PUTTING INVESTORS FIRST: EXAMINING PROPOSALS TO STRENGTHEN ENFORCEMENT AGAINST SECURITIES LAW VIOLATORS

HEARING

BEFORE THE

SUBCOMMITTEE ON INVESTOR PROTECTION, ENTREPRENEURSHIP, AND CAPITAL MARKETS

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PUTTING INVESTORS FIRST: EXAMINING PROPOSALS TO STRENGTHEN ENFORCEMENT AGAINST SECURITIES LAW VIOLATORS

Wednesday, June 19, 2019

U.S. HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON INVESTOR PROTECTION,
ENTREPRENEURSHIP, AND CAPITAL MARKETS,
COMMITTEE ON FINANCIAL SERVICES,
Washington, D.C.

The subcommittee met, pursuant to notice, at 3:33 p.m., in room 2128, Rayburn House Office Building, Hon. Carolyn Maloney [chairwoman of the subcommittee] presiding.

Members present: Representatives Maloney, Sherman, Scott, Himes, Foster, Gottheimer, Gonzalez, Porter, Axne, Casten, Ocasio-Cortez; Huizenga, Stivers, Wagner, Hill, Mooney, and Davidson.

Also present: Representatives Beatty and McAdams.

Chairwoman MALONEY. The Subcommittee on Investor Protection, Entrepreneurship, and Capital Markets,will come to order. Without objection, the Chair is authorized to declare a recess of the subcommittee at any time. Also, without objection, members of the full Financial Services Committee who are not members of the subcommittee are authorized to participate in today's hearing.

Today's hearing is entitled, "Putting Investors First: Examining Proposals to Strengthen Enforcement Against Securities Law Violators." I now recognize myself for 3 minutes to give an opening statement.

This is a legislative hearing on eight different bills that would strengthen the enforcement of securities laws. Proper enforcement of the securities laws helps maintain investor confidence in our markets. Investors need to know that their rights will be protected and that bad actors who try to take advantage of them will be punished.

Investors also need to know that if a bad actor is caught and the SEC proves that the bad actor committed fraud that investors will get their money back. At the very least, wrongdoers shouldn't get to keep the money they have earned by defrauding investors. This is just, fair, and common sense.

Unfortunately, the 2017 Supreme Court decision in *Kokesh* v. *SEC* significantly damaged the SEC's ability to return funds to harmed investors by holding that SEC claims for disgorgement of ill-gotten profits are subject to a 5-year statute of limitations. This means for the long-running frauds, like Bernie Madoff's Ponzi scheme, the SEC would not be able to claw back all of the bad actor's profits. The *Kokesh* decision has already cost investors about $900 million in disgorgement of ill-gotten profits, according to the SEC.

The Court relied on a narrow technical interpretation of the statute and effectively invited Congress to fix this technical issue, and SEC Chairman Clayton has asked Congress to fix this issue, too, which he calls a "gap in investor protection."

Mr. McAdams has a bill that would fix this issue and clarify that equitable remedies like disgorgement are not subject to a 5-year statute of limitations.

And, unfortunately, the impact of the *Kokesh* decision was supercharged by another Supreme Court decision in *Gabelli* v. *SEC*. In that case, the Court held that the 5-year clock on SEC penalties starts when the fraud occurs and not when the fraud is actually discovered.

This gives the SEC even less time to bring an enforcement action against wrongdoers, because the SEC never discovers a fraud as soon as it occurs, there is always a lag between when the fraud occurs and when it is discovered.

Mr. Gonzalez has a bill that would reverse the harmful *Gabelli* decision and would once again give the SEC the tools it needs to crack down on securities fraud.

Finally, Ms. Porter has a bill that would strengthen the SEC civil penalty authorities by increasing the size of the penalties and by authorizing the SEC to seek different kinds of penalties for different kinds of violations. This is a much-needed update that would modernize the SEC's penalty authority and would deter repeat offenders, and I strongly support her bill.

I look forward to hearing from our witnesses on all of the bills today. And with that, the Chair recognizes the ranking member of the subcommittee, Mr. Huizenga, for 4 minutes for an opening statement.

Mr. HUIZENGA. Thank you, Madam Chairwoman, and I appreciate our panel being here with us here today.

The Securities and Exchange Commission has a three-part mission: protect investors; maintain fair, orderly, and efficient markets; and facilitate capital formation. Specifically, within the Commission, the Division of Enforcement investigates potential violations of Federal securities law and prosecutes these cases in Federal court or in administrative proceedings before the SEC's own administrative law judges.

Their enforcement priorities are guided by five core principles. First, focus on the Main Street investor. Second, focus on individual accountability. Third, keep pace with technological change. Fourth, impose remedies that most effectively further enforcement goals. And finally, consistently assess the allocation of SEC resources.

In Fiscal Year 2018, the SEC brought 821 enforcement actions and obtained nearly $3.9 billion in disgorgement and civil penalties resulting from those actions. Additionally, they returned $794 million to harmed investors, suspended trading in the securities of 280 companies, and obtained nearly 550 suspensions and bars.

The SEC has always been recognized for its effective yet fair enforcement program which encourages capital formation while protecting investors and markets. Today's hearing focuses on several proposals purported to strengthen enforcement against securities law violators for the protection of investors and the integrity of the U.S. capital markets.

I believe in a strong and effective enforcement program that protects investors and keeps bad actors out of the marketplace. However, these draft proposals that we are discussing today will do very little to help put investors first. Instead, they create more barriers to capital formation and limit investment opportunities for American workers and Main Street investors.

The U.S. IPO market is steadily decreasing at an alarming rate while foreign markets, such as in China, are continuing to grow. In 2017, China's IPO market produced over one-third of the world's initial public offerings, or IPOs, whereas the U.S. is only seeing half the number of domestic IPOs that it had just 20 years ago.

Over this same time period, the regulatory compliance cost for businesses has doubled here in the United States. In fact, 20 years ago, American investors could pick from over 7,000 listed stocks. Today, there is just half that. This radical reduction should be of great concern to this committee and all the mom-and-pop investors who are out there.

We, as lawmakers, should be working to create an atmosphere that helps promote more capital formation to allow the free flow of capital, strengthen job creation, and increase economic growth. Congress needs to consciously put to work John and Jane 401(k) first. We can do this by putting forward proposals that promote economic opportunities that give those mom-and-pop investors more choices and increase their ability to grow their savings and retirements accounts.

And with that, Madam Chairwoman, I yield back.

Chairwoman MALONEY. Thank you.

The Chair now recognizes the gentleman from California, Mr. Sherman, for 2 minutes.

Mr. SHERMAN. Thank you.

Last year, the SEC and the PCAOB issued a joint statement highlighting over 220 U.S. listed companies with a combined total of $1.8 trillion in market capitalization for which the PCAOB cannot provide effective audit oversight. That means a lot of money invested by Americans where we cannot audit the audit. I would encourage U.S. Trade Representative Lighthizer to focus on this issue in his discussions with China.

But that is the first part of my opening statement, to focus on where we want everything to meet the platinum standard, where we want to make sure that there is a footnote to a financial statement with an auditor and an oversight of the auditor. That is wonderful. But the SEC has been reluctant to look at the other side, the unregistered investments. They want to live in a rarified world of polishing the platinum.

But what about such things as cryptocurrencies? These are investments where there is no audit. There is no footnote. There is no PCAOB. There is no registration statement. But you have investors investing in God knows what, and the SEC says, "Not our problem."

First, these cryptocurrencies take the animal spirits, the willingness of Americans to invest, take some of that out of our economy where it would help companies employ people and instead say, "No, why don't you bet over here on a company that has no employees, Bitcoin?"

And then second, we are told, "Well, it is not an investment." It is only an investment. That is why people are buying Bitcoin, that is why it is being advertised, people buy it and it will go up in value.

And then finally, as a medium of exchange, Bitcoin is clearly inferior to most of the currencies available. And a report indicates that 46 percent of the transactions where it is used as a medium of exchange are criminal. So, it is not really a medium of exchange for law-abiding Americans. It is an investment whose regulation pales in comparison to the worst financial statement Madoff ever put out.

I yield back.

Chairwoman MALONEY. Thank you.

Today, we welcome the testimony of a distinguished panel of witnesses. First, we have Jordan Thomas, who is a partner at Labaton Sucharow in New York. Second, we have Urska Velikonja, who is a professor of law at Georgetown University Law Center. Third, we have Andrew Vollmer, who is a professor of law at the University of Virginia Law School. And last but not least, we have Stephen Crimmins, who is a partner at Murphy & McGonigle.

Witnesses are reminded that your oral testimony will be limited to 5 minutes, and without objection, your written statements will be made a part of the record.

Mr. Thomas, you are now recognized for 5 minutes to give an oral presentation of your testimony. Thank you.

STATEMENT OF JORDAN A. THOMAS, PARTNER, LABATON SUCHAROW

Mr. THOMAS. Chairwoman Maloney, Ranking Member Huizenga, and members of the subcommittee, thank you for inviting me to testify today.

Today, my testimony will be based on my experience as a first responder to corporate wrongdoing at the Department of Justice, the Securities and Exchange Commission, and at Labaton Sucharow, where I head the Whistleblower Representation Practice.

In my work I have seen firsthand the devastation that can come from securities violations. I am increasingly concerned that the investor protection status quo isn't working and that, without your intervention, our financial watchdogs will be fighting a losing battle.

The reality, and you won't hear it admitted often or publicly, is that securities violations are extremely difficult to detect, investigate, and prosecute. And due to the vast scope, rapidly growing and dizzyingly complex markets, products, and transactions they are responsible for, our financial watchdogs are losing ground. Investors are being injured, and too many bad guys are getting away.

Particularly troubling to me is that even when securities violators are caught, they are not being held fully accountable because of a series of adverse Supreme Court decisions which undermine long-term deterrence.

Fortunately, the proposals before this committee can provide much-needed legal relief to our financial watchdogs. It is my hope that these proposals will enjoy some bipartisan support that the fix to the *Digital Realty* decision recently received.

Of the many proposals currently considered by this committee, I believe the most critical one is restoring the SEC's ability to obtain full disgorgement of ill-gotten gains from wrongdoers. Disgorgement has always been an essential component of SEC enforcement. Prior to *Kokesh,* common sense prevailed and wrongdoers were required to return every cent of their ill-gotten gains. Now, fraudsters engaged in long-running schemes will be rewarded for hiding their misconduct.

And in their 2018 annual report, the SEC Division of Enforcement estimates that the Commission will be forced to forego approximately $900 million in disgorgement. That is 25 percent of the monetary sanctions collected annually, moneys that could have gone to defrauded investors.

Another critical element of effective SEC enforcement is the ability to obtain civil monetary penalties. Even if the Commission is able to obtain full disgorgement from wrongdoers, long-term deterrence dictates that the SEC should also receive significant monetary penalties against these violators so that potential violators will refrain from engaging in wrongdoing rather than just writing it off as a low-risk detection and a cost of doing business.

One related proposal is designed to address the *Gabelli* decision that Chairwoman Maloney referenced. That decision stated at the beginning of the statute of limitations period was when the violation occurred, not on the date the SEC discovers it. The proposal suggests that the SEC have an expanded statute of limitations period of 10 years.

Again, since securities violations are incredibly difficult to detect, and our securities law shouldn't incentivize securities violators to conceal their wrongdoing, I strongly believe that a legislation solution to the *Gabelli* decision is important, and my written statement suggests different ways to do so.

Another related proposal would update and strengthen the current statutory provisions for SEC civil monetary penalties. Among other things, the proposal would increase the statutory maximums for civil money penalties, provide that the size of penalties could be linked to the amount of victim losses, and establish a fourth-tier penalty that could be imposed against recidivist violators. This proposal is long overdue.

In particular, the provision allowing penalties to be assessed at the level of victim harm would be an important addition for the SEC cases because there are some cases where wrongdoers may not have gained significant monetary profits, but cause substantial harm.

Similarly, the provisions for enhanced penalties against recidivists, as well as new statutory provisions regarding penalties for violations of Federal court injunctions, would greatly strengthen the remedies, particularly when those standard remedies were not effective with the recidivists.

The committee is also considering oversight related to the PCAOB, and, frankly, the PCAOB has an important mission, first-rate staff, and in the enforcement space, less than stellar results. I believe that the PCAOB, with actual intelligence from whistle-blowers, could be more effective, and that could change the dynamic and increase their effectiveness.

Due to time limitations, I only briefly addressed a few of the legislative proposals, but I stand ready to answer your questions about all of the proposals.

[The prepared statement of Mr. Thomas can be found on page 40 of the appendix.]

Chairwoman MALONEY. Professor Velikonja, you are now recognized for 5 minutes for your testimony.

STATEMENT OF URSKA VELIKONJA, PROFESSOR OF LAW, GEORGETOWN UNIVERSITY LAW CENTER

Ms. VELIKONJA. Chairwoman Maloney, Ranking Member Huizenga, members of the subcommittee, thank you for this opportunity today.

At Georgetown, I teach, research, and write about securities enforcement. I am going to limit my prepared remarks to making two points.

First, today's hearing is, "Examining Proposals to Strengthen Enforcement," but the eight discussion drafts actually include two very different kinds of proposals. The first kind increases market oversight and strengthens sanctions, increases sanctions, and so forth.

The second kind, more urgent, codifies existing relief in SEC enforcement now decades old. I am talking about disgorgement in civil cases. So, failure to adopt the proposed amendments doesn't preserve the status quo as is typical for legislation. It would significantly hamper SEC enforcement.

Let me explain. Disgorgement is the second most commonly imposed relief in SEC enforcement. It is ordered in 56 percent of cases resolved in Fiscal Years 2010 to 2018. Only civil fines are imposed more often, in 66 percent of cases. Where disgorgement is imposed, it is 80 percent of monetary penalties that that defendant is ordered to pay.

Total disgorgement orders during that period amounted to $145 billion compared to $9.8 billion for civil fines during the same period. Of that, $140 billion is in court cases.

Now, these figures include cases where a disgorgement order was deemed satisfied with orders in the parallel criminal case. So if we exclude all cases where there was a parallel action unaffected by the *Kokesh* decision, we are still talking about a lot of money threatened.

During this period, the SEC imposed $13 billion of the $23 billion monetary penalties during that period that weren't in a second proceeding as well; 57 percent is disgorgement. Of that, almost $10 billion is in court cases.

They include Charles Kokesh. They also include virtually all significant FCPA cases. They include cases against Citigroup, Morgan Stanley, Bank of America, you name it.

All of that is now in jeopardy. Why? Disgorgement in court cases is not specifically expressly included in securities laws, right? It is an equitable remedy the SEC has been seeking since the 1960s. In *Kokesh,* the Supreme Court says disgorgement is a penalty. Typically, courts can't impose penalties without statutory authorization. And so if disgorgement is a penalty, then the SEC has no authority to seek disgorgement in court at all.

Now, the Supreme Court sort of stepped aside, didn't actually decide this issue, but now the case is already percolating. So this is going to happen in Congress and it is imperative for Congress to step in and codify that the SEC can sue fraudsters in court and seek disgorgement.

Second point, I want to offer some statistics relevant to the limitations period, the 5-year statute of limitations you are discussing.

Now, since *Kokesh* and *Gabelli,* as we have heard, the SEC can no longer seek penalties for violations committed more than 5 years before the SEC filed suit. Five years is less than you would think. The average investigation takes about 2 years to complete. Of more than 8,000 cases filed during the same period that I described earlier, 2010 to 2018, 37 percent included at least some violations that took part outside the 5-year limitations period, and that share has been increasing. In 2018, half of the cases included violations that were more than 5 years before the SEC filed suit.

Now, the limitations period doesn't affect all cases equally. Insider trading, pump-and-dump schemes, and market manipulations are much more likely to be detected, investigated, and prosecuted within the 5-year period.

There are broker-dealer cases, investment advisers stealing from their clients, Ponzi schemes, accounting frauds. They take much longer to detect in the first place, let alone investigate and prosecute.

So the typical case affected most significantly by the *Kokesh* decision is an offering fraud by an individual offender, the no-name defendant, someone you have never heard of. So, Charles Kokesh in that sense is not atypical. Let me describe what he did and what is at stake.

He owned two small investment funds from 1995 to 2007. When the funds were dissolved, he embezzled investors' funds, paid himself unearned fees, and reimbursed unauthorized expenses. Ultimately, he misappropriated $35 million from 21,000 investors. He—I am quoting here from the record—specifically targeted smaller investors, those investing $5,000 or less, because they would be less likely to sue if they discovered his schemes. With stolen funds, he then bought a gated mansion, a private polo ground, and a personal stable of more than 50 horses.

The jury found Kokesh guilty, but because of the 5-year limitations period, he was ordered to pay only $7.3 million plus interest, far less than the $35 million he stole.

Now, the SEC did not unnecessarily delay that investigation. There are 12,000 investment funds in the United States. The SEC isn't currently funded to review all, even periodically. So unless you believe bad actors should be allowed to keep property stolen more than 5 years ago, you should either increase the SEC's budget or put in place realistic limitations periods.

Defendants also should care about this. The SEC is likely to expedite investigations, perhaps being less careful.

With that, I will conclude.

[The prepared statement of Ms. Velikonja can be found on page 48 of the appendix.]

Chairwoman MALONEY. Thank you. Your time has expired.

Mr. Crimmins, you are now recognized for your 5 minutes for your testimony.

STATEMENT OF STEPHEN J. CRIMMINS, PARTNER, MURPHY & MCGONIGLE PC, AND FORMER DEPUTY CHIEF LITIGATION COUNSEL AND SENIOR OFFICER, SEC'S ENFORCEMENT DIVISION

Mr. CRIMMINS. Thank you, Chairwoman Maloney, Ranking Member Huizenga, and other members of the subcommittee, and thank you for dealing with these extremely important issues for SEC enforcement, where I was proud to serve for 14 years, now a couple of decades ago. They are critical issues, and they come at a tough time for the SEC.

They have had to drop 400 professionals in recent years with a flatlined budget of $1.6 billion, even though they used no tax dollars since 1996 thanks to Congress' legislation. Hopefully, the proposal to increase their budget at least to $1.85 billion will make it. But in any event, these are important topics that the subcommittee is dealing with.

As prior speakers have said, *Kokesh* has created a real problem for the SEC, defining disgorgement as a penalty, creating all kinds of problems. The Supreme Court wrote unanimously in an opinion by Justice Sotomayor, who is a great scholar, in good faith finding that the disgorgement did kind of match up with what is a penalty, but they asked a very good question. Did Congress, having defined specific penalties under the securities laws and those careful tiers we see in the proposal, really want to have a separate penalty, two different kind of penalties in the same case? How could that be?

I would urge the subcommittee to answer the question of the Supreme Court with a resounding, "Yes, we do want disgorgement as a core remedy of the SEC's enforcement program!" Since the *Texas Gulf Sulphur* decision in 1971, the SEC needs it. Please yell a loud "yes" in answer to the Supreme Court.

The other *Kokesh* issue, of course, is what should be the statute of limitations? Should it be 5 years, which is traditionally imposed for a penalty? Should it be not at all, which is traditionally imposed for tamer equitable remedies, a tame version of disgorgement? Should it be 10 years? What should it be?

My concern with the proposal is that it uses a rule of construction to try to interpret what should be. A rule of construction is an invitation, frankly, to the defense bar, where I presently live, to litigate. It is an opportunity as part of our zealous advocacy for the people we represent as defendants to find issues to create, to litigate, to take up to appellate courts. We are buying the SEC 5 years or 10 years of litigation that is really going to be kind of worthless litigation to sort all this out.

Instead, I would urge the subcommittee to bite the bullet, adopt a statute of limitations across-the-board for all SEC remedies, but make it an appropriate one.

And what should that be across-the-board, a statute of limitations, including for disgorgement and other equitable remedies?

I would suggest that we take a page from Congress itself, when Congress back in Sarbanes-Oxley legislated a statute of limitations for private securities litigation and said 2 years from discovery of the violation, reasonable discovery of the violation, but no more than 5 years from the conduct.

The SEC should get different treatment, better treatment. They act in the public interest. They have fewer resources. I would suggest use Congress' framework for private-led "2-and-5," change it to something like "3-and-5," 3 years from reasonable investigation of the conduct and no more than 10 years from the actual event.

Three years is plenty of time to do an investigation, and it serves the interests of our courts and our juries to be able to have witnesses who can actually remember things.

So for that reason, holding the SEC's feet to the fire to do their investigation within 3 years from reasonable discovery is more than fair and more than enough, and 10 years from the event is a very comfortable period.

As a safety valve, if they are getting close to the end, they can ask the defense for a tolling agreement. It is virtually always granted.

Moving on quickly—my time is almost up—to restitution. That is a little bit of a concern. Restitution is different from disgorgement where you just give up your profits. Restitution is you go across the universe, everybody who has lost money, and that can add up to immense amounts. And then when we talk about some of the proposals having treble penalties or dealing with recidivists, we can do the math and get up into the trillions of dollars.

I am a little concerned about adding a restitutionary remedy either directly as restitution or as part of a penalty calculation. I think that should be thought through.

Public company oversight—I am almost out of time. Whatever Jordan said, I totally agree. They absolutely need all the proposed additions.

And again, thank you to the subcommittee.

[The prepared statement of Mr. Crimmins can be found on page 30 of the appendix.]

Chairwoman MALONEY. Professor Vollmer, you are now recognized for 5 minutes for your testimony.

STATEMENT OF ANDREW N. VOLLMER, PROFESSOR OF LAW, UNIVERSITY OF VIRGINIA SCHOOL OF LAW

Mr. VOLLMER. Chairwoman Maloney, Ranking Member Huizenga, and members of the subcommittee, thank you for inviting me here today. As I mention in my written statement, my comments today are solely my own and are not on behalf of anyone else.

My written remarks begin with a couple of principles that usually guide legislation in the Federal securities area, and the first is that securities regulation should reduce unnecessary barriers to raising capital for large and small businesses. We should be particularly attentive to ways to help entrepreneurs find the capital that they need.

Two other important principles are the need to protect investors and the need for vigorous but fair enforcement of the securities laws.

I would like to direct my comments to one of the bills that you are considering, and that is the bill that would deny exchange trading to companies that have auditors not subject to PCAOB inspection. That is a serious problem that deserves your attention, but the solution in the bill is much more limited than the problem is.

The potential problem exists for all reporting companies and companies filing registration statements in registration, but the proposed solution is limited to exchange listed or exchange trading in those companies.

The number of exchange companies, as I think Ranking Member Huizenga pointed out, is much smaller than the number of reporting companies. So if legislation did no more than just stop exchange trading for companies that don't have auditors inspected by the PCAOB, many of those companies would continue to trade in the United States, maybe do business as usual, in the over-the-counter markets. That is probably not a sufficient remedy. So in my written statement, I propose two alternatives for you to consider.

Another set of bills that you are looking at would extend or eliminate the 5-year statute of limitations for SEC enforcement cases that seek penalties or disgorgement, and one of them would give the SEC a new power to recover investor loss. If enacted, these bills would seriously disrupt the current enforcement system and would make it more arbitrary and less fair.

Giving the SEC the power to recover investor loss would be unprecedented. It would overshadow many private securities cases and class actions. Congress should not take this dramatic step without studying the question much more thoroughly.

The bills would also give the SEC a very long or unlimited amount of time to bring enforcement cases. Extending the statute of limitations would frustrate compelling social interests that legislatures have recognized for centuries by enacting statutes of limitations.

Another concern is that longer statute of limitations for the SEC would cause further delay in what are already long and damaging SEC investigations. The length of an SEC investigation is correlated to the statute of limitations because a reasonable statute of limitations acts as an incentive to the staff to finish the investigation and make a decision to sue or not.

So one of the main arguments for extending the statute of limitations is that some misconduct is well concealed. That is not the whole picture. All too often, SEC cases are initiated after a violation because the SEC was aware of the potential misconduct but failed to investigate it. There is example after example which I give in my written statement.

I am happy to answer questions on those matters, those bills, or any of the bills you are considering.

[The prepared statement of Mr. Vollmer can be found on page 66 of the appendix.]

Chairwoman MALONEY. Thank you.

I now recognize myself for 5 minutes for questions.

Mr. Crimmins, I would like to ask you something about Professor Vollmer, what he said in his testimony. He said that Mr. McAdams' bill authorizing the SEC to seek disgorgement of illegal profits beyond the 5-year statute of limitations would be, "a sharp break from the longstanding system."

As a former litigator in the SEC's Enforcement Division, do you think that is accurate? Prior to the Supreme Court's *Kokesh* decision in 2017, didn't the SEC already have the authority to seek disgorgement beyond the 5-year statute of limitations?

Mr. CRIMMINS. Yes, Chairwoman Maloney. Thank you.

I agree totally that before we had the *Kokesh* decision, it was unlimited. The remedy of disgorgement was considered to be a traditional equitable remedy, and it just wasn't fundamentally fair to allow a fraudster to hold on to illegal gain. And if that happened after 5 years, 10 years, 15 years, or 20 years, the courts, acting in fundamental fairness and in equity, those considerations, could do it.

So really, by extending the statute of limitations, my proposal of a 3-and-10, bite the bullet, do a statute of limitations rule for all claims is a practical matter to get it done easily and in streamlined fashion.

Whatever it is for disgorgement, absolutely yes. The SEC should be allowed to get disgorgement. Penalty is a different matter, restitution is a different matter, and I think those are things where we should have a conversation. But on disgorgement, that is core. I totally agree.

Chairwoman MALONEY. Thank you.

Mr. Thomas, some people have argued that the SEC doesn't need disgorgement authority because private parties can already sue to recoup private investor losses. But is that true? Aren't there cases where the private parties cannot sue for damages?

For example, investors can't sue for fraud under the Investment Advisors Act, and if private parties can't sue for damages on their own, doesn't that mean that the SEC should have the authority to seek disgorgement?

Mr. THOMAS. That is correct, Chairwoman Maloney. I think it is important to know that what makes our legal system great and unique is that we have overlapping jurisdiction. So we have both Federal and State and private litigants and public litigants that are all policing the marketplace to ensure that investors are protected.

Chairwoman MALONEY. Thank you.

Professor Velikonja, you presented really interesting data in your testimony showing that different types of violations are much more profitable and much less likely to be discovered than others.

I was particularly struck by the fact that violations of the Foreign Corrupt Practices Act, or FCPA, are the most profitable violations for bad actors and are also the least likely to be discovered within the 5-year statute of limitations. Only 4 percent of FCPA violations occur entirely within the 5-year statute of limitations.

So in your opinion, would Ms. Porter's bill to strengthen the SEC's civil penalties adequately deter FCPA violations?

Ms. VELIKONJA. That is a wonderful question.

So, yes, FCPA cases typically very. They take a long time to detect. They also take a longer time to prosecute. FCPA defendants typically exercise—sign a tolling agreement.

So to some extent, I will sort of push back on my own data to say, yes, only 4 percent of the violations are entirely within the limitations period, but in part, that is the result that the defendant has agreed to allow the SEC to investigate fully, go abroad, in exchange for perhaps not bringing the case in the first place.

But limiting remedies to 5 years for disgorgement, and disgorgement in FCPA cases is absolutely key, it is the bulk of the monetary penalties imposed in FCPA cases, limiting that to 5 years, the defendants presumably are going to push back and say, "I am not going to do a tolling agreement," or less likely, would reduce the sanctions. And the type of violation, it is already detected at very load low rates. We don't have great estimates, but the best we have says about 6 percent of foreign bribery schemes, long-lasting foreign bribery schemes are detected and sanctioned.

Chairwoman MALONEY. Thank you. And my time has expired.

The Chair now recognizes the distinguished ranking member, Mr. Huizenga, for 5 minutes for questioning.

Mr. HUIZENGA. Thank you, Madam Chairwoman. I will try and move quickly through a number of issues.

Mr. Vollmer, are you familiar with the CHOICE Act that was passed last Congress?

Mr. VOLLMER. No.

Mr. HUIZENGA. Okay. Well, one of the things that the CHOICE Act that we had come out of here was a—

Mr. VOLLMER. I'm sorry. I misheard you. The CHOICE Act. Yes. Sorry.

Mr. HUIZENGA. Okay. One of the things that we tried to construct within that was making sure that there was a balance and enhanced due process protections along with reforms to the SEC's enforcement program. And I am curious, as you look at this, do you see any provisions from the CHOICE Act with that balance?

Mr. VOLLMER. No. I think they are conspicuously absent. And there were many provisions in the CHOICE Act both that helped form capital, promoted capital formation, but also injected notes of fairness in the SEC enforcement process.

And if I could, may I just correct a statement that was made a moment ago? My written statement does not say that allowing the SEC to sue for disgorgement would be a sharp break from practice, as the other panelists have said. The SEC has sued for disgorgement since the 1960s. What my written statement said is allowing the SEC to sue for investor loss would be a sharp break from precedent. I'm sorry.

Mr. HUIZENGA. Okay. No. I appreciate that.

Do you think it would be a healthier approach to have this two-pronged approach on both the investor protection and due process, as well as the enforcement?

Mr. VOLLMER. I think that adding some additional fairness elements to the SEC enforcement process would be a great gain and would provide more certainty and predictability.

Mr. HUIZENGA. Okay.

Mr. Crimmins, the PCAOB whistleblower bill seems to me to be redundant. With the SEC having primacy over that, as created under Dodd-Frank, the SEC whistleblower office, couldn't reporting described in this legislation be reported to the SEC as part of this whistleblower?

Mr. CRIMMINS. Ranking Member Huizenga, you make a good point in terms of the overlap. Anything that the PCAOB does, I believe, can be done by the SEC. They have oversight, and they do more cases focused on accounting, but the SEC always has that power.

For that reason, in my written testimony, which you may be referring to, I agree with you on that, that while a whistleblower program at the PCAOB is a great idea because it has worked well at the SEC, my concern is the cost of setting up a whistleblower office and processing whistleblower claims.

And I am wondering if there isn't a way to team the two agencies such that the whistleblower can go to PCAOB, have PCAOB handle the case, and get a whistleblower bounty. With the mechanics of processing the claim, the mechanics of evaluating it, and so forth, which require an infrastructure, why not let the SEC take care of that?

Mr. HUIZENGA. It makes sense. I would agree more isn't always necessarily better on that.

But I do want to talk a little bit about the Transparency Act, the Enforcement Transparency Act. If these proceedings were made public and public companies whose financial statements are implicated by a PCAOB enforcement proceeding against an auditor be susceptible to negative market reaction, and even though the allegations are untested and may not actually involve the company themselves, do you have a concern with that?

Mr. CRIMMINS. It is a concern, but it is a concern with just about everything that the SEC does. The SEC acts publicly in everything, and sometimes the pendency of an investigation, if it becomes public, or the pendency, certainly, of litigation, will have that impact. It is inevitable. But we have a justice system that acts publicly. And when you are dealing with public accounting firms, just, I would respectfully suggest, that really we ought to make public, the same way we do with the SEC.

Mr. HUIZENGA. I am running out of time quickly here, but it would seem to me the PCAOB has the ability to refer those cases to the SEC, at which point they become public anyway.

The Holding Foreign Companies Accountable Act, you acknowledge, Mr. Vollmer, a serious problem, and you had said the OTC markets would still be available. And it seems to me that those investors could still invest in those companies, just not here, and would therefore forfeit any of the protections that our marketplace would have, and they could invest those offshore in foreign markets. And I am going to be following up with that.

And then I just need to make a statement about *Kokesh*. I think all of us understand that we need to be going after these bad actors, and the SEC needs those resources. And I want to make sure that they have the ability to not keep any of those ill-gotten gains and to be able to distribute those recovered funds from harmed investors. I do believe that the SEC is in the process of trying to work through that. But I am supportive in concept, and we have seen nearly a billion dollars being foregone. So we need to address that.

With that, you have been very kind and generous. Thank you.

Chairwoman MALONEY. The gentleman yields back.

The gentleman from Georgia, Mr. Scott, is recognized for 5 minutes.

Mr. SCOTT. Thank you very much, Chairwoman Maloney.

This is a fantastic hearing, and you all are very informed.

But what I want to start out with, you all are aware that the Securities and Exchange Commission's 2018 annual report estimates that the 2017 case of *Kokesh* v. *the SEC* Supreme Court decision held that disgorgement is a penalty and subject to a 5-year statute of limitations. But they say that because of this, it has caused the Securities and Exchange Commission to forego as much as $900 million in disgorgement of ill-gotten gains.

Is that accurate? I would like to make sure everybody agrees on that point before I go further.

Mr. THOMAS. I do.

Mr. SCOTT. Okay. Now, do you agree that this is because certain fraud schemes may run for years prior to the discovery? Does everybody agree with that?

Mr. Vollmer?

Mr. VOLLMER. I agree that is one of the possibilities, but my written statement points out that there are other reasons for delayed enforcement, not just from the concealment. And, no, I do not agree with the $900 million figure. I think it is an entirely suspect number.

Mr. SCOTT. Well, let me ask you if you agree with Mr. Thomas. And in Mr. Thomas' testimony, he points out the paradox that is created by this decision, stating that this decision rewards violators who are good at hiding their misconduct.

Do you agree, Mr. Vollmer?

Mr. VOLLMER. I agree that a natural consequence of statutes of limitations is that some violations that are concealed for very long times can go unremedied. The question is whether that is a severe enough and substantial enough problem to alter the general rule of a 5-year statute, and I say the evidence has not been presented to us.

Mr. SCOTT. I have a short period of time, but I want to get to these points.

It brings to light, the reason I am going through this, two issues. First, the need to clarify whether the SEC has disgorgement authority; and second, the need to ensure that our regulators are equipped with the tools they need to effectively police our markets and root out bad actors.

Now, Mr. Thomas, defend your comments.

And I think Mr. Vollmer will agree with you, won't you, Mr. Vollmer?

Mr. VOLLMER. I will agree if I possibly can.

Mr. SCOTT. Yes.

Mr. THOMAS. I like Andy very much, but I hope he will agree. You know, to go to one of the points that you made, Congressman Scott, is the SEC's estimate of $900 million as a consequence. I actually think that number is low, and I will just give you one example.

In the *Merrill Lynch* case, I represented three whistleblowers. It resulted in the SEC recovering $415 million, and that period of misconduct was relatively consistent, and it was more than 5 years.

I believe that the monetary sanctions in that case would have been halved if the *Kokesh* ruling had occurred before that, and that is just one case, $200-plus million would have disappeared from them.

Mr. SCOTT. And, Ms. Velikonja, you spoke very eloquently on this. Would you like to add something to this? I saw you shaking your head.

Ms. VELIKONJA. We haven't been given any explanation where the $900 million figure comes from, so I understand both Mr. Vollmer and Mr. Thomas. It sounds big. It also sounds sort of right.

I would probably side with Mr. Thomas in why the number is kind of low. It is precisely because the SEC has been using tolling agreements, agreements extracted from the defendants to toll the statute of limitations, allowing the SEC to complete the investigation.

Think of a big case such as a big FCPA case, *Petrobras,* which the SEC settled in September of 2018. The disgorgement order in *Petrobras* alone was $933 million. Much of that was outside the 5-year limitations period. Now, if the period is applied stringently, that amount would be in jeopardy. It wasn't precisely because Petrobras had executed a tolling agreement. It might be a lot less willing to do so going forward.

Mr. SCOTT. Right.

And finally, Mr. Thomas, you said something in your testimony. You said we are fighting a losing battle. What did you mean by that?

Mr. THOMAS. I mean that the SEC is underresourced, and they are fighting on multiple fronts in an emerging, growing market. And if they can't, when they catch people, get all of their ill-gotten gains, if they can't have significant penalties that lead to real deterrence, then they are going to do what economists would expect people to do. They would assess the risk of detection and the potential consequence and say: I am going to take that risk. Okay.

Chairwoman MALONEY. The gentleman's time has expired.

Mr. SCOTT. Thank you for your courtesy, Madam Chairwoman.

Chairwoman MALONEY. Thank you.

The gentlewoman from Missouri, Mrs. Wagner, is recognized for 5 minutes.

Mrs. WAGNER. I thank the Chair and the ranking member and our witnesses for being here.

Mr. Vollmer, I recognize that China is taking advantage of our laws and without auditor inspections from the PCAOB might be putting audit client company assets at risk, which could hurt Main Street investors.

I am concerned, however, that prohibiting trading in public companies is also a drastic measure, perhaps an overcorrection that would also adversely affect Main Street investors who might own shares of those companies, either directly or through mutual funds, in their retirement accounts.

What are the implications if trading prohibitions on hundreds of public companies were implemented?

Mr. VOLLMER. If it were done at once, as the bill seems to propose, it would be quite disruptive to the marketplace. Current shareholders need some reasonable advance notice so they can try and sell out if there were to be a total flat ban. That is not the proposal in the bill.

Mrs. WAGNER. Right.

Mr. VOLLMER. The bill would allow trading to continue in the United States, Ranking Member Huizenga, not just abroad. They certainly might be able to trade abroad. We can't deal with that. But they could still be traded in the United States in the U.S. over-the-counter markets the way the bill is currently written. It would only prohibit exchange trading.

Mrs. WAGNER. So what happens to the exchange traded funds, the ETFs, the mutual funds that own shares of those non-U.S. companies that would be delisted?

Mr. VOLLMER. They would continue to trade, I think reasonably well, if it is a fairly high volume traded security.

Mrs. WAGNER. Are there less drastic or disruptive alternatives, Mr. Vollmer, that would not be as harmful to the U.S. capital markets?

Mr. VOLLMER. I think there are, and I propose two in my written statement.

One, quickly, would be a case-by-case determination by the SEC, quite similar to a process the SEC uses today over 100 times a year to stop trading when there is inadequate public information available, and that is called a Section 12(j) proceeding.

The SEC could do that. Only minor changes are needed for current law.

And then, I proposed a more creative solution, which would be a bonding or insurance policy requirement.

Mrs. WAGNER. I saw that.

Mr. Vollmer, I am also concerned about the decline in American IPOs over the last few decades and the growing trend of American companies opting for private capital as opposed to public markets. Meanwhile, China's IPO market produced over one-third of the world's IPOs in 2017, which makes the decline in American IPOs, frankly even more troubling.

Why should we find these trends concerning, sir?

Mr. VOLLMER. I agree that there are some quite concerning trends.

I think we need more study about why the Chinese companies have been able to engage in frequent IPOs and we have a declining trend in the United States. I don't have an answer to that. But I agree with you, we need to do more work.

Mrs. WAGNER. What do you think some of the biggest deterrents could be to companies going public?

Mr. VOLLMER. Oh. There are many issues that scholars have identified, and I don't think that scholars have come to rest on any one. Regulatory burdens through the registration process are one. A second is that when you become a reporting company, you take on a whole series of very costly obligations.

Mrs. WAGNER. But any of the bills discussed in today's hearing create these kind of additional requirements on American public companies, adding to their regulatory compliance costs.

Mr. VOLLMER. I agree completely. Not every one of the bills today being considered, but many of them, increase the cost of compliance, increase disclosure cost, and those all add to the cost of raising capital.

Mrs. WAGNER. And these increased compliance costs for public companies deter private companies from going public, is that correct?

Mr. VOLLMER. I agree with that, yes.

Mrs. WAGNER. How does a company going public not only benefit the economy in terms of jobs, but also in terms of Main Street investors in America?

Mr. VOLLMER. Oh, there are lots of economic studies that have been done about the benefits to our society at large from IPOs, but mostly from almost all forms of capital raising. It leads to economic growth, new products.

Mrs. WAGNER. I just don't want to see the constant decline as we have seen now over decades and decades. As China and other actors move into this space, it is something that we have to really look at, and I think you are right, study in terms of the deterrent factors to private companies in the United States of America going public.

I thank you for your testimony.

I yield back to the Chair.

Chairwoman MALONEY. The gentleman from Florida, Mr. Sherman, is recognized for 5 minutes.

Mr. SHERMAN. I have moved west on the gentleman from California. Yes, indeed, one of those warm weather States.

I know we can do legal analysis as to whether a cryptocurrency is a security. I would like to form a corporation and avoid—we have talked about how difficult it is to go public and register your company. I will just declare that my share certificates are currency. In fact, if you bring me a share in the company that I form, I will give you a pack of gum. I will give you three packs of gum. Bitcoin is being sold as an investment. That is why anybody buys it, you buy it because you think it is going to go up.

Can anybody explain to me any practical reason why we go through all these extraordinary efforts to protect investors? God forbid they invest in a company where footnote number 72 is inconsistent with FASB No. 193. Why do we go through all that if we are going to let investors invest in bitcoin?

Yes, Mr. Crimmins?

Mr. CRIMMINS. I would respond to that by saying that we can't look at it monolithically as coins or digital assets. We are dealing with three separate things. And the SEC recently, I think, got it right. They said, if you have shares of a company, just what you said, or fractionalized shares of a hard asset, maybe it is an office building or an orange grove or whatever, and you are depending on other people and what they are telling you to give you a return, that is just like stock. It is a security; it needs to be regulated that way.

But they also said, the SEC, in a matter they had before them, a no action matter, that when somebody wanted to have tokens for a private jet rental service that would combine different companies, and they said, you know what, those coins, what is it, but it is no different from a New York City subway token back when we had tokens.

Mr. SHERMAN. That is for somebody who—because the vast majority of New York subway tokens are used not as investments. Somebody could invest.

Mr. CRIMMINS. Precisely.

Mr. SHERMAN. But like a yen, yen is a currency. One-millionth of 1 percent or a hundredth of a percent of the times people buy yen is as an investment. The number one reason to buy yen is because you want to buy a Toyota or a thousand Toyotas for your dealership.

Bitcoin clearly crosses the line. It is not a medium of exchange; it is a medium of investment. The SEC isn't doing its job. And it has us analyzing little details of what they want to do while ignoring their main job, which is protecting investors.

I want to shift to another issue. My colleague from Massachusetts, Ms. Pressley, wants to create transparency at the PCAOB. Good. But transparency does not mean that you disclose that somebody is under investigation or what the investigation is. If so, we wouldn't have grand juries. We would just say, well, there is an accusation. Let's put it on the front page. Let's punish the defendant. We don't need a trial. We don't need a grand jury. Just try them in public. We first see whether there—before we punish somebody, because there is some reason to investigate, we do the investigation.

Do any of our witnesses have a reason why, if there is just a reason to investigate, that we should destroy the credibility of one of the audit firms? Does anybody have a comment?

Mr. Thomas?

Mr. THOMAS. Congressman Sherman, I think that one way to look at it is that the SEC's investigations are confidential and nonpublic, and they successfully protect the reputations of companies and individuals. And I believe that there is a way to provide more transparency to PCAOB investigations and enforcement actions than currently exists.

Right now, very sophisticated people don't know the individuals' and audit firms' failings, because of the structure of the PCAOB. If you can get a CARFAX and know about a bad car or a broker check for a broker, maybe we should know more about our auditors.

Mr. SHERMAN. On the other hand, just because there is a rumor about me and the police officer thinks I might be speeding—I am going to go to the other witness sitting—

Ms. VELIKONJA. May I supplement this?

Mr. SHERMAN. Yes.

Ms. VELIKONJA. It is not that an investigation would be public. It is once the proceedings are filed, which is after a long confidential internal process, several layers of review, like the SEC, that is the point when the process becomes public, like the SEC. So, for example, an SEC enforcement action is filed.

Mr. SHERMAN. We don't know that when there is no indictment.

Ms. VELIKONJA. Excuse me?

Mr. SHERMAN. In the criminal justice system.

Ms. VELIKONJA. It is like an indictment, right? This is what we are doing.

Mr. SHERMAN. It is like an indictment.

Ms. VELIKONJA. That is what we are talking about.

Mr. SHERMAN. If you meet the standard and you are going to indict somebody, you make that public. You don't make the non-indictment public.

Ms. VELIKONJA. And that is what the Pressley bill proposes to do.

Mr. THOMAS. And I agree with that, Congressman.

Chairwoman MALONEY. The gentleman from Arkansas, Mr. Hill, is recognized for 5 minutes.

Mr. HILL. Thank you, Chairwoman Maloney.

I appreciate the panel. It is a very interesting discussion on these bills. I spent a big part of my career in the securities business, both on the institutional and the retail side, and one of the saddest things to witness over the past few years was the Stanford Ponzi scheme and the impact on retail investors, a lot in the Southwest. I live in Arkansas, and Arkansas and Texas and Memphis were sort of disproportionately, I think, impacted by Mr. Stanford's malfeasance.

I am interested, Mr. Vollmer, in—that occurred over 10 years ago, the second largest in history, I think, to the Madoff issue. Pretty contemporaneous when those two things were happening. But the Madoff recovery has been pretty impressive, if you look at both sets of the recovery methods, really impressive, I think far exceeding what people thought might be reality there. But the Stanford victims in Arkansas haven't been as fortunate. It has only returned, I think, something like 5 cents on the dollar.

Could you tell me why this receivership process has taken so long and what might be done differently?

Mr. VOLLMER. Representative Hill, let me start by saying the Stanford matter is not a statute of limitations problem. Let's understand that. The SEC staff was aware of problems at Stanford 2 years after he registered as an investment adviser.

But your question is an important one. I am not familiar with the details about the differences between the Madoff recovery and the Stanford recoveries, but I do know that a major obstacle to enforcement in the Stanford case was his use of entities offshore, his bank and other entities that he used. And I believe it is pretty clear that that posed lots of problems during the investigation getting information. And so I suspect, but I do not know, that some of the efforts to recover might have been encountering similar international difficulties.

And the one positive note I can sound is that there is an office within the SEC that is dedicated to looking into international matters and making international enforcement matters work better.

And so maybe there will be more effective efforts available in the future.

Mr. HILL. I would invite the whole panel to send me a note and write me your thoughts on this issue if you have better ways, so that other future investors don't have to deal with this kind of crisis. And I hope the Commission continues to make an effort to pursue recovery in this matter.

Mr. Vollmer, also, I really appreciate Mr. Sherman's bill talking about audit standards offshore, particularly in China. He has been a major warrior on accounting standards over the years and also in trade fairness and also transparency for investors. And there is no doubt that companies that don't get audited statements could put mom-and-pop investors here at risk.

But I am concerned that by prohibiting trading in public companies, that is also a pretty drastic step and maybe an overreaction to what is a tough problem, which could also affect companies. For example, we have so much of the market now that is in mutual funds or exchange-traded funds that include non-U.S. companies.

What are your thoughts on that? I know you have other suggestions. You suggested using Section 12(j) on delinquent filing cases and also a bonding method. Do you want to take a minute and talk about those?

Mr. VOLLMER. There are a couple of different aspects to this. I do think that just cutting off trading is a serious remedy, and if you were to do it so there was no trading in the United States—

Mr. HILL. It puts us at a competitive disadvantage, doesn't it? Isn't this best handled by listing standards? Why don't the companies just change auditors?

Mr. VOLLMER. There have been lots of efforts to try to solve this problem. I leave it to those who are better informed about it than I am. And I do think there are some alternatives. But I don't think you want a two-tier system of disclosure quality, and so I do think we have to deal with companies that have auditors not subject to inspection. It is not right to have deferential treatment, I don't think. And I do think you have to worry about whether the absence of the inspection, in fact, is concealing problems with the underlying financial statement.

Mr. HILL. I agree.

Mr. VOLLMER. We don't want that.

Mr. HILL. I would urge all of you, again, to write additional thoughts on an alternative to just plain delisting or stopping trading.

And I yield back. Thank you, Chairwoman Maloney.

Chairwoman MALONEY. The gentleman's time has expired.

The gentleman from Texas, Mr. Gonzalez, is recognized for 5 minutes.

Mr. GONZALEZ OF TEXAS. Thank you, Madam Chairwoman. And thank you to the panel.

In my law practice, for 20 years before coming to Congress, I prosecuted fraud and breach of contract claims on behalf of civil clients. My career both before and after being elected to Congress has been dedicated to fighting for the rights of the American consumer here in this committee. And what I always learned was that fraudsters like to hide, and they want everything done fast and loose. I believe if you like a shorter statute of limitations, you are playing right into the hands of the Stanfords and the Madoffs and the Gabellis and the Kokeshes.

The *Gabelli* and the *Kokesh* cases were very simple. The Supreme Court determined that the 5-year statute of limitations runs from the date of offense and not the date of the discovery of the fraud. Simple as that. Now, let's be clear. In a day and age where people are still waiting for the compensation from fraud from Stanford Capital Management, it is hard to believe that we have folks who would be advocating for a shorter statute of limitations in terms of collecting those proceeds.

I stand with the American people, who believe that we can do much better, and we have a duty to do it here in this committee and an opportunity to do it now.

Instead of a discovery rule which is open to much interpretation, I believe a hard-and-fast 10 years from the date of the offense is sufficient for the government to engage in what the fraudsters do not want, which is careful consideration of the evidence.

It is one thing to say we want to do something about the fraud on our seniors and our disabled and many of our veterans who come back with disabilities from foreign wars, and another thing to just simply do it. Today, we have an opportunity to do it. This is a chance to do something about it, because if we don't, we are leaving the money in the pockets of the crooks who abuse our seniors and our veterans and those who are in difficult places in our society.

I have a few questions, and the first question I would like to direct to Professor Velikonja. Can you please explain for my constituents back home how under the current law you can use 12-year-old evidence to convict someone for fraud but then are limited to only 5 years of theft to compensate the injured?

Ms. VELIKONJA. The enforcement action typically is a two-step process. One is establishing that there was a violation and that at least some portion of that violation took place within the 5-year limitations period. And for that you can, in fact, use older evidence. It may be relevant to establishing all sorts of steps, so long as the violation was completed less than 5 years before filing suit.

At step two, you are trying to figure out what the appropriate monetary penalties are. Those, likewise, are limited to 5 years. So by their sort of technical application of the statute, that is how it works. But as I explain in my written and oral remarks, that does mean that Charles Kokesh gets to keep his polo ponies and his gated mansion, while his 21,000 investors that he targeted specifically so that they wouldn't sue him because they were too small don't really get much compensation.

But I also want to—this is not primarily about compensation. Many of the schemes are like Congressman Hill suggested, Ponzi schemes offering fraud. The money is gone; it has been spent.

So it is not so much about compensation and just investor compensation. It is about forcing the defendant to pay either now or 20 years later, when he finally comes into some money, and pay that disgorgement order, even if none of it ultimately ends up in the investors' hands.

Mr. GONZALEZ OF TEXAS. So, in essence, the 5-year limitation allows a lot of crooks to keep the money in their pockets?

Ms. VELIKONJA. Yes, it would.

Mr. GONZALEZ OF TEXAS. Assume for me, if you will, that we are left with a 5-year statute of limitations. How would that affect the SEC's enforcement practices, in your views? Would we be rushing to judgment to beat the deadline?

I know you mentioned earlier that sometimes they agree to tote the statute of limitations. Believe it or not, I would have some defendants agree to that on type cases on civil litigation. But would we be rushing to judgment to file more cases because of the 5-year statute? Is that happening now? And would we file cases before we do the investigation because of the time constraints?

Ms. VELIKONJA. That definitely ought to be a concern. There is already internal—the Inspector General at the SEC has sort of flagged this as an issue. They would expedite investigations and chances are the SEC might, in fact, file cases a little bit more quickly after a somewhat less thorough investigation to go get within the statute, which is not in the defendant's interests. It is not in the interest of safe capital markets and it is not in the interest of the defendants, because once you are under investigation, you are under a dark cloud. Once you are being sued, you are under a darker cloud.

Mr. GONZALEZ OF TEXAS. Thank you. I yield back.

Chairwoman MALONEY. The gentleman's time has expired.

The gentleman from Ohio, Mr. Davidson, is recognized for 5 minutes.

Mr. DAVIDSON. Thank you, Madam Chairwoman. I first want to say that I appreciate you holding this hearing today on the topic, but I do want to focus on an industry that, though it isn't necessarily addressed in these legislative proposals, it is desperately in need of clarity as it pertains to securities laws and how we protect investors, and that is cryptocurrency. It has already been addressed by Mr. Sherman. And this is a rapidly growing industry. It is poised to disrupt many parts of our markets, and could be transformative for many parts of our financial lives.

With yesterday's announcement that Facebook is launching their own cryptocurrency, along with partners such as Visa, Lyft, Mastercard, Andreessen Horowitz and many other reputable global firms, it is a sign that these digital assets aren't just going to go away.

It is important that we maintain core investor protections while at the same time figuring out a principled way to enable American markets to flourish. And toward that end, I have introduced the Token Taxonomy Act. It would define what is and what is not a security.

This is a nonpartisan approach. I have everyone from myself and Josh Gottheimer in this committee, on this subcommittee even, Tulsi Gabbard, Darren Soto, Eric Swalwell. I think there are some folks left of Swalwell and some folks right of me. We have the ideological spectrum covered here in Congress, eight Members currently, and we are loading it up two by two to try to address the regulatory certainty.

Mr. Crimmins, recently you wrote about the first draft of this. And we collected input in December; until April we reintroduced this legislation. What questions are facing investors in digital assets as it pertains to securities laws, and how is regulatory uncertainty hurting investors in this market?

Mr. CRIMMINS. Right. Thank you. And I appreciate what you did in the Token Taxonomy Act with your colleagues on both sides of the aisle. This is something that is really different from what it was 2 or 3 years ago. Two or 3 years ago, when we talked about cryptocurrency, it was this murky, secretive stuff that was trying to get transactions, financial activities away from government, away from Wall Street, put it under a blanket, use it to funnel drug money and terrorist financing, really scary stuff. And that still is something that we do have to deal with.

But what we are seeing now is what you are talking about, I would suggest, with LIBOR and some of the other initiatives we have seen more recently, one recently approved by the SEC, and that is a recognition that blockchain technology, the distributed ledger which allows for security in financial transactions, can be used legitimately. It is not only that the people under the blanket tried to hide their activities; it can be used legitimately, but how, how to get it right.

Mr. DAVIDSON. And so when you talk about how to get it right, it is interesting. They didn't leave the United States to avoid sunlight. Facebook has attracted all the attention they can in the whole world, and where do they go? They went to Switzerland, where they have regulatory certainty. It is not clear that it is truly distributed in the sense that a nonprofit controls it. It is not true that—it is not clear from all that was published in the White Paper.

But are there places that are providing the certainty that are ahead of us in providing clarity for investors and people who would launch the product?

Mr. CRIMMINS. That is the problem. When regulation began, there were small jurisdictions, I think Malta and—

Mr. DAVIDSON. Liechtenstein.

Mr. CRIMMINS. Liechtenstein. Now we have Switzerland, which is not exactly a small player in the financial scene, leading the way ahead of America. That shouldn't be. And they have Crypto Valley and all this stuff they are doing there. They are trying to get it right. But the choices they make shouldn't be the ones that dominate the world.

The choices that dominate the economies generally should be the ones made by this country, the largest economy in the world. We should be, in a considered fashion by your colleagues here on both sides, working in a bipartisan fashion, as you are with Token Taxonomy, trying to get it right.

Mr. DAVIDSON. Thank you for that. And when you look, these are American firms broadly launching it. We have the ideas, we have the innovation. What we don't have is Congress providing the certainty. And I appreciate the challenge the SEC has been up against, the CFTC has been up against, and, frankly, we are waiting for Congress to act.

One of the main reasons for having disclosures in securities laws is the reduction in information asymmetry between the investor and a promoter of an investment. And sometimes the promoter of the investment, as has been illustrated, isn't an entity. You know, Satoshi Nakamoto, who is that? There is no headquarters for bitcoin. It has always left a quandary. How do you do it? Some of these others are transparent in their launching it. But if it is truly decentralized and can no longer be altered, how do we do it? We need the certainty.

Thank you for that, and I look forward to further discussions. I think Facebook may have finally tipped the balance to where there is momentum and more people at least understand some of the nature of blockchain.

Chairwoman MALONEY. Thank you. The gentleman's time has expired.

The gentlewoman from California, Ms. Porter, is recognized for 5 minutes.

Ms. PORTER. I am glad to have the opportunity today to discuss during this hearing two bills that I have introduced in this Congress. The first significantly increases the fines that firms must pay when they break the SEC laws, and the second is to make sure that executive officers and not shareholders either pay those fines or at least that investors are aware of whether or not investors will ultimately end up paying those fines.

The SEC's penalty scheme is outdated and it is ineffective in disincentivizing bad behavior. According to then-SEC Chairwoman Mary Schapiro, the Commission's statutory authority to obtain civil monetary penalties with appropriate deterrent effect is limited in many circumstances.

The Stronger Enforcement of Civil Penalties Act of 2019 is, as you know, a bipartisan bill that would increase the penalty amount in each of the three existing tiers of violations, and then would add a fourth tier for particularly egregious rule-breaking. And the Corporate Management Accountability Act would require SEC-regulated firms to disclose the procedures that they have developed to claw back and pay fines with executive compensation, as opposed to out of the pockets of investors. These and other consumer protection measures are really important guardrails to make sure that we have a healthy marketplace for American families to invest in.

As you know, over half of American families invest in the stock market, and they are very concerned about being cheated by bad actors on Wall Street. And so I urge my colleagues on both sides of the aisle to support these two bills.

I wanted to ask Professor Velikonja, some people have argued to me that increasing penalties doesn't necessarily correlate with an increase in deterrence. And I wondered if you could speak to whether or not there are any empirical indications about the relationship between increased sanctions and decreased violations?

Ms. VELIKONJA. Thank you for this question. The question of deterrence and does it work has been studied extensively, yet there is very limited evidence that deterrence works. Does the death penalty increase crime or decrease crime? Who knows?

What we do know is that sanctions, combined with visible and active enforcement, do tend to deter misconduct. Think about tax evasion if it is policed more heavily. Think about parking tickets. Think about speeding and so forth. So those are the types of violations where we have observed that deterrence works.

Charles Kokesh, for example, when he committed his fraud, the threatened sanctions would have been a civil fine plus double that for disgorgement. That is not what he was thinking about. He was trying to not get detected. He thought he was never going to get caught.

It is unclear that deterrence works at all with these sort of small-time no-name defendants. Large firms, repeat players, on the other hand, do presumably care about deterrence, right? They know they are going to stay in the same market.

Finally, I want to point this out as we are talking about deterrence and enforcement. That is not a goal of SEC enforcement. If you read the statute, it talks about investor protection and public interest, which is further defined as capital market formation, competition—I forget the third one. But anyway, so those are the goals of enforcement, not deterrence.

Ms. PORTER. That is right. I want to emphasize that point, because I really agree with you that this focus solely on deterrence or these arguments about deterrence really miss the larger framework around penalties. So while we want to deter wrongdoing in any instance where we can, there is an important compensatory and normative purpose of penalties.

And so increasing these penalties is very important for compensation for victims who may be harmed, and that is one of the reasons that in this bill we propose to have a greater of scheme in terms of disgorgement. It is not just a set fine amount, but it is really looking at the harm an investor suffered and scaling the compensation to that.

And I also wanted to ask you about—do you think that compensation clawbacks for rule-breaking should be assessed only when we can definitively prove that the individual is culpable for the infraction and because the level of culpability is often difficult to determine in the corporate setting?

Ms. VELIKONJA. Precisely. In a large firm, the corporation is going to be diffuse. In the types of firms where we worry about investors paying twice, first when they were harmed and then when they are paying the fine, executives delegate authority. So it is very hard to actually find you, John Doe, you are the one who did it.

Clawbacks are not about punishing wrongdoers; they are about accountability. An executive, the top five people, the highest paid executives know that the buck stops with them. And that is what the bill does.

Ms. PORTER. Thank you so much.

Chairwoman MALONEY. Thank you. The gentlelady's time has expired.

And the gentleman from Utah, Mr. McAdams, is recognized for 5 minutes.

Mr. MCADAMS. Thank you, Madam Chairwoman, for allowing me to be here today. And I thank the panelists for your testimony, both written and verbal, today.

As has been discussed, I am one of the sponsors of the discussion draft before us specifically related to the *Kokesh* v. *SEC* case, which held that disgorgement is a penalty and, thus, subject to a 5-year statute of limitations, regardless of whether or not the SEC was able to detect the violation within that timeframe.

According to the SEC, that case has cost investors over $800 million by limiting the time the SEC has to recover funds. Nearly $1 billion since 2017, and that number will only climb higher—$1 billion in potentially ill-gotten gains from defrauded investors that are unrecoverable. SEC Chairman Clayton has expressed an interest in a fix for this, and I believe that my discussion draft would do exactly that.

I think we all share the goals of protecting investors and ensuring that the SEC has the appropriate authority to deter wrongdoing, to promote market integrity, confidence in the market, and to ensure that investors are well taken care of. And we may have different ideas how to balance those objectives, and that is what I think we are here to explore today.

So, Professor Velikonja, you mentioned your fear that the courts will eventually rule that the SEC is not authorized to seek disgorgement in civil actions or any equitable remedies in civil actions and that the *Kokesh* decision hints at this potential outcome. I am hopeful that you can elaborate on the potential results of that if a court rules that way.

Specifically, would that leave investors protected or more vulnerable, and what would that mean for the SEC's enforcement capabilities?

Ms. VELIKONJA. So cases, as I mentioned, have already been filed challenging the disgorgement authority in court. I imagine that if you look at a Supreme Court decision and you can't square disgorgement as a penalty and it not being—in other words, disgorgement, if it is a penalty, a court cannot impose it. So you could still see a court order—

Mr. MCADAMS. Without statutory authorization.

Ms. VELIKONJA. Precisely, without statutory authorization. You might see courts ordering, in a case where you can actually identify investors and trace their funds to the violator, maybe order some sort of restitution remedy, but it could and would not order disgorgement, which means that in a typical case like an offering fraud, the civil fine would be, what, $175,000?

Mr. MCADAMS. Which gets to the point that it is just a cost of doing business, right? If you are limited to actual restitution, you may actually—

Ms. VELIKONJA. Precisely. You are just giving back what you stole, right?

Mr. MCADAMS. So it leaves investors more vulnerable and also undermines confidence in the market.

Ms. VELIKONJA. But what it does mean is, for example, in cases where there are identifiable victims, like insider trading in options, you might still have disgorgement and compensation, perhaps.

Mr. MCADAMS. Foreign bribery, I think you—

Ms. VELIKONJA. Some sort of like—foreign bribery is outside the limitations period, right? There is a problem there. And also, if you are going to use it as a restitution, who is the victim of foreign bribery? Can you identify one? If you can't compensate, you can't order it.

Mr. MCADAMS. Right. I generally think that we make better policy decisions when we allow data to inform our thinking. And so I want to also follow up on some of your work outside of this testimony, but you analyzed SEC enforcement actions filed in 2010 through Fiscal Year 2018, right? What did that data show you, and what does that body of information tell you about some of this legislation we are considering today?

Ms. VELIKONJA. My goal with that study was to see, had the *Kokesh* decision been enforced, if it is applied, what differences would it have made in the cases filed? I made certain assumptions. One thing I shared with you was that many cases are affected by the *Kokesh* decision. If we don't get into the question of, is disgorgement a penalty and, thus, not allowed at all, if we just talk limited to the 5-year limitations period, 37 percent of cases include violations older than 5 years, half in 2018. So, this is a big issue.

Now, I mentioned earlier, tolling agreements can be used to some extent to stretch the limitations period. Then, I focused in my paper, in my study of then the impact is greater in cases that are not settled. So who are we talking about? Ponzi schemers offering frauds.

Mr. MCADAMS. And you talk about—we can debate the value of deterrence in some of these cases, but what incentive does this give to a promoter of a Ponzi scheme if disgorgement goes the way of a penalty limited to a 5-year statute of limitations?

Ms. VELIKONJA. For a Ponzi schemer, typically, they don't think they are going to get caught. They are probably still going to do it. But what it does change is the market, the investors' perception about fairness of the markets. If I am an investor, I am putting money under my mattress.

Mr. MCADAMS. I would note that we have seen some data from the SEC on their enforcement actions. I have severe concerns that the *Kokesh* decision ties the SEC's hands, and leaves our investors vulnerable and without appropriate remedies from bad actors.

I would like to thank all of the witnesses for your testimony. I would urge this committee to remedy the *Kokesh* decision as soon as possible.

And with that, Madam Chairwoman, I yield back.

Chairwoman MALONEY. Thank you very much.

And I want to thank all of the panelists. You gave us a lot to think about.

Before we wrap up, I would like to take care of some administrative matters, particularly one. Without objection, I would like to submit letters and statements for the record from the Council of Institutional Investors; Public Citizen; SIFMA; the North American Securities Administrators Association; Lynn Turner; and a statement from Mr. Himes, who had to leave early.

And I would like to thank all of our witnesses for your testimony today, and I am deeply grateful.

The Chair notes that some Members may have additional questions for this panel, which they may wish to submit in writing. Without objection, the hearing record will remain open for 5 legislative days for Members to submit written questions to these witnesses and to place their responses in the record. Also, without objection, Members will have 5 legislative days to submit extraneous materials to the Chair for inclusion in the record.

Mr. HUIZENGA. Madam Chairwoman?

And Mr. Huizenga is recognized.

Mr. HUIZENGA. Thank you, Madam Chairwoman.

I just would like to submit for the record as well an article written by one of our witnesses, Mr. Crimmins, entitled, "What Restitution Could Mean for SEC Enforcement Cases."

Chairwoman MALONEY. Without objection, it is so ordered.

Mr. HUIZENGA. Thank you.

Chairwoman MALONEY. Thank you very much. This hearing is adjourned.

[Whereupon, at 5:01 p.m., the hearing was adjourned.]

A P P E N D I X

June 19, 2019

House of Representatives Committee on Financial Services
Subcommittee on Investor Protection, Entrepreneurship and Capital Markets

"Putting Investors First: Examining Proposals to Strengthen Enforcement Against Securities Law Violators"
Wednesday, June 19, 2019, 2 pm
2128 Rayburn House Office Building

Testimony of Stephen J. Crimmins

(Mr. Crimmins was Deputy Chief Litigation Counsel and a senior officer of the SEC's Enforcement Division until 2001, and since then has defended clients in SEC enforcement matters. He served as Chair of the Federal Bar Association's Securities Law Section and as Chair of the DC Bar's Corporation, Finance and Securities Law Section. He is a partner in the Murphy & McGonigle PC law firm in New York and Washington.)

Chair Maloney, Ranking Member Huizenga, and Members of the Subcommittee: Thank you for the opportunity to appear today to express my views on pending proposals to assure that the SEC's enforcement staff has the tools to assure that our securities markets remain the cleanest and fairest in the world, and strong magnets drawing the capital needed to build American prosperity.

I. An Emergency That Needs to Be Addressed

Before addressing specific proposals, let me briefly urge you to support your House colleagues in boosting the SEC's budget at least to the presently proposed $1.85 billion. Giving the SEC the funding it desperately needs is the most important thing anybody can do to deliver on our goal of putting investors first and strengthening securities enforcement.

The SEC's budget has been essentially frozen around $1.6 billion for years, resulting in a multi-year hiring freeze, and a reduction of about 400 professional staff through attrition. Yet the SEC is now dealing with bigger and more complex trading markets, more complicated products, huge datasets, cross-border scams, etc. It now oversees $97 trillion in annual securities trading, the activities of 27,000 registered market participants, filings and disclosures by 8,000 reporting companies (4,300 exchange-listed), and the activities of 22 national securities exchanges, 10 credit rating agencies, 7 active registered clearing agencies, plus the PCAOB, FINRA, MSRB, SIPC, FASB, etc.[1] And in just the last year, it authorized "a diverse mix of 821 enforcement actions"; presided over 984 pending administrative proceedings; and directed the management and settlement of 1,777 pending federal court actions.[2]

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[1] SEC Congressional Budget Justification, https://www.sec.gov/files/secfy20congbudgjust_0.pdf., p. 3 (3/18/2019).
[2] *Id.*, p. 23, 25

Everybody forgets that the SEC spends no tax dollars. And that it entirely supports itself. Since bipartisan legislation in 1996, the SEC has run entirely on filing fees that are so small that nobody has ever complained about them. Interestingly, Dodd-Frank wrote into law that the SEC's authorized (not appropriated) budget needed to grow to $2.25 billion by 2015 and implicitly should be well above $2.25 billion today, yet in 2019 it's still stuck around $1.6 billion. It is just plain wrong to go cheap on investor protection, fair and orderly trading markets, and capital formation in the world's largest and most important economy. Particularly when abundant filing fee money is available at no cost to taxpayers from willing market participants and issuers who benefit from a strong and effective SEC.[3]

II. Statute of Limitations for Commission Actions

The SEC's claims for civil monetary penalties (often substantial in amount) and for professional bars (of brokers, accountants, corporate officers, directors, and others) have long been subject to the 5-year statute of limitations in 28 U.S.C. §2462. However in 2017, the Supreme Court's *Kokesh* decision extended the application of this 5-year limitation statute to SEC "disgorgement" claims that seek to recover a violator's illegal profits.[4] Before 2017, it had been understood that SEC claims for disgorgement of illegal profits were not subject to any statute of limitations.

Responding to this new imposition of a 5-year statue of limitations on SEC disgorgement claims, the SEC Enforcement Division's 2018 Annual Report noted, in view of the multi-year character of many securities violations, that the ruling "has limited our ability to obtain disgorgement in certain long-running frauds." The SEC estimated that the ruling "may cause us to forego up to approximately $900 million in disgorgement, of which a substantial amount likely could have been returned to retail investors."[5]

Need for Uniform Limitations Period for SEC Claims. The present bill proposal would extend the statute of limitations for civil monetary "penalty" claims from the present 5 years to 10 years. But the proposal would leave at 5 years the statute of limitations for SEC claims for professional bars and certain other SEC claims. Importantly, by not specifying an appropriate limitation for disgorgement claims, the proposal may have the unintended consequence of leaving some or perhaps all SEC disgorgement claims still subject to a 5-year limitation period – that is, still stuck in the problem created by *Kokesh*..

A companion bill proposal attempts, through a "rule of construction" clause, to restore the SEC to a world where its disgorgement claims would not be subject to any limitations period

[3] In Dodd-Frank Congress "authorized to be appropriated to carry out the functions, powers, and duties of the Commission – for fiscal year 2015, $2,250,000,000." Now codified at 15 U.S.C. §35(5).
[4] *Kokesh v. SEC*, 137 S.Ct. 1635 (2017).
[5] SEC Enforcement Division 2018 Annual Report, p. 5 (Nov. 2, 2018): https://www.sec.gov/files/enforcement-annual-report-2018.pdf.

at all, as was the case before the 2017 *Kokesh* decision. However this rule of construction provision only applies to SEC claims for what it calls the "equitable relief" of "disgorgement in the amount of any unjust enrichment obtained," apparently by the violator. No problem if such "equitable disgorgement" were all that the SEC claimed. But defense counsel will cite *Kokesh* itself to argue that the SEC claims much more – that, in substance, the SEC claims a "penalty disgorgement" that remains subject to a "penalty" statute of limitations, far different and much larger than simple equitable disgorgement.

Writing for a unanimous Supreme Court in *Kokesh*, Justice Sotomayor said that SEC disgorgement differs considerably in character from traditional forms of "equitable disgorgement." Among other things, she found that disgorgement "as it is applied in SEC enforcement proceedings, operates as a penalty," citing the following: (i) When victims are too dispersed, SEC disgorgement is simply paid into the U.S. Treasury, and is thus "not compensatory." (ii) SEC disgorgement "sometimes exceeds the profits gained" by the violator, who may be required to disgorge gains obtained by "third parties," in some cases where the violator personally "never received any profits." (iii) SEC disgorgement may include gross gains, "without consideration of a defendant's expenses that reduced the amount of illegal profits." (iv) SEC disgorgement does "not simply restore the status quo; it leaves the defendant worse off." (v) Overall "disgorgement in this context is punitive, rather than a remedial, sanction," and designed "not only to 'prevent the wrongdoer's unjust enrichment' but also 'to deter others' violations of the securities laws.'"[6]

Defense counsel would likely rely on this unanimous Supreme Court language to show that SEC disgorgement is very different from the "equitable disgorgement" covered by the present bill proposal's rule of construction. In so doing, defense counsel will likely convince at least some judges that the SEC's "penalty disgorgement" remains subject to the penalty statute of limitations – thus resulting in potentially years of litigation uncertainty for the SEC, regardless of the ultimate outcome after appeals. Nor is it feasible to try to craft a substitute rule of construction that would attempt to treat "penalty disgorgement" as different from other "penalties," a definitional nightmare that likewise would only spawn confusion and again years of litigation attempting to sort it out.

The realistic and effective approach here is to take the present opportunity to simply legislate a statute of limitations – but an appropriate statute of limitations – for all SEC disgorgement claims. Additionally, considering the full range of SEC remedies – not just disgorgement – the inconsistency of having some SEC claims subject to a 5-year limitation period and other SEC claims subject to a 10-year limitation period makes no sense. The unfortunate reality is that this disparity would have the effect of forcing the SEC to continue to have to bring all of its claims within 5 years, as the SEC would not want to have to explain why it waited until it became time barred on all of its other claims (at the 5-year threshold) before filing a claim against a violator for just civil monetary penalties. So whether Congress ultimately

[6] *Kokesh v. SEC*, 137 S.Ct. 1635, 1644-45 (2017).

decides that the statute of limitations for SEC claims should be 5 years or 10 years or something else, the statute of limitations period should be the same for all SEC claims – a uniform statute of limitations applying across the board.

Hybrid Approach to Assure Reliable Testimony. Separately, there can be a serious policy question whether it is in the public interest to stretch any statute of limitations beyond 5 years. Across the full range of federal and state law, statutes of limitations generally range, depending on the claim, between 1 and 6 years, and it is rare to find a limitations period beyond 6 years. The reason for this is that it can be very hard for witnesses to give reliable testimony many years after the events in question. Beyond 5 or 6 years, experience shows that witnesses can remember situations generally, but not particular events, meetings and conversations. And memory may turn on the significance of an event to them personally. So litigants on both sides of a case may through passage of time lose the ability to question a witness who originally had important testimony to give, but who now is at best hazy in recalling the events.

So how do we accommodate the competing considerations of giving the SEC enough time to find and pursue violators, while at the same time giving our courts and juries testimony from witnesses who can reliably recall events and accurately provide sworn testimony? In answering this question, we can take a lesson from the approach Congress chose in setting the statue of limitations for private securities cases, where legal claims are similar but do not involve the SEC. In the Sarbanes-Oxley Act of 2002, Congress provided that such actions must be brought "not later than the earlier of – (1) 2 years after the discovery of the facts constituting the violation; or (2) 5 years after such violation." 28 U.S.C. §1658(b). Interpreting this "2-and-5" provision, the Supreme Court clarified that the limitations period "begins to run once the plaintiff did discover or a reasonably diligent plaintiff would have 'discovered[ed] the facts constituting the violation' – whichever comes first," but "irrespective of whether the actual plaintiff undertook a reasonably diligent investigation."[7]

Acting in the public interest, the SEC should get more time than private plaintiffs. But the same hybrid structure can still be applied – perhaps by adopting a "3-and-10" approach in SEC cases. Thus, the SEC would have to file its action "not later than the earlier of – (1) 3 years after the discovery of the facts constituting the violation; or (2) 10 years after such violation." This 3-and-10 structure would give the SEC potentially as long as a generous 10 years after the violation to act against concealed violations, but still require it to complete its investigation and file suit within 3 years from reasonable discovery of the violation. In this way, the SEC would be assured of having sufficient time to file suit where facts are hidden, but it would still have to work diligently to be able to responsibly present witnesses who had some recollection of the events. If Congress sees a need to further accommodate the SEC, such a provision could also explicitly provide that, where a violation involves a continuing course of related conduct, the statute of limitations for the entire course of conduct would only begin to run at the conclusion of the course of conduct.

[7] *Merck & Co. v. Reynolds*, 559 U.S. 633, 653 (2010) (quoting 28 U.S.C. §1658(b)(1)).

Safety Valve. Experience shows that generally the SEC can complete an investigation within 3 years of discovering the misconduct, so such a 3-and-10 approach is reasonable. In the rare case where the SEC needs more than 3 years to complete an investigation, it can ask the subjects of its investigation, who will after 3 years of investigating be known, to consent to a routine "tolling agreement" voluntarily extending the statute of limitations, a request that is virtually always agreed to in SEC investigations. Alternatively, the SEC can simply file litigation based on what it knows after investigating the matter for 3 years. If it gets additional information during the course of its litigation (for example through pretrial depositions), it can ask the court to allow it leave to amend its complaint, and the relevant procedural rule provides that the court "should freely give leave when justice so requires."[8]

III. Equitable Relief in Commission Actions

Need to Confirm SEC Ability to Compel Disgorgement of Illegal Gains. As enacted in the 1930s, the securities laws allowed the SEC to seek injunctions against securities violations and other limited relief, but they did not specifically authorize the SEC to obtain a monetary recovery. Beginning around 1970, the SEC persuaded courts that their equitable jurisdiction to grant injunctive relief inherently allowed them to decree that wrongdoers must "disgorge" any ill-gotten gains they received from their violations.[9] More recently, Congress has confirmed that the SEC has the power to seek "equitable" remedies, but without specifically enumerating disgorgement as among those remedies.[10] In 1990, Congress gave the SEC authority to seek civil monetary "penalties" to punish wrongdoing, but the SEC also continued to seek and obtain "disgorgement" of illegal gains.[11]

Two years ago, in ruling for the first time that SEC disgorgement claims should be subject to a 5-year statute of limitations, as discussed above, a unanimous Supreme Court startled many observers by also raising fundamental doubts about the SEC's long-accepted power to obtain disgorgement at all. The Court left the answer to this question for a future day, noting that its ruling was limited simply to the statute of limitations question, and that the opinion should not be interpreted as ruling, in Justice Sotomayor's words, "on whether courts possess authority to order disgorgement in SEC enforcement proceedings or on whether courts have properly applied disgorgement principles in this context."[12]

Demanding that violators surrender their illegal profits with interest has for many decades been at the core of the SEC's enforcement program, and rightly so. But now, the Supreme Court's unanswered question has left the SEC's disgorgement remedy in limbo. Congress

[8] Rule 15(a)(2), Federal Rules of Civil Procedure.
[9] *Kokesh v. SEC*, 137 S.Ct. 1635, 1640 (2017), citing *SEC v. Texas Gulf Sulphur Co.*, 312 F. Supp. 77, 91 (S.D.N.Y. 1970), *aff'd in part and rev'd in part*, 446 F.2d 1301 (2d Cir. 1971).
[10] Securities Exchange Act §21(d)(5), 15 U.S.C. §78u(d)(5).
[11] *Kokesh*, 134 S.Ct. at 1640, citing 104 Stat. 932, codified at 15 U.S.C. §77t(d).
[12] *Id.* at 1642, n. 3.

should not allow this uncertainty to persist. It is time to explicitly state in legislation that the SEC may seek full disgorgement of violators' profits.

The present bill proposal would do this. However, for the reasons discussed above, there is the problem of how the proposal describes "disgorgement." A better and clearer approach may be to slightly modify the proposal's description of the disgorgement that the SEC would be formally authorized to seek so that it would read as follows: "(ii) disgorgement, *including without limitation* the amount of any unjust enrichment obtained through the act or practice with respect to which the Commission is bringing such action or proceeding, *and without regard to whether any such amount may be construed to be a penalty*" (italicized material added).

Challenges of Adding a Restitution Remedy. The present bill proposal would separately give the SEC the ability to seek the additional remedy of restitution – something the SEC has not previously done over its 85-year history. This proposal would be viable only with a substantial increase in the SEC's budget. At current flatlined budget levels and seriously reduced staffing levels, the SEC has difficulty managing a docket of cases that seek simply findings of securities law violations, disgorgement of the violator's profits, additional monetary penalties, injunctions (or cease-and-desist orders), and professional bars.

Restitution is very different and would get the SEC into the business of doing far more labor-intensive cases. Restitution is the functional equivalent of a class action "damages" claim because restitution requires the violator not just to refund illegal profits and pay a penalty, but additionally to compensate each and every investor who may have suffered a monetary loss flowing from the violation. To illustrate, a violator may have earned no personal profit as a member of a company's executive group during a period when it failed to disclose a material fact, but ultimate disclosure of the omitted fact may wipe out $500 million or more in market cap, and result in hundreds of millions in losses to investors who bought or sold the company's securities over the time the material fact was illegally concealed.

Proving restitution claims would require the SEC to prove causation of investor losses with reasonable precision, in far more labor-intensive and prolonged litigation than it presently handles, followed by collection efforts to try to get the defendant company (effectively its current shareholders) and defendant present or former executives to pay the restitution ordered into a distribution fund, and then a prolonged claims process to carry out the distribution to shareholders impacted by varying loss levels, including fair proration if the full loss amount could not realistically be collected. Class action lawyers quickly file such claims following a stock drop, but then after initial court motions and discovery, some (not all) may seek to quickly negotiate settlements in amounts that cover attorneys' fees and "pragmatic" additional relief that may simply involve improved corporate governance provisions without actual monetary payments (or with amounts comfortably with D&O policy limits). However as a public agency, the SEC could not conveniently wrap up its restitution (essentially damages) cases so quickly and easily, and would be charged by Congress and the public to seek the full relief its lawsuit demanded and not settle cheap for attorneys' fees and small actual recoveries.

So how could the SEC handle this different and far more labor-intensive kind of litigation? At present funding levels, the SEC could radically cut back on the number of cases it brings, meaning that many frauds would never be exposed, investors would continue to suffer, and violators would go free. This obviously makes no sense. The alternative is to radically increase the SEC's budget from its present $1.6 billion level to something more like $4-5 billion, and substantially grow its enforcement staff and infrastructure to handle this heavier litigation load. There's no question that the SEC needs a much bigger budget, but increasing it this much and this fast is probably not realistic.

Finally, there is the question of the interplay between disgorgement and restitution. Would the SEC seek both disgorgement of the violators' profits and restitution of victims' losses, or would it choose disgorgement or restitution? If a choice, what would be the basis for decision between them? If both, defense counsel may raise Constitutional fairness and other objections that would send the SEC down the road of years of unproductive litigation.

IV. Stronger Enforcement of SEC Civil Penalties

The bill proposal increases by roughly 25% to 33% the dollar amount of each penalty "tier" in the penalty structure that has been in place for the last 30 years in the federal securities laws. For serious violations (Third Tier), it alternatively allows the penalty to equal "gross pecuniary gain" obtained by the violator if that is higher, or the "amount of losses incurred by victims" if that is still higher. And it allows the penalty amount to be trebled (a new Fourth Tier) if within the five years before the conduct the entity or individual had resolved an unrelated securities fraud case. And due to an ambiguity already existing in the statute, such penalty amount could be imposed for each act or transaction over a course of dealing,[13] resulting in a maximum penalty calculation easily in the trillions of dollars, as discussed below.

Issues Presented. While nobody wants to go light on fraudsters, this overall approach creates some problems. First, the proposal again requires us to consider the restitution issues discussed above. Setting penalty amounts, in the alternative, at a level equal to "the amount of losses incurred by victims as a result of the violation" is another way of setting the SEC on the course of seeking restitution (damages), discussed above. As presently drafted, the proposal would have the SEC make an equitable claim for restitution (damages) and then additionally seek a penalty amount equal to the restitution amount. So in the example given above, the defendant executive serving during a nondisclosure and the defendant company's current shareholders (as the company's equity owners) would be on the hook to pay those who were

[13] Law 360 recently reported that a brokerage firm charged with filing defective suspicious activity reports over an extended period was found to have committed 2,720 "violations," one for each defective report, and that the SEC then multiplied this number by the penalty amount to demand $22.7 million, an amount that the firm said would put it out of business. "Brokerage Firm Fights 'Draconian' SEC Bid For $23M Penalty," Securities Law 360 (6/11/2019), reporting on *SEC v. Alpine Securities Corp.*, Case No. 17-CV-4179 (S.D.N.Y.).

shareholders back at the time of the nondisclosure an amount up to twice the full stock drop (the loss in market cap), once as restitution and a second time as penalty.

And the "recidivist" provision in the penalty proposal would increase this substantially if the individual or the entity had resolved another SEC case within the previous five years (which would likely have involved conduct 8 to 10 years ago, given the time needed for investigation and litigation), even if the previous SEC resolution was a no-admit settlement of one of the negligence-based antifraud provision. In such a case, the defendant corporation could be ordered to pay restitution, and then pay a penalty equal to three times the restitution amount, for a total of four times the stock drop amount to be paid by current shareholders to shareholders during the stock drop period, with some shareholders overlapping and others not.

And if the individual or entity had ever settled an earlier SEC court or administrative case with an injunction or cease-and-desist order – provisions found in virtually all SEC settlements – the penalty amounts for the second case would get astronomically higher. Even if the earlier settlement was for a technical charge not involving fraud and without an admission, the penalty in the new case would be imposed for "each day" during the period of the new violation. So if the events involved in the nondisclosure hypothetical discussed above stretched over six months, then the penalty equal to the restitution amount (or three times the restitution amount) could be imposed for each of the 180 days over the six month period, for a total penalty amount of 540 times (three times 180) the amount of the stock drop (loss in market cap).

Effective But Measured Alternative. This is certainly talking tough, but it's not realistic and may cause the law (and the SEC) to lose credibility. With a sky's-the-limit approach and no guidance from Congress, the SEC will wonder, on a case-by-case basis, whether to ask the court for thousands or for trillions. This will build in opportunities for defense counsel to raise a range of due process and equal protection Constitutional and other challenges that risk tying up the SEC in litigation for years – a replay of the Constitutional litigation the SEC is presently working its way through over the process for appointing and removing its administrative law judges. This is not something the SEC needs.

To make a meaningful difference, a more measured approach to enhancing the toughness of SEC penalties is what's needed here. One such alternative would be the following: (i) Increase the specific dollar amounts for each penalty tier as stated in the proposal. (ii) Provide that alternatively penalties could equal gross pecuniary gain, if greater than the specific dollar amounts in the tier calculation, also as stated in the proposal. (iii) Provide that each "course of action" – essentially each type of misconduct in a case, but not each individual transaction – shall constitute a separate act for purposes of assessing penalties. Such an approach has been used by the SEC and its administrative law judges, and it typically results in a single-digit and thus credible number of penalties for purposes of penalty calculation.[14]

[14] *See Matter of J.S. Oliver Capital Management, LP,* 2016 WL 3361166 at *15 and n. 106, 108 (June 17, 2016).

Finally, provide that once the penalty amount has been determined by using this approach, the federal court judge or SEC administrative law judge must then make an overall assessment of the fairness, for Constitutional and other purposes, of the resulting amount by applying certain specifically enumerated factors that Congress has previously directed must be applied in setting penalties in the SEC's administrative proceedings.[15] But do not additionally include a restitution measure of penalty, a treble penalty provision, or a separate Tier Four recidivist calculation, as these additional measures will create unintended problems for the SEC without actually resulting in additional collectible monetary recoveries for investors or meaningful additional deterrent effect for law enforcement purposes.

V. PCAOB Enforcement Reforms

Public Hearings at the PCAOB: The proposal for public PCAOB hearings has been recommended for some time by persons within and outside the PCAOB. The administration of justice generally should be public, and to assure clean markets and build investor confidence, there is a particular need for "public" hearings when the PCAOB evaluates "public" accountants working for "public" companies. The argument on the other side is that, by having proceedings conducted in secret, the PCAOB preserves the reputation of those charged in the event that some or all of the claims are ultimately not proven. While this concern is understandable, it would apply equally to all of the SEC's litigation in federal court and in administrative proceedings, but these SEC proceedings have been public for the SEC's entire 85-year history, and no one has argued this should be changed.

Disclosure of Use of Firm That PCAOB Cannot Inspect: The PCAOB and the SEC have had continuing difficulty obtaining records and information from accounting firms in certain foreign jurisdictions in recent years. Companies raising capital in the U.S. that use such firms beyond a reasonable period should have their access to U.S. markets limited.

Whistleblower Program at the PCAOB: The whistleblower program has been a big success at the SEC, and it would undoubtedly also help the PCAOB carry out its mission. The only concern is that it would require a very small agency to use limited staff positions to staff a whistleblower office to receive complaints and process bounty claims. An alternative would be for the PCAOB to refer whistleblower bounty claims to the SEC's whistleblower office, which has overlapping jurisdiction over accounting matters and which already has in place the staff and other infrastructure needed to effectively run a whistleblower program. In short, there may be a way for the SEC and the PCAOB to partner on this for greater efficiency.

[15] For example, in Securities Exchange Act §21B(c), Congress directed the SEC to apply a variety of enumerated "public interest" factors in assessing penalties, along with "such other matters as justice may require." And in §21B(d), Congress provided for an assessment of ability to pay in making a penalty determination.

Conclusion

I will conclude by thanking the Subcommittee and its staff for their careful consideration of these important issues at the heart of SEC enforcement. I am ready to respond to any questions Members may have concerning my testimony today.

(The views above are solely those of the author, and may or may not reflect the views of the author's professional colleagues, clients or others as to particular items discussed.)

Written Statement of Jordan A. Thomas
before the
House Committee on Financial Services
Subcommittee on Investor Protection, Entrepreneurship, and Capital Markets
Regarding
"Putting Investors First: Examining Proposals to Strengthen Enforcement
Against Securities Law Violators"
June 19, 2019

Chairwoman Maloney, Ranking Member Huizenga, and Members of the Subcommittee:

Good afternoon. Thank you for inviting me to testify before the Subcommittee regarding a number of legislative proposals to strengthen enforcement against securities law violators. Strong enforcement of the federal securities laws is essential to protecting the health of our securities markets. This Subcommittee's consideration of a number of draft legislative proposals to bolster SEC enforcement efforts is both timely and much needed.

I know the enormous value of effective SEC enforcement from my years of experience in the public and private sector. I am currently Chair of the Whistleblower Representation Practice at the New York law firm Labaton Sucharow. I joined Labaton in 2011 to start the first whistleblower practice focused exclusively on violations of the federal securities laws. I have represented clients who have launched many high-profile SEC cases and obtained precedent-setting whistleblower awards.

My legal practice as an SEC whistleblower advocate was a natural outgrowth of my many years of public service, the last eight of which were in the SEC's Division of Enforcement, where I served as an Assistant Director, and before that as an Assistant Chief Litigation Counsel. During that time I worked on numerous high-profile enforcement actions, including those involving Enron, Fannie Mae, UBS, and Citigroup. I also had a leadership role in the development of the SEC Whistleblower Program, including drafting the proposed legislation and implementing rules, and briefing House and Senate staffs on the proposed legislation. Before joining the SEC, I was a Trial Attorney at the Department of Justice, specializing in complex financial services litigation involving the FDIC and Office of Thrift Supervision.

From my experience as an SEC Enforcement lawyer and more recently in representing securities law whistleblowers, I have witnessed firsthand that a vigorous enforcement program is essential to strong and healthy securities markets. Markets depend on trust. Most critically, investors must have confidence that "the game isn't rigged" against them, and that when violations occur, they will be detected, investigated, and punished. If enforcement is seen as ineffective, investor confidence in market integrity will fall. That's bad not just for individual investors, but for our capital markets as a whole.

Thus, I commend the Committee for considering a variety of important proposals to strengthen enforcement against securities law violators.

1. Bolstering SEC Enforcement Remedies: Disgorgement, Penalties, and Statutes of Limitations

a. Restoring the Disgorgement Remedy After Kokesh

Of the many issues currently under consideration by the Committee, I believe that the most critical is restoring the SEC's ability to obtain full disgorgement of ill-gotten gains from wrongdoers.

Thus, I strongly support a legislative proposal to overturn *Kokesh v. SEC*, 137 S.Ct. 1635 (2017), a recent Supreme Court decision that severely hampers the SEC's efforts to recover full disgorgement of illegal profits in massive, long-running frauds.

Disgorgement is an essential component of SEC enforcement. While the original securities laws did not expressly authorize the SEC to seek disgorgement of wrongful gains in civil injunctive actions, the courts long ago agreed that they could order disgorgement in SEC actions as an exercise of their equitable authority to grant relief ancillary to an injunction.[1] And after many years of case law providing for disgorgement in civil actions, Congress amended the securities laws to permit disgorgement in SEC administrative proceedings as well.[2] Because disgorgement was considered an equitable remedy designed to take away the profits of wrongdoing, not a penalty assessment, courts for decades ruled that disgorgement was not subject to a statute of limitations.[3]

In *Kokesh*, however, the Supreme Court upended this longstanding authority, holding that disgorgement in the SEC enforcement context was a "penalty" that was therefore subject to a five-year statute of limitations contained in 28 U.S.C. 2462. The impact of this decision is enormously damaging; and it is most damaging in the cases that present the most egregious and longest-running frauds and abuses. *Kokesh* itself demonstrates this. The Commission's case against Kokesh was based on fraud committed from 1995 to 2009, which included the misappropriation of $34.9 million, and the filing of numerous false and misleading SEC reports to conceal the wrongdoing. The lower courts granted the SEC's request for disgorgement of the entire $34.9 million, but under the Supreme Court's ruling, the SEC was precluded from recovering nearly $30 million of ill-gotten gains that resulted from violations outside the 5-year limitations period.

Unfortunately, it is all too common for large-scale securities frauds and abuses to remain undetected for many years, since continuing a profitable scheme depends on keeping it secret. Fraudsters are often sophisticated and highly motivated to keep their cons going by engaging in elaborate schemes to conceal them. And many other large-scale (non-fraud) abuses also involve long-running misconduct that can be extremely hard to detect. One example I am very familiar with is the SEC's $415 million case against Merrill Lynch, which arose from my clients whistleblower tips. The Commission's case was based on long-running misconduct at Merrill Lynch, which over more than a decade, executed complex options trades that lacked economic substance and artificially reduced the required deposit of customer cash in the firm's reserve account. Through this reckless conduct, Merrill Lynch violated the SEC's Customer Protection Rules and put tens of billions of dollars of customer funds at risk in order to finance its own trading activities at lower costs. This extensive yet obscure misconduct might have gone unnoticed, but was eventually brought to light and successfully prosecuted as a result of my clients whistleblower tips. Even so, at the time the Commission brought its case, much of the conduct at issue had occurred more than five years earlier. Thus, application of the restrictive five-year statute of limitations provided in *Kokesh* would have greatly reduced the monetary recovery (disgorgement and penalties) obtained by the SEC.

In short, the ruling in *Kokesh* rewards violators who are good at hiding their misconduct. And the better they are at continuing their scheme by hiding it, the more fraudulent proceeds *Kokesh* allows them to keep. This perverse outcome has had an immediate and drastic impact on SEC enforcement: in its 2018 Annual Report, the SEC's Division of Enforcement estimated that the Commission may be

[1] E.g., *SEC v. Texas Gulf Sulphur Co.*, 312 F. Supp. 77, 91 (SDNY 1970), aff'd in part and rev'd in part, 446 F.2d 1301 (1970); *SEC v Commonwealth Chemical Securiites Inc.*, 574 F. 2d 90 (2d Cir. 1978).

[2] See, e.g., Exchange Act Section 21(d)(3), which was added as part of the Securities Enforcement Remedies and Penny Stock Reform Act of 1990.

[3] E.g., *SEC v. Rind*, 991 F.2d 1486 (9th Cir. 1993); *Riordan v. SEC*, 627 F.3d 1230 (D.C. Cir. 2010).

forced to forgo approximately $900 million in disgorgement because of *Kokesh*.[4] This figure is more than just a mere government statistic – it represents nearly a billion dollars in illegally obtained profits that will not be returned to defrauded investors.

Thus, it is critical for Congress to pass legislation to undo the harm caused by *Kokesh*. The proposal under consideration would effectively do this in two ways. First, it would amend Section 21(d)(5) of the Exchange Act to expressly state that the equitable relief available to the SEC in any action or proceeding includes restitution to investors and disgorgement of unjust enrichment. I support this amendment. Although *Kokesh* did not speak to the authority of courts to order disgorgement in SEC enforcement actions, the opinion contained a footnote reserving judgment on that issue, and this has already led to challenges by defendants in SEC cases. The proposed legislative change would put this issue to rest. Similarly, while restitution is well recognized as an equitable remedy, the SEC has only infrequently sought restitution in its enforcement cases; thus, an express statutory authorization of restitutionary relief would remove any doubt about the SEC's ability to seek this remedy.

Second, the proposal would include a rule of construction specifying that any equitable relief sought under Section 21(d)(5) would not be construed as a penalty subject to the statute of limitations provisions in Title 28. This change is needed to provide an unambiguous statement of Congressional intent that disgorgement, restitution and other equitable remedies in SEC actions not be subject to general federal statutes of limitations.

In addition to the existing provisions in this proposal, I urge Congress to include in the legislation an "effective date" provision that would most fully undo the harm caused by the *Kokesh* decision. To do this, the provision should expressly state that it applies in all SEC actions or proceedings commenced after the date of enactment, as well as in all SEC actions or proceedings pending on the date of enactment. This provision is necessary to clearly express Congress's intent about the effect of the legislative change. Without this provision, defendants who have committed misconduct before the legislative change may claim that any unjust enrichment they obtained more than five years ago remains beyond the reach of SEC enforcement. An unambiguous statement of Congressional intent can put to rest any such arguments about a so-called "retroactive" application of the law.[5]

b. Strengthening the Impact of Civil Money Penalties

Another critical element of effective SEC enforcement is the ability to obtain civil monetary penalties. Even if the Commission is able to obtain full disgorgement from wrongdoers, an order of disgorgement only makes a violator give up the amount of profit derived from the wrongdoing (plus interest). Effective deterrence requires that the SEC also be able to impose significant money penalties against violators. Two of the legislative proposals under consideration relate to the SEC's money penalty authority, and both would make important changes to the law to strengthen securities enforcement.

One proposal is designed to respond to the Supreme Court decision in *Gabelli v. SEC*, 568 U.S. 442 (2012), which held that the SEC is subject to a five-year statute of limitations when seeking civil

[4] SEC Division of Enforcement, Annual Report for 2018 at 12 (available at https://www.sec.gov/files/enforcement-annual-report-2018.pdf).

[5] See *Landgraf v USI Film Products*, 511 U.S. 244 (1994) (first step for a court in determining retroactive effect of a statute is to determine whether the statute includes a clear statement of Congressional intent). In this situation, there should be no concern about potential unfairness in applying this provision to newly-filed or pending cases against securities law violators, who have no reasonable expectations that they were entitled to keep their ill-gotten gains. As explained above, prior to the Supreme Court's decision in *Kokesh*, the weight of authority supported the Commission's ability to obtain disgorgement of ill-gotten gains regardless of the 5-year statute of limitations in 28 U.S.C. 2462.

money penalties, and that the five-year limit begins on the date the violation occurs, not on the date the SEC discovered it. This bill would give the SEC a 10-year statute of limitations for civil money penalties, beginning at the time of the violation.

I agree that a legislative response to the *Gabelli* decision is needed to help strengthen the SEC's enforcement arsenal. As noted above, many of the largest and most egregious securities violations occur over extended time periods. In cases like *Kokesh* and *Merrill Lynch*, for example, the majority of the misconduct occurred more than five years before the SEC brought its cases. Thus, lengthening the statute of limitations for civil money penalties to 10 years would better enable to Commission to seek and obtain penalties commensurate with the full scope of the violation in such cases. However, as *Kokesh* also illustrates, in some cases even a limitations period of ten years from the date of the violation would not capture all of the misconduct, because the violation was fraudulently concealed for over a decade.

An alternative response to *Gabelli* could be to retain a general five-year statute of limitations for SEC civil money penalties, but with a carve-out that specifically provides that in cases of continuing violations or fraudulent concealment, the statute does not begin to run until the date of the last act that was part of the continuing violation or fraudulent concealment. This approach would be more focused on allowing penalties for long-running, continuous violations, which are frequently continued by means of fraudulent concealment. For example, the statute could state that in the case of fraud or other violations that are concealed by false or misleading statements or deceptive conduct, the Commission may obtain penalties for all such violations as long as it commences its action within five years of the last statement or act or practice employed to conceal the violation.

There are pros and cons to the different approaches. A general ten-year statute of limitations is simple to administer and provides clarity and certainty about when penalties are available. But some may argue that ten years is too long for a general, across the board statute of limitations available for all types of securities law violations, including minor or technical violations. The current five-year statute of limitations has other advantages, such as encouraging the SEC to focus its enforcement efforts on more recent conduct and to complete investigations and bring cases more quickly. By contrast, an approach that adds a continuing violation or fraudulent concealment exception to the existing five-year statute is more complex and may result in more litigation regarding the boundaries of the carve-out for continuing violations or fraudulent concealment. However, it has the advantage of being targeted at those cases – large and egregious long-running frauds -- where it is most appropriate for the Commission to obtain penalties for older misconduct.

Another legislative proposal under consideration would update and strengthen the current statutory provisions for SEC civil money penalties. Among other things, the proposal would increase the statutory maximums for civil money penalties, provide that the size of penalties could be linked to the amount of victim losses, and establish a new "fourth tier" penalty that could be imposed against recidivist violators. This proposal is long overdue and would strengthen the SEC's national enforcement program. In particular, the provision allowing penalties to be assessed at the level of victim harm would be an important addition to SEC sanctions in those cases where a wrongdoer had wreaked enormous investor harm but for some reason claimed to have minimal personal gain. Similarly, the provisions for enhanced penalties against recidivists, as well as the new statutory provisions regarding penalties for violation of federal court injunctions or SEC orders, would greatly strengthen the enforcement remedies available against repeat violators.

2. Strengthening Whistleblower Anti-Retaliation Protections

The proposals addressed above show the need for legislation to respond to several recent Supreme Court rulings that have seriously impaired SEC enforcement efforts. Along these lines, I strongly urge the Subcommittee to consider legislation to address another recent Supreme Court decision that has been quite harmful to securities law enforcement. This is the decision in *Digital Realty Trust, Inc. v Somers*, 138 S.Ct. 767 (2018), which seriously undermined the statutory anti-retaliation protections afforded to securities law whistleblowers.

In the Dodd-Frank Act of 2010, Congress established a new and robust SEC whistleblower program. The three key components of the program were: monetary awards to whistleblowers who provided original information leading to successful SEC cases; enhanced anti-retaliation protections for securities law whistleblowers; and confidentiality for whistleblowers. As this Subcommittee well knows, the SEC whistleblower award program has had a dramatic impact on SEC enforcement. Since implementation of the whistleblower program, the SEC has brought successful enforcement cases with over $1.7 billion in monetary sanctions in cases based on whistleblower information and has paid out nearly $400 million in whistleblower awards.

While the monetary awards component of the program has been hugely successful, the statute's anti-retaliation protections have had a more checkered history, with the *Digital Realty* decision being the most damaging blow. To strengthen those protections, Congressional action is needed to overturn the outcome of *Digital Realty* and to restore statutory anti-retaliation protections to whistleblowers who report misconduct internally through their employers' compliance systems.

When the SEC developed its rules governing the whistleblower program in the months following the enactment of Dodd-Frank, one of the most hotly contested issues was how the Commission should handle internal whistleblower complaints. At the time, many corporate commenters urged the Commission to ***require*** whistleblowers to report internally before reporting misconduct to the SEC in order to be eligible for a whistleblower award. These commenters asserted that if the Commission allowed whistleblowers to sidestep established internal corporate compliance programs, this would undermine the effectiveness of internal compliance and impair companies' ability to detect and respond to misconduct. Other commenters, however, pointed out that a rule forcing whistleblowing employees to report internally first, without any regard for the company's culture or the effectiveness of its compliance program, could well lead employees to avoid reporting wrongdoing entirely. In its final rules, the SEC declined to require internal reporting as a prerequisite for award eligibility. However, the Commission did recognize the benefit of encouraging and supporting effective internal compliance systems, and therefore included provisions in the final rules that were designed to encourage internal reporting – most notably, a provision that made internal reporting a "plus factor" that could justify granting a higher percentage award. Thus, the SEC sought to incentivize internal reporting without requiring it.

After the rules were finalized, however, the corporate community took a completely different view. In resisting anti-retaliation lawsuits brought by employees who had reported their concerns of misconduct internally, companies now argued that the Dodd-Frank anti-retaliation protections did not cover those employees, claiming that they were not "whistleblowers" because they had not reported information to the SEC. The SEC sided with the whistleblowing employees, going so far as to issue an interpretive rule stating that persons who reported internally were whistleblowers for purposes of the statute's anti-retaliation provisions. Lower courts split on the legal question, but in the *Digital Realty* case, the Supreme Court ruled against an employee who had been terminated shortly after internally reporting suspected securities law violations. The Court held that the statutory anti-retaliation protections applied only to persons who provided information to the Commission.

This decision is harmful not only to individual employees who report internally, but to the public policy objective of promoting effective internal compliance programs. As someone who counsels prospective whistleblowers facing the life-changing decision about whether and how to report misconduct, I can tell you that after *Digital Realty*, the question answers itself: a whistleblower who has any concern at all about retaliation must now report to the SEC either before or at the same time as reporting internally, in order to get the full anti-retaliation protection provided by law. Many are likely to bypass internal compliance, the first line of defense for investors, altogether. The policy that the corporate community argued for vehemently back when the SEC wrote its rules – to support and encourage internal reporting – has been completely undermined as a result of *Digital Realty*.

Congress can easily fix this. The *Digital Realty* decision was based on the Court's interpretation of the statutory definition of "whistleblower" in Exchange Act section 21F(a)(6). Congress can undo the outcome of the decision by amending that statutory definition. A legislative amendment to the definition, similar to the definition of "whistleblower" provided in SEC Rule 21F-2(b), would make clear that the statutory anti-retaliation protections provided by Dodd-Frank apply to whistleblowers who report information internally.

3. Clawbacks of Executive Compensation

Another important topic under consideration by the Committee is the issue of how to create more accountability for corporate senior executives when the corporation under their management commits misconduct resulting in fines or penalties. The legislative proposal being considered would require the SEC to adopt rules for issuer disclosure of policies regarding clawbacks of executive compensation when the issuer has been required to pay certain covered fines or penalties. The rules would require issuers to disclose whether they have adopted policies and procedures to recoup and/or withhold compensation from named executive officers when the issuer has paid a covered fine or penalty. If the issuer has not adopted such policies, it would have to disclose why not; if it has adopted policies, it would have to describe its policies and provide disclosure about the amounts it had recouped over the prior three years.

The proposal aims to highlight whether the senior executives at publicly traded companies are held accountable when the company has been required to pay a fine or penalty for misconduct. This is a laudable goal. Far too often, corporations violate the law and are required to pay fines or penalties, but the executives responsible for management of the corporate business suffer no consequences. The proposal under consideration would provide greater transparency about corporate policies for recouping compensation from the executives on whose watch a corporate issuer engaged in misconduct warranting fines or penalties. Although this proposal will not require companies to make immediate changes to their clawback policies, the required disclosure will at least have the effect of giving shareholders greater insight into issuer practices, and thereby may help them in promoting more aggressive use of clawbacks to hold management accountable.

In this regard, the Subcommittee may also wish to revisit the clawback provision enacted in Section 304 of the Sarbanes-Oxley Act (commonly referred to as SOX 304). SOX 304 provides that when an issuer is required to prepared an accounting restatement due to misconduct, the CEO and CFO of the issuer shall reimburse the issuer for bonuses and certain specified incentive-based compensation and profits from securities sales received in the 12-month period following the misstated financials. The SOX 304 clawback is a potentially powerful remedy, as it provides that CEOs and CFOs can be held responsible for reimbursement even when they are not personally charged with misconduct.[6]

[6] *SEC v. Jensen*, 835 F.3d 1100, 1116 (9th Cir. 2016) ("disgorgement is merited to prevent corporate officers from profiting from the proceeds of misconduct, whether it is their own misconduct or the misconduct of the companies they are paid to run").

However, the courts have held that there is no private right of action under SOX 304.[7] Enforcement is reserved to the discretion of the SEC, whose aggressiveness in using the remedy has varied. Congress may wish to consider ways to strengthen and promote more frequent use of the SOX 304 clawback, including creating a private right of action under SOX 304.

4. Bad Actor Disqualifications

In another topic related to SEC enforcement practices, the Subcommittee is considering a legislative proposal related to the Commission's processes for granting waivers to "bad actors" who would otherwise be disqualified from certain activities (or benefits) under the federal securities laws.

Under SEC rules and several statutory provisions, persons who become subject to various types of enforcement orders (so-called "bad actors," because the enforcement order arises from their violation of law), are disqualified from certain activities under the securities laws. These activities include: participating in certain private securities offerings under SEC Regulation D; using exemptions from registration for certain securities offerings under SEC Regulation A or E; qualifying for the streamlined disclosure regime available for "well-known seasoned issuers" under SEC rules; and relying on the safe harbor from liability for forward-looking statements provided in the Securities and Exchange Acts. The disqualifications are automatic under the terms of the applicable rule or statute, but the Commission has the authority to grant waivers from such disqualifications. In recent years, in the context of settlements of SEC enforcement actions, the Commission's determination of whether or not to grant certain disqualification waivers has become increasingly controversial.

The proposal under consideration would impose new requirements on the Commission in its processes for considering whether to grant disqualification waivers. Specifically, the proposed legislation would: (1) require the waiver process to the conducted and decided at the Commission level, rather than at the staff level (by delegated authority); (2) require the Commission to consider whether the waiver would be in the public interest, protect investors, and promote market integrity; (3) require public notice and the opportunity for public comment on at a public hearing on whether a particular waiver should be granted; (4) require the Commission to keep a public record of all waiver requests and create a public database of ineligible bad actors.

I support the objectives of this proposal. Given the increasing attention focused on the waiver process and the frequency with which waivers have been granted to major financial firms, there is a real need for greater transparency around the Commission's waiver process. Waiver requests can be a major issue in settled resolutions of SEC enforcement cases; changes to the process may initially cause disruption to some settlement negotiations, but if these changes bring more clarity and predictability to the SEC's standards for deciding waiver requests, the longer-term outcome can help to reduce some issues that are currently contested in settlement negotiations.

5. PCAOB Issues

The Committee also has under consideration several legislative proposals related to the Public Company Accounting Oversight Board. One of particular interest to me is a proposal to establish a whistleblower program at the PCAOB, similar to the SEC whistleblower program established by the Dodd-Frank Act. This proposal would provide for monetary awards to whistleblowers who provide original information about a violation of the Sarbanes-Oxley Act, the rules of the PCAOB, and the provisions of the securities laws relating to the preparation of audits and auditor independence, as well

[7] *Cohen v. Viray*, 622 F.3d 188 (2d Cir. 2010); *In re Digimarc Corp. Derivative Litigation*, 549 F.3d 1223 (9th Cir. 2008).

as applicable professional standards. The proposal would also provide anti-retaliation protection for whistleblowers.

There is no doubt that a successful PCAOB whistleblower program would encourage more reporting of public company accounting frauds or misdeeds surrounding public company audits. However, there are significant differences between the SEC's and PCAOB's enforcement programs, and because of these, the crafting of a workable PCAOB whistleblower program cannot be a matter of simply replicating the SEC's program. Most notably, to date, the PCAOB's enforcement program has brought a relatively few number of cases, and the amount of money penalties recovered has also been quite small. Thus, it is questionable how much an award program like the SEC's, which provides for awards between 10 and 30 percent of SEC recoveries over $1 million in an individual case, would incentivize potential whistleblowers to report information to the PCAOB. An alternative approach that might provide a greater incentive is one that paid whistleblowers between 10 and 30 percent of the monetary sanctions collected, but never less than a specific dollar amount, such as $50,000 or $100,000. Such awards could be funded by PCAOB penalty collections, which are otherwise by statute designated for use in funding a scholarship program.

Another proposal under consideration is to make PCAOB disciplinary proceedings public. This change would help bring to light, in a timely manner, auditing deficiencies at accounting firms or the companies they audit, and thereby help to deter violations. I agree that this is a worthwhile objective. The public does not currently have great insight into the PCAOB's enforcement work, due in part to the fact that, unlike the SEC, much of their work is not made public. This proposal will improve public transparency.

The third PCAOB-related proposal under consideration is the Holding Foreign Companies Accountable Act. This proposal addresses a problem the PCAOB has encountered in some jurisdictions when it is prevented from inspecting foreign public accounting firms that audit foreign companies listed on U.S. national securities exchanges. Under the proposal, if the PCAOB is unable to conduct an inspection of the foreign firm, it will notify the issuer, which is then required to disclose in its annual report if it is owned or controlled by a foreign government or by an entity controlled by a foreign government. Also, the proposal provides that the SEC shall prohibit the trading, on a national securities exchange or alternative trading system, of the securities of an issuer that the PCAOB has been unable to inspect over a specified period of years.

The problem that this proposal is directed at is a serious one. Investors rightfully expect that the financial statements of companies traded on U.S. exchanges are subject to appropriate oversight. The inability of regulators to inspect the auditors of such companies raises serious concerns, which this proposal is targeted to address.

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In conclusion, I commend the Subcommittee for its attention to the critical issue of preserving and strengthening securities law enforcement. I would be pleased to provide further assistance on any of the proposals that are under consideration.

GEORGETOWN LAW

Urska Velikonja
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Written Testimony of

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Before the United States House of Representatives
Committee on Financial Services
Subcommittee on Investor Protection, Entrepreneurship, and Capital Markets

"Putting Investors First: Examining Proposals to Strengthen Enforcement Against Securities Law Violators"

June 19, 2019
2:00 p.m.
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Witness Background Statement

Urska Velikonja is a Professor of Law at the Georgetown University Law Center in Washington, D.C., where she teaches courses in securities regulation, securities enforcement, and contracts. She has assembled a database of all SEC enforcement actions filed since fiscal year 2007, a dataset that now includes more than 15,000 defendants and almost thirty enforcement characteristics of each enforcement action. Using that information, Professor Velikonja has authored a half-dozen academic research papers on various aspects of SEC enforcement. The papers include *Reporting Agency Performance: Behind the SEC's Enforcement Statistics*, 101 CORNELL LAW REVIEW 901 (2016); *Public Compensation for Private Harm: Evidence from the SEC's Fair Fund Distributions*, 67 STANFORD LAW REVIEW 331 (2015); *Waiving Disqualification: When Do Securities Violators Receive a Reprieve?*, 103 CALIFORNIA LAW REVIEW 1081 (2015); *Securities Settlements in the Shadows*, 126 YALE LAW JOURNAL FORUM 124 (2016); *Are the SEC's Administrative Law Judges Biased? An Empirical Investigation*, 92 WASHINGTON LAW REVIEW 315; and *Public Enforcement After* Kokesh: *Evidence from SEC Actions*, 108 GEORGETOWN LAW JOURNAL (forthcoming in December 2019).

Before joining the Georgetown faculty in 2017, Professor Velikonja taught at Emory University and the University of Maryland, and visited at the University of Chicago, Duke University and the University of Ljubljana. Before teaching, Professor Velikonja practiced for three years in the Banking, Finance & Capital Markets Group at Schoenherr, an international law firm based in Vienna, Austria, and clerked for Judge Stephen F. Williams of the U.S. Court of Appeals for the D.C. Circuit.

Professor Velikonja holds a J.D., *magna cum laude,* and an LL.M. from Harvard Law School, and an LL.B. from the University of Ljubljana.

Professor Velikonja has not received any federal grants or any compensation in connection with her testimony; furthermore, she is not testifying on behalf of any organization. The views expressed in her testimony are solely her own.[1]

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1. I would like to thank Alejandro J. García for research assistance with this testimony. Portions of the discussion in Parts I and II of this written testimony draw from my forthcoming article *Public Enforcement After* Kokesh: *Evidence from SEC Actions*, 108 GEORGETOWN LAW JOURNAL (forthcoming in December 2019). Discussion in Part III draws heavily from my published article *Waiving Disqualification: When Do Securities Violators Receive a Reprieve?*, 103 CALIFORNIA LAW REVIEW 1081 (2015).

Ms. Chairwoman Maloney, Ranking Member Huizenga, Members of the Subcommittee

Thank you for inviting me to testify at this hearing. My name is Urska Velikonja. I am a Professor of Law at the Georgetown University, where I teach courses on securities regulation and enforcement, among other topics. I am here today solely as a scholar and am not testifying on behalf of any entity.

The proposals that the subcommittee is considering today do much more than "strengthen enforcement against securities law violators;" the proposed legislation also codifies existing enforcement remedies that are threatened by recent U.S. Supreme Court decisions. Inaction will significantly impair the efficiency and honesty of our capital markets.

Allow me to explain. You have in front of you two kinds of legislative proposals. The first kind are improvements to the existing regime: rewarding PCAOB whistleblowers to encourage early reporting, improving the process for granting waivers from bad actor disqualifications, and increasing the civil fines that the SEC can impose. The second kind of legislative proposals codify an existing practice in SEC enforcement, now decades-old, such as disgorgement in civil actions. These practices are threatened by recent Supreme Court decisions in *Kokesh v. SEC*[2] and *Gabelli v. SEC*[3]. These cases threatens not only SEC disgorgement but also similar remedies sought by the SEC and its sister enforcement agencies such as the CFTC, federal banking regulators, and the FAA, among others, but I will focus my remarks on the SEC alone. As a result, failure to act and adopt the proposed amendments does not preserve the status quo. Rather, inaction would significantly hamper SEC enforcement since lower courts applying these new decisions are blocking long-standing agency practices.

My comments are divided in three parts. In Part I, I discuss the Discussion Drafts that propose increasing civil fines and codifying equitable relief in civil actions. In Part II, I supply data on the impact of short limitations periods on SEC enforcement, and suggest that an increase in the limitations period is necessary. Finally, in Part III, I provide data on SEC's bad actor disqualification and waiver practices. Specifically, my comments suggest that the proposed amendments are necessary to bring transparency and accountability to the waiver process.

I. STRENGTHENING RELIEF IN SEC ENFORCEMENT

Securities laws require information disclosure, ban trading on inside information, and prohibit fraud. These laws are necessary but not sufficient by themselves. Consistent and strong enforcement of those laws is necessary as well. The United States' securities enforcement program is the envy of the developed and developing world, and the SEC has served as a model for securities regulators around the globe.[4] That success is a product of impressive foresight by its New Deal creators and the ingenuity of its subsequent caretakers, in particular its first enforcement directors Irving Pollack and Stanley Sporkin.

2. 137 S. Ct. 1635 (2017).
3. 568 U.S. 442 (2013).
4. For example, the OECD anti-bribery program is modeled on the U.S. anti-bribery program. The Chinese securities regulator, the China Securities Regulatory Commission, has copied the SEC.

Recent Supreme Court decisions, in particular *Kokesh*, threaten that legacy. The four Discussion Drafts in front of you today propose to modify the legal and equitable relief available to the SEC. All four propose new and increased sanctions, whereas Representative McAdams' Discussion Draft also codifies the SEC's right to seek disgorgement in civil actions, which is threatened by the Supreme Court decision in *Kokesh*. The Drafts also propose expanding the universe of available remedies. I will first address the codification of disgorgement and then the need for increased sanctions.

A. Codifying Disgorgement in Civil Actions

When originally enacted in the 1930s, securities laws did not authorize the SEC to obtain any monetary relief. The SEC sometimes obtained compensatory relief in settlements, but did not seek monetary relief in court until the 1960s.[5] Beginning in the 1960s, the SEC asked courts for relief ancillary to injunctions, including disgorgement, to bolster its enforcement efforts.[6] Other equitable remedies sought by the SEC include restitution, asset freezes, and receivership. Most of these remedies are not expressly authorized by securities laws, yet they have become the mainstay of securities enforcement. Over time, settling securities defendants have agreed to tailored relief, crafted to improve compliance and protect capital markets from future misconduct. Such relief includes appointing independent monitors and consultants, requiring defendants to review internal policies and submit reports to the SEC, even requiring a public company to pre-clear the CEO's Twitter activity.[7]

Since these remedies are not explicitly authorized by the securities laws, the question of their legality exists, although it has been largely theoretical until recently. The U.S. Supreme Court has not decided the issue but did signal disapproval in a footnote in *Kokesh*.[8] The SEC is authorized by statute to seek in civil actions only injunctions, officer and director bars, civil monetary penalties, penny stock bars, and equitable relief.[9] The statutes authorize the SEC to seek disgorgement in an administrative proceeding,[10] but there is currently no statutory provision that authorizes disgorgement in the majority of enforcement actions, that the SEC files in court.

This omission does not imply that legislative drafters intended for the SEC to obtain disgorgement only in administrative proceedings but not in court. Rather, courts had "routinely ordered disgorgement" in SEC actions well before 1990,[11] and so both the SEC and congressional legislators discussing the then-proposed Securities Enforcement Remedies and Penny Stock

5. *See* John D. Ellsworth, *Disgorgement in Securities Fraud Actions Brought by the SEC*, 1977 DUKE L.J., 641, 642-43 (1977) (listing SEC settlements from 1943 and 1945 that resulted in investor compensation despite the lack of statutory authority to order monetary relief).

6. In 1965, the SEC sued Texas Gulf Sulphur Co. and its insiders for accounting fraud and insider trading, and sought restitution. In 1971, the Second Circuit decision in SEC v. Texas Gulf Sulphur Co. recognized that the SEC had equitable power to "require[] corporate insiders who traded on material nonpublic information to disgorge their illegal trading profits." 446 F.2d 1301 (2d Cir. 1971).

7. SEC v. Elon Musk, 1:18-cv-8865 (2d Cir., Apr. 26, 2019).

8. In footnote 3 of the *Kokesh* majority opinion, the Supreme Court questioned the legality of disgorgement in SEC civil actions but did not decide the issue. See Kokesh, 137 S. Ct. at 1642 n.3.

9. Section 21(d) of the Securities Exchange Act.

10. Pub. L. No. 101-429, 104 Stat. 931, 937-40, §§ 202(a), 203 (codified at 15 U.S.C. §§ 78u-2, 78u-3 (2013)).

11. *See* Donna M. Nagy, *The Statutory Authority for Court-Ordered Disgorgement in SEC Enforcement Actions*, 71 S.M.U. L. REV. 895, 910-11 (2018) (citing to Hearings Before the Subcomm. on Sec. of the Comm. on Banking, Hous. and Urban Affairs on S. 647, 101st Cong. 426 (1990) (written responses of Richard Breeden, Chaiman, SEC)).

Reform Act assumed that the SEC did not need statutory authorization to seek equitable relief such as disgorgement.[12] More recently, the Dodd-Frank Act in 2010 amended the Commodity Exchange Act to specifically authorize the CFTC to obtain equitable restitution and disgorgement. No such authorization appeared necessary for the SEC because the practice of disgorgement in civil actions was long-standing. Furthermore, Congress endorsed the practice in section 922 of the Dodd-Frank Act which authorizes the SEC to reward whistleblowers based on "any monies, including penalties, disgorgement, and interest" ordered in "any judicial or administrative action."

In *Kokesh,* the Supreme Court held that disgorgement of ill-gotten gains was a penalty, not an equitable remedy. Typically, courts cannot impose penalties without statutory authorization. Thus, by implication, if disgorgement is a penalty, the SEC has no authority to seek disgorgement in actions filed in court. No court has reached that conclusion yet, but it is only a matter of time. Inability to seek disgorgement in court would severely hamper SEC enforcement. The SEC routinely seeks disgorgement in enforcement actions filed in court. Disgorgement is the second most commonly-imposed relief in SEC enforcement actions. Disgorgement was ordered in 54.4 of percent of resolved cases filed in fiscal years 2010 to 2018 (56.3 percent of cases in which the SEC prevailed).[13] Only civil fines are imposed more often.[14] Total disgorgement orders during the period amounted to $145 billion, dwarfing civil fines that amounted to $9.8 billion. Of that total, more than $140 billion in disgorgement was imposed in civil actions. These figures include disgorgement that is ordered in SEC enforcement actions, but is deemed satisfied with payments in parallel criminal cases or credited for payments in parallel criminal or civil actions. Even if amounts credited or deemed satisfied were excluded, disgorgement represents the majority of monetary penalties imposed during the period ($13 billion or 57 percent of aggregate monetary penalties), and the bulk of that disgorgement, $9.9 billion, was imposed in civil actions.[15]

There are no ready alternatives to disgorgement in civil actions. It is unlikely that the SEC could divert all disgorgement cases to administrative proceedings in lieu of bringing them in court. Although the Dodd-Frank Act authorized the SEC to bring any of its actions in administrative proceedings,[16] the Supreme Court's decision in *Lucia v. SEC*[17] upended administrative adjudication at the SEC. Only a few new contested cases have been filed in administrative proceedings since March 2018, and a case challenging the constitutionality of ALJ removal protections is currently pending in district court.[18] Unless civil fines are substantially increased as proposed in Representative Porter's Discussion Draft "Stronger Enforcement of Civil Penalties Act of 2019,"[19] the SEC cannot substitute civil fines for disgorgement. Civil fines are capped at the defendant's pecuniary gains from violations, which would merely deprive the violator of that gain. Restitution could substitute for disgorgement in cases where the SEC seeks to distribute the funds, but the relief is of limited utility where the defendant did not gain at the victims' expense

12. *See id.*

13. The tally includes individual and joint-and-several liability.

14. An injunction or a cease-and-desist order is imposed in almost every case resolved in favor of the SEC. Civil fines were imposed in 4,183 cases (61.2% of resolved cases and 66.3% of cases in which SEC prevailed).

15. *See* Velikonja, *Public Enforcement After* Kokesh: *Evidence from SEC Actions*, 108 GEORGETOWN LAW JOURNAL (forthcoming in December 2019), at 19-20 & tbl. 1.

16. *See* Dodd-Frank Act § 929P(a)(1), 124 Stat. 1376, 1862 (2010).

17. 138 S. Ct. 2044 (2018).

18. *See* Lucia v. SEC, Complaint for Declaratory and Injunctive Relief, Civ. Action No. 18cv2692 DMS JLB (D.D.C., Nov. 28, 2018).

19. https://docs.house.gov/meetings/BA/BA16/20190619/109677/BILLS-116pih-enfcivpen.pdf.

(e.g., accounting fraud) or where victims losses are not easily traced to defendant's gain (e.g., foreign bribery, insider trading).

Representative McAdams' Discussion Draft codifies equitable relief in SEC enforcement actions, including disgorgement.[20] The proposal is modeled on section 6c of the Commodities Exchange Act, which authorizes the CFTC to seek equitable relief in actions filed in district court.[21] The Discussion Draft adds officer and director bars, injunctions, and a catch-all provision for other equitable relief. That addition is necessary because at least two district courts have opined that injunctions, too, are "penalties" under *Kokesh,* as are professional bars[22] and potentially officer and director bars.[23] If that situation were not remedied, the SEC could not impose those types of relief for violations older than five years.[24] The codification proposed in the McAdams Discussion Draft is essential for maintaining the status quo in securities enforcement.

B. Strengthening Enforcement Penalties

In addition, Discussion Drafts by Representatives McAdams,[25] Porter,[26] and Sherman[27] propose new remedies, that include equitable restitution and trading prohibitions for foreign firms listed on U.S. exchanges, unless the PCAOB can regularly inspect their auditors; and expanded remedies, including (1) civil fines that are based on investor losses and not merely the violator's ill-gotten gains, (2) civil fines equal to the treble the ill-gotten gain (as is already available in insider trading cases), and (3) increased sanctions for recidivists.

I will limit my remarks to the expanded remedies proposed in Representative Porter's Discussion Draft "Stronger Enforcement of Civil Penalties Act of 2019."[28] The Discussion Draft proposes increasing civil fines across the board, but most significantly for violations that generate large illicit gains or produce substantial investor losses. Importantly, the proposal recognizes that securities violations vary considerably, and not all result in zero sum transfers from victims to wrongdoers. Some violations, such as accounting fraud, produce large investor losses with only minimal gain to wrongdoers. Others produce large gains to wrongdoers without easily identifiable victims who lost money, such as insider trading in publicly-traded securities. Still other securities violations are so lucrative that even monetary penalties in the hundreds of millions of dollars fail to deter, for example foreign bribery.[29] The one-size-fits-all approach currently enacted into law does not fit the varied universe of securities violations well. The "Stronger Enforcement"

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20. https://docs.house.gov/meetings/BA/BA16/20190619/109677/BILLS-116pih-sea34.pdf.

21. 7 U.S.C. § 6c(d)(3).

22. Johnson v. SEC, 87 F.3d 484 (D.C. Cir. 1996); Saad v. SEC, 873 F.3d 297 (D.C. Cir. 2017).

23. Gabriel K. Gillett, Howard S. Suskin, and Adam G. Unikowsky, *After* Kokesh, *Does the SEC Have a New Time Limit for Claims Seeking an Officer or Director Bar?*, AM. BAR ASS'N (Aug. 25, 2018), https://www.americanbar.org/groups/litigation/committees/securities/articles/2018/summer2018-after-kokesh-does-the-sec-have-a-new-time-limit-for-claims-seeking-an-officer-or-director-bar/.

24. *See* SEC v. Cohen & Baros, 332 F.Supp.3d 575 (E.D.N.Y. July 12, 2018); SEC v. Jones, 300 F.Supp.3d 312 (D. Mass. Jan. 5, 2018).

25. https://docs.house.gov/meetings/BA/BA16/20190619/109677/BILLS-116pih-sea34.pdf.

26. https://docs.house.gov/meetings/BA/BA16/20190619/109677/BILLS-116pih-enfcivpen.pdf; https://docs.house.gov/meetings/BA/BA16/20190619/109677/BILLS-116pih-cmaa.pdf.

27. https://docs.house.gov/meetings/BA/BA16/20190619/109677/BILLS-116pih-forcoacc.pdf.

28. https://docs.house.gov/meetings/BA/BA16/20190619/109677/BILLS-116pih-enfcivpen.pdf.

29. Jonathan M. Karpoff, D. Scott Lee & Gerald S. Martin, Foreign Bribery: Incentives and Enforcement (Apr. 7, 2017), https://ssrn.com/abstract=1573222 (showing that foreign bribery is profitable even for firms that are caught by U.S. regulators and ordered to pay fines).

Discussion Draft takes these variations into account and provides alternative measures for setting civil fines to deter appropriately:

(1) Modest increases for first- and second-tier penalties.
(2) Substantial increases for third-tier penalties for most serious violations:
    a) The proposal categorizes as most serious not only violations that produce substantial losses to investor but also those that generate substantial pecuniary gains. As noted, not all securities violations generate substantial investor losses: foreign bribery, for example, typically does not generate investor losses, but does produce substantial gains for offenders.
    b) The proposal offers three alternatives methods to set civil fines. In addition to a per-violation fine, the proposal adds aggregate investor losses or treble pecuniary gain as alternative measures of civil money penalties.
(3) Adds fourth-tier civil fines for recidivists.

The proposed third-tier penalties are a significant improvement over existing rules. The provisions add flexibility and enable the SEC to punish and deter the most serious violations. Existing rules cap civil fines in court at the gross amount of pecuniary gain or $775,000 per violation. Because serious securities violations do not always produce large pecuniary gains, the SEC has sometimes had to engage in creative statutory interpretation to obtain appropriate relief. In 2012, for example, the SEC fined BP plc $525 million for understating the amount of oil that was leaking from the damaged oil well after the Deepwater Horizon explosion. BP plc made no obvious "amount of pecuniary gain" from its violations, so the negotiated fine was a multiple of the per-violation fine for third-tier violations. Under the rules in force at the time, the maximum third-tier fine was $725,000 per violation. The SEC's complaint identified perhaps a half-dozen materially misleading statements, each a violation. But the total fine of $525 million would require the SEC to have found 724 violations.

The reason that SEC could be creative here is because securities laws do not define what constitutes a "violation." If BP's series of misleadingly-low estimates were treated as a "course of conduct" and thus a single securities violation, the maximum civil fine would be $725,000. If each misleading statement were treated as a violation, then the maximum civil fine would be 6 times $725,000, or $4.35 million. If the communication of a misleading statement to each investor constitutes a violation, then the potential fine increases by a factor of several million, certainly well more than $525 million that the SEC ultimately imposed. Creative math was possible because BP settled with the SEC. The SEC has been less successful in contested cases. It has persuaded some judges to multiply the fine by the number of injured investors when their number was small, but never when it was large.[30] But the SEC's methodology is ad hoc and somewhat unpredictable, and is certainly susceptible to a Supreme Court challenge.

The Porter Discussion Draft does not define a "violation" either, but rather offers a superior solution by adding another method to set civil fines. In addition to capping civil fines at the gross amount of pecuniary gain or $775,000 per violation, it authorizes the SEC to base the civil fine on

30. See Jonathan N. Eisenberg, *Calculating SEC Civil Money Penalties*, HARV. L. SCH. FORUM ON CORP. GOV. & FIN. REG. (Jan. 24, 2016), https://corpgov.law.harvard.edu/2016/01/24/calculating-sec-civil-money-penalties/.

aggregate investor losses, which is both, more predictable and consistent with optimal deterrence theory.[31] That formula would permit the civil fine that the SEC imposed on BP plc.

The Discussion Draft also increases the cap on third-tier civil fines to treble the gross pecuniary gain. Optimal deterrence theory contends that merely depriving the violator of the gain does not deter misconduct.[32] Instead, the amount must be adjusted by the likelihood of detection. If an offender gains $100 with each violation, is caught only once every five times, and is ordered to pay a $100 fine when prosecuted, she and other bad actors have the incentive to continue breaking the law since they are ahead by $400, on average, by the time she has been caught once. Detection rates for securities violations are notoriously difficult to estimate,[33] but are almost certainly well below 50 percent which the existing civil penalty regime implicitly presumes.[34] The best estimate suggest that only 25 percent of serious accounting frauds are prosecuted.[35] Other violations are prosecuted even less often: only 6.4 percent of long-lasting foreign bribery schemes are prosecuted.[36] Treble gain at least enables the SEC to increase civil fines in enforcement actions where detection rates are notoriously low, such as for FCPA violations. Moreover, in insider trading cases the SEC can obtain civil fines capped at "three times the profit gained or loss avoided as a result of such unlawful purchase, sale, or communication."[37] Other securities violations are detected at rates as low as insider trading, and a civil fine that triples the gain is an improvement over the status quo. Finally, and least importantly, to the extent that the statute of limitations cannot be extended to capture all violations, larger civil penalty authority could make up for some of the deterrence shortfall introduced by short limitations periods.

II. STATUES OF LIMITATIONS AND REPOSE

Two Discussion Drafts propose modifying the statutes of limitation for penalties and remedies in securities enforcement actions, and I support both. Representative Gonzalez's Discussion Draft extends the limitations period for civil monetary penalties from five to ten years.[38] Representative McAdams' Discussion Draft authorizes the SEC to seek disgorgement, restitution, injunctions, and officer and director bars in court, and further defines all as equitable relief.[39] As such, it exempts these remedies from the federal five-year statute of limitations and subjects them to a more flexible equitable limitations period of laches (i.e., unreasonable delay in the pursuit of legal claims).

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31. *See* Gary Becker, *Crime and Punishment: An Economic Approach*, 76 J. POL. ECON. 169 (1968) (arguing that violators will be deterred if they bear the social cost of their wrongdoing, adjusted for the likelihood of detection).

32. *See id.*

33. *See* Urska Velikonja, *The Cost of Securities Fraud*, 54 WM. & MARY L. REV. 1887, 1911 (2013) (reporting estimates of detected accounting fraud that range from 2.39 percent to 100 percent).

34. The maximum total monetary penalty under existing regime is double the gross pecuniary gain, disgorgement plus a third-tier civil fine, which implies a 50 percent detection rate.

35. *See* Alexander Dyck, Adair Morse & Luigi Zingales, How Pervasive Is Corporate Fraud?, at (Aug. 2014) (unpublished manuscript), available at http://faculty.haas.berkeley.edu/morse/research/papers/DyckMorseZingalesPervasive.pdf.

36. Karpoff, Lee & Martin, *supra* note 29, at 5.

37. Section 21A(a)(2) of the Securities Exchange Act.

38. https://docs.house.gov/meetings/BA/BA16/20190619/109677/BILLS-116pih-sol.pdf.

39. https://docs.house.gov/meetings/BA/BA16/20190619/109677/BILLS-116pih-sea34.pdf.

With few exceptions, all penalties in SEC enforcement are currently subject to the federal catch-all five-year statute of limitations under section 18 U.S.C. § 2462, which applies to any "action, suit or proceeding for the enforcement of any civil fine, penalty, or forfeiture, pecuniary or otherwise."[40] The five-year limitations period applies only to claims for legal relief, such as civil fines and forfeiture orders, but not to equitable relief.[41] Under *Gabelli v. SEC,*[42] a 2013 Supreme Court decision, the limitations period under section 2462 runs from when the violation is committed, and not from when the SEC discovers (or reasonably could have discovered) the violation.[43] The five-year limitations period applies only to claims for legal relief, such as civil fines and forfeiture orders, but not to equitable relief.[44] The Supreme Court held in the 2017 case *Kokesh* that disgorgement of ill-gotten gain was a penalty, contrary to longstanding agency practice, and thus subject to the five-year limitations period. As a result, Charles Kokesh was able to keep all but $5 million of $35 million he embezzled from his investors.[45]

The section 2462 limitations period creates two significant issues for SEC enforcement. First, despite considerable investment in market oversight, most securities violations remain very difficult to detect and take a long time to investigate.[46] As a result, 37 percent of SEC enforcement actions include violations that took place outside the five-year limitations period. There is considerable variation among types of violations: insider trading is typically prosecuted within the limitations period whereas foreign bribery, accounting fraud, and cases against financial intermediaries are not.[47] Second, because section 2462 was not drafted specifically for SEC enforcement, the distinctions it draws among remedies are artificial. Penalties and forfeiture are subject to the five-year limitations period, whereas non-punitive relief is not. In *Kokesh*, the Supreme Court attempted to distinguish between penalties, subject to the limitation, and non-penalties, which are not. It held that disgorgement was a penalty because (1) it is imposed as a consequence of violating public laws,[48] (2) it seeks to deter violations which is "inherently punitive";[49] and (3) it is only sometimes paid to compensate defrauded investors.

But the Court did not explain what other types of relief might be punitive and therefore subject to the limitation, which creates considerable uncertainty and has produced unnecessary litigation for defendants and federal enforcement agencies alike.[50] So far, two district courts have opined that SEC injunctions, the archetypal equitable relief, are penalties under the vague *Kokesh* test and thus subject to the five-year limitations period,[51] as are professional bars.[52] If these

40. 28 U.S.C. § 2464.

41. *See* Meeker v. Lehigh Valley R.R. Co. 236 U.S. 412, 423 (1915).

42. 568 U.S. 442 (2013).

43. Gabelli, at 454.

44. *See* Meeker v. Lehigh Valley R.R. Co. 236 U.S. 412, 423 (1915).

45. The disgorgement award against Charles Kokesh was reduced from $35 million to $5 million. *See* SEC v. Charles Kokesh, Amended Final Judgment, No. 09-cv-1021 SVM/LAM (Oct. 31, 2018).

46. SEC investigations take on average two years to complete. As a result, a violation that took place more than three years before the SEC opened an investigation will be time-barred.

47. Urska Velikonja, *Public Enforcement After* Kokesh, *supra* note 15.

48. Kokesh, at 1643.

49. *Id.*

50. For example, restitution, which is always used to compensate investors, is often imposed in criminal and civil enforcement actions for violations of public laws and also deters. The fact that the government has the right to investigate violations at all will deter some violators, but that does not mean that investigations are penalties.

51. SEC v. Cohen & Baros, 332 F.Supp.3d 575 (E.D.N.Y. July 12, 2018); SEC v. Jones, 300 F.Supp.3d 312 (D. Mass. Jan. 5, 2018).

52. Saad v. SEC, 873 F.3d 297 (D.C. Cir. 2017).

decisions are upheld, securities violators could defraud investors with impunity, so long as they avoid prosecution for five years.

A. Extending the Statute of Limitations of Civil Monetary Penalties in SEC Enforcement Actions (Gonzalez Discussion Draft)

The Discussion Draft proposed by Representative Gonzalez extends the limitations period for civil monetary penalties from five to ten years. I believe that it would be a considerable improvement over the status quo.

My study of all SEC enforcement actions filed in fiscal years 2010 to 2018 shows that 37 percent of SEC enforcement actions include violations older than five years.[53] A large majority of those (34.2 of all cases and more than 92 percent of time-barred cases) prosecute schemes that took place over a long period of time, in which some of the violations took place within and the rest outside the five-year limitations period. In a small percentage of cases, 2.8. percent, *none* of the alleged violations took place *within* the five-year limitations period.[54] Significantly, the relative share of cases that allege violations *entirely within* the five-year limitations period has gradually declined during the study period, from 70 percent in FY 2010 and 2011 to 50 percent in FY 2018.[55]

The limitations period does not affect all securities violations equally. As shown in the table below, the SEC is able to detect and prosecute insider trading and market manipulation very quickly: only 12.2 percent of insider trading cases and 23.4 percent of market manipulation cases are affected by section 2462's limitations period. The SEC, FINRA and exchanges actively monitor public markets where these violations typically take place, so many are immediately revealed.[56] Most insider trading prosecutions are initiated after an announcement of a tender offer that is accompanied by unusual trading patterns.[57] Once the SEC secures trading information from brokerages, it is only a matter of time before the enforcement staff find traders who received tips, freeze their accounts when necessary, and serve them with a complaint. In fact, the SEC has filed enforcement actions for insider trading within days of the violation.[58] Similarly, unusual increases in trading volumes and in prices of otherwise obscure pink-sheet stocks allow the staff to identify pump-and-dump schemes early, and to prosecute perpetrators quickly.

53. Urska Velikonja, *Public Enforcement After* Kokesh, *supra* note 15, at 28.

54. Many of defendants in such cases signed tolling agreements with the SEC to stop the limitations clock. *See id.* at 38-40.

55. The share of cases entirely inside the five-year SOL is as follows: FY 2010 (70.5%), FY 2011 (71.3%); FY 2012 (68.4%); FY 2013 (69.1%); FY 2014 (66.2%); FY 2015 (59.9%); FY 2016 (56.5%); FY 2017 (59.4%); FY 2018 (51.4%).

56. *See* Michael A. Perino, *Real Insider Trading*, St. John's School of Law Legal Studies Research Papers Series No. 19-5, at 28 tbl. 3, *available at* https://ssrn.com/abstract=3338536.

57. *See id.* at 47 tbl. 12 (showing that 67 percent of insider trading prosecutions involve announcements of M&A activity).

58. See e.g., SEC v. Zhichen Zhou & Yannan Liu, Complaint, No. 1:15-cv-8796-TPG, at 2 (Nov. 9, 2015) (alleging that Zhou sold shares on announcement of a merger on November 2, 2015, one week before the SEC filed the complaint); SEC v. Alda Ltd. et al., Complaint for Violations of Federal Securities Laws, at 2-6, Civ. Action No. 2:17-cv-1287 (Feb. 24, 2017) (alleging that traders bought shares between February 10 and 14, 2017, and sold them on February 14 & 15, 2017, after Fortress acquisition was announced).

TIMING OF VIOLATION BY SUBJECT MATTER

	Entirely Inside SOL	Partly Outside SOL	Entirely Outside SOL
Insider Trading	708 (87.8%)	82 (10.2%)	16 (2.0%)
Market Manipulation	736 (76.3%)	216 (22.4%)	13 (1.3%)
Securities Offering	1737 (69.1%)	820 (31.7%)	32 (1.2%)
Public Finance Abuse	212 (65.4%)	96 (29.6%)	16 (4.9%)
Issuer Reporting	657 (53.6%)	522 (42.6%)	47 (3.8%)
Investment Adviser, Transfer Agent & SRO	733 (51.5%)	642 (45.1%)	48 (3.4%)
Broker-dealer	301 (48.9%)	296 (48.1%)	18 (2.9%)
FCPA	6 (4.0%)	107 (71.8%)	36 (24.2%)
All	5167 (63.0%)	2802 (34.2%)	228 (2.8%)

By contrast, foreign bribery may never come to light without a whistleblower complaint, and typically takes a long time to prosecute because the evidence must be gathered abroad and often translated. Cases against financial intermediaries, including broker-dealers, investment advisers, transfer agents, and SROs, too, are more likely than the median securities case to include older charges: half of cases against financial market intermediaries include violations older than five years. They include long-lasting customer abuse schemes like those by Charles Kokesh, Bernard Madoff,[59] and Allen Stanford,[60] but also sophisticated and well-concealed violations by Wall Street firms.[61] The reason for the delay is that violators can take steps to hide their actions.

The five-year limitations period effectively caps at relatively low levels civil fines that the SEC can obtain in the types of cases that take a long time to detect and to investigate, including the most serious Ponzi schemes, Wall Street frauds, and accounting frauds. The Kokesh case nicely illustrates the point. Charles Kokesh owned and controlled two registered investment advisory firms. From 1995 until 2007 when the funds were dissolved, Kokesh embezzled investors' funds, paid himself unearned performance fees, and reimbursed unauthorized expenses, ultimately misappropriating about $35 million from more than 21,000 investors.[62] After the jury found Kokesh liable for fraud, the SEC asked the district court to impose a third-tier civil fine equal to the gross amount of pecuniary gain as a result of the violation, a total of $34,927,329.[63] Because

59. *See* U.S. Sec. & Exch. Comm'n, SEC Charges Bernard L. Madoff for Multi-Billion Dollar Ponzi Scheme, No. 2008-293 (Dec. 11, 2008), https://www.sec.gov/news/ press/2008/2008-293.htm.

60. *See* U.S. Sec. & Exch. Comm'n, SEC Charges R. Allen Stanford, Stanford International Bank for Multi-Billion Dollar Investment Scheme, No. 2009-26 (Feb. 17, 2009), https://www.sec.gov/news/press/2009/2009-26.htm.

61. For example, in 2016 Merrill Lynch was ordered to pay $415 million in monetary penalties, including $57 million in disgorgement because it used cash in custodial accounts "to fund its own business activities through a series of increasingly complex trades" and allowed "clearing banks to hold general liens over tens of billions of dollars of securities owned by its customers", contrary to clear prohibitions. Merrill Lynch, Pierce, Fenner & Smith Inc. & Merrill Lynch Professional Clearing Corp, Order Instituting Administrative and Cease-and-Desist Proceedings and Imposing Remedial Sanctions and a Cease-and-Desist Order, Exchange Act Release No. 78,141 (June 23, 2016).

62. Sec. & Exch. Comm'n v. Kokesh, Complaint, 1:09-cv-1021 (D.N.M., Oct. 27, 2009).

63. *See* SEC v. Kokesh, Plaintiff's Motion for Entry of Final Judgment Against Defendant Charles R. Kokesh, at 9-10, Civ. No. 09-cv-1021-SMV-LAM (Dec. 2, 2014).

of the limitations period, the district court ordered Charles Kokesh to pay a much smaller amount as a civil fine, $2,354,593, which equaled "the amount of funds that [Kokesh] himself received during the limitations period" (i.e., after October 28, 2004).[64] Extending the limitations period for civil monetary penalties to ten years would enable the SEC to punish more of the misconduct it discovers and would not allow defendants to avoid prosecution or a portion of the fine because a portion of charged violations happens to be older than five years.

There are several standard policy arguments in favor of limitations periods, but none undermine the proposed amendment. The first is that limitations periods provide repose, that is "certainty about a plaintiff's opportunity for recovery and a defendant's potential liabilities."[65] A ten-year limitations period as proposed in the Discussion Draft provides as much certainty as a five-year limitations period. In fact, the more precise definition of civil monetary penalties in the Discussion Draft provides more certainty than the imprecise definition of "penalties" offered in *Kokesh.*

The second policy argument in favor of limitations periods is that they "promote justice by preventing surprises through the revival of claims that have been allowed to slumber until evidence has been lost, memories have faded, and witnesses have disappeared."[66] To the extent that evidence deteriorates over time, a shorter limitations period is favorable to a longer one, but that is typically balanced against the policy goals of deterrence and retribution. There is no statute of limitations for murder, for example, even though unreliable eyewitness evidence is often used to prove murder. Documentary evidence, which is predominantly used in securities enforcement actions,[67] typically does not deteriorate with time, although the ability to explain the document's context may.

But if fresh evidence is the reason for a short limitations period, statutes are a poor mechanism for achieving that objective. There is no rule of evidence that bars the SEC from using older evidence to prove more recent violations. Fraudulent schemes that the SEC prosecutes are often long-lasting. Charles Kokesh, for example, began to steal from his clients fourteen years before the SEC sued him and continued to do so until about two years before suit. Bernard Madoff's and Allan Stanford's schemes, also, lasted for several decades. When the SEC set out to prosecute long-lasting schemes, it can present to the judge and the jury evidence of when Kokesh began stealing and how he stole funds over time. In the case against Kokesh, the limitations period became relevant only when the district court set out to calculate monetary penalties. Only then did the court choose to ignore financial statements and receipts showing embezzlement that were older than five years at the time the SEC filed suit. Moreover, if the objective of a limitations period is to ensure fresh evidence at sanctioning, it fails. The initiation of a legal proceeding tolls the statute of limitations. As long as enforcement proceedings begin within the limitations period, the age of evidence at sanctioning is irrelevant. In the case of Charles Kokesh, the district court set monetary penalties in 2015, almost six years after the SEC filed suit. By that point, it considered evidence that was almost eleven years old to set civil fines.

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64. Kokesh, 137 S. Ct. at 1641.
65. Gabelli, at 448 (quoting from Rotella v. Wood, 528 U.S. 549, 555 (2000)).
66. Gabelli, at 448 (quoting from Railroad Telegraphers v. Railway Express Agency, Inc., 321 U.S. 342, 348-49 (1944)).
67. Witnesses lie and dissemble, documents typically do not.

Finally, limitations periods are designed to prevent unreasonable delay. In *Gabelli*, the Supreme Court explained that limitations periods exist because "even wrongdoers are entitled to assume that their sins may be forgotten."[68] Over time, offenders may have self-rehabilitated and could be prejudiced by the late-filed action.[69] Statutes of limitations promote certainty in legal affairs[70] and reduce "the danger of official punishment because of acts in the far-distant past."[71] But that is not what the five-year limitations period for SEC actions does. The SEC does not typically prosecute old violations. Few SEC enforcement actions are dismissed for being entirely outside the limitations period. Instead, in a vast majority of cases in which it applies, the limitations period means that liable wrongdoers pay reduced monetary penalties.

Extending the limitations period to ten years might raise the concern that the SEC would begin to prosecute stale claims, but existing enforcement practices moderate that risk considerably. The SEC Enforcement Manual urges staff to proceed quickly and to prioritize enforcement of ongoing violations.[72] Moreover, limited staff means that the SEC can prosecute only a minority of violations and is is unlikely to shift its focus to old violations. And if it did, congressional oversight and public scrutiny can control any theoretically-possible overreach.

If the limitations period is not extended, the SEC will adjust. It might expedite investigations,[73] perhaps after investigating cases less thoroughly than before *Kokesh*. That could harm potential defendants. An enforcement action can put a defendant's business under a dark cloud, so SEC's internal procedures require enforcement staff to convince different superiors, including their immediate bosses, the Director of Enforcement, then the division head, and then finally the politically-appointed Commissioners to file the enforcement action.[74] This is the most important, yet least appreciated, due process protection that defendants in public enforcement actions enjoy. If the limitations period is not extended, the SEC will rely more heavily on technology and analytics,[75] perhaps at the expense of prosecuting violations that are not amenable to computerized oversight.[76] The SEC's limited resources mean that it cannot be everywhere at all times, so *Kokesh* might push the agency to look for misconduct under the street light. That will benefit the most sophisticated players who ply their trade in dark pools, buy and sell opaque

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68. Gabelli, at 449 (quoting from Wilson v. Garcia, 471 U.S. 261, 271 (1985).

69. See Ochoa & Wistrich, *The Puzzling Purposes of Statutes of Limitation*, 28 PAC. L.J. 453, 464-66 (1997); Note, *The Statute of Limitations in Criminal Law: A Penetrable Barrier to Prosecution*, 102 YALE L.J. 630, 634 (1954).

70. Gabelli, 133 S.Ct. at 1221 (explaining that statutes of limitations provide "security and stability to human affairs" and are thus "vital to the welfare of society").

71. Toussie v. United States, 397 U.S. 112, 114-15 (1970).

72. *See* SEC. & EXCH. COMM'N, DIV. OF ENFORCEMENT, ENFORCEMENT MANUAL 13, 15 (2016).

73. *See* U.S. Sec. & Exch. Comm'n, Office of Inspector General, Memorandum, at 4 (Oct. 5, 2018), https://www.sec.gov/Inspector-Generals-Statement-on-the-SECs-Mgt-and-Performance-Challenges-Oct-2018.pdf (urging quick investigations, but not at the expense of quality).

74. In other words, the Division of Investment Management must sign off on any enforcement action against investment advisers and funds, and the Division of Corporation Finance must approve any enforcement action for accounting misrepresentations.

75. The SEC has already build predictive models and algorithms for accounting fraud, insider trading, and cherry picking by broker dealers. The 2018 budget allocates $45 million for additional information technology enhancements. *See* U.S. Sec. & Exch. Comm'n, Investor Protection, Capital Formation and Market Integrity Are Top Priorities in SEC Budget Request, Press Release 2018-14 (Feb. 12, 2018), https://www.sec.gov/news/ press-release/2018-14.

76. For most offering frauds, fraudulent securities are not registered or traded in public markets, so visibility is very low.

instruments, and occupy corrupt boardrooms, but also some of the most straight-forward frauds, those that prey on the least-sophisticated retail investors.

A. Statute of Limitations for Equitable Relief (McAdams Discussion Draft)

Representative McAdams' Discussion Draft authorizes the SEC to seek disgorgement, restitution, injunctions, and officer and director bars in court, and further defines all as equitable relief.[77] As such, it exempts equitable relief from the five-year statute of limitations and subjects it to a more flexible equitable limitations period of laches (i.e., unreasonable delay in the pursuit of legal claims).

Much of what I wrote in Part II.A applies here as well, but more forcefully. Doing nothing undermines capital markets and threatens retail investors. Charles Kokesh is not atypical of SEC defendants ordered to pay disgorgement. Kokesh "specifically targeted smaller investors (those investing $5,000 or less) because they would be less likely to sue if they discovered his schemes."[78] He funded an extravagant lifestyle with monies stolen from retail investors, "including by purchasing a gated mansion, buying and renovating a private polo ground, and keeping a personal stable of more than 50 horses."[79] The SEC moved diligently after Kokesh's fraud was first uncovered, and filed its enforcement action two years later. Because Kokesh was able to conceal his fraud for more than a decade, the five-year limitations period allowed him to keep the bulk of the money he stole from investors. Treating disgorgement and restitution as equitable relief would exempt them from section 2462 and allow the SEC to seek relief so long as it did not unreasonably delay prosecution.

Treating disgorgement, restitution, and bars as equitable relief does not enable the SEC to prosecute wrongdoers decades after their violations. Equitable defense of laches requires that the SEC proceeds with diligence in the pursuit of its claims, so that it does not delay enforcement unreasonably. The language in the Discussion Draft is modeled on section 6c of the Commodities Exchange Act, which authorizes the CFTC to seek equitable relief in actions filed in district court.[80] That provision was added in the Dodd-Frank Act in 2010 and has been used without controversy. Because the two agencies—the SEC and the CFTC—police similar misconduct in similar assets, similar sanctions are appropriate.

III. BAD ACTOR DISQUALIFICATIONS

In 2015, I published an academic study of a group of mandatory collateral consequences in securities laws called "bad-actor" and "ineligible-issuer" disqualifications.[81] Bad actor disqualifications are collateral consequences of civil and criminal securities enforcement actions; these bar individuals and firms sanctioned for serious securities violations from relying on relaxed disclosure and reporting requirements when raising external capital. Bad actors cannot raise funds

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77. https://docs.house.gov/meetings/BA/BA16/20190619/109677/BILLS-116pih-sea34.pdf.

78. SEC v. Charles Kokesh, Memorandum Opinion and Order Granting Plaintiff's Motion for Entry of Final Judgment, at 9, No. 09-cv-1021 SVM/LAM (Mar. 30, 2015).

79. David J. Lynch, *Supreme Court Justices Question SEC Enforcement Tool*, FIN. TIMES (Apr. 18, 2017).

80. 7 U.S.C. § 6c(d)(3).

81. Urska Velikonja, *Waiving Disqualification: When Do Securities Violators Receive a Reprieve?*, 103 CAL. L. REV. 1081 (2015).

through private placements, for example.[82] Ineligible issuers cannot tap public markets using the automatic shelf registration statement but can continue to register securities on the shelf, which is only marginally slower.[83]

First enacted in 1940, the primary goal of bad actor disqualifications is to reduce the risk of future violations in the securities markets. Recidivism among securities violators is common, and a prior enforcement action is a solid predictor of future misconduct. The objective of disqualifications is to make unavailable relaxed provisions for selling securities that require less disclosure and oversight, and force disqualified issuers instead to sell securities by providing somewhat more substantial disclosure and subjecting them to greater SEC oversight. As such, bad actor disqualifications are prophylactic measures that protect investors and markets from high-risk issuers.[84]

We know that many securities defendants are likely to reoffend but we do not know which ones. Because of that, triggering events are intentionally overbroad, and the statutes authorize the SEC to waive bad actor disqualifications on showing of good cause. The Commission has delegated the task to the Division of Corporation Finance, which in turn has sub-delegated that authority to staff: the Chief of the Office of Small Business Policy waives bad actor disqualifications under Regulations A and D, and the Office of Enforcement Liaison waives ineligible-issuer disqualifications.[85] Each of the five Commissioners retains the right to request that the entire Commission vote on any waiver decision.

The waiver of a bad actor disqualification is appropriate when the defendant can show the SEC that the risk it will defraud investors again is sufficiently low to warrant a waiver. The good cause test is a multi-factor test that includes at least some considerations that are plausibly correlated with the risk of fraud in the disqualified offering.[86] The first is that an individual who committed securities fraud is unlikely to obtain a waiver of the disqualification. If an executive has been charged with fraud and that executive remains with the company, a waiver to the firm typically is not granted because the risk of repeat misconduct is substantial. Secondly, longer-lasting frauds, likewise, suggest a higher risk of recidivism. Thirdly, failure to take remedial steps also increases the risk of future violations. All these factors are considerations against granting a good-cause waiver from bad actor disqualifications.

The fourth and final factor for granting a good-cause waiver under the existing approach is unrelated to the recidivism risk but instead takes into account the impact on the issuer or third parties if the waiver is denied, and this is the most problematic rationale. It was added to avoid harm to innocent third parties and it includes situations where a waiver is clearly appropriate: disqualification under rule 506(d) of Regulation D will bar from private placements not only the firm or individual that was found liable in an SEC enforcement action, but also any company in which the disqualified firm or individual owns or controls 20 percent or more of the stock. As a result, disqualification of a private equity firm would also disqualify portfolio companies in which

82. 17 C.F.R. 230.506(d).
83. 17 C.F.R. 230.405.
84. *See id.* at 1101-02.
85. *See* Velikonja, *Waiving Disqualification*, *supra* note 81, at 1093 n.72.
86. *Waivers of Disqualification Under Rules 505 and 506 of Regulation D*, DIV. OF CORP. FIN., SEC (Mar. 13, 2015), http://www.sec.gov/divisions/corpfin/guidance/disqualification-waivers.shtml.

that private equity firm owns a minority stake.[87] Portfolio companies typically operate independently and so their risk of committing fraud is unrelated to the fraud risk of their minority owner. In that case, disqualification of portfolio firms would harm third parties with no benefit to investors.

In my study referred to above, I reported that between July 2003 and December 2014, almost ***82 percent*** of all granted waivers were issued to large financial firms (i.e., subsidiaries of public firms that were registered broker-dealers or investment advisers and had more than 1,000 employees), a class that includes ***fewer than 4 percent*** of all defendants in SEC enforcement actions. Not only that, financial firms that were subsidiaries of public firms almost always received a waiver when disqualified. That discrepancy might be justifiable if those defendants posed a low risk of recidivism and/or their disqualification would produce substantial losses to innocent third parties.

The empirical evidence on the misconduct risk of large financial firms and their employees is quite mixed. Large firms are often named as defendants in SEC enforcement actions, but their size is just as likely the cause as is their propensity for fraud. The median advisory firm has 10 registered advisers, whereas the largest has more than 30,000.[88] If bad advisors are spread evenly through the population of advisors, then a large firm will have more of them even if the average employee is just as honest as the average advisor nationwide. For at least some firms, this does not appear to be true. In particular, some large financial firms are much more likely than others to hire "bad apples" fired by other firms[89], and engage in repeat misconduct.[90] If large financial firms are not low-risk because of their size, then the only justifiable reason for their different treatment as compared with other classes of defendants would be factors that mitigate the risk of securities fraud, such as closer SEC or other regulatory oversight, the imposition of an internal monitor, or improved self-policing.[91] But waiver orders are light on detail, so it is unclear how closely does the SEC staff scrutinize the existence of alternative risk-reduction measures.

SEC staff appears to treat large non-financial firms with kid gloves as well. When Tesla's CEO Elon Musk settled with the SEC in October 2018 for lying about a pending acquisition, and was enjoined from violating section 10(b) of the Securities Exchange Act, that settlement triggered bad actor disqualifications for the private placement exemption for Musk and Tesla, as well as for three private companies that Elon Musk controls: The Boring Company, Neuralink, and Space Exploration Technologies (SpaceX). SEC staff promptly issued waivers to Tesla and the three private companies, even though Musk controls them and remains high-risk for securities fraud. Waiver requests by all three private companies that Musk controls are very clear that the

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87. *See, e.g., In re* Certain Current Funds, Third Party Issuers & Portfolio Cos. affiliated with Credit Suisse AG, Securities Act Release No. 9589 (May 19, 2014), http://www.sec.gov /rules/other/2014/33-9589.pdf.

88. Fewer than 5 percent of registered investment advisers have more than 500 registered advisers. Mark Egan, Gregor Matvos & Amit Seru, *The Market for Financial Adviser Misconduct*, 127 J. POL. ECON. 233 (2019).

89. *See id.*; http://eganmatvosseru.com/index.php/firm-rankings/ (listing Oppenheimer, Wells Fargo, UBS, and Morgan Stanley among firms where more than 10 percent of registered advisers have a record of misconduct).

90. *See, e.g.*, Luis M. Aguilar & Kara M. Stein, Comm'rs, SEC, Dissenting Statement in the Matter of Oppenheimer & Co., Inc. (Feb. 4, 2015), http://www.sec.gov/news/statement/dissenting -statement-oppenheimer-inc.html (dissenting from a waiver grant to Oppenheimer and citing more than thirty separate regulatory actions to suggest that Oppenheimer is likely to violate securities laws again).

91. *See* Velikonja, *Waiving Disqualification*, *supra* note 81, at 1103-04.

companies have "not taken any remedial actions in response".[92] Tesla's waiver request lists as remedial steps only those actions that Tesla was required to take under the settlement with the SEC.[93]

An alternative explanation for the high rate of good-cause waivers granted to large financial firms is that although they may not present a low risk for recidivism, their disqualification would produce large third-party effects. But as I showed in my study, large firms requesting and receiving waivers are not innocent bystanders nor would their disqualification cause particularly harmful third-party effects. For example, Tesla argued that failure to receive a waiver from Regulation D would harm its shareholders. Tesla is a public company and has not issued securities to outside investors in a private placement since 2011.[94] Tesla's need for Regulation D exemption, at this point, is merely theoretical, and there are solid substitutes to the exemption that would allow Tesla to raise funds, albeit with more disclosure and more SEC oversight. Similarly, Jefferies, a brokerage firm fined by the SEC for defrauding the federal Troubled Asset Relief Program (TARP),[95] suggested in its request for a waiver that a bad actor disqualification would have "an adverse effect on third parties that have retained, or may retain" Jefferies in the future, and so it needed a waiver.[96] What Jefferies describes is not a third-party effect but rather a direct cost to Jefferies from losing future business. As long as the disqualified firm is not a monopolist in any market, competitors can and will step up to serve the disqualified firm's clients.

Nor would disqualifications typically amount to a "corporate death penalty"[97]—an analogy that is grossly exaggerated. Based on this exaggerated analogy, large financial firms routinely received waivers of the ineligible issuer disqualification before the financial crisis. In 2009, during the settlement process between the SEC and Bank of America related to proxy fraud in BofA's acquisition of Merrill Lynch, waivers became a sticking point. Bank of America insisted in July 2009 that it could not operate without a waiver from the ineligible issuer disqualification.[98] It refused to settle with the SEC unless it was assured of waivers. The SEC ultimately relented. But Bank of America exaggerated the harm if it was denied a waiver. The alternative to automatic shelf

92. https://www.sec.gov/divisions/corpfin/cf-noaction/2018/the-boring-company-101618-506d.pdf; https://www.sec.gov/divisions/corpfin/cf-noaction/2018/space-exploration-technologies-corp-101618-506d.pdf; https://www.sec.gov/divisions/corpfin/cf-noaction/2018/neuralink-101618-506d.pdf.

93. https://www.sec.gov/divisions/corpfin/cf-noaction/2018/tesla-inc-101618-506d.pdf.

94. In 2013, Tesla sold $55 millions of securities to Elon Musk under Regulation D. If that exemption were not available to Tesla at the time, it could have sold those same securities to Musk under the statutory private placement exemption. The net harm to Tesla from the disqualification would have been zero. *See id.*

95. *See In re* Jefferies LLC, Exchange Act Release No. 71695 (Mar. 12, 2014), https://www.sec.gov/litigation/admin/2014/34-71695.pdf.

96. Letter from Paul R. Eckert, Wilmer Cutler Pickering Hale & Dorr LLP, to Sebastian Gomez Abero, Chief, Office of Small Bus. Policy, Div. of Corp. Fin., SEC, In the Matter of Jefferies LLC; File No. 3-15785, Jefferies LLC, SEC Exemptive Letter attachment at 4 (Mar. 12, 2014), http://www.sec.gov/divisions/corpfin/cf-noaction/2014/jefferiesllc-3b-506d-031814.pdf.

97. Daniel M. Gallagher, Comm'r, SEC, Why Is the SEC Wavering on Waivers? Remarks at the 37th Annual Conference on Securities Regulation and Business Law, (Feb. 13, 2015), https://www.sec.gov/news/speech/021315-spc-cdmg.html.

98. OFFICE OF INSPECTOR GEN., SEC, REPORT OF INVESTIGATION: INVESTIGATION OF THE CIRCUMSTANCES SURROUNDING THE SEC'S PROPOSED SETTLEMENTS WITH BANK OF AMERICA, INCLUDING A REVIEW OF THE COURT'S REJECTION OF THE SEC'S FIRST PROPOSED SETTLEMENT AND AN ANALYSIS OF THE IMPACT OF THE BANK OF AMERICA'S STATUS AS A TARP RECIPIENT 41 (2010) (quoting from Bank of America's request that a waiver denial "would be unduly and disproportionately severe" and would have "significant negative consequences on Bank of America and its shareholders").

registration—the securities offering rules that ineligible issuers are barred from using—is not bankruptcy but regular shelf registration, which requires only marginally more substantial oversight and entails only minimal delay. It should come as no surprise that Bank of America was not harmed when it was disqualified under the same provision in October 2014. Citigroup became an ineligible issuer in 2010 and again in 2014, and performed just fine during the three years that it was disqualified. (Both are among a handful of disqualified large financial firms that did not receive waivers.)

In other words, it appears that staff has continued to deny waivers to individuals and small firms because they pose a high risk of recidivism, but has continued to grant waivers from bad actor disqualifications to large public and financial firms not because they pose a low risk, but because they would otherwise refuse to settle with the SEC.

The Discussion Draft's proposals are an excellent way to return disqualifications to their intended objective—as prophylactic measures to reduce fraud risk. First, the Discussion Draft requires that the Commission, and not staff, make waiver determinations. Currently, staff make waiver determinations in an opaque process, so little is known about who receives a waiver and why, and whose waiver requests have been denied and why. Elevating the decision to the Commission would improve the transparency and predictability of the process. Second, the Discussion Draft requires a mandatory public hearing before the decision on any waiver. The hearing requirement clearly separates the Commission vote on the enforcement action from its vote on the bad actor disqualification waiver, and does so by delaying the vote on the waiver by as much as 180 days. By doing that, the proposal allows the Commission to focus on one question at a time: proper sanction for the violation at step one, and evaluating recidivism risk at step two. The Commission would no longer be susceptible to criticism that it is using disqualifications as leverage in enforcement action settlements, and waiver conversations would no longer overlap with settlement conversations. Third, the Discussion Draft includes clear language that bars consideration of "direct costs to the ineligible person" in deciding on whether to grant a waiver from bad actor disqualifications. If the objective is protecting investors and capital markets from bad actors, it is irrelevant whether the already-sanctioned firm would be harmed by the violation.

HEARING BEFORE THE SUBCOMMITTEE ON INVESTOR PROTECTION, ENTREPRENEURSHIP, AND CAPITAL MARKETS

OF THE COMMITTEE ON FINANCIAL SERVICES

OF THE UNITED STATES HOUSE OF REPRESENTATIVES

Putting Investors First: Examining Proposals To Strengthen Enforcement Against Securities Law Violators

Testimony of Andrew N. Vollmer

June 19, 2019

Chairwoman Maloney, Ranking Member Huizenga, and Members of the Subcommittee:

I am pleased to have an opportunity to comment on several timely and important issues related to the enforcement of the federal securities laws. I will address (1) general principles that should guide legislation in the federal securities law area, (2) the problem of foreign businesses using the U.S. capital markets without providing investors the additional assurances of an auditor inspected by the Public Company Accounting Oversight Board, and (3) limitations periods for SEC enforcement cases, the length of SEC investigations, and relief in the form of restitution of investor loss.

I have extensive experience with the SEC enforcement process and have written about various aspects of it. A summary of my background and a list of enforcement articles are at the end of these written remarks. The views I express in this written statement and in my oral testimony are solely my own and are not on behalf of and do no necessarily reflect the views of any other person. For convenience, I will refer to a person involved in an SEC investigation or charged with a violation of the securities laws as a defendant.

General

Legislation in the federal securities area should be guided by several general principles. The leading principle is that the federal securities laws should make the United States an attractive and efficient place for raising capital for businesses large and small. Smoothing the path to capital encourages innovation, productivity, research, expansion, and economic growth. It increases the nation's wealth and personal liberty and autonomy.

A major component of the regulation of capital markets is the protection of investors. Investors need confidence in the system before they will risk their resources. They need companies to make appropriate disclosures, and they need to know that the system imposes checks on the accuracy and completeness of the information.

That leads to a third principle. Enforcement is an essential part of an effective system of securities regulation. Enforcement should be vigorous but fair. Vigorous enforcement reduces non-compliance and gives all market participants assurance that the rules will be followed. Fair enforcement increases accuracy of results, promotes the legitimacy and acceptability of the enforcement process, fosters respect for the law, and therefore advances the statutory goals of encouraging capital formation while protecting investors and markets.

The SEC enforcement process should guard against arbitrary, abusive, and harsh enforcement provisions that over-deter beneficial economic activity. It should be based on the rule of law and should provide each defendant with adequate advance notice of specific and identifiable standards of conduct, a meaningful opportunity to prepare and present a defense, and an ability to bring cases that lack merit to a rapid close. Fairness to defendants should be one of the highest values protected by the process used to enforce the federal securities laws.

The bills you are considering should be measured against these standards. Several of the bills would not promote the aims of capital formation, economic growth, and fair enforcement, in contrast to many of the provisions in the Jobs and Investor Confidence Act passed in the House last Congress with strong bi-partisan support. These bills address the SEC enforcement process and increase the power and authority of the SEC and the enforcement staff, but they do so without adequate justification or understanding of their likely effects on market participants and capital markets. To a large extent, the enforcement bills would make securities activities in the United States more costly and would burden the capital formation process without sufficient offsetting benefits.

My written comments address PCAOB inspection of auditors and proposals to allow the SEC to recover investor loss and to extend the statute of limitations for SEC enforcement cases, but I would be pleased to answer specific question about any of the bills being considered.

Issuer auditors not subject to PCAOB inspection

Let's look at the bill to hold foreign companies accountable. The bill has a worthy objective, but the solution adopted in the bill could be more effective.

The concern of the bill is that some companies raising capital in the United States use auditors that are not inspected by the Public Company Accounting Oversight Board.[1] This is a valid concern. Our securities regulation system puts a premium on the reliability and accuracy of the financial statements in registration statements or the public filings of companies obliged to make periodic reports about their operations. A person that prepares or issues or participates in the preparation or issuance of any audit report of such an issuer must register with the PCAOB and must be subject to periodic inspections by the PCAOB. See 15 U.S.C. §§ 7212(a), 7214. Another section of the law specifically addresses PCAOB registration and regulation of a foreign public accounting firm that prepares or furnishes an audit report for a reporting company or plays a substantial role in the preparation of an audit report. Id. § 7216.

Before enactment of the Sarbanes-Oxley Act in 2002, a House Report directly linked the creation and function of the PCAOB to confidence in the financial statements of reporting companies. The Report said that the PCAOB was to enforce compliance by accountants with competency standards applicable to audits of financial statements required to be filed with the SEC and that the goal was to improve the accuracy and reliability of corporate disclosures under the securities laws. See Report of the House Committee on Financial Services, Rep. No. 107-414 (April 22, 2002).

A few countries do not permit PCAOB inspections of their accounting firms, and a long list of companies that are U.S. reporting companies have auditors that are not subject to inspection.[2] The existence of U.S. reporting companies with auditors not inspected by the PCAOB is not acceptable. It creates a two-tiered system of disclosure quality in the United States and creates doubt about the trustworthiness of the financial statements of those companies.

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1 See SEC Chairman Jay Clayton, SEC Chief Accountant Wes Bricker, and PCAOB Chairman William D. Duhnke III, Statement on the Vital Role of Audit Quality and Other Information Internationally – Discussion of Current Information Access Challenges with Respect to U.S.-listed Companies with Significant Operations in China (Dec. 7, 2018), available at https://www.sec.gov/news/public-statement/statement-vital-role-audit-quality-and-regulatory-access-audit-and-other.

2 The PCAOB website has a list of companies with auditors not subject to PCAOB inspection. See Issuers that are Audit Clients of PCAOB-Registered Firms from Non-U.S. Jurisdictions where the PCAOB is Denied Access to Conduct Inspections, https://pcaobus.org/International/Inspections/Pages/IssuerClientsWithoutAccess.aspx.

The bill proposes to address the problem by instructing the SEC to prohibit the trading of a reporting company's securities on a national securities exchange or alternative trading system when the PCAOB has not been able to inspect a foreign public accounting firm retained by the issuer. The goal is to protect the U.S. capital markets from an increased risk of faulty audited financial statements.

A possible outcome of the legislation is that some foreign companies might leave the U.S. capital markets, some foreign companies might not raise capital in the U.S., and current shareholders of some foreign companies might not be able to sell their shares at all or at liquid market prices. The question is whether these disadvantages are substantial enough to tolerate use of audited financial statements when the auditor is not being inspected by the PCAOB. Welcoming foreign companies to raise capital in the United States and allowing liquidity and free trading of shares in the United States are important policies, but the disclosure system has been the heart of U.S. securities regulation since 1933 and 1934. As long as PCAOB inspection of auditors is an important part of maintaining confidence and accuracy in the financial statements of U.S. reporting companies, the obligation should be applied uniformly and consistently. U.S. investors might still be able to invest in companies that do not comply. The companies could list and trade in a foreign market. U.S. investors can buy in foreign markets, but they will know that the entire system of securities regulation is different. That would be the individual investor's choice and not the choice of U.S. policy makers.

Some will argue that advance disclosure that a company's auditor is not subject to inspection is sufficient. The people who bought, and the exchange that listed, the securities had advance notice and went ahead. Investors should be allowed to decide for themselves.

In many circumstances, that is a compelling argument, but it is not persuasive here. Disclosure that a company's auditor is not subject to inspection is not sufficient. It was not the option Congress chose, and it does not deal with the disparity between those reporting companies whose auditors are subject to PCAOB inspection and those companies whose auditors are not. A PCAOB inspection supports the reliability of all of a company's financial statement disclosures. Telling investors that the auditor is not inspected by the PCAOB casts doubt on the entirety of the financial statements and therefore defeats the goal of providing investors with assurances that financial information is accurate and complete. An extreme example of a similar disclosure would be a large, bold statement that a company's disclosures might not be accurate, but that is not an acceptable way of complying with the federal securities laws.

The goal of the legislation therefore is sound, but the proposed solution is too narrow because the bill would prevent trading on U.S. exchanges or alternative trading systems, but the number of exchange listed companies is much smaller than the number of reporting companies. The PCAOB registration and inspection requirement applies to auditors of reporting companies. In 2016, the number of companies filing an annual report on Form 10-K was 7589. The number of Form 10-K filings gives a rough order of magnitude of reporting companies but understates the number because foreign private issuers file annual reports on Form 20-F. At the end of 2016, the number of exchange listed companies was under 4000. The remedy in the bill is limited to exchange listed companies and therefore does not match the potential problem of non-exchange listed reporting companies with an auditor not subject to PCAOB inspection.

Congress could consider two alternatives. The first is to enable the SEC to employ the section 12(j) remedy it currently uses when a reporting company fails to meet its periodic filing and disclosure requirements. These are called delinquent filing cases, and the SEC has brought around 120 of them in each of the past four fiscal years. See SEC Division of Enforcement, Annual Report for FY 2018 at 9, https://www.sec.gov/files/enforcement-annual-report-2018.pdf. The Commission uses section 12(j) of the Exchange Act, which authorizes the SEC to suspend or revoke the registration of a security when the issuer failed to comply with any provision of the Exchange Act or its regulations. No U.S. broker-dealer may effect a transaction in a security whose registration was revoked or suspended.

Failing to have an auditor subject to PCAOB inspection affects the quality of an issuer's disclosure in a way that is similar to an issuer's failure to meet its public filing obligations. Congress therefore could enable the SEC to use section 12(j) proceedings on a case-by-case basis to de-register an issuer's securities when the issuer has an auditor not subject to PCAOB regulation and inspection. A statute or SEC regulation would need to make explicit that a company filing a periodic report or a registration statement with an audit report has a requirement to use an auditor subject to PCAOB inspection.

A second alternative remedy would be much more narrowly tailored to the protection of investors and would avoid at least some of the main disadvantages of a solution based on de-listing or de-registration. The main disadvantages are that de-listing or de-registration would severely restrict the ability of current shareholders of U.S. reporting companies to sell their shares unless the company developed a liquid market in another country and would discourage other foreign companies from offering securities through the U.S. markets. Some of those foreign companies would be attractive investment opportunities if the companies satisfied U.S. regulatory requirements.

This second alternative could require an issuer that has a significant part of its operations or financial results audited by an auditor not subject to PCAOB inspection to post a bond or maintain an insurance policy equal to a large amount of money, such as half of the company's market capitalization at the end of the preceding fiscal year. The amount of the bond would be available to satisfy a financial sanction imposed by the SEC or a court in an SEC enforcement proceeding or a financial judgment imposed by a court in a federal securities law case brought by a private plaintiff. The financial sanction or financial judgment would need to be based on a problem with the audited financial statements. The bond or insurance policy would need to be issued by a U.S. institution, and the proceeds would need to be accessible within the territory of the United States.

This alternative is more narrowly tailored because it would seek to protect investors in the United States from a problem connected to the absence of PCAOB inspection of audit reports while still permitting U.S. trading in the securities of the foreign companies and still permitting foreign companies to raise capital here. Investors would be protected by having access to funds in the United States to compensate for loss from a securities law violation originating with a defect in the financial statements.

A bond or insurance policy approach would still have disadvantages. The requirement would increase the cost of U.S. capital for the affected foreign companies and could deter some of them from offering securities in the U.S. markets or could cause some foreign companies to leave the U.S. markets, which would deprive investors of the opportunity to benefit in the United States from those investments. Nonetheless, a bond or insurance policy requirement would be a less restrictive solution than a prohibition on trading in the United States.

The bill has various drafting issues that should be addressed. The provisions should apply when a person with an auditor not subject to PCAOB inspection uses an American Depositary Share program of some sort. The provisions also should apply when a foreign public accounting firm not subject to PCAOB inspection plays a substantial role in the preparation and furnishing of an audit report.

Limitations periods, disgorgement, investor loss, and the length of investigations

Several bills seek to address the Supreme Court decision in SEC v. Kokesh, 137 S. Ct. 1635 (2017). These bills would upend the traditional reliance on a combination of private and public enforcement of the federal securities laws, leading to unpredictable disruption, and would inject arbitrariness and unfairness into the enforcement system. The result would be to increase the cost of raising capital in the United States and impede economic growth.

These written comments are limited to two features of the proposals. First is the proposal to allow the SEC to recover investor loss. Second is the proposal to abolish or extend the statute of limitations for certain forms of relief in SEC enforcement cases.

Investor loss

A bill we are considering and a bill in the Senate would authorize the SEC to recover investor loss in an enforcement case. The bill Representative McAdams introduced would allow the SEC to seek and a federal court to grant any equitable relief, including "restitution to investors in amounts equal to the amount of loss to such investors." The bill in the Senate, S. 799, would authorize the SEC to recover "restitution to an investor in the amount of the loss that the investor sustained as a result of a violation" by a registered person.

These provisions would be unprecedented in the federal securities laws. Congress has never given the SEC power to calculate a monetary recovery in an enforcement case based on investor loss or damage.[3] Congress has given the SEC many different forms of relief, but they have all related to prevention and deterrence, such as injunctions, civil penalties, and revocation of a person's registration as a broker-dealer or investment adviser. Private actions recover compensation for loss, but private actions provide a defendant with a variety of procedural protections not available in SEC enforcement cases. Those protections include the plaintiff's need to prove reliance, loss, and loss causation, to meet higher pleading standards, and to sue within strict statutes of limitations. Since the creation of the federal securities laws in 1933 and 1934, Congress has retained private enforcement and kept the public enforcement system different. Granting the SEC the power to sue for compensation for investor damage would be a sharp break from this long-standing system.

The natural and inevitable result of giving the SEC the power to sue for investor loss would be that the agency would bring the cases with the largest dollar amount of loss. Those cases would likely be important claims to bring, but having the SEC initiate and litigate them probably would not be an efficient allocation of resources. The same cases would nearly certainly be brought by plaintiffs lawyers as class actions. The plaintiffs bar has a significant incentive to sue when the potential damage award is large.[4] Any time a private plaintiff would bring a case, the SEC would have significantly reduced reasons for doing so, and allowing the SEC to obtain the same relief as the private plaintiffs is unnecessary. Nonetheless, SEC litigation for investor loss is apt to displace private litigation in some circumstances and to cause unpredictable disruption to the public-private enforcement regime.

A secondary effect would likely be that cases for large investor loss would come to dominate the time and resources of the Division of Enforcement. They are prominent cases and attract headlines, and they often have large, complicated sets of facts. The SEC

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3 See Barbara Black, Should the SEC Be a Collection Agency for Defrauded Investors?, 63 Bus. Law. 317 (2008).

4 See, e.g., Randall Thomas & James D. Cox, Mapping the American Shareholder Experience: A Survey of Empirical Studies of the Enforcement of the U.S. Securities Law, 6 Euro. Co. & Fin. L. Rev. 164 (2010); James D. Cox & Randall S. Thomas, SEC Enforcement Heuristics: An Empirical Inquiry 53 Duke L.J. 737, 749, 764 (2003).

would need to have the resources to distribute recovered funds to injured investors. If investor loss cases began to account for a significant part of the docket of the Division of Enforcement, the remaining SEC enforcement agenda would suffer. The SEC Division of Enforcement has a broad mandate to cover all requirements under the federal securities laws, including public offering cases, private offering cases, insider trading cases, broker-dealer violations, mutual fund violations, and investment adviser violations. The legislation could alter the incentives and allocation of resources to pursue problems in more technical and lower profile areas.

The need to give the SEC the authority to sue for investor loss is questionable for another reason. In many cases, such as violations in securities offerings, investor loss equals gain to the defendant, and the SEC has authority to require defendants to disgorge ill-gotten gains.[5] In any case in which defendant gain is approximately the same as investor loss, the power to obtain disgorgement and the power to sue for investor loss would be largely duplicative and the ability to recover investor loss would be superfluous.

Statute of limitations

The second topic to address in the bills related to *Kokesh* is the extension of the statute of limitations for SEC enforcement cases. The bill introduced by Representative Gonzalez would give the SEC ten years to seek civil monetary penalties, as opposed to the current five-year period in 28 U.S.C. § 2462, and the bill of Representative McAdams would completely eliminate a limitations period for SEC claims for investor loss, disgorgement, or any other remedy deemed to be equitable.

Congress should not extend the statute of limitations for any type of relief in an SEC enforcement case. Giving the SEC significantly more time to bring enforcement cases would frustrate the compelling social interests that legislatures have recognized for centuries by enacting limitations periods. A further concern is that a longer statute of limitations for the SEC would cause further delay in what are already long and damaging SEC investigations. All too often, SEC cases are initiated years after a violation has

[5] See 15 U.S.C. § 78u-2(e); Donna M. Nagy, The Statutory Authority for Court-Ordered Disgorgement in SEC Enforcement Actions, 71 S.M.U. L. Rev. 895 (2018).

occurred not because the SEC was unaware of a problem but because the investigation took too long or the staff had notice of possible misconduct and failed to look into it promptly and carefully.

Limitations periods serve weighty social interests. A federal cause of action "brought at any distance of time" is "utterly repugnant to the genius of our laws." Adams v. Woods, 2 Cranch 336, 342 (1805). "Statutes of limitation are vital to the welfare of society and are favored in the law. They are found and approved in all systems of enlightened jurisprudence. They promote repose by giving security and stability to human affairs." Wood v. Carpenter, 101 U.S. 135, 139 (1879). Important public policies lie at their foundation: "repose, elimination of stale claims, and certainty about a plaintiff's opportunity for recovery and a defendant's potential liabilities." Rotella v. Wood, 528 U.S. 549, 555 (2000). As time goes by, evidence becomes less reliable, and the results of investigations and litigation become less accurate. "Just determinations of fact cannot be made when, because of the passage of time, the memories of witnesses have faded or evidence is lost. In compelling circumstances, even wrongdoers are entitled to assume that their sins may be forgotten." Wilson v. Garcia, 471 U.S. 261, 271 (1985). See also Gabelli v. SEC, 133 S. Ct. 1216, 1221 (2013).

Congress therefore should not extend or remove a statute of limitations lightly. It should have strong reasons for giving the SEC more time to seek certain forms of relief. The claim is that SEC Enforcement is hobbled "as a result of Ponzi schemes and similar long-running, well-concealed frauds that are perpetrated by smooth talking 'investment professionals,'"[6] but that is not the full picture. Many examples show that the SEC commences an enforcement case years after a violation occurred because it failed to investigate in a timely way after learning that a violation might be occurring. The problem in many instances is not that the SEC lacked a sufficient basis to look into possible misconduct.

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[6] SEC Chairman Jay Clayton, Keynote Remarks at the Mid-Atlantic Regional Conference (June 4, 2019), https://www.sec.gov/news/speech/clayton-keynote-mid-atlantic-regional-conference-2019#_ednref8. See also SEC Chairman Jay Clayton, Testimony before the Financial Services Committee of the House of Representatives (June 21, 2018) (referring to "clever fraudsters" and a fraud that "is well-concealed and stretches beyond the five-year limitations period"), https://www.sec.gov/news/testimony/testimony-oversight-us-securities-and-exchange-commission.

Take the Madoff and Stanford cases as examples. These two incidents are cited as support for a longer statute of limitations,[7] yet in both the SEC had information about problems years before launching serious inquiries. In the Madoff case, the SEC OIG found that

> the SEC received more than ample information in the form of detailed and substantive complaints over the years to warrant a thorough and comprehensive examination and/or investigation of Bernard Madoff and BMIS for operating a Ponzi scheme, and that despite three examinations and two investigations being conducted, a thorough and competent investigation or examination was never performed. The OIG found that between June 1992 and December 2008 when Madoff confessed, the SEC received six substantive complaints that raised significant red flags concerning Madoff's hedge fund operations and should have led to questions about whether Madoff was actually engaged in trading.[8]

In the Stanford case, the SEC OIG found that "the SEC's Fort Worth office was aware since 1997 that Robert Allen Stanford was likely operating a Ponzi scheme, having come to that conclusion a mere two years after" Stanford's investment adviser registered with the SEC. Over the next 8 years, the SEC's Fort Worth Examination group conducted four examinations of Stanford's operations, "concluding in each case that Stanford's CDs were likely a Ponzi scheme or a similar fraudulent scheme." "While the Fort Worth Examination group made multiple efforts after each examination to convince the Fort Worth Enforcement program ... to open and conduct an investigation of Stanford, no meaningful effort was made by Enforcement to investigate the potential fraud or to bring an action to attempt to stop it until late 2005."[9] Other examples exist of

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7 Senators Warner and Kennedy referred to Madoff and Stanford in their statement about the introduction of a bill to extend the statute of limitations for SEC enforcement cases. https://www.warner.senate.gov/public/index.cfm/2019/3/warner-kennedy-introduce-bill-to-help-investors-harmed-by-fraud.

8 SEC OIG, Investigation of Failure of the SEC To Uncover Bernard Madoff's Ponzi Scheme 20-21 (August 31, 2009) (footnote omitted), https://www.sec.gov/about/offices/oig/reports/investigations/2009/oig-509.pdf.

9 SEC OIG, Investigation of the SEC's Response to Concerns Regarding Robert Allen Stanford's Alleged Ponzi Scheme 16 (March 31, 2010), https://www.sec.gov/about/offices/oig/reports/investigations/2010/oig-526.pdf.

long delays between the time SEC staff learned of potential misconduct and the time the SEC brought an enforcement case.[10]

Another reason to be cautious about extending the limitations period for SEC enforcement cases is that SEC investigations frequently take too long, and the existence of a reasonable statute of limitations acts as an incentive for the SEC staff to complete or close investigations. A major concern about the SEC enforcement process is with the length of investigations. I discussed this issue in earlier publications.[11] Long investigations contribute to the social evils meant to be resolved with statutes of limitations but also create an additional set of harms. Long investigations create uncertainty, which can lead businesses to fail or postpone research and investment in potentially beneficial goods and services. Individuals suffer. They can be fired or put on administrative leave during investigations even when no misconduct occurred. The existence of an investigation can become public, injuring reputations and causing investors to withdraw money and customers to abandon a company. The longer an investigation, the worse these problems are.

In my experience, the length of SEC investigations is strongly correlated to the five-year limitations period for fines, penalties, and forfeitures in 28 U.S.C. § 2462. The Commission and the staff have an incentive to complete investigations in time to commence enforcement proceedings before the five-year statute of limitations for monetary penalties and disgorgement expires. The limitations period thus has the salutary consequence of driving the staff to shorten investigations, although a five-year period could not really be considered unduly short.

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10 SEC OIG, Failure to Timely Investigate Allegations of Financial Fraud (February 26, 2010), https://www.sec.gov/about/offices/oig/reports/investigations/2010/oig-505.pdf; SEC OIG, Investigation of the Failure of the SEC's Los Angeles Regional Office to Uncover Fraud in Westridge Capital Management Notwithstanding Investment Adviser Examination Conducted in 2005 and Inappropriate Conduct on the Part of Senior Los Angeles Official (October 26, 2010), https://www.sec.gov/about/offices/oig/reports/investigations/2010/oig-533.pdf.

11 Andrew N. Vollmer, Four Ways To Improve SEC Enforcement, 43 Sec. Reg. L.J. 333, 342-43 (2015); Andrew N. Vollmer, Need for Narrower Subpoenas in SEC Investigations, New York Law Journal 4, 9 (October 9, 2014). See, e.g., SEC v. Graham, 21 F. Supp. 3d 1300, 1303 (S.D. Fla. 2014) ("The SEC investigated the case for at least seven years."), aff'd in part, rev'd in part, and remanded, 823 F.3d 1357 (11th Cir. 2016).

The end of the five-year limitations period is not always sufficient to cause the SEC staff to reach a conclusion about the matter under investigation. The staff of the Division of Enforcement often avoids the effect of the limitations period by entering into one or more tolling agreements. In a tolling agreement, the person being investigated agrees with the staff to suspend the running of time for purposes of calculating any limitations period. See SEC Division of Enforcement, Enforcement Manual 3.1.2 (November 28, 2017). The use of tolling agreements permits the SEC to begin enforcement actions based on alleged misconduct many years old.

Extending the current five-year limitations period would only worsen all these problems. A longer limitations period is likely to lead to longer and longer investigations. A ten-year period seems inordinately long given the catalogue of ills from lengthy investigations and litigation based on old conduct.

A way to achieve real benefits in this area is to reform the SEC enforcement system. The SEC should improve its procedures for discovering serious securities law problems earlier, and it can and should take steps to shorten the length of investigations.[12]

Perhaps some categories of cases, such as FCPA cases, have features that make the current five-year limitations period not sufficient for an effective enforcement program. If Congress receives convincing data that the five-year period prevents obtaining effective relief in certain types of cases, the better approach would be to define a few specific and narrow exceptions from the five-year period. The SEC does not need blanket authority for longer investigations to deal with special circumstances. A rule could be crafted to give the SEC longer time periods in exceptional cases. For example, a provision to grant the SEC extra time could require the SEC to prove that a case involved serious and widespread misconduct and that the SEC could not reasonably have commenced an action within five years after the alleged violation.

Congress also should address additional matters if it is inclined to reconsider the limitations period for SEC cases. First, a limitations period should apply to the power of

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[12] See Andrew N. Vollmer, Four Ways To Improve SEC Enforcement, 43 Sec. Reg. L.J. 333, 342-43 (2015); Andrew N. Vollmer, Need for Narrower Subpoenas in SEC Investigations, New York Law Journal 4, 9 (October 9, 2014).

the SEC to commence an enforcement case and should not apply to any particular form of relief. The statute of limitations should not be tied to fines, disgorgement, restitution, injunctions, or other relief. That is how section 2462 operates now, but that statute is difficult to interpret and does not easily apply to SEC enforcement cases. The expiration of a limitations period should stop the SEC from suing.

Second, a limitations period should apply to SEC enforcement cases brought in district court or as administrative proceedings. The litany of social harms from long investigations and ancient misconduct exists no matter what forum the SEC uses.

Third, a new statute of limitations should restrict and control tolling agreements. The staff currently uses them to prolong the five-year limitations period. Congress might not want to prohibit all tolling agreements, but they should be rare.

Fourth, a limitations period should not exclude the time a defendant was outside of or absent from the United States. The exclusion would mean that no statute of limitations applies to a foreign legal entity or to many foreign individuals. The reasons to have limitations periods apply to foreign persons as well as those located in the United States. In the age of instant global communications and information and bilateral and multilateral agreements on enforcement cooperation, this provision seems anachronistic. It also would extend already long limitations periods and complicate calculations of the limitations periods.

Background

I am Professor of Law, General Faculty, and Director of the John W. Glynn, Jr. Law & Business Program at the University of Virginia School of Law. I teach Securities Regulation, Advanced Topics in Securities Regulation, and Securities Litigation and Enforcement. I was Deputy General Counsel of the Securities and Exchange Commission from mid-2006 to March 2009 and was a partner in the securities litigation and enforcement practice of Wilmer Cutler Pickering Hale and Dorr LLP before and after my time at the SEC. While at the Commission, one of my main areas of responsibility was to advise the Commissioners and the Division of Enforcement on legal aspects of contemplated enforcement proceedings. While in private law practice, I represented many individuals and companies that were in SEC investigations and private securities litigation or that discovered potential misconduct before an investigation or private litigation began.

I have written on various aspects of the SEC enforcement process:

Accusers as Adjudicators in Agency Enforcement Proceedings, 52 U. Mich. J.L. Reform 103 (2018).

A Rule of Construction for the Personal Benefit Requirement in Tipping Cases, 11 N.Y.U. J.L. & Lib. 331 (2017).

SEC Revanchism and the Expansion of Primary Liability Under Section 17(a) and Rule 10b-5, 10 Va. L. & Bus. Rev. 273 (2016).

Computer Hacking and Securities Fraud, 47 Sec. Reg. & L. Rep. (Bloomberg BNA) 1985 (October 19, 2015).

Four Ways To Improve SEC Enforcement, 43 Sec. Reg. L.J. 333 (2015).

Need for Narrower Subpoenas in SEC Investigations, New York Law Journal 4 (October 9, 2014).

A Chance to Rein in Securities Class Actions, Wall Street Journal A17 (March 4, 2014).

Should Class Actions To Enforce Rule 10b-5 Be Expanded or Curtailed?, 44 Sec. Reg. & L. Rep. (Bloomberg BNA) 325 (2012).

How hedge fund advisers can reduce insider trading risk, 3 Journal of Securities Law, Regulation & Compliance 106 (2010).