TESTIMONY OF THE UNITED STATES SECURITIES AND EXCHANGE COMMISSION

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THE DODD-FRANK WALL STREET REFORM

AND CONSUMER PROTECTION ACT

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BEFORE THE

UNITED STATES SENTENCING COMMISSION

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WASHINGTON, D.C.

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Madam Chairwoman and Members of the Commission –

Thank you for the invitation to testify on behalf of the U.S. Securities and Exchange Commission (hereinafter, "SEC") on the topic of potential amendments, in response to the Dodd-Frank Wall Street Reform and Consumer Protection Act[1] (hereinafter, "the Dodd-Frank Act"), to the provisions of the Sentencing Guidelines covering securities fraud offenses. The SEC welcomes the opportunity to lend its expertise in the area of securities fraud enforcement to the Sentencing Commission as it reviews and, if appropriate, amends the Sentencing Guidelines to better account for the facts and circumstances present in various types of securities fraud offenses.

I should state at the outset of my testimony that my purpose today is not to opine on the various policy judgments that the Sentencing Commission must make in determining the appropriate criminal sentence, whether of incarceration or otherwise, for securities fraud offenses. As I am sure you are aware, the SEC does not have criminal enforcement authority. The SEC does, however, have considerable experience and expertise in the interpretation, application, and enforcement of the federal securities laws. My testimony today will therefore focus on some observations about federal securities fraud offenses, the various fact patterns that often occur with regard to these offenses, and how these fact patterns are accounted for in the Sentencing Guidelines as currently written. I will attempt to identify issues that you may wish to consider in evaluating the need for amendments to the Guideline provisions governing securities fraud offenses.

It should go without saying that securities fraud is a serious offense. Congress most recently recognized this in the passage of the Dodd-Frank Act. At the core of the SEC's mission

[1] Pub.L. 111-203, H.R. 4173 (July 21, 2010).

is a recognition that securities fraud poses a serious threat to individual investors, the securities markets as a whole, and the financial well-being of our nation. Over the last few decades, securities fraud schemes have taken a variety of forms, including but not limited to the insider trading scandals of the 1990s, the accounting fraud schemes of the early 2000s, the mutual fund timing, analyst conflict, and stock options back-dating schemes that came to light a few years later, the massive Ponzi schemes at the end of the last decade, and, most recently, the insider trading schemes that have reemerged. And of course, there has been the continuous threat of pump-and-dump schemes, boiler room operations, smaller scale Ponzi schemes, and affinity fraud schemes, to name just a few. The SEC, in conjunction with the Department of Justice, pursues schemes like these and many more as part of our constant effort to ensure the integrity of our financial markets and to protect individual investors.

Section 1079A(a)(1)(A) of the Dodd-Frank Act directs the Sentencing Commission to "review and, if appropriate, amend" the Sentencing Guidelines applicable to "persons convicted of offenses relating to securities fraud or any other similar provision of law, in order to reflect the intent of Congress that penalties for the offenses under the guidelines and policy statements appropriately account for the potential and actual harm to the public and the financial markets from the offenses." In carrying out this directive, it is important to recognize that the anti-fraud provisions of the federal securities laws apply to a wide range of misconduct. The various types of misconduct violating the federal securities laws can produce different types of "harm to the public," such as harm to individual investors, harm to the securities markets, or harm to both. Some securities fraud offenses may be directed primarily to individual investors, inflicting harm that impacts individual investors in large amounts. Some securities fraud offenses may primarily affect the integrity of the securities markets, inflicting harm in a widespread way that impacts individual investors in small amounts but undermines the markets as a whole. Other securities fraud offenses may inflict harm on both individual investors and the securities markets. The anti-fraud provisions of the federal securities laws reach this entire range of misconduct.

The extensive reach of the anti-fraud provisions of the federal securities laws is a function of, among other things, first, the absence of a requirement that actionable claims be limited to securities traded on a national securities exchange and, second, the expansive definition of a "security." For example, a central anti-fraud provision of the federal securities laws, Section 10(b) of the Securities Exchange Act of 1934, broadly applies to fraud in connection with the purchase or sale of securities, whether such securities are registered on a national securities exchange or "not so registered."[2] With regard to securities not registered on a national securities exchange, Section 10(b) and Rule 10b-5[3] thereunder extend the reach of the anti-fraud prohibition to fraud schemes in connection with the purchase or sale of a security and through the use of the mails or by "any means or instrumentalities of interstate commerce." The courts have interpreted the use of "any means or instrumentalities of interstate commerce" to include the use of bank checks,[4] interstate highways and airspace,[5] and the intrastate use of the interstate telephone system[6] by investors to purchase securities. Furthermore, the federal securities laws define a "security" to include any "investment contract,"[7] whether oral or written,

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[2] 15 U.S.C. § 78j(b).

[3] 17 C.F.R. § 240.10b-5.

[4] *Reyos v. United States*, 431 F.2d 1337, 1348 (10th Cir. 1970).

[5] *United States v. Kunzman*, 54 F.3d 1522, 1527 (10th Cir. 1995).

[6] *Myzel v. Fields*, 386 F.3d 718, 727 (8th Cir. 1967).

[7] *See* 15 U.S.C. §§ 77b(a)(1), 78c(a)(10), 80a-2(a)(36), 80b-2(a)(18).

a term that has been given a far reaching definition by the Supreme Court.[8] The definition of a "security" also includes a "note,"[9] which has also been given a broad reading by the Supreme Court.[10]

The result is that the federal securities laws as written and interpreted by the courts have an appropriately wide reach. Section 10(b), which is the securities fraud offense most frequently prosecuted criminally, serves as a multi-purpose tool that the SEC and the Department of Justice can employ to combat a wide array of securities frauds schemes. Each year, the SEC brings a significant number of cases under Section 10(b), and these cases are directed at varying fraudulent conduct covered by that provision. Some of that misconduct is directed at investors, some of it at institutions, some of it at markets, and some of it at a combination of the above.

None of this is to suggest that any of the conduct covered by the federal securities laws is not serious. Indeed, all of this misconduct is expressly made criminal if committed with the requisite criminal intent.[11] My point is rather that the misconduct covered by the anti-fraud provisions of the federal securities laws, including Section 10(b), can vary widely. Some of the fraudulent conduct committed in violation of the securities laws causes a more direct and substantial harm to the markets as a whole, while other misconduct causes a more direct and substantial harm to individual investors. The Sentencing Guidelines as currently written do not fully distinguish among the differing types of harm resulting from fraudulent conduct addressed by the broad reach of Section 10(b) and other anti-fraud provisions of the securities laws.

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[8] *See SEC v. W.J. Howey Co.*, 328 U.S. 293, 298-99 (1946); *SEC v. Edwards*, 540 U.S. 389, 394 (2004).

[9] *See* 15 U.S.C. §§ 77b(a)(1), 78c(a)(10), 80a-2(a)(36), 80b-2(a)(18).

[10] *See Reves v. Ernst & Young*, 494 U.S. 56, 67 (1990).

[11] *See* 15 U.S.C. §§ 77x, 78ff.

For example, by focusing on the number of victims of an offense – defined as those who suffer loss proximately caused by the offense[12] – the Guidelines can at times overlook the manner in which individuals were victimized, which can bear on culpability as well. In addition, one can imagine a securities fraud scheme that, while not harming a large number of individual investors directly and proximately, causes harm to and uncertainty in the financial markets as a whole. The Sentencing Guidelines, however, do not always account for these distinctions between various methods of committing securities fraud and the effects therefrom, even though such distinctions may be significant factors in determining appropriate criminal sanctions. Thus, in considering amendments to the Guidelines to address "securities fraud" offenses, it may be more helpful to think of the various types of securities fraud offenses and differing factual scenarios that violate the securities laws. In this way, the Sentencing Commission can ensure that the Guidelines appropriately "account for the potential and actual harm to the public and the financial markets from the offenses."

It is also worth noting that this is not the first time that the Sentencing Commission has been called upon to consider the propriety of the Guideline provisions applicable to financial crimes such as securities fraud. As a result of the financial scandals involving Enron, Worldcom, Adelphia, and other entities in the early part of the 2000s, Congress passed the Sarbanes-Oxley Act of 2002.[13] Among other things, the Sarbanes-Oxley Act called on the Sentencing Commission to modify the Guidelines in certain respects with regard to financial crimes. This

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[12] *See* U.S.S.G. § 2B1.1 Application Note 1 (defining a "victim" as one who suffers "actual loss"); *id.* § 2B1.1 Application Note 3(A)(i) (defining "actual loss" as "reasonably foreseeable pecuniary harm that resulted from the offense"); *United States v. Olis*, 429 F.3d 540, 545-46 (5th Cir. 2005) (explaining the legal causation and factual causation aspects of "loss" under the Guidelines).

[13] Pub.L. 107-204, 116 Stat. 745 (July 30, 2002).

was on the heels of amendments to the Guidelines in November 2001 that substantially increased the penalties for financial crimes.[14] The Sentencing Commission responded to the Sarbanes-Oxley Act by amending the Guidelines in 2003 to, among other things, (1) raise the base offense level to 7 for offenses carrying a maximum statutory term of imprisonment of 20 or more years, (2) revise the loss table, (3) provide for a 6-level enhancement for offenses that involve 250 or more victims, (4) include a 4-level enhancement for an offense that substantially jeopardizes the safety and soundness of either a financial institution or a publicly-traded company with more than 1,000 employees, and (5) provide for a 4-level enhancement for offenses committed by certain corporate officers and securities professionals.

The result of these modifications to the Guidelines with regard to securities fraud offenses was dramatic. The SEC's experience has shown that securities fraud offenses, by nature, frequently involve large dollar amounts, large numbers of victims (whether holders of publicly-traded stock or investors in a Ponzi scheme), sophisticated means, and, in the case of a publicly-traded company, an officer of the company. Thus, while the Dodd-Frank Act calls on the Sentencing Commission to consider whether provision should be made for an upward departure "in a case involving a securities fraud or any similar offense, if the disruption to a financial market is so substantial as to have a debilitating impact on that market," the capacity to make meaningful upward departures in the case of the most serious securities frauds may be limited. In the case of a securities fraud offense that results in disruption of the financial markets, the adjusted offense level would likely already be a level 43,[15] thus leaving the Sentencing

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[14] *Compare* U.S.S.G. § 2B1.1 (2000), *with* U.S.S.G. § 2B1.1 (2001).

[15] *See, e.g.*, *United States v. Favara*, 615 F.3d 824, 828 (7th Cir. 2010) (calculating the defendant's advisory Guideline offense level as a 40); *United States v. Parris*, 573 F. Supp. 2d 744, 747 (E.D.N.Y. 2008) (calculating the defendant's advisory Guideline sentencing range of 360 months to life in a securities fraud prosecution).

Commission and the courts with little further ability to punish the offender for market disruption that his or her offense may have caused.

There is, however, an area in which the Sentencing Commission may be able to consider the congressional directive with regard to securities fraud offenses. That is the area of "loss" calculations. In the context of securities fraud offenses, the calculation of the "loss" amount will generally have a significant impact on the calculation of the adjusted offense level. The amendments to the Sentencing Guidelines following the Sarbanes-Oxley Act included a reference in the Application Notes to Section 2B1.1 directing district courts to consider, in calculating "loss" amounts, "[t]he reduction that resulted from the offense in the value of equity securities or other corporate assets."[16]

As the Sentencing Commission may be aware, the SEC pursues remedies such as disgorgement and civil penalties in the civil enforcement actions it brings. These remedies can at times differ from the calculation of the "loss" that a securities fraud offense caused. Disgorgement has been described as an equitable remedy in which the defendant is ordered to turn over "all gains flowing from the illegal activity."[17] Similarly, civil penalties under the federal securities laws can be based on the "gross amount of pecuniary gain" to the perpetrator as a result of the violation.[18] While the SEC's disgorgement and penalty amounts differ somewhat from the "loss" calculation under the Guidelines, the SEC's experience in calculating these types of figures may be of some relevance to the Sentencing Commission. In particular, the SEC's experience has shown that the calculation of gain resulting from securities fraud offenses can be a highly complicated exercise, often requiring the testimony of expensive expert witnesses.

[16] U.S.S.G. § 2B1.1 Application Note 3(C)(iv) (2003).

[17] *SEC v. Platforms Wireless Intern. Corp.*, 617 F.3d 1072, 1096 (9th Cir. 2010).

[18] *E.g.*, 15 U.S.C. § 78u(d)(3)(B).

A body of case law has developed around the calculation of disgorgement and penalty amounts in the context of SEC enforcement actions. The Sentencing Guidelines, however, provide little express guidance on making complicated "loss" calculations in the securities fraud context, and the case law in that area is somewhat sparse and not entirely consistent. The circuit courts have struggled with whether the civil loss causation standard articulated by the Supreme Court in *Dura Pharmaceuticals, Inc. v. Broudo*[19] should be applied in calculating "loss" for purposes of criminal securities fraud prosecutions.[20] With regard to insider trading securities fraud offenses in particular, there is also some disagreement regarding the proper method of calculating for Guideline purposes the "gain resulting from the offense,"[21] with one circuit adopting an approach analogous to the disgorgement analysis used in SEC enforcement actions.[22] Further clarity in this area may be one way in which the Sentencing Commission can carry out the congressional directive to ensure that the Guidelines "account for the potential and actual harm to the public and the financial markets from the offenses." If the Sentencing Commission deems it appropriate, the SEC would certainly be willing to lend its expertise in this area in assisting the Sentencing Commission and its staff in formulating additional guidance in this area.

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[19] 544 U.S. 336 (2005).

[20] *See United States v. Olis*, 429 F.3d 540, 546-47 (5th Cir. 2005) (identifying various ways to calculate "loss" in securities fraud cases); *United States v. Rutkoske*, 506 F.3d 170, 179 (2d Cir. 2007) (endorsing the use of the Supreme Court's "loss causation" approach in *Dura Pharmaceuticals* to calculating criminal "loss" amount); *United States v. Berger*, 587 F.3d 1038, 1042-43 (9th Cir. 2009) (declining to apply the "loss causation" standard of *Dura Pharmaceuticals*).

[21] *Compare United States v. Nacchio*, 573 F.3d 1062, 1072 (10th Cir. 2009), *with United States v. Mooney*, 425 F.3d 1093, 1100 (8th Cir. 2005) (*en banc*).

[22] *Nacchio*, 573 F.3d at 1072 (holding that "the civil disgorgement remedy provides an appropriate guidepost for sentencing in criminal insider trading cases).

The last topic I wish to address is the offense of insider trading. As noted above, Congress has directed the Sentencing Commission to consider the "harm to . . . the financial markets" from securities fraud offenses. Illegal insider trading is a classic example of a criminal offense that harms the integrity of the securities markets, with the particular individual victims of insider trading being largely unidentifiable. Indeed, that appears to be the theory underlying the Guideline provision governing insider trading, which looks not to the "loss" to victims, but rather "gain" to the defendant, in calculating the appropriate offense level.[23]

In recent months, both the SEC and the Department of Justice have brought a series of civil and criminal enforcement actions in response to insider trading rings. As noted above, a number of amendments have been made to the general fraud Guideline found in Section 2B1.1 in response to the corporate and other financial scandals of recent years. Little attention, however, has been focused on the Guideline provision found in Section 2B1.4 addressing insider trading offenses. Indeed, Section 2B1.4 has remained unchanged since its first inclusion in the 2001 version of the Sentencing Guidelines. As a consequence, Section 2B1.4 may not at times capture the varying severity of offenses in the insider trading area.

So, for example, while the general fraud provision of Section 2B1.1 has been amended to provide expressly for a 4-level enhancement for securities fraud offenses committed by certain corporate officers and securities professionals, Section 2B1.4 contains no such provision. And while the recent prosecutions of insider trading offenses have revealed that those schemes may be quite sophisticated, Section 2B1.4, unlike Section 2B1.1, contains no enhancement for the use of sophisticated means to carry out the offense. This is not to suggest that the provisions of Section 2B1.1 should simply be replicated in Section 2B1.4, but rather that the Sentencing

[23] U.S.S.G. § 2B1.4(b)(1).

Commission may wish to take this opportunity to make Section 2B1.4 reflect in a more measured and carefully calibrated way the harm flowing from insider trading offenses. In other words, since the severity of insider trading offenses can vary widely, then perhaps the Guidelines should as well. This may be an area ripe for consideration by the Sentencing Commission in order to carry out the congressional directive of ensuring that the Guidelines “appropriately account for the potential and actual harm to the public and the financial markets from the offenses.”

I thank you for the opportunity to share the insights of the Securities and Exchange Commission with regard to the prosecution of securities fraud offenses.