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

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[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]

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[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.