of all funds created[131] in 2004, 14 out of 31, were associated with mutual fund market timing and late trading, a trend that continued into 2005. Although the major accounting scandals broke in 2001 and 2002, accounting

130. *See* Petition for Relief Pursuant to 18 U.S.C. § 3771(d)(3) and Objection to Plea Agreements and Deferred Prosecution Agreement, U.S. v. Alcatel–Lucent France, S.A., at 11, No. CR–20906 (S.D. Fl., May 2, 2011) (explaining that the SEC refused to create a fair fund in the bribery case).

131. A fair fund is "created" when the SEC makes a definitive determination that the collected sanctions will be distributed to defrauded investors. That decision usually postdates the settlement of its enforcement action.

fraud cases take longer to investigate, and ultimately settle.[132] Nine of 25 funds created in 2006, and 7 of 18 created in 2007 were associated with accounting frauds. Market timing and accounting fraud enforcement actions resulted in large settlements, so the aggregate amount for funds created in those years is correspondingly large. In 2012 and 2013, the Commission settled a number of large financial crisis cases, which shows up in the number and the amounts deposited into associated fair funds.

FAIR FUNDS CREATED AND AMOUNT ORDERED FOR DISTRIBUTION BY YEAR (2002-2013)*



* Fair funds are tallied by calendar year, not by fiscal year that the SEC follows (October 1 until September 30).

The 2010 GAO study suggested that the number of fair funds and the amounts distributed through fair funds declined after 2007 because the SEC decided "that fair funds are not appropriate for certain kinds of cases."[133] One

132. There are additional explanations for longer delays. First, an overwhelming majority of accounting fraud enforcement actions included individual defendants. Individuals whose reputations and livelihoods may be on the line fight SEC's investigations harder, so one would expect a delay. In addition, even where the SEC settled early, it sometimes waited for the class action to survive the motion to dismiss before it set up a fair fund and directed the monies to the class action account. *See e.g.*, Sec. & Ecxh. Comm'n v. Take–Two Interactive Software, Inc. et al., No. 05–cv–5443 (S.D.N.Y. Mar. 21, 2011) (settled in 2005, but created a fair fund in 2011, after the class action settled in late 2010).

133. GAO STUDY, *supra* note 98, at 15.

could read the chart reproduced above as providing support for the GAO's proposition. But a closer look at the enforcement actions and the fair funds data reveals that the SEC did not change its criteria for establishing a fair fund during the study period.[134] What changed was the SEC's enforcement activity.

Much of the decline is attributable to a change in the type and the number of enforcement actions brought since 2007, and the ability of the SEC to collect monetary sanctions.[135] Between 2003 and 2006, the SEC ordered defendants to pay more than $3 billion per year in monetary sanctions;[136] aggregate sanctions imposed in 2007 and 2008 were considerably smaller, at $1.6 billion and $1.03 billion, respectively.[137] Moreover, the SEC's collection rates have varied during the period, ranging from a low of $521 million in 2008 to a high of $2.3 billion in 2005.[138] The SEC cannot distribute funds that it has not collected, and so defendants' inability to pay reduces the amounts available for investor compensation.

In addition, after Madoff's Ponzi scheme, the SEC increased its efforts to detect similar violations, at the expense of more vigorous prosecution of issuers for fraudulent disclosure and investment advisers.[139] Recoveries in Ponzi schemes and offering frauds are usually a tiny percentage of ordered disgorgements and civil fines because the perpetrators dissipated the assets before the scheme was unmasked. In addition, funds recovered in Ponzi schemes are typically distributed through receiverships, not fair funds, and are thus outside the scope of this study. Finally, in some recent cases, the SEC has allowed defendants to compensate investors in lieu of the SEC ordering them to pay disgorgement.[140] Investors received compensation as a result of the SEC's enforcement, but not through a fair fund. Overall, it

134. Without more information, it is difficult to divine which cases would be inappropriate. One SEC insider reported that funds are distributed whenever possible, and that the attitude has been consistent throughout the studied period.

135. According to the *Select SEC and Market Data* reports, civil fines imposed between 2006 and 2009 were much smaller than civil fines imposed before that period. Moreover, SEC's collections during those years were relatively low, $979 million in 2007, $521 million in 2008, and $1.694 billion in 2009. *See* U.S. SEC. & EXCH. COMM'N, IN BRIEF: FY 2013 CONGRESSIONAL JUSTIFICATION 30 (2012).

136. $3.3 billion in 2003 is $4.2 billion in 2013 dollars. The calculation was performed using the Bureau of Labor Statistics calculator to yield dollars in 2013. *Databases, Tables & Calculators by Subject,* BUREAU LAB. STAT., http://data.bls.gov.

137. Aggregate monetary sanctions were collected from the SEC's reports on Select SEC and Market Data for the years 2004–2013. *See* SELECT SEC AND MARKET DATA, *available at* http://www.sec.gov/about.shtml.

138. *See* SEC 2014 BUDGET JUSTIFICATION, *supra* note 71, at 30.

139. The SEC has also targeted more individuals, whose settlements are on average considerably smaller, and has more than doubled enforcement actions against Ponzi schemes to 92 per year. *See* 2012 SEC SETTLEMENTS, *supra* note 98, at 5–12.

140. *See e.g.*, In the Matter of Claymore Advisors, LLC, at 9 (reporting that the defendant had established a distribution plan administered by a third party for $45,396,878).

appears that fair fund distributions track enforcement activity, but the SEC's enforcement activity declined between 2007 and 2012.[141]

3. Are Fair Funds Distributions Duplicative

A common criticism of fair funds is that the SEC "wastes resources on repetitive cases" by creating customized distribution plans where damages are also distributed in a parallel class action.[142] A review of distribution plans indicates that the criticism is not supported by evidence.

The study identified the process the SEC used to distribute the funds in 218 cases.[143] In 18 cases, the order instituting proceedings or the final consent judgment identifies the victims and their harms, orders the defendant to compensate them, often in full, and directs the defendant to make payments within a short period of time. For example, the SEC's settlement with Goldman Sachs directed the company to pay $150 million to Deutsche Industriebank AG and $100 million to the Royal Bank of Scotland N.V. instead of paying the civil fine to the SEC or U.S. Treasury.[144] Monetary sanctions in these enforcement actions are usually set at the level that would fully compensate classes of defrauded investors identified during the SEC's investigation. More than half of direct-payment fair funds have been created since 2010.

FAIR FUND DISTRIBUTION PLANS (2002-2013)

	No. of Plans (n=218)	Fair Fund Amount (in $M)
SEC Settlement Directs Payment	18	1,160.7
Fair Fund Distributed in Parallel Proceeding	54	2,131.1
Class Action	47	1,996.4
Receivership & Bankruptcy	4	18.1
Criminal	3	116.6
SEC Customized Distribution Plan	146	9,201.8
No Parallel Class Action	67	716.5
Class Actions w/o Monetary Settlement	26	1,248.1
Class Action not Sufficiently Similar	7	316.4
Earlier Parallel Class Settlement	5	76.2
Later Parallel Class Settlement	41	6,844.6

141. *See* 2012 SEC SETTLEMENTS, *supra* note 98, at 12.

142. Sant'Ambrogio & Zimmerman, *supra* note 15, at 2013–14.

143. In 18 cases the SEC either has not yet decided how to distribute the funds.

144. Final Judgment as to Defendant Goldman at 2–3, Sachs & Co., Sec. & Exch. Comm'n v. Goldman, Sachs & Co. & Fabrice Tourre, No. 10–cv–3229 (S.D.N.Y. July 15, 2010).

In 47 cases, the SEC developed the fair fund distribution plan with reference to the class action that was based on the same set of underlying facts, and had already settled or was about to be settled. In all these plans, the SEC directed the funds to the class action account, and proposed that the funds be distributed following the same or very similar process as the distribution of the class action settlement. To avoid duplicating the administrative cost, the SEC used the same distribution agent (sometimes identified as a fund or claims administrator) to identify and notify the eligible participants, process their claims, and distribute the funds.[145]

In 7 cases, a court ordered restitution in a parallel criminal proceeding, appointed a receiver, or initiated bankruptcy proceedings against the same defendant. In those cases, the SEC directed the fair funds to the parallel proceeding.

The SEC created a customized distribution plan in 146 cases. Unlike in private litigation, the cost of distributing the fair fund is often borne by the sanctioned firm and does not reduce investors' recoveries.[146] Sixty-seven of the cases where the SEC created a customized plan were not accompanied by parallel securities litigation. Of 79 cases with parallel private litigation, private actions were dismissed or resulted in non-monetary recovery in 26 cases. Seven cases settled with sufficiently different classes of victims that parallel distribution would not be practical.[147] In the aggregate, the SEC did not duplicate distribution in 172 of 218 fair fund cases, or 78.9% of the time.

This leaves 46 cases where private and public settlement and distribution proceedings proceeded in parallel, and the SEC created a customized

145. The universe of distribution agents is small. Majority of non–SEC administered funds were administered by four firms, A.B. Data, the Garden City Group, Gilardi, and Rust Consulting. To expedite the process, on July 15, 2013 the Commission approved a pool of nine firms from which future fund administrators will be appointed to administer the distribution of disgorgement or fair funds. *See* Sec. & Exch. Comm'n, Delegation of Authority to Director of the Division of Enforcement, Release No. 34–70049 (Aug. 1, 2013).

146. *See* GAO, IMPROVEMENTS, *supra* note 99, at 29 n. 39 (reporting that 70 percent of fair funds "have provisions whereby fund proceeds are used to pay administrative expenses," while in 30 percent of cases, the defendants "pay fair fund expenses"). *See also* In the Matter of Strong Capital Management, Inc., 3–12448, Proposed Plan of Distribution at 6, Aug. 3, 2011; In the Matter of Millenium Partners L.P. et al., 3–12116, OIP at 14, Dec. 1, 2005 (providing that Respondent pay up to $5 million to the distribution consultant and fund administrator); U.S. Sec. & Exch. Comm'n, Questions and Answers Regarding the Distribution Funds in Analysts Cases, http://www.sec.gov/news/press/globaldistqa.htm ("The firms will pay *all* of the Distribution Fund Administrator's fees, costs, and expenses. . . . Investors will not have to bear *any* of this expense.") (emphasis in original).

147. All 7 settlements were part of the Global Research Analyst Settlement. The parallel class action, which settled in April 2009 for $586 million, included hundreds of issuer defendants and underwriters, in addition to twelve investment banks targeted by the SEC. The allocation of damages among defendants was confidential, so it is impossible to determine whether investment banks that the SEC targeted paid anything. *See* Stipulation and Agreement of Settlement at 14, In re Initial Public Offering Securities Litigation, No. 21–mc–92 (S.D.N.Y. Apr. 2, 2009).

distribution plan—cases that can fairly be described as duplicative. In all but 5 of these cases, private litigation was settled after the SEC's enforcement action—on average more than 5 years later.[148] The SEC collected $6.84 billion in civil fines and disgorgements in enforcement actions that settled before class action settlements. Although the Commission could have waited for the outcome of parallel securities litigation, the wait would have been very long. Since the SEC had been criticized for distributing fair funds slowly,[149] it responded by distributing the funds to defrauded investors through customized distribution plans.[150]

This haste was not without problems. In its zeal to settle quickly, the SEC sometimes failed to identify securities violations with sufficient specificity to identify potentially eligible participants in the subsequently created fair fund. The most notorious example is the Global Research Analyst Settlement and subsequent fair fund distribution. In 2003 and 2004, the SEC settled enforcement actions against twelve investment banks and two individuals for pressuring research analysts into issuing falsely optimistic reports about companies in order to win their investment banking business.[151] The defendants agreed to pay almost $1.4 billion to settle enforcement actions, of which $432.5 was to be distributed to defrauded investors through several fair funds.[152] Some of the settlements identified specific fraudulent research reports and subsequent overpriced public offerings, whereas others failed to do so, even though defendants and the SEC had access to information that would permit them to identify defrauded investors and their losses.[153] As a result of that failure, the fund administrator could not draft distribution plans and distribute funds in three of twelve fair funds.[154] The court reviewing the Global Research Analyst Settlement and fair fund distribution described the process as "embarrassing."[155] Instead of compensating victims (who existed, but were not identified in the orders

148. Mean class action settlement delay for 39 class actions settled after the SEC settled its enforcement action in the same case was 1907 days and the median 1979 days.

149. See discussion *supra* in Part I.C.

150. This group includes two notorious fair fund cases, WorldCom and the Global Research Analyst Settlement. In both cases, the fair fund distribution plan was litigated. The court reviewing the WorldCom fair fund declared it was "fair and reasonable." Official Comm. of Unsecured Creditors of WorldCom, Inc. v. SEC, 467 F.3d 73, 83 (2d Cir. 2006). The court reviewing the Global Research Analyst Settlement was less generous

151. *See* Sec. & Exch. Comm'n v. Bear Stearns & Co., Inc., 626 F. Supp. 2d 402, 404 (S.D.N.Y. 2009).

152. *See id*.

153. *See id*. at 411.

154. *See id*. ("[T]he Distribution Funds negotiated by Bear Stearns, J.P. Morgan, and Merrill Lynch/Blodget were doomed from the outset because there was a complete disconnect between the amount of disgorgement and civil penalties on the one hand and investor losses on the other.").

155. *Id*. at 402.

imposing sanctions), the court remitted almost $79 million in paid civil fines and disgorgements to the U.S. Treasury.[156]

The analysis of the SEC's fair fund distribution plans thus yields several conclusions. First, the evidence refutes the assertion that the SEC wastes resources on duplicative compensation proceedings. Most of the time, the SEC's action is the only legal proceeding instituted against the defendant.

Second, the scholarly consensus holds that the SEC does not even attempt to coordinate its actions with parallel private litigation.[157] It is true that the SEC does not consider the existence of parallel private litigation when it investigates and settles enforcement actions. However, once an enforcement action concludes, the SEC usually coordinates the distribution of collected funds with parallel proceedings. In cases where it does not, parallel private litigation either failed or dragged on for years. Rather than face criticism for delays, the Commission was eager to distribute the funds it collected pursuant to a customized distribution plan.

Third, it appears that the SEC took the court's harsh words after the Global Research Analyst Settlement to heart and learned from its mistakes. Its recent settlements provide more detail about misconduct to facilitate the subsequent distribution to investors. Where the defendant is solvent and trustworthy, and the victims identifiable without a notice and claims process, the SEC has ordered the defendant (as part of the settlement) to compensate directly the victims—eliminating the need to create a distribution fund. For example, all settlements in municipal bid-rigging cases identify harmed municipalities and municipal institutions, and direct investment banks to pay more than $240 million in civil fines and disgorgements directly to the victims as compensation. The same is true for several large market-timing fair funds.[158]

Finally, there have been recent proposals to include victims in the settlement process between defendants and public agencies.[159] The SEC does not appear to consult defrauded investors when it crafts the settlement with the defendant. But the Commission's recent settlements directing investment banks to pay harmed investors directly suggest that the SEC has made an effort to identify victims during the settlement process. Moreover, although defrauded investors generally do not have a voice in the SEC's settlement of the enforcement action, they do participate in the parallel class action, where they have a say in the design of the distribution plain. Class action settlements have long observed rules that encourage victim participation,

156. A total of $432.5 million were included in the fair fund. The fund distributed almost $378 million to investors. *See* Sec. & Exch. Comm'n v. Bear Stearns & Co., Inc., 626 F. Supp. 2d 402 (S.D.N.Y. 2009).

157. *See* Zimmerman, *supra* note 11, at 557.

158. *See id*.

159. *See id*. at 563–68; Lemos, *supra* note 34; Sant'Ambrogio & Zimmerman, *supra* note 15.

including individualized notice, opportunities to intervene or object, and have divided members with different interests into subclasses that are each entitled to separate representation in settlement and distribution negotiations.[160] Usually, the fair fund that is directed to a class action is distributed under the same distribution plan as the class action settlement. As a result, harmed investors have a voice in how the fair fund is distributed, even if the SEC's rules do not give them a say.[161]

III. FAIR FUND DISTRIBUTIONS AS INVESTOR COMPENSATION

The primary purpose of the SEC's enforcement activity is deterrence. Using the census of fair funds just described, this Part considers to what extent does the SEC also compensate defrauded investors for their harms, in addition to deterring misconduct. This approach is the mirror image of the approach taken by empirical literature on private securities litigation, which examines whether private actions deter securities misconduct, in addition to compensating investors as their *raison d'être*.[162]

Thus, this Part assesses *to what extent* monetary recoveries distributed through fair funds compensate investors for their losses, by reviewing the data on fair fund distributions and on parallel securities class actions based on the same set of underlying facts. Then, the Part turns to the circularity critique of investor compensation and considers *whether* compensation through fair funds is a mere transfer of wealth from shareholders to themselves. It does so by assessing fair funds based on the type of securities violation, the identity of the settling defendant, and whether the availability of D&O insurance and indemnification shifts the cost of the SEC's enforcement against individual officers and directors to firms (and indirectly their shareholders).

A. Amounts of Fair Fund Distributions

This section considers whether amounts distributed through fair funds are small or large relative to investors' losses. Public commentary suggests that the SEC's compensation efforts are not worth the candle, and that private litigation recoveries dwarf the Commission's contribution.[163]

160. *See* Zimmerman, *supra* note 11, at 546.

161. *See* 17 C.F.R. § 201.1106 (providing that "no person shall be granted leave to intervene or to participate or otherwise to appear in any agency proceeding or otherwise to challenge [a distribution plan, eligibility determination, or disbursement].")

162. Professors Cox and Thomas have asked and analyzed the mirror–image question: what role private litigation plays in enforcement of securities laws. *See* Cox & Thomas, *supra* note 81, at 763.

163. See *supra* notes 82–85 and accompanying text.

The study finds that the universe of securities violations includes only two types of cases: issuer reporting and disclosure violations, and all others. All issuer reporting and disclosure fair funds are accompanied by private litigation, and the SEC's contribution in such cases is small (15.5% of the aggregate amount distributed to investors). In all other securities violations, including insider trading, securities offering, market manipulation, investment adviser and broker-dealer violations, the SEC's distribution is either the only source of compensation (in 71.3% of cases) or the fair fund distribution itself dwarfs all other sources of victim compensation, including private litigation.

1. Do Fair Funds Undercompensate Investors

Shortly after the fair fund provision was enacted, commentators expressed doubt that the provision would achieve the desired result of compensating harmed investors.[164] As a general matter, securities fraud, in particular fraudulent disclosure by issuers, is an inefficient way to steal: victims' losses often exceed any benefit to the wrongdoers by several orders of magnitude.[165] The Commission is also severely resource constrained. It cannot pursue all serious securities violations and certainly cannot compensate all defrauded investors.[166] When it does, securities laws limit monetary sanctions—disgorgements and civil fines—that the SEC can impose and potentially distribute to compensate defrauded investors.

Disgorgements are limited to "the amount by which [defendants] were unjustly enriched" by the violation.[167] The SEC can hold one party liable in disgorgement for the improper profits of another, but the amount cannot exceed the amount of the third-party benefit.[168] Civil fines, likewise, are limited. The most recent inflation adjustment authorizes the SEC to fine individuals up to $160,000 and firms up to $775,000 for each violation, or the "gross amount of pecuniary gain" from the violation, whichever is greater.[169] The term "violation" is not defined by statute. Arguably, the SEC can multiply the maximum fine by the number of individual violations, and come out with a very large total fine.[170] Moreover, the language authorizing the fine up to the "gross amount of pecuniary gain" authorizes the SEC to

164. See discussion *supra* in Part I.B.

165. *See generally* Velikonja, *supra* note 82 (detailing the categories and the extent of economic losses from fraudulent disclosures).

166. *See* Cox & Thomas, *supra* note 81, at 757.

167. SEC 308(C) REPORT, *supra* note 48, at 3.

168. *See* Sec. & Exch. Comm'n v. First Jersey Sec., Inc., 101 F.3d 1450, 1475 (2d Cir. 1996), cert. denied 522 U.S. 812 (1997).

169. 15 U.S.C. §§ 77t(d), 78u(d)(3); 17 C.F.R. 210.1005 & tbl. V to subpart E, 78 Fed. Reg. 14181 (Mar. 5, 2013).

170. *See* Winship, *supra* note 14, at 1126 n.119.

impose a civil fine that equals the amount of disgorgement, doubling the total monetary sanction against the defendant.[171] In fraudulent disclosure cases, courts have interpreted that language to mean the amount by which the issuer overstated its earnings (although the issuer did not benefit from the overstatement), and have authorized the SEC to order civil fines in excess of $10 billion and more.[172] The SEC settles issuer reporting and disclosure enforcement actions for well below the statutory ceiling. In other types of securities cases, however, the statutory constraint on monetary sanctions is real.

As a result of these limitations, *ceteris paribus* one would expect the SEC's distributions to be smaller than damages in parallel private litigation, since the latter does not face similar legal ceilings (other than the amount of loss the plaintiffs suffered). The best way to assess to what extent fair fund distributions compensate defrauded investors would be to collect information on the magnitude of the harm caused by the violation and the amounts distributed to investors. Unfortunately, investors' losses are rarely quantified (or even quantifiable) in the SEC's enforcement actions.[173] Some actions specify the amount of gain to the wrongdoer, but illegal gain does not necessarily equal the aggregate amount of loss to the victims.

Instead, we must rely on circumstantial evidence, which suggests that the SEC's contribution is negligible for some types of fraud, but large for others. The aggregate and average figures for fair fund distributions compared with class action settlements are consistent with the proposition that the SEC as a resource constrained public agency can bring relatively few enforcement actions. Between 2003 and 2012, the SEC created 222 fair funds (fourteen were created in 2013 or are still in process) and distributed $12.98 billion to defrauded investors (in 2013 dollars). During the same period, 920 securities class actions settled for $60 billion.[174] Individual fair fund distributions are similar in size to private securities litigation settlements: their respective means are $60.7 million for fair funds ($16.9 million median) and $56 million for securities class actions ($8.4 million median).[175] Both populations are skewed to the left, meaning that most cases are small, but a few large settlements increase the population mean. About half of all class action

171. Insider trading carries higher potential fines of up to three times the profit gained or loss avoided. 15 U.S.C. § 78u–1(a)(2).

172. *See* Sec. & Exch. Comm'n v. WorldCom, Inc., 273 F.Supp.2d 431, 433–35 (S.D.N.Y. 2003).

173. Some orders imposing sanctions note that the defendant "collected tens of millions of dollars" from illegal conduct, but most do not. In the Matter of Edward D. Jones, Order Instituting Administrative and Cease–and–Desist Proceedings, Sec. Act. Rel. 8520, Dec. 22, 2004.

174. *See* ELLEN M. RYAN & LAURA E. SIMMONS, SECURITIES CLASS ACTION SETTLEMENTS: 2012 REVIEW AND ANALYSIS 3 (2013).

175. *See id*. (reporting mean figure for the period 1996–2011) (figures have been adjusted to 2013 dollars).

settlements and fair funds are smaller than $10 million.[176] Settlements in excess of $100 million, also described as "mega-settlements," account for nearly three-quarters of all distributed amounts in class actions and fair funds, but only about 15% of cases.[177] In addition to the much larger number of settlements and distributed amounts, the other meaningful difference between class actions and fair funds is at the right tail of the distribution. The largest securities class action settlements are considerably larger than the SEC's fair funds: $7.23 billion (Enron settlement) vs. $816.5 million (AIG fair fund).

More than 60% of class action settlements and more than 90% of all damages paid in class actions are for accounting fraud.[178] Fraud at a large firm like Enron or WorldCom can cause tens of billions of dollars in market capitalization to evaporate.[179] The average class action for accounting fraud settles for a tiny fraction of that loss, 4.6 percent,[180] which has led commentators to conclude that the "securities class action fails as a mechanism for compensation."[181] Because the SEC's settlements in issuer and disclosure cases are generally smaller than the relatively small class action settlements, the SEC's contribution to investor compensation for accounting fraud is small, consistent with the conventional wisdom.[182]

2. Do Fair Funds Overcompensate Investors

176. 55.3% of class action settlements and 44.5% fair funds are smaller than $10 million. *See id*. at 5.

177. *See id.* at 4 (noting that in 2012, mega–settlements accounted for 11% of all settlements and 74% of all settlement dollars). There have been 38 fair funds that distributed $100 million or more: 16% of funds distributed 73% of all fair fund dollars.

178. *See* CORNERSTONE RESEARCH, *supra* note 125, at 11–12.

179. *See* Velikonja, *supra* note 82, at 1913–14 (2013) (reporting that upon disclosure of the truth, fraudulent firms' stock market losses are considerable).

180. Between 1996 and 2012, median class actions in cases alleging accounting violations settled for 4.6% of the market capitalization loss upon disclosure of fraud. *See* RYAN & SIMMONS, *supra* note 173, at 12. The percentage understates what share of plaintiffs' loss is covered by damages, because only buyers are included in the class (not those who held on to securities and suffered the loss) and entitled to damages. *See id*. at 7.

181. Coffee, *supra* note 14, at 1547. These percentages understate the compensatory role of class actions. Not all investors who lost money have standing to sue. *See* Elliott J. Weiss, *The Lead Plaintiff Provisions of the PSLRA After a Decade, or "Look What's Happened to My Baby,"* 61 VAND. L. REV. 543, 557 (2008). Professor Weiss was able to collect some data from parties involved in the distribution of class settlements. In some well–known cases, plaintiffs were compensated for almost 50 percent or more of their losses. *See id*. at 558–59. Moreover, for every defrauded shareholder who overpaid, there is an equally innocent shareholder who sold at an inflated price. Investors with diversified portfolios are as likely to be sellers as to be buyers of fraudulent stock, so, on average, investors' expected losses from fraud over time approximate zero. *See* Velikonja, *supra* note 82, at 1901. If average investor's net losses from fraud are considerably smaller than the negative stock market reaction would suggest, damages compensate a greater share of those losses for all investors as a class.

182. *See also* discussion *infra* in Part III.A.3.

But the SEC does not only sanction issuer reporting and disclosure violations, it prosecutes a great variety of securities misconduct. Many of these violations have elements of theft, embezzlement, and consumer fraud. Their prosecution and subsequent distribution of collected monetary sanctions to defrauded investors reverses real transfers of value by wrongdoers back to the victims. There is evidence suggesting that the SEC's compensation through fair fund distributions for some categories of securities violations is significant.

The conclusion is based on three findings of this study. First, in several fair fund distributions eligible participants who filed claims with the fund administrator were fully compensated for their losses.[183] This does not imply that the SEC forced the wrongdoer to pay monetary sanctions equal to the social cost of its misconduct. It is likely that some of the victims did not file claims and/or that they filed claims but not all of their losses were eligible for compensation, a common result in large-scale compensation schemes, including class action litigation.[184] But the finding suggests that some investors are made whole through fair fund distributions.

Second, the study identified 18 cases where the order imposing sanctions directed the defendant to pay defrauded investors specified amounts of money. Penalties in most such cases were set at the level that would appear to compensate fully investors identified in the order or consent decree.[185] Again, it is possible that the orders did not include all of the victims or the full extent of their losses.

Finally, evidence from settled parallel securities class actions suggests that the SEC came very close to fully compensating defrauded investors in two dozen market timing and late trading cases, as well as in seven cases against the NYSE specialist firms for improper trading practices.[186] The

183. *See e.g.*, Sec. & Exch. Comm'n v. Concorde America, 9:05–cv–80128 (1335 investors defrauded by market manipulation were fully compensated); Sec. & Exch. Comm'n v. McCloskey et al., 1:04–cv–01294 (12 investors who sold to individuals trading on inside information were fully compensated); Sec. & Exch. Comm'n v. SG Limited, 1:00–cv–11141; Sec. & Exch. Comm'n v. Agora, Inc. et al., 1:03–cv–1042 (fully compensated).

184. *See* Catherine Weiss, Michael Hahn & Andrew S. Zimmerman, *States Provide Model for Handling Controversial Class Action Awards,* NAT'L L. J., Nov. 25, 2013 (noting the ongoing controversy about leftover funds in class action settlements).

185. *See e.g.*, Final Consent Judgment, Sec. & Exch. Comm'n v. State Street Bank and Trust Co., No. 1:10–cv–10172 (D. Mass. Feb. 4, 2010) (giving defendant credit for reimbursing investors, and ordering additional compensation); Final Consent Judgment, Sec. & Exch. Comm'n v. GE Funding Capital Market Servs., NO. 2:11–cv–7465–WJM–MF (D.N.J. Dec. 23, 2011) (directing the defendant to pay identified municipal entities specific amounts as compensation).

186. For example, Strong Capital Management, Inc. and affiliated companies paid $140 million to settle the SEC enforcement action for market timing, but only $13.5 million in a subsequent class action settlement; Banc of America Capital Management, Inc. paid $375 million to settle with the SEC and $17.8 million to settle a subsequent class action. Overall, market–timing defendants paid $2.96 billion to settle with the SEC and $232 million to settle parallel class actions. *See also* John C. Coates IV, *Reforming the Taxation and Regulation of Mutual Funds: A*

Commission settled its enforcement actions years before the class actions were settled, and the SEC's settlements were larger than class action settlements by an order of magnitude, because courts took into account monies that investors already received as compensation.[187]

In response to fair fund distributions in market timing cases, some management groups have actually complained that fair funds overcompensate investors.[188] Their complaint appears to be unfounded. Both, the courts and the SEC take into account parallel compensation proceedings when distributing funds to investors.[189] And both have refused to distribute to investors more than the amount necessary to compensate the full extent of their losses.[190]

However, large fair fund distributions (relative to investors' likely losses) that predate class action settlements have the potential dilute the SEC enforcement action's deterrent. According to the policy expressed in its settlements, the SEC allows defendants to offset damages paid in a class action against the disgorgement amount in the enforcement action, but denies credit against the civil fine part of the sanction. The purpose of the prohibition is to "preserve the deterrent effect of the civil penalty."[191] But most parallel class actions settle years after the SEC has settled its enforcement action, and often after the SEC has distributed the fair fund to

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Comparative Legal and Economic Analysis, 1 J. LEGAL ANAL. 591, 593 & n.3 (2009) (arguing that several fair funds were larger "than any plausible loss to affected mutual funds").

Similarly, stock exchange specialists paid $247 million in 2004 to settle SEC's enforcement actions, and $18.5 million in 2012 to settle parallel securities litigation. *See* SEC, Press Release, Distributions Begin to Victims of Improper Trading a NYSE Specialist Firms, July 19, 2006, http://www.sec.gov/news/press/2006/2006–120.htm; class settlement in 1:03–cv–8918, Oct. 24, 2012.

187. *See id.*

188. *See e.g.*, COMM. ON CAPITAL MKTS. REGULATION, INTERIM REPORT OF THE COMMITTEE ON CAPITAL MARKETS REGULATION 82 (2006), available at http:// www.capmktsreg.org/pdfs/11.30Committee_Interim_ReportREV2.pdf/ ("At present, however, there are no limitations on recoveries in concurrent, private lawsuits even after the SEC has made a Fair Funds distribution, raising the possibility of a wasteful double–recovery by shareholders.")

189. *See* Plaintiff Memorandum in Support of its Motion for Distribution of Settlement Funds and Appointment of Distribution Agent, Sec. & Exch. Comm'n v. Dean L. Buntrock, 2005 WL 2610696 (N.D.Ill., Aug. 26, 2005) (arguing that "to the extent that all injured investors have been made whole, whatever is left in the Fair Funds should revert to the Treasury"); In re Am. Intern. Group, Inc. Securities Litigation, April 11, 2013, 2013 WL 1499412, at 6 (S.D.N.Y. 2013); In re Mut. Funds Inv. Litig., 608 F. Supp. 2d 677, 678–79 (D. Md. 2009) (granting summary judgment to defendants because any damages caused by market timing in benefit plans were "fully offset by the restitution paid by defendants [through a fair fund] pursuant to regulatory settlements").

190. *See id*.

191. *See e.g.*, In the Matter of Franklin Advisers, Inc. & Franklin/Templeton Distributors, Inc., Admin. Proc. File No. 3–11769, Order Instituting Administrative Cease–and–Desist Proceedings, Dec. 13, 2004 ("To preserve the deterrent effect of the civil penalty, Respondents agree that they shall not, after offset or reduction in any Related Investor Action based on Respondent's payment of disgorgement in this action, further benefit by offset or reduction of any part of Respondent's payment of a civil penalty in this action ('Penalty Offset').")

investors.[192] Despite the prohibition against offset of the civil fine, defrauded investors cannot receive damages in a subsequent class action settlement that would exceed their uncompensated losses. Where investors have been fully compensated from the fair fund, courts have granted defendants' summary judgment motions in class action litigation because plaintiffs' damages had already been "fully offset."[193] Where the class action proceeds to settlement, the settlement amount reflects the amount of compensation that investors already received from the fair fund, regardless of whether the distributions were designated as disgorgement or civil fine. As the end result, the defendant effectively pays the full amount of investors' damages, but no civil fine as additional deterrent.

It is worth reviewing the limited circumstances in which this scenario plays out: (1) parallel private and public actions proceed on the basis of the same underlying facts; (2) the SEC settles its enforcement action and distributes the fair fund before the class action settlement; and (3) the SEC's settlement is so large relative to investors' losses that a fair fund distribution fully compensates defrauded investors. This is not a concern in enforcement actions for issuer reporting and disclosure violations, where investors' losses usually dwarf any payments made by the defendants,[194] but could be an issue in actions against securities market intermediaries.

To avoid diluting the deterrent effect of the civil fine in these circumstances, the SEC could wait for the class action to settle before it distributes the fair fund to defrauded investors, but that would usually delay distribution for many years. Alternately, the SEC could distribute the disgorgement part of the fair fund and wait to distribute the civil fine part until after the class action has been resolved (or remit the civil fine to the U.S. Treasury if investors have been made whole).

The only situation where one could argue that fair fund distributions *overcompensate* investors is where the sanctioned firm is bankrupt.[195] Consistent with the principle of absolute priority, section 510(b) of the Bankruptcy Code subordinates shareholders' damages claims for securities fraud to claims of the bankrupt company's creditors.[196] Because bankrupt firms are, by definition, insolvent, the Bankruptcy Code effectively precludes equity holders with securities fraud claims from recovering anything from

192. See discussion *supra* in Part II.B.3.

193. *See* In re Am. Intern. Grp., Inc. Securities Litigation, at 6.

194. *See* Black, *supra* note 7, at 338 n.166 (explaining that the penalty for securities violation does not change as a result of parallel shareholder litigation, but the harmed investors' recoveries can increase, though not exceed their losses).

195. "Overcompensate" in the sense that shareholders receive more than they should under bankruptcy law.

196. 11 U.S.C. § 510(b). The idea behind the provision is that equity holders should not receive anything until all creditors have been paid in full.

the bankrupt estate.[197] As a result, securities class actions against bankrupt companies are ordinarily dismissed.[198]

The SEC may pursue an enforcement action against a bankrupt firm (as well as against its executives and auditor),[199] but the automatic stay in bankruptcy stops it from collecting any money judgment from the firm.[200] The SEC's claim for civil penalty and disgorgement is treated as an unsecured creditor claim and is distributed pro rata, along with other unsecured creditors.[201] However, section 510(b) does not preclude the SEC from distributing civil fines and disgorgements to defrauded shareholders through a fair fund. When the SEC distributes monetary sanctions it collected from the bankrupt company to defrauded shareholders, the ultimate result is that unsecured creditors' recoveries are smaller as a result of the monetary penalties paid in the SEC's enforcement action, while shareholders' recoveries are greater because of the fair fund distribution.[202]

The abstraction described above became reality in WorldCom, which filed for bankruptcy protection soon after it revealed a massive accounting fraud.[203] The SEC collected $750 million from the bankruptcy estate as a civil fine and distributed it to defrauded shareholders, who would otherwise receive nothing.[204] This outcome gave rise to considerable scholarly and popular criticism.[205]

Yet WorldCom is the exception, not the rule for fair fund distributions. Thirty-one companies that were primary defendants in the fair fund sample

197. *See* Zack Christensen, Note, *The Fair Funds for Investors Provision of the Sarbanes–Oxley: Is It Unfair to the Creditors of the Bankrupt Debtor*, 2005 U. ILL. L. REV. 339, 348–49 (2005); Mark J. Roe & Frederick Tung, *Breaking Bankruptcy Priority: How Rent–Seeking Upends the Creditors' Bargain*, 99 VA. L. REV. 1235, 1285–86 (2013).

198. Though the case continues against individual defendants, D&O insurers, auditors and underwriters. *See* James J. Park, *Securities Class Actions and Bankrupt Companies*, 111 MICH. L. REV. 547, 551, 561 (2013).

199. Sec. & Exch. Comm'n v. First Fin. Group, 645 F.2d 429 (5th Cir. 1981).

200. 11 U.S.C. § 362(b)(4).

201. *See* Kasey T. Ingram, *The Interface Between the Bankruptcy Code and a Disgorgement Judgment Held by the Securities and Exchange Commission*, 5 TRANSACTIONS: THE TENN. J. BUS. L. 31, 42–48 (2003) (explaining that the SEC may petition the bankruptcy court to exclude the monetary sanction from bankruptcy discharge, meaning that that the debtor emerging from bankruptcy still owes the entire amount).

202. *See* Sec. & Exch. Comm'n v. WorldCom, Inc., 273 F. Supp. 2d 431, 435 (S.D.N.Y. 2003).

203. *See id.* at 431–33.

204. *See* Christensen, *supra* note 195, at 356.

205. *See e.g.*, Black, *supra* note 7, at 332–33; Christensen, *supra* note 195, at 375 (arguing that Congress should amend the Fair Fund provision to prevent it from "alter[ing] the well–established distributional priorities of the Bankruptcy Code"); Roe & Tung, *supra* note 195, at 1285–86 (explaining that fair fund distributions "directly contradict[]" bankruptcy priority); David A. Skeel, Jr., *Welcome Back, SEC?*, 18 AM. BANKR. INST. L. REV. 573, 583–84 (2010) ("The bankruptcy laws ordinarily subordinate a shareholder's securities claims, but the SEC has evaded this rule and ignored the priority framework.").

filed for bankruptcy within 2 years of the SEC's enforcement action.[206] Of those, 16 were issuer reporting and disclosure cases, where priority conflicts between creditors and shareholders are particularly likely.[207] In enforcement actions against those 16, however, the SEC imposed a financial penalty against only 2 companies: Nortel Networks, and WorldCom. Nortel Networks paid $35 million, while WorldCom settled for $750 million, and these civil fines were distributed to defrauded shareholders. But Nortel Networks paid the civil fine fourteen months before filing for bankruptcy, and the fine did not directly reduce creditors' recoveries in bankruptcy.[208] In all other cases the SEC either did not pursue the bankrupt debtor at all or did not order the company to pay monetary sanctions.[209]

Instead, the SEC prosecuted individuals and auditors and investment banks, who paid $280 million and $492 million, respectively, and the SEC distributed $772 million it collected through fair funds to harmed investors. The SEC's settlements with executives and auditors were not part of the bankruptcy estate and did not deplete the monies earmarked for unsecured creditors. The same defendants that settled with the SEC often ended up settling with the bankruptcy trustee and paying additional damages to compensate creditors.[210]

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206. Several others were acquired (e.g., Wachovia, Countrywide, Strong Capital Management, Inc.), put into receivership or entered voluntary liquidation, where fair fund distributions did not upset bankruptcy priority.

207. Bankrupt companies were somewhat overrepresented in our sample compared with securities class actions. Professor Park found that 16% class actions were filed against bankrupt companies, whereas 22.9% fair funds created in issuer and disclosure cases include bankrupt companies. *See* Park, *supra* note 196, at 561.

Eight of remaining 15 cases against bankrupt companies were unregistered offerings, pump–and–dump and Ponzi schemes. These types of defendants rarely have large creditors other than defrauded investors. Rather, claimants against the estate are defrauded investors, who are also the recipients of the fair funds.

208. Nortel Networks paid a $35 million civil fine to the SEC in November 2007 and filed for bankruptcy protection in January 2009. The accounting frauds that the SEC prosecuted occurred in 2000–01 and 2003–04. The fair fund distribution to shareholders may have reduced creditors' recoveries indirectly, because the funds would have been available for distribution to creditors when Nortel filed for bankruptcy in January 2009. But Nortel Networks also could have spent the money otherwise before filing for bankruptcy.

209. For example, the SEC sued the executives in the American Home Mortgage Investment Corporation, Sec. & Exch. Comm'n v. Strauss et al., 1:09–cv–4150; Sunbeam, Sec. & Exch. Comm'n v. Albert J. Dunlap, 9:01–cv–8473, Final Judgment, Sept. 4, 2002 (settling with the defendant for a $500,000 civil penalty); and Peregrine Systems, Sec. & Exch. Comm'n v. Peregrine Systems, 3:03–cv–1276, Final Judgment, July 23, 2003 (not requiring civil penalties or disgorgement in light of the firm's Chapter 11 bankruptcy); http://www.sec.gov/litigation/litreleases/2009/lr20942.htm/ (reporting a settlement with several executives).

210. For example, audit firm Deloitte & Touche paid $50 million to settle the SEC's enforcement action for repeated audit failure in bankrupt Adelphia, and $210 million to settle parallel securities litigation. *See* Press Release, U.S. Sec. & Exch. Comm'n, SEC Charges Deloitte & Touche for Adelphia Audit (Apr. 26, 2005), *available at* http://www.sec.gov/news/press/2005–

As a result of the SEC's selective enforcement, only bankrupt WorldCom paid $750 million to the SEC for distribution to defrauded shareholders from its bankruptcy estate. The WorldCom fair fund cast a dark shadow over the SEC's distribution efforts, but WorldCom is the exception, not the rule. There is no empirical support for the allegation that SEC's fair fund distributions systematically overcompensate defrauded shareholders.

3. How Common is Parallel Private Litigation

Securities class actions often accompany enforcement actions.[211] But not every enforcement action is accompanied by private litigation: parallel securities class actions were filed in 65.4% of cases in which the SEC established a fair fund, and settled for non-zero monetary damages in only 45.6% of cases (104 of 228).[212] In more than half of the fair fund distributions—54.4%—defrauded investors received no compensation from private litigation, the traditional source of compensation.

VENN DIAGRAM OF THE OVERLAP BETWEEN SEC FAIR FUNDS AND SECURITIES CLASS ACTION SETTLEMENTS

Fair fund cases without filed parallel private lawsuits are on average smaller than cases with parallel litigation; seventy-nine such fair funds distributed $879 million (6.1% of aggregate fair fund amount), with a mean fund of $11.1 million and a median of $2.5 million (compared with $60.72 million mean and $16.96 million median for all fair funds). This group

65.htm; Stipulation and Agreement of Settlement Between Class Members and Deloitte & Touche, In re Adelphia Communications Corp. Securities & Deriv. Litig., No. 03–md–1529 (LMM) (S.D.N.Y. May 23, 2006).

211. But as discussed in preceding section, the converse is not true.

212. In 8 cases, it could not be determined whether a parallel class action was filed. Analyzing a related question, Professors Cox and Thomas found relatively little overlap between SEC enforcement actions and private class actions. *See* Cox & Thomas, *supra* note 81, at 745.

includes three categories of cases. The first and the largest category comprises of smaller frauds, predominantly against individual defendants, including insider trading, certain broker-dealer and investment adviser violations (e.g., failure to supervise a rogue employee), and other market manipulations.[213] What these cases have in common is that it is not cost-effective for private litigants to bring a lawsuit because the amounts are small, and the legal bar to survive a motion to dismiss set by the Private Securities Litigation Reform Act of 1995 ("PSLRA") and the Supreme Court is very high.[214] In the second category are a dozen or so cases where the enforcement action and the ensuing fair fund distribution fully compensate defrauded investors. Moreover, the nature of the violation was such that plaintiffs could not detect the fraud and litigate before the SEC announced its enforcement action. This category includes a handful of cases against investment banks for market timing and municipal bid-rigging. Finally, in the third category are cases where the primary violator is judgment-proof, either because it is put in receivership or liquidated (if a firm), or convicted (if an individual).

SUMMARY OF PARALLEL CLASS ACTIONS

Outcome of Parallel Litigation	**Number (n=228)**
No Parallel Litigation	79
Parallel Securities Litigation	149
Dismissed	31
Monetary Settlement	104
Non-monetary Settlement	9
Ongoing	5

Of 149 cases with accompanying private securities litigation, in 104 cases there was a monetary settlement in at least one of the class actions that were filed, in 31 cases all filed class actions were dismissed, and the remainder are still ongoing or settled for non-monetary relief. The reasons for dismissals are not surprising. With the aim of weeding out weak cases,

213. *See id.* at 750 (reporting limited class actions in cases against investment advisers, broker–dealers and for market manipulation).

214. Unlike in large cases where plaintiffs can sometimes establish a strong inference of scienter that PSLRA requires to survive the defendant's motion to dismiss by relying on news articles in the Wall Street Journal, these cases do not attract the same sort of attention. *See e.g.*, Class Action Complaint, at 12–13, Michael Pflugrath v. Bear, Stearns Companies, Inc. et al., No. 03–cv–8864 (S.D.N.Y. Nov. 7, 2003).

Congress enacted the PSLRA in 1995 and significantly raised pleading requirements for securities class actions under Rule 10b-5. The PSLRA requires that the complaint allege with specificity: the statement or omission that is false or misleading and why;[215] if pleaded on information and belief, particularity as to facts on which that belief is formed;[216] and facts giving rise to a strong inference that the defendant acted with the required state of mind.[217] The PSLRA also requires plaintiffs to plead and prove loss causation,[218] and generally precludes discovery pending decision on a motion to dismiss.[219]

While PSLRA screens eliminated many unmeritorious strike suits, they also bar many meritorious suits, in particular those that do not fit neatly in the material-misrepresentation-followed-by-subsequent-correction-and-price-decline mold. Class actions against securities market intermediaries are among those particularly likely to be dismissed, despite a successful parallel SEC enforcement action or even criminal conviction—suggesting that plaintiffs' allegations had merit. Several class actions with parallel fair fund distributions were dismissed for failure to plead scienter with sufficient specificity;[220] others failed to plead "loss causation"—a causal connection between the fraud and the economic loss—as required by the Supreme Court's decision in *Dura Pharmaceuticals, Inc. v. Broudo;*[221] and some were dismissed because of the statute of limitations.[222] Finally, a handful of class actions were dismissed because the court concluded there is no private cause of action.[223]

In sum, in more than half of the fair fund distributions—54.4%—defrauded investors do not receive compensation in parallel securities litigation, either because no private action was filed or because it became victim of one of the PSLRA screens. As a result, in the majority of fair fund cases, the fair fund is the only source of investor compensation.[224]

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215. 15 U.S.C. § 78u–4(b)(1).

216. *Id.*

217. 15 U.S.C. § 78u–4(b)(2); see Tellabs, Inc. v. Makor Issues & Rights, Ltd., 127 S. Ct. 2499, 2507–10 (2007).

218. § 78u–4(b)(4); see Dura Pharms., Inc. v. Broudo, 544 U.S. 336, 341–43 (2005).

219. § 78u–4(b)(3)(B).

220. *See e.g.*, Order, In re Biogen Idec, Inc. Securities Litigation, No. 05–10400 (D. Mass. Sept. 14, 2007).

221. 544 U.S. 336 (2005). *See e.g.*, Memorandum and Order, Swack v. Lehman Brothers Holdings, Inc., No. 03–10907–NMG (D. Mass. Aug. 17, 2005).

222. *See e.g.*, Order, Capone et al. v. MBIA, Inc., No. 05–3514 (S.D.N.Y. Feb, 12, 2007).

223. *See e.g.*, Stipulation and Order of Dismissal, Smith et al. v. Hartford Financial Services Group, Inc. et al., No. 04–344 (D. Conn. Jan. 30, 2008) (concluding there is no private cause of action for undisclosed revenue sharing between investment advisors and inferior investment funds they were promoting, and for receiving kickbacks for such promotions).

224. In four cases, investors received additional compensation from a receiver. In a few others, defendants were also convicted and criminal sanctions included restitution. While the Financial

Aggregate damages in parallel securities class actions amounted to $39.35 billion. The median successful class action accompanied by a fair fund distribution settled for $30.98 million. Mean class action recovery is much larger, $382.06 million, but the mean is skewed by a handful of very large class action settlements in notorious accounting fraud cases (WorldCom, Enron, Tyco).[225] About two thirds of class actions settled *after* the SEC settled its enforcement action against the securities violators. Class actions that settled before the SEC's settlement settled for less, $199.8 million compared with $484.5 million for class actions that settled later, but the difference is not statistically significant.[226]

In cases where investors receive compensation from both a fair fund and a parallel class action, the average share of total compensation that comes from the fair fund is 41.1% (median 33.4%). (In all other cases, of course, investors receive all of their compensation from the fair fund.) But aggregate numbers conceal real diversity in the underlying cases. All but one issuer disclosure and reporting fair funds are accompanied by parallel securities litigation, and accompanying class actions are also very likely to prevail. Of 104 class actions with monetary settlements, 59 were in accounting fraud cases. Only 6 class actions alleging accounting fraud were dismissed, while 59 settled for $35.42 billion in the aggregate. Accounting fraud class action settlements accounted for 90.33% of aggregate class action recoveries in the study—this finding is consistent with other studies of class action settlements.[227] Large class action settlements dwarf fair fund distributions in accounting fraud cases.

By contrast, parallel securities litigation is less likely to be filed and to prevail in all other categories of securities violations. Of 157 fair funds created in cases that did not allege issuer reporting and disclosure violations, 79 were accompanied by parallel private litigation (50.3%), and 45 parallel class actions yielded monetary settlements (28.7%). For example, only 2 of 15 insider trading cases were accompanied by private litigation, and both

Industry Regulatory Authority (FINRA), which licenses, regulates, and oversees brokerage firms and registered securities representatives, has the authority to levy fines against registered individuals and firms and brings twice as many enforcement actions as the SEC (1,541 in 2012), its fines are considerably smaller than the SEC's. In 2012, FINRA levied fines amounting to $69 million (compared with $3 billion for the SEC), and paid $34 million as restitution to defrauded investors. *See* FIN. IND. REG. AUTHORITY, FINRA 2012 YEAR IN REVIEW AND ANNUAL FINANCIAL REPORT 3 (2013). In 2011, FINRA's fines totaled $71.9 million, of which $19.4 million were distributed to defrauded investors. *See* FIN. IND. REG. AUTHORITY, FINRA 2011 YEAR IN REVIEW AND ANNUAL FINANCIAL REPORT 2 (2012). In the aggregate, FINRA's contribution to investor compensation for large–scale frauds is nominal, and is likely to remain so. *See* Andrew F. Tuch, *Investment Bankers, and the Failure of Self–Regulation* (unpublished manuscript).

225. These three settlements represent 47.6% of all class action recoveries in the study.

226. The two figures look very different, but the samples from which they were calculated are small and variable so, statistically speaking, the means are similar.

227. *See* CORNERSTONE RESEARCH, *supra* note 125, at 1, 11–12.

class actions were dismissed.[228] Two of 7 market manipulation cases were accompanied by private litigation; one action was dismissed, while the other settled for $775,000.[229] Seven of 19 securities offering cases[230] were accompanied by private litigation, and four succeeded, settling for the aggregate $416 million. About half of enforcement actions against investment advisors were accompanied by private litigation (32 of 61), and 19 of those settled for the aggregate $409 million in damages. By contrast, fair funds in investment advisor cases distributed $3.87 billion to defrauded investors.

DISTRIBUTION OF PARALLEL CLASS ACTION SETTLEMENTS (2003-2013)

	Filed Class Actions in FF Cases	Successful Class Action in FF Cases	Aggregate Class Action Recoveries (in $M)	Fair Fund Distribution as % of Total Recovery
Broker Dealer	34 of 47	16 of 47	492.5	81.4
Insider Trading	2 of 15	0 of 15	0	100
Investment Adviser	32 of 61	19 of 61	409.1	90.4
Issuer Reporting and Disclosure	68 of 69	59 of 69	35,422.3	15.5
Market Manipulation	2 of 9	1 of 9	0.8	96.7
Municipal Securities	2 of 6	1 of 6	45.2	84.2
Securities Offering	7 of 19	4 of 19	416.4	77.7

As the table makes clear, the SEC's contribution to compensation in issuer reporting and disclosure cases is small. By contrast, in all other cases, private litigation fails to compensate defrauded investors for their losses. Small potential damages reduce the economic incentive to file a class action for some securities violations. Moreover, filed class actions that do not allege

228. *See* Order, In re Biogen IDEC, Inc., No. 05–10400 (D.Mass, Sept. 14, 2007) (dismissing the complaint for failure to plead scienter); Memorandum of Decision on Motions to Dismiss, Albert Brodzinsky v. FrontPoint Partner LLC et al., No. 11– 0010 (E.D.N.Y., Apr. 26, 2012) (dismissing the complaint because the plaintiffs lacked standing to sue).

229. *See* Final Judgment, Final Judgment of Fees and Expenses, and Order of Dismissal at 5, In re Spear & Jackson Securities Litigation, No. 04–80375–CIV–MIDDLEBROOKS/JOHNSON (S.D. Fla. May 14, 2007).

230. We were unable to determine whether a parallel class action was filed in 2 cases.

accounting fraud are much more likely to be dismissed, although the allegations of misconduct are no less serious (as the SEC enforcement actions indicate). As a result, fair fund distributions are the dominant source of compensation for securities violations except for issuer reporting and disclosure violations.[231]

A few large class action settlements thus obscure the importance of fair fund distributions as a source of compensation in the average securities case. The most common SEC enforcement actions that yield considerable recoveries for defrauded investors are not against WorldCom or Tyco for accounting fraud, they are for the less visible, yet often far more lucrative securities violations by market professionals against their customers, such as improper trading by exchange specialists, market timing, undisclosed commissions and fees, collusion and unfair competition. In many of such cases, defrauded investors may not even know that they have been victimized, let alone be in the position to pursue a successful securities class action. With the exception of a handful of very large accounting frauds, fair fund distributions are the most important, if not the only source of investor compensation.

B. The Circularity of Fair Fund Distributions

The most common and serious critique of the SEC's efforts to compensate defrauded investors through fair funds is that such distributions are circular. When a firm pays a penalty for secondary market fraud, the money comes from the firm's current shareholders who are ostensibly the victims of the fraud. These payments add "injury to injury" and victimize the victims for the second time.[232]

The discussion below analyzes to what extent the circularity critique is justified for fair funds, by looking at the types of cases in which the SEC distributes monies collected from securities violators to defrauded investors, and by looking at who bears the cost of monetary sanctions imposed by the SEC's enforcement actions. Only about a third of fair fund distributions can be characterized as circular. The SEC goes to some length to target individual defendants, in particular in issuer reporting and disclosure cases where the risk that the sanction will penalize the victims is the greatest. Importantly, insurance and indemnification, which shift the cost of class action damages to firms and their insurers, are rarely available for monetary sanctions imposed in SEC enforcement actions.

231. See discussion *supra* in Part III.A.1.
232. Sorkin, *supra* note 23.

1. Classification of Securities Violations

The circularity critique is most appropriate for cases that involve fraudulent disclosures by public companies. Management overstates the company's performance, which pushes up the company's stock price. Unless the firm issues new stock or trades in its own stock during the period of overstatement, its gain from the misrepresentation is minimal.[233] Forcing the firm to pay the penalty for accounting fraud forces its current shareholders, many of whom suffered losses from the fraud, to bear the cost of that penalty. If the penalty is then distributed to defrauded shareholders through a fair fund, shareholders in effect pay the penalty to compensate themselves. Moreover, shareholders can largely eliminate the cost of such fraud by diversifying their holdings and actively trading. At least *ex ante*, they are as likely to buy overpriced stock as to sell it, so their expected loss from accounting fraud is zero.

Circularity is thus potentially a problem for fair fund distributions in issuer reporting and disclosure cases where the fraud-committing firm pays the civil fine as the primary defendant. Seventy fair funds, or 29.7% of all, were created in issuer reporting and disclosure cases and distributed $6.32 billion to defrauded investors. Of that amount, issuers paid $5.09 billion in monetary sanctions, or 35.5% of the total amount distributed through fair funds. Several of the largest fair funds were created in massive accounting frauds—six of the ten largest fair funds—and in all but one, Enron, the fraud-committing firm paid the bulk of the monetary sanction distributed through the fair fund. With regard to these cases—AIG, WorldCom, BP, Fannie Mae—the circularity critique may be appropriate.[234]

But the salience of these cases distorts their significance—they are not representative of the class and one cannot extrapolate from them to evaluate the population of fair funds. Many of the fair funds in the issuer reporting in disclosure category are not like AIG or Fannie Mae. In 29 of 70 cases, the *fraud-committing firm paid no monetary sanction* into the fair fund.[235] Third-party defendants—executives, the auditor, and investment banks—contributed to the fair fund in 60 of 70 issuer reporting and disclosure cases, and paid $1.24 billion in settlements, or 19.6% of amounts that were distributed through fair funds in these cases.[236]

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233. The inflated stock price enables the firm to make cheap acquisitions using its own stock or negotiate better loan terms. *See e.g.*, Cenco Inc. v. Seidman & Seidman, 686 F.2d 449, 451 (7th Cir. 1982).

234. *See* sources cited *supra* note 24.

235. Two firms paid penalties that were remitted to the U.S. Treasury (Dynegy and Xerox).

236. This is in stark contrast with securities class actions, where third–party defendants were included in the settlement in only 7.6 percent of cases and contribute an even smaller percentage of aggregate damages. *See* Park, *supra* note 196, at 562–63.

The circularity critique does not extend easily to other fair funds. Distribution of payments from individual defendants to defrauded investors is never circular.[237] Overall, individual defendants paid 64.6% of monetary sanctions deposited into fair funds created in market manipulation cases, and 37.2% in insider trading cases.[238]

Moreover, not all sanctions ordered against firms and subsequent distributions to defrauded investors are circular. In the case where a firm sells securities to investors based on fraudulent information about the quality of those securities, the firm *itself* wrongfully benefits from the sale at the expense of the purchasers.[239] Similarly, investment banks wrongfully benefit from pressuring their research analysts to issue favorable reports about companies to help investment banks win those companies' securities business.[240] Where the wrongdoer firm is publicly-held, the penalty is ultimately borne by that firm's (innocent) shareholders, but that does not make the sanctions against the firm inefficiently circular and unfair. The firm's payment in such a case is no different from damages for price fixing or for polluting drinking water. It forces the firm to internalize the costs of its activities and improves shareholders' incentives to monitor management.[241] And it gives management—paid in large part in the company's stock—proper incentives to prohibit and detect employee misconduct.[242] Without

237. This statement assumes that individuals pay sanctions out–of–pocket. For a discussion of the roles that D&O insurance and indemnification play in the SEC enforcement actions against individuals, see discussion *infra* in Part III.B.3.

238. The firm paid a monetary sanction in 2 of 15 insider trading fair funds, and where it did, the firm itself was a conduit of the securities violation. *See* Final Judgment as to Relief Defendants, Sec. & Exch. Comm'n v. Yves. M. Behamou, No. 1:10–cv–8266 (S.D.N.Y. Nov. 16, 2011) (ordering hedge funds that benefitted from insider trading to disgorge $33 million).

239. *See e.g.*, Complaint, Sec. & Exch. Comm'n v. J.P. Morgan, 1:12–cv–1872 (alleging that J.P. Morgan sold and underwrote mortgage–backed securities claiming that 0.04% of loans were delinquent, knowing that 7% were in fact delinquent); Complaint, Sec. & Exch. Comm'n v. State Street Bank and Trust Co., Complaint 1:10–cv–10172 (D. Mass. Feb. 4, 2010) (alleging that fund offering documents and marketing materials understated the funds' exposure to subprime mortgage securities); Complaint, Sec. & Exch. Comm'n v. Wachovia Bank, N.A., 2:11–cv–7135 (D.N.J. Dec. 8, 2011) (explaining how several investment banks formed a cartel to fix interest rates paid to municipalities for reinvestment of municipal bond proceeds, which yielded banks millions in illegal profits).

240. *See* Press Release, U.S. Sec. & Exch'n Comm., Ten of Nation's Top Investment Firms Settle Enforcement Actions Involving Conflicts of Interest Between Research and Investment Banking (Apr. 28, 2003), *available at* http://www.sec.gov/news/press/2003–54.htm.

241. *See* Coffee, *supra* note 14, at 1562; Amanda M. Rose & Richard Squire, *Intraportfolio Litigation*, 105 NW. U. L. REV. 1679, 1694 (2011) (explaining theoretically why corporate payments in such cases are efficient).

242. *See e.g.*, In the Matter of Pilgrim Baxter & Associates, Ltd., Inv. Advisers Act Rel. 2251, June 21, 2004, Order Instituting Administrative and Cease–and–Desist Proceedings (finding that the President of Pilgrim Baxter established a hedge fund in order to engage in market timing and late trading in mutual funds he managed); In the Matter of General American Life Insurance Co. & William C. Thater, Sec. Act Rel. No. 8832, Aug. 9, 2007, Order Instituting Administrative and Cease–and–Desist Proceedings (finding that William Thater received a $130,000 performance

imposing fines against firms for securities violations from which the firms benefit, their shareholders (and managers furthering shareholders' interests) would have an incentive to ignore or even encourage lucrative misconduct.[243]

Finally, the circularity critique depends in large part on the fact that diversified shareholders are both, the victims of fraudulent disclosures and the ones paying damages. But most defendants in SEC enforcement actions are not publicly held firms, in particular in cases against broker-dealers, investment advisors, hedge funds, and other privately-held entities, etc. Their shareholders, who bear the cost of the penalty, are often insiders, who also manage these firms and are frequently themselves sanctioned by the SEC for the same misconduct.[244] Defendants bearing the cost of monetary sanctions paid to the SEC are not the same individuals as defrauded customers, who are entitled to compensation. Compensation is further justified because brokerage customers and mutual fund investors (unlike shareholders harmed by fraudulent disclosures) cannot self-insure through diversification against the risk that their broker will charge excessive commissions, execute trades to benefit the broker-dealer firm, or allow preferred clients to dilute the value of the customer's mutual fund investment.[245] Diversification is either impossible or illegal,[246] and thus the argument for compensation is much stronger.

With this analytical preface in mind, let us turn our attention to the SEC's fair fund distributions. The case mix of fair funds tracks enforcement actions. The SEC consciously brings enforcement actions in all areas within

bonus and his employer sizeable management and advisory fees for allowing a privileged customer to benefit from late trading, at the expense of other mutual fund investors.); Complaint, Sec. & Exch. Comm'n v. K.W. Brown & Co. et al., 9:05–cv–80367 (contending that the broker's compensation structure created an improper conflict of interests with customers, and gave him an incentive to steer more profitable trades to the firm's trading account); In the Matter of Robertson Stephens, Inc., Sec. Exch. Act Rel. 47144, Jan. 9, 2003, Order Instituting Administrative and Cease–and–Desist Proceedings (finding that a senior research analyst issued misleading reports about companies in which he and other senior executives of the investment advisor owned stock worth several million dollars).

243. *See e.g.*, In the Matter of Fidelity National Capital Investors, Inc., Sec. Exch. Act Rel. 49824, June 8, 2004, Order Instituting Administrative and Cease–and–Release Proceedings (sanctioning the firm for failing to flag a Ponzi scheme, and noting that 8% of total commissions from 3,000 brokerage accounts came from the one account that Mark Drucker used for his Ponzi scheme).

244. *See e.g.*, Plan of Distribution at 2, In the Matter of Pilgrim Baxter & Assoc., Ltd., Admin Prod. File No. 3–11524 (Nov. 22, 2006).

245. See *supra* notes 26–31 and accompanying text.

246. Only accredited investors—individuals with net worth of more than $1 million or with annual income of $200,000 for individuals and $300,000 for married couples—are legally allowed to invest in private companies, including hedge funds. *See* 17 C.F.R. § 230.405. As a practical matter, most hedge funds expect a minimum investment of $1 million or more, further limiting the ability of those less affluent to diversify. *See* Lily Chang, Why and How Do Hedge Fund Managers Set Minimum Subscription Amounts? 1, Drinker Biddle Hedge Fund Report, http://www.drinkerbiddle.com/files/ftpupload/PORTAL/Hedge%20Fund%20Law%20Report.pdf.

its jurisdiction.[247] Although issuer reporting and disclosure cases are overrepresented in the fair fund sample relative to the number of enforcement actions (23% of enforcement actions and 29.7% of fair fund distributions are associated with issuer reporting fraud), the majority of cases in which a fair fund is created and distributed is not for issuer reporting violations. Most fair funds target profitable consumer fraud and anticompetitive behavior by market professionals that harms their customers. For example, all broker-dealer cases involve schemes designed to swindle unsuspecting customers: allowing certain preferred clients to time the market and engage in after-hours trading at the expense of mutual fund investors and in exchange for excess advisory and management fees,[248] undisclosed kickbacks to brokers for recommending more expensive investment products to their customers,[249] pressuring research analysts to issue favorable reports about companies to help investment bankers win those companies' securities business,[250] churning.[251]

Enforcement actions against investment advisors and investment companies, the largest class of SEC-overseen fair funds, are similar to broker-dealer cases in that they police transfers of wealth from outsiders to insiders: using mutual fund investors' funds to bribe brokers for promoting investments in those funds,[252] charging investors for expenses that the fund did not incur,[253] allowing its employees to self-deal with mutual funds that they supervise at the expense of mutual fund investors,[254] cherry picking (i.e., allocating cheaply bought securities to the firm's own account and more expensive ones to customer's accounts), etc.[255]

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247. *See* U.S. SEC. & EXCH. COMM'N, FISCAL YEAR 2013 AGENCY FINANCIAL REPORT 13–14, 17 ("The SEC also pursued violations of all shapes and sizes, including complex cases stemming from the financial crisis, to send a strong message of deterrence. . . . [N]o institution is too large to be held to account and no violation is too small to escape scrutiny.").

248. *See* In the Matter of Canadian Imperial Holdings, Inc. & World CIBC Markets Corp., Admin. Proc. File No. 3–11987, Order Instituting Administrative Proceedings, July 20, 2005, Sec. Act Rel. No. 8592, at 11 (explaining that Canadian Imperial Holdings earned $43 million from market timing and late trading customers and World Markets $28 million plus millions in other fees); Sec. & Exch. Comm'n v. Daniel Calugar, 2:03–cv–1600 (hedge fund manager that market–timed several mutual funds paid $153 million to settle the case).

249. *See* In the Matter of Morgan Stanley DW, Inc., Admin Proc. File No. 3–11335, Order Instituting Proceedings.

250. *See* Press Release, *supra* note 238.

251. Press Release, U.S. Sec. & Exch'n Comm., Broker Accused of Defrauding Elderly Nuns Settles Case with SEC, Jan. 6., 2011, http://www.sec.gov/news/press/2011/2011–2.htm.

252. *See* In the Matter of Franklin Advisers, Inc. and Franklin/Templeton Distributors, Inc., Investment Advisers Act of 1940 Release No. 2337, Dec. 13, 2004.

253. *See* In the Value Line, Inc. et al., Investment Advisers Act of 1940 Release No. 2945, Nov. 4, 2009.

254. *See* In the Putnam Investment Management, LLC, Investment Advisers Act of 1940 Release No. 2192, Nov. 13, 2003.

255. *See* Complaint, Sec. & Exch. Comm'n v. K.W. Brown & Co. et al., 9:05–cv–80367, Apr. 28. 2005.

SEC FAIR FUND DISTRIBUTIONS BY UNDERLYING MISCONDUCT
(2002-2013)

SEC Classification	Distributed Amount (in $M)	% of Distributions (by amount)	% of Distributions (by number)
Broker Dealer	2,152.8	15.0	20.8
Insider Trading	100.9	0.7	6.4
Investment Adviser/ Investment Company	3,868.3	27.0	26.3
Issuer Reporting and Disclosure	6,322.5	44.1	29.7
Market Manipulation	25.7	0.2	3.8
Securities Offering	1,451.4	10.1	8.9
Municipal	240.2	1.7	3.0

Compensation for these violations is neither circular nor futile. Sanctioned firms received real benefits at the expense of defrauded customers who suffered real losses. The overlap between shareholders who bear the cost of the penalty and those who are harmed by the misconduct is, at most, minimal.[256] The circularity critique may be justified with regard to $5.09 billion paid by issuers and distributed to defrauded investors through fair funds created in issuer reporting and disclosure violations. While the amount is large, it represents only 35.5% of all fair fund distributions. Other fair funds distributions cannot be described as circular.

256. Most fair funds exclude from eligibility for the fair fund distribution directors, officers, their family members and entities they and their family members control, employees who were terminated for cause or resigned in connection with the violations, their family members and controlled entities, and aiders and abettors in the scheme, and their officers, directors, terminated employees and related persons. *See e.g.*, Motion to Approve Distribution Plan, at 6–7, Sec. & Exch. Comm'n v. MBIA, Inc., No. 07–cv–658, Dkt. No. 23 (listing ineligible claimants).

2. Defendants in Enforcement Actions

The SEC's enforcement actions usually target the firm as the primary defendant. Firms as primary defendants paid 86.4 percent of monetary amounts distributed through fair funds. The firm as primary violator is much more likely to pay a monetary sanction in SEC-overseen cases than in court-overseen cases. Firms pay monetary sanctions in 56 percent of court-overseen cases and in 84 percent of SEC-overseen cases.[257] It is not uncommon for the firm to pay no monetary sanction for accounting fraud, insider trading, or market manipulation, which are typically resolved in judicial proceedings. If the firm is sanctioned, however, the amount of monetary sanction it pays is similar in SEC- and court-overseen cases, $62.8 million and $95.6 million.[258]

But almost as often as it targets firms, the SEC goes after individual defendants and accounting firms and investment banks as aiders and abettors. A comprehensive search for parallel proceedings against individual and secondary defendants is beyond the scope of this study. However, orders imposing sanctions and fair fund distribution plans typically indicate whether individuals are also sanctioned and whether financial penalties against individual and secondary defendants are added to the fair fund.

Individuals were sanctioned in 160 of 236 of fair funds or 67.8%. Individuals paid monetary sanctions into 141 or 59.7% of fair funds. These figures are consistent with prior studies of SEC enforcement activity against individual defendants.[259] Overall, individual defendants contributed $1.32 billion or 9.2% of the total amount distributed through fair funds.

Individuals are considerably more likely to pay monetary sanctions in court-overseen fair fund cases than in SEC-overseen cases. Settlements with individuals were included in fair funds in 73 percent of court-overseen cases and 40 percent of SEC-overseen cases,[260] and individuals paid 10.4% and 7.3% of aggregate fair fund amounts in each subsample. The average contribution by individual defendants, however, is similar in SEC- and court-

257. The difference is statistically significant at the 1 percent confidence level.

258. The difference is not statistically significant.

259. For example, Michael Klausner and Jason Hegland report that 93% of enforcement cases include an individual defendant. In about 70% of cases, individuals pay civil money penalties, and in roughly 45% of cases disgorgements. By rough measure, individuals pay monetary penalties in 65% of enforcement actions, which is consistent with data reported here. *See* Michael Klausner & Jason Hegland, *SEC Practice in Targeting and Penalizing Individuals Defendants,* THE HARVARD LAW SCHOOL FORUM ON CORPORATE GOVERNANCE AND FINANCIAL REGULATION (Sept. 3, 2013, 9:23 AM), http://blogs.law.harvard.edu/corpgov/2013/09/03/sec–practice–in–targeting–and–penalizing–individual–defendants.

260. The difference is significant at the 1 percent confidence level.

overseen cases, $10.5 million and $9.0 million, respectively.[261] The higher likelihood of individual contribution in court-overseen fair funds is attributable to the SEC's determination to charge individual defendants for issuer disclosure and reporting violations, and to the fact that market manipulation and insider trading, which are resolved in court, are largely in the domain of individual wrongdoers (though they often use firms as conduits).

Enforcement actions against secondary defendants for aiding and abetting the primary violator are less common.[262] The majority of aider and abettor cases are against auditors and investment banks who paid monetary sanctions in 17 fair fund cases, for a total payment of $620 million. As with individual defendants, aiders and abettors were considerably more likely to contribute in court-overseen funds.[263] Aiders and abettors as secondary defendants are asked to contribute where the corporation as the primary violator did not benefit from the misconduct and/or is judgment-proof. The obvious example is accounting fraud, and 11 of 17 aider and abettor contributions were paid into fair funds created in issuer reporting and disclosure cases. The remaining 6 aider and abettor payments were in cases where the primary violator was offering unregistered securities or engaged in a Ponzi scheme, and is bankrupt by the time the SEC initiates enforcement proceedings.

261. Payments by individual defendants are aggregated by case. The reported means are thus the combined payments into a fair fund by all individual defendants.

262. The study uses the term "aider and abettor" narrowly and consistently with how others writing in the area are using it. It is worth noting that the distinction becomes hazy outside of the issuer reporting and disclosure cases. For example, mutual fund market timing cases could all be designated as aider and abettor cases, because the investment advisers and broker–dealer helped hedge funds to trade and dilute the mutual fund assets (and earn large fees in the process).

263. Statistically significant at the 1 percent confidence level.

WHO PAYS (2002-2013)[264]

	Firm	Individual Defendants	Secondary Defendants
Overall			
% of funds	67.4	59.7	7.2
% of aggregate amount	86.4	9.2	4.3
Aggregate payment (in $M)	12,384.9	1,324.8	620.4
SEC-overseen Funds			
% of funds	84.2	40.0	1.2
% of aggregate amount	92.6	7.3	0.04
Aggregate payment (in $M)	5,026.3	398.8	2.1
Court-overseen Funds			
% of funds	56.0	73.0	11.3
% of aggregate amount	82.7	10.4	6.9
Aggregate payment (in $M)	7,358.6	926.0	618.4

PAYMENTS BY INDIVIDUAL AND SECONDARY DEFENDANTS BY TYPE OF SECURITIES VIOLATION (2002-2013)

SEC Classification	Individual Defendants (in $M)	% of Fair Fund in Class	Aiders and Abettors ($M)	% of Fair Funds	Paid by Non-Firm Def. (% of total)
Broker Dealer	200.3	9.30	0	0	9.30
Insider Trading	37.5	37.19	0	0	37.19
Investment Adviser/ Investment Company	397.3	10.27	12.3	0.32	10.59
Issuer Reporting and Disclosure	640.0	10.12	597.4	9.45	19.57
Market Manipulation	16.6	64.65	0	0	64.65
Securities Offering	32.2	2.22	3.5	0.24	2.46
Municipal	0.03	0.01	0	0	0.01

264. There are good reasons to believe that the named defendants actually paid ordered amounts out of pocket, unlike in securities class actions. See discussion *infra* in Part III.B.

One might argue that the reason for the differences between administrative and judicial proceedings is that courts police the SEC's enforcement choices. But with the exception of Judge Rakoff's two recent refusals to approve SEC settlements and a handful of others, courts have been reluctant to overturn SEC's settlements.[265] It appears unlikely that judicial oversight causes the SEC to adopt vastly different settlement practices. Rather, the differences can best be explained by the types of cases that securities laws funnel to courts versus those that the SEC adjudicates.

Overall, individual and secondary defendants contributed to fair funds in 62.3 percent of cases. In the aggregate, they contributed 13.6 percent of all amounts distributed through fair funds. Individuals and secondary defendants did not contribute much in securities offering cases (including municipal securities), but they contributed significant amounts in market manipulation, insider trading, and issuer reporting and disclosure cases. Sanctioned individuals are usually well-paid executives, but their resources are limited compared to firms that employ them. By any measure, non-issuer defendants were ordered to pay a considerable share of monetary sanctions distributed to defrauded investors through fair funds, in particular in accounting fraud cases.

3. Availability of Insurance and Indemnification

The fact that individuals are ordered to pay damages or fines for securities fraud does not imply that they pay out-of-pocket. Individuals are nearly always listed as defendants in securities class actions, but they virtually never contribute to class action settlements because of D&O insurance and corporate indemnification.[266] If corporations, and indirectly their shareholders, bear the cost of the sanction against individual defendants, the sanction effectively targets the corporation, not its officers or directors. Shifting the cost to the firm undermines the deterrent effect of sanctions against individuals, and increases the risk that the payment of damages is inefficiently circular for defrauded shareholders.[267]

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265. *See Rakoff's Revenge*, THE ECONOMIST, Apr. 13, 2013 (describing Judge Rakoff's rejection of SEC's settlement with Citigroup). *See generally* Hillary A. Sale, *Judges Who Settle*, 89 WASH U. L. REV. 377 (2011) (arguing that judges are not "doing their jobs" of policing settlements).

266. *See* Michael Klausner, Jason Hegland & Matthew Goforth, *How Protective is D&O Insurance in Securities Class Actions?—An Update*, at 5, 8, Working Paper Series Paper No. 446, http://ssrn.com/abstract=2260815 (reporting that CEOs were named as defendants in 93% and CFOs in 80% of securities class actions filed between 2006 and 2010, and paid out–of–pocket in 2%).

267. As the preceding section discusses, shifting the sanction to the firm will not always lead to circularity. Where the firm benefitted from the misconduct, either intentionally or for failing to supervise its employees, it is efficient to force the firm to bear the cost of the sanction. Issuer disclosure and reporting violations pose a circularity risk.

Unlike in private litigation,[268] D&O coverage is either unavailable or very limited for SEC enforcement actions.[269] Some D&O insurers cover defense costs associated with an SEC investigation as a rider, but many do not offer it.[270] In general, D&O insurance policies exclude from the definition of covered loss fines and penalties, as well as matters deemed uninsurable under applicable law.[271] Thus, civil fines paid to the SEC are not covered by the D&O policy.[272] As for disgorgement, many courts and insurance carriers take the position that disgorgement represents the return of ill-gotten gain and is not a loss that can be covered—it represents the return of an amount that the corporation or the officer or director should never have received in the first place.[273]

While D&O insurance appears to be largely unavailable to cover monetary sanctions imposed in enforcement proceedings, corporations are authorized under section 145(a) of the Delaware General Corporation Law to indemnify officers and directors for any amounts paid in to settle actions where the officer or director "acted in good faith and in a manner the person reasonably believed to be in or not opposed to the best interests of the corporation."[274]

Although indemnification may be permitted, several factors suggest it is not the norm for firms to indemnify officers and directors for monetary sanctions that the SEC imposes (in contrast with private litigation). First,

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268. Tom Baker & Sean J. Griffith, *How the Merits Matter: Directors' and Officers' Insurance and Securities Settlements*, 157 U. PA. L. REV. 755, 761 (2009) (observing that "the vast majority of securities [class actions] settle within or just above the limits of the defendant corporation's D&O coverage"). The prevalence of insurance does not imply that firms and their shareholders do not bear the cost of securities fraud litigation. Rather, shareholders bear the cost in either case, because the firm pays for the insurance premium with corporate revenues, annually reducing its earnings and shareholder returns.

269. *See* Trautman & Altenbaumer–Price, *supra* note 114, at 355–57; e–mail from Kevin LaCroix to author (Nov. 21, 2013) (on file with author).

270. *See* Trautman & Altenbaumer–Price, *supra* note 114, at 349.

271. E–mail from Kevin LaCroix to author (Nov. 21, 2013) (on file with author). *See also Chubb Specimen Policy* at § 5 (definition of "Loss" excludes "fines or penalties" and "any amount not insurable under the law").

272. *See* J.P. Morgan v. Vigilant, 91 A.D.3d 226, Slip Op. at 5 (N.Y. App. Div. 1st Dep't 2011) ("Bear Stearns did not seek coverage for the $90 million SEC penalty.").

273. *See id*. at 7 (quoting the plaintiff who was seeking insurance coverage as acknowledging "that it is reasonable to preclude an insured from obtaining indemnity for the disgorgement of its own ill–gotten gains"). *See also* Level 3 Communications, Inc. v Federal Ins. Co., 272 F3d 908, 910 (7th Cir 2001) (stating that "a 'loss' within the meaning of an insurance contract does not include the restoration of an ill–gotten gain"); e–mail from Kevin LaCroix to author (Nov. 21, 2013) (on file with author). New York's highest state court recently concluded that an investment adviser was not precluded as a matter of law from seeking coverage for disgorgement of the illegal gains of its customers (in its enforcement action against the investment adviser, the SEC ordered it to disgorge its own, as well as the hedge funds' profits from market timing). *See* J.P. Morgan v. Vigilant, 91 A.D.3d 226, Slip Op. at 7 (N.Y. App. Div. 1st Dep't 2011).

274. Most SEC actions are settled without the admission of guilt, and thus eligible for indemnification under section 145(a).

where the sanctioned individual is also the sole shareholder of the firm, as is the case in an important minority of enforcement actions against broker-dealers and investment advisers, indemnification itself would be circular and is thus unlikely.[275] Effectively, these individuals paid monetary sanctions to the SEC out of their own pocket. Second, where the defendant firm is bankrupt, we can, likewise, assume that individual defendants were not indemnified and paid monetary sanctions out-of-pocket.[276] Third, section 145(a) authorizes the board of directors to indemnify sanctioned individuals, but does not require indemnification unless the individual was acquitted, rather than merely settled.[277] The vast majority of individuals subject to an SEC enforcement action for fraud are terminated.[278] Unless required to, firms are not eager to indemnify disgraced former executives, in particular when firms are trying to rebuild their reputations.[279]

The Commission has adopted a clear policy against allowing indemnification.[280] Some SEC settlements include language prohibiting indemnification or insurance coverage.[281] Other settlements are negotiated

275. *See e.g.*, In the Matter of Weiss Research, Inc. et al., Inv. Advisers Act Rel. 2525, June 22, 2006, Order Instituting Public Administrative and Cease–and–Desist Proceedings (reporting that the individual defendant "owns and controls" the investment adviser); In the Matter of Veras Capital Master Fund et al., Sec. Act Rel. 8646, Dec. 22, 2005, Order Instituting Administrative and Cease–and–Desist Proceedings (noting that individual defendants owned and managed the investment adviser firm that launched funds).

276. *See e.g.*, Final Consent Judgment, Sec. & Exch. Comm'n v. Jeremy Lent et al., 4:04–cv–4088 (sanctioned for accounting fraud of NextCard); Final Consent Judgment, Sec. & Exch. Comm'n v. James Powell et al., 4:06–cv–311 (accounting fraud in Daisytek); Final Judgment, Sec. & Exch. Comm'n v. Roger Covey et al., 1:00–cv–4240 (accounting fraud in System Software Associates).

277. Only officers and directors who are successful on the merits against the SEC are entitled to reimbursement for expenses, including attorney's fees. *See* DEL. CODE ANN. tit. 8, § 145 (c).

278. *See* Jonathan M. Karpoff, D. Scott Lee & Gerald S. Martin, *The Consequences to Managers for Financial Misrepresentation*, 88 J. FIN. ECON. 193, 201 & tbl.3 (2008) (showing that 88.4% of CEO defendants and 93.4% of all individual defendants were terminated by the time the SEC sanctions them).

279. E–mail from Stephen Lamb to Walter Ricciardi (Nov. 22, 2013) (on file with author) (explaining ordering individuals to pay disgorgement, until 2010 a prerequisite for adding individual settlements to a fair fund, usually suggests ill–gotten gain, which implies that in most situations, individual officers would not be entitled to indemnification). *But see* Floyd Norris, *Former Xerox Executives to Pay $22 Million*, N.Y. TIMES, June 6, 2003 (reporting that Xerox announced it was contractually required to indemnify officers for $19 of $22 million in fines and disgorgements that the SEC ordered them to pay, including for disgorgement of millions of insider trading gains).

280. *See e.g.*, 17 C.F.R. § 230.461(c) (authorizing the SEC to refuse to accelerate the effective date of the registration statement for registered investment companies that insure or indemnify "any director or officer of the company against any liability to the company or its security holders" for willful or reckless securities violations). The provision does not prevent indemnification where the officer or director settled the case with the SEC without admitting guilt, which is the normal practice. *See* discussion *supra* at note 265 and accompanying text.

281. *See e.g.*, Consent of Defendant Jack B. Grubman, Sec. & Exch. Comm'n v. Jack B. Grubman, No. 03–cv–2938–WHP (S.D.N.Y. Apr. 28, 2003) ("Defendant agrees that he shall not

with firms and individuals in the shadow of threatened repercussions if a firm decides to indemnify individuals.[282] It is likely that individuals pay considerable amounts out-of-pocket to settle enforcement actions, with their payments added to fair funds for distribution to defrauded investors. This result increases the deterrence of the SEC's enforcement and reduces the circularity of its compensation.

IV. FURTHER IMPLICATIONS

A. What the Results Tell Us About Fair Fund Distributions

The results of the study yield several important conclusions that contradict the conventional wisdom about public compensation for private harm generally and the SEC's efforts to compensate investors specifically.

First, the widespread contention that the SEC "wastes resources on repetitive cases"[283] is largely without empirical support. It is true that issuer reporting and disclosure cases are invariably accompanied by parallel litigation. But for other types of securities violations, the SEC's fair fund distribution is usually the only source of compensation for defrauded investors. Only 45.6% of fair funds distributions were accompanied by successful private litigation, and only 28.7% of the cases not associated with issuer reporting and disclosure violations.[284] Moreover, fair fund distributions dwarf class action damages except for issuer reporting and disclosure violations.

Only a relatively small percentage of fair fund distributions, 35.5% by amount and 29.7% by number, can be described as circular, where the firm that did not benefit from fraudulent disclosure pays monetary sanctions that are later distributed to defrauded shareholders. In all other cases the SEC targets individual and secondary defendants, who pay out-of-pocket, without resort to insurance and indemnification, and entity defendants who made large profits from their misconduct.

Where the firm pays to settle an enforcement action for a securities violation from which it profited, the sanction prevents wrongdoer firms and their shareholders to profit from misconduct. Without imposing fines against

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seek or accept, directly or indirectly, reimbursement or indemnification, including but not limited to payment made pursuant to any insurance policy, with regard to all amounts that Defendant shall pay.").

282. In May 2004, the SEC fined Lucent $25 million for failure to cooperate: Lucent advanced defense costs to some employees facing an SEC enforcement action without being required to do so by law or corporate charter. *See* Latham & Watkins, Newsletter, No. 7, Second Quarter 2004.

283. Sant'Ambrogio & Zimmerman, *supra* note 15, at 2013–14.

284. FINRA has made some effort to compensate defrauded investors, but its overall contribution has been nominal, at best. *See supra* note.

firms for securities violations from which the firms benefit, their shareholders (and managers furthering shareholders' interests) would have an incentive to ignore or even encourage lucrative misconduct. The subsequent distribution to defrauded investors compensates them for losses that they could not avoid or mitigate, and is not inefficiently circular.

The SEC's enforcement is more varied than class actions, and far more likely to target individuals. Many enforcement actions in the fair fund sample are not accompanied by private litigation.[285] In those cases, the SEC's action is the only source of compensation *as well as deterrence*.

The study did not find evidence that SEC's fair fund distributions should be scaled back. To the contrary, since private enforcement against investment advisers and broker-dealers is largely futile, the SEC should aim distribute monetary sanctions to defrauded investors in smaller actions against broker-dealers and investment advisors.

B. Fair Fund Distributions as Evidence of Administrative Flexibility

The SEC mismanaged the Global Research Analyst Settlement and subsequent distribution.[286] The Commission failed to identify specific misconduct in the enforcement action, and as a result it was unable to draft a coherent distribution plan for compensating defrauded investors. It remitted to the U.S. Treasury almost $80 million that otherwise could have been distributed to defrauded investors, and the court justifiably chided the SEC for the avoidable failure.[287] The SEC was also widely criticized for its fair fund distribution to shareholders in bankrupt WorldCom.[288]

But subsequent enforcement actions and related distribution funds suggest that the SEC has learned from its mistakes. Its recent settlements provide more details about misconduct, facilitating subsequent distribution. Where the defendant is solvent and trustworthy, and the victims identifiable without a notice and claims process, the SEC has ordered the defendant (as part of the settlement) to compensate directly its victims—eliminating the need to create a distribution fund.[289] Where victims are more difficult to identify, whenever possible the SEC coordinates its distribution with parallel proceedings.[290] In issuer disclosure and reporting cases, which are always accompanied by securities class actions, the SEC has directed fair funds to class action settlements, instead of creating customized plans. This reduces the administrative cost associated with the distribution.

285. See discussion *supra* in Part III.A.3.
286. See discussion *supra* in Part II.B.1.
287. *See id*.
288. See discussion *supra* in Part III.A.2.
289. See discussion *supra* in Part II.B.3.
290. *See id.*

And since WorldCom, the SEC has not sanctioned firms pushed into bankruptcy by accounting fraud. Instead, it has aggressively pursued individual and secondary defendants, and used more than $772 million it recovered from non-firm defendants to compensate defrauded shareholders. In addition, the SEC generally has shown a willingness to forego a fair fund distribution in accounting fraud cases by not insisting on a $1 disgorgement, which would allow the SEC to distribute the entire pot.[291]

The SEC implemented these changes within a year or two of its initial missteps. By contrast, securities class actions today target the same defendants for the same misconduct (fraudulent disclosures) as securities class actions did nineteen years ago, when the PSLRA tightened the pleading and class certification requirements. The only things that change are the names of the defendant companies. If there is a securities violation and the reward is worth the cost of pursuing it, the class action will be brought.[292] The most lucrative *and* successful class actions are those associated with restatements and accounting irregularities, representing 60% of settlements and more than 90% of damages. Plaintiff attorneys rationally bring class actions with the highest expected value—issuer reporting and disclosure violations—and far fewer in cases not associated with fraudulent disclosures.

Many believe that private securities litigation is flawed, yet private plaintiffs—unlike the SEC—cannot and will not change their litigation strategy. Private plaintiffs' (and their attorneys') strategy changes only when the Supreme Court or Congress modify the pleading requirements and thus the availability of private securities litigation.[293] By contrast, the SEC's experience shows that public compensation efforts are considerably more flexible.

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291. *See* Final Judgment, Sec. & Exch. Comm'n v. Terex Corp., 3:09–cv–1281 (D. Conn. Aug. 19, 2009) (despite authorization in the judgment to move to create a fair fund with $8,000,001, the SEC chose not to do so); Final Judgment, Sec. & Exch. Comm'n v. Citigroup Inc., 1:10–cv–1277 (D.D.C. July 29, 2010) (despite authorization to move to create a fair fund with $75,000,001, the SEC has yet to do so); Settlement Agreement, Sec. & Exch. Comm'n v. General Electric, 3:09–cv–1235 (D. Conn. Aug. 4, 2009) (agreeing to a $50 million penalty without adding a nominal disgorgement); Final Judgment, Sec. & Exch. Comm'n v. Diebold Inc., 1:10–cv–00908 (D.D.C. June 14, 2010) ($25 million civil penalty without disgorgement, ordered to be remitted to Treasury).

292. *See* Amanda M. Rose, *Reforming Securities Litigation Reform: Restructuring the Relationship Between Public and Private Enforcement of Rule 10b–5,* 108 COLUM. L. REV. 1301, 1329 (2008). *See also* Steven Shavell, *The Fundamental Divergence Between the Private and the Social Motive to Use the Legal System*, 26 J. LEGAL STUD. 575, 578 (1997) (showing that private enforcement can overdeter as well as underdeter); A. Mitchell Polinsky, Private Versus Public Enforcement of Fines, 9 J. LEGAL STUD. 105 (1980) (arguing that in many cases financially motivated private enforcement will result in underdeterrence, particularly where the external damage from the violation is large and enforcement costs high).

293. *See* SECURITIES CLASS ACTION FILINGS: 2012 YEAR IN REVIEW 6, *available at* http://securities.stanford.edu/clearinghouse_research/2012_YIR/Cornerstone_Research_Securities_Class_Action_Filings_2012_YIR.pdf (reporting that 85 percent of securities class actions are brought under Rule 10b–5).

C. What the Results Reveal About Public Compensation for Securities Fraud

Since the 1970s, the U.S. Supreme Court and Congress have limited the availability of private securities litigation.[294] It is unclear whether class action suits that are filed today are more meritorious than before the Supreme Court and Congress intervened.[295] This study suggests, however, that private securities litigation targets only one type of securities violation, accounting fraud. In part, the reason is economics. Accounting fraud cases with the potential for large damages attract private attorneys to file class actions and cover litigation expenses, with the hope of large contingency fee recoveries. In part, the Supreme Court has interpreted section 10(b) of the Securities Exchange Act to effectively limit private remedies to fraudulent disclosure.[296] The original language and the intent of section 10(b) were not so circumscribed.[297] As a result of this (mis)interpretation, the likelihood of surviving the motion to dismiss is considerably higher for class actions alleging accounting fraud than for those alleging other securities violations, as this study demonstrates. Defrauded investors filed class actions in cases against investment advisors, broker-dealers, and investment banks, yet those class actions have a much higher dismissal rates than class actions filed in issuer reporting and disclosure cases. Whether by design or by happenstance, statutory and judicial screens eliminate entire classes of meritorious private suits, in particular those against market professionals for a variety of low-visibility, high-profit securities violations.[298]

This study suggests that the SEC is compensating defrauded investors in cases where private litigation no longer serves its compensatory function. The rise of public compensation, such as the SEC's fair funds, then can be understood as an adaptive response to the elimination of private remedies for securities fraud. The Article predicts that public compensation will persist and likely increase as the availability of private litigation declines. The collateral benefit of the shift towards more public compensation is better

294. In an oft–repeated opinion, Justice Rehnquist described "widespread recognition" that private securities litigation presents a "danger of vexatiousness different in degree and in kind from that which accompanies litigation in general." Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 739 (1975).

295. *See e.g.*, see Michael A. Perino, Did the Private Securities Litigation Reform Act Work?, 2003 U. ILL. L. REV. 913, 915 (concluding "there are as many, if not more, class actions filed annually after passage of the PSLRA as before" but also that the PSLRA may have improved "overall case quality" in some instances).

296. *See* Steve Thel, *The Original Conception of Section 10(b) of the Securities Exchange Act*, 42 STAN. L. REV. 385, 463–64 (1991).

297. *See id*.

298 . For example, the SEC ordered Morgan Stanley DW to pay $50 million, Franklin/Templeton $20 million, and Hartford Investment Financial Services $55 million, while parallel class actions were dismissed. In market timing cases federal prosecutors secured criminal convictions against individual securities violators.

deterrence, but both benefits are vulnerable to congressional control over the SEC's budget. The SEC is not self-funding and is dependent on congressional budget appropriations to fund its operations. Its limited enforcement budget cannot be expanded without congressional approval to target more securities violations where compensation is more likely. That funding insecurity threatens to undermine the deterrent and compensation functions of securities enforcement.

CONCLUSION

The study in this Article provides several conclusions. The most important for legal academics and policy-makers is also the most obvious. Salient anecdotes do not make data. Just because the SEC took money from creditors to compensate shareholders of bankrupt WorldCom does not imply that the SEC always does that. Just because the SEC botched the Global Research Analyst Settlement and fair fund distributions does not imply that the SEC always botches distributions. And just because the SEC creates large fair funds in accounting fraud cases that are accompanied by private litigation does not imply that all, or even most, fair fund distributions waste the SEC's resources on repetitive cases.[299] Numerous news articles and quotes from angry judges cannot make up for the lack of research. That omission is made more conspicuous and problematic by frequent references in the literature on administrative compensation schemes to the SEC's distribution efforts. The study thus hopes to set the record straight.

That record suggests that contrary to widespread belief, fair fund distributions are neither small nor, for the most part, inefficiently circular transfers from harmed shareholders to themselves. Fair fund distributions do not duplicate securities class actions: a majority of SEC's distributions is not accompanied by parallel private litigation. While private litigation targets fraudulent disclosures by public companies, the SEC's fair funds compensate harmed investors for what can best be described as consumer fraud or anticompetitive behavior by market professionals. Targeted misconduct is often difficult for the victims to detect and avoid, but very lucrative for financial firms and their employees. Private litigants cannot and do not pursue such misconduct for economic, legal and structural reasons. Finally, where possible, the SEC aims to limit administrative cost by directing collected monetary sanctions for distribution in a parallel proceeding.

As the Supreme Court continues to limit the availability of private class actions for securities fraud, public compensation may increase in importance.

299. *See* Brief for the Securities Industry and Financial Markets Association and the Futures Industry Association as Amici Curiae in Support of Respondents at 25–26, Stoneridge Inv. Partners, LLC v. Scientific–Atlanta, Inc., No. 128 S. Ct. 761 (2008) (No. 06–43).

If the SEC's enforcement resources increase, investors may see no net loss in compensation, but better deterrence of securities violations.