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

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

Based on a couple of well-known cases, fair fund distributions have been derided as a smaller, feebler version of private securities litigation—a waste of the SEC's resources on duplicative cases. This is the first empirical study to examine the population of 243 fair funds created between 2002 and 2013, through which the SEC will distribute $14.46 billion to defrauded investors. Contrary to conventional wisdom, this study finds that the SEC's distributions are neither small nor, for the most part, inefficiently circular transfers from shareholder victims to themselves. Two-thirds of fair funds compensate investors for what can best be described as customer fraud or anticompetitive behavior by financial intermediaries.

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

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INTRODUCTION

The success of the Securities and Exchange Commission (SEC) is conventionally measured by the number of enforcement actions it brings, the multimillion-dollar fines it secures, and the high-impact trials it wins.[1] But the SEC does not just punish wrongdoing. Over the last twelve years, the SEC has quietly become an important source of compensation for defrauded investors.[2] Since

1. *See, e.g.*, Jean Eaglesham, *SEC Pads Case Tally with Easy Prey: Late Surge Helps Offset Steep Drop in Enforcement Actions*, WALL ST. J. (Oct. 17, 2013, 11:27 PM ET), http://online.wsj.com/news/articles/SB10001424052702304384104579141863675545256 (explaining that enforcement "numbers matter to the agency"); Joshua Gallu, *Tourre Case Buoys SEC as Congress Weighs Funding*, BLOOMBERG (Aug. 4, 2013, 9:00 PM PDT), http://www.bloomberg.com/news/2013-08-05/sec-gets-shot-in-the-arm-with-victory-in-tourre-case.html.

2. *See* SEC, FISCAL YEAR 2012 AGENCY FINANCIAL REPORT 41 tbl.1.10 (2012); SEC, FY 2011 PERFORMANCE AND ACCOUNTABILITY REPORT 2 (2011) [hereinafter SEC 2011 PAR]; SEC, PUTTING INVESTORS FIRST: 2009 PERFORMANCE AND ACCOUNTABILITY REPORT 11 (2009).

2002, the SEC has deposited $14.46 billion[3] for defrauded investors into 243 distribution funds, usually called "fair funds" after the statute that authorizes them.[4] To put this figure into context, the aggregate amount distributed through fair funds over the past decade is substantially larger than the SEC's budget over the same period.[5]

The fair fund provision allows the SEC to distribute civil fines and disgorgements of ill-gotten profits collected from the defendants it prosecutes. Other federal agencies also direct distributions of funds they collect from defendants to victims;[6] the Commodity Futures Trading Commission (CFTC),[7]

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

4. The Federal Account for Investor Restitution (FAIR) Fund provision is located in section 308 of the Sarbanes-Oxley Act of 2002. Pub. L. No. 107-204, § 308, 116 Stat. 745, 784-85 (codified as amended at 15 U.S.C. § 7246 (2013)). The SEC compensates investors in a variety of ways, not just through fair funds. Other methods include disgorgement funds, receiverships, coordinated prosecutions, and clawback actions. Disgorgement funds are SEC-administered distribution funds where only disgorgement is distributed to defrauded investors. The SEC also pursues emergency actions in court to stop frauds related to unregistered securities and Ponzi schemes. These cases are usually resolved, and recovered funds are distributed through bankruptcy or quasi-bankruptcy proceedings, including equity receivership. The entity used to perpetuate the fraud is always deeply insolvent, and so most funds are ordinarily recovered from "relief defendants," persons who are not wrongdoers but received ill-gotten funds without a legitimate claim to those funds. *See* Andrew Kull, *Common-Law Restitution and the Madoff Liquidation*, 92 B.U. L. REV. 939, 950 & n.42 (2012). Finally, the SEC frequently coordinates its enforcement actions with other agencies, including the Department of Justice (DOJ), state securities regulators and prosecutors, and the Financial Industry Regulatory Authority (FINRA, formerly the National Association of Securities Dealers (NASD)), which sometimes results in a distribution in the parallel action but not in the SEC enforcement action. For instance, in the case against Bernard L. Madoff Investment Securities LLC, the SEC did not collect a fine. But the DOJ will return $2.4 billion to defrauded investors recovered in criminal actions against perpetrators, with another $9 billion recovered from relief defendants in a Securities Investor Protection Act (SIPA)-administered receivership. *See Frequently Asked Questions*, MADOFF VICTIM FUND, Q26-Q28, http://www.madoffvictimfund.com/FAQ.shtml (last updated Nov. 18, 2013) (explaining the difference between recoveries in receivership from Madoff's entity and the DOJ's forfeiture).

5. The SEC's budget between 2003 and 2013 amounted to $12.04 billion. *See Frequently Requested FOIA Document: Budget History—BA vs. Actual Obligations*, U.S. SEC. & EXCHANGE COMMISSION, http://www.sec.gov/foia/docs/budgetact.htm (last modified May 7, 2014).

6. Unlike other federal agencies, the SEC is authorized to distribute civil fines in addition to disgorged assets to injured investors through fair funds, increasing the aggregate dollar amount available for victim compensation. *See* Barbara Black, *Should the SEC Be a Collection Agency for Defrauded Investors?*, 63 BUS. LAW. 317, 319 n.13 (2008). The Miscellaneous Receipts Act requires agencies to deposit any money they receive, including civil fines they collect, "in the Treasury as soon as practicable without deduction for any charge or claim." 31 U.S.C. § 3302(b) (2013). That does not necessarily preclude an agency from structuring the settlement with the defendant so as to compensate the victims. The Office of the Comptroller of the Currency (OCC) reached a settlement with large mortgage servicers for widespread deficiencies in foreclosure practices and imposed a $394 million civil fine. By law, the OCC could not itself distribute the civil fine to injured borrowers. Instead, the

the Federal Trade Commission (FTC),[8] and the Department of Justice (DOJ),[9] among others, have the authority to distribute ill-gotten gains (but not civil fines) recovered from defendants to their victims.[10] But the SEC's distributions are of particular interest because they are the most extensive and sustained effort by a public agency to compensate the victims of misconduct.[11] Between 2004 and 2012, the SEC used fair funds to distribute more than 75% of all collected monetary penalties.[12] By contrast, the FTC distributed 7.3% of ordered monetary penalties in 2013, and 3.3% in 2012.[13]

Despite the SEC's enthusiasm for the fair funds provision,[14] the high aggregate dollar amount distributed, and the large number of funds, the SEC's compensation efforts have been neglected by scholars, policymakers, and the

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OCC agreed to hold those penalties in abeyance to the extent the servicers compensated borrowers as much as the civil fine amounts that the OCC would otherwise assess. OFFICE OF THE COMPTROLLER OF THE CURRENCY, U.S. DEP'T OF THE TREASURY, INTERIM STATUS REPORT: FORECLOSURE-RELATED CONSENT ORDERS 5-6 (2012).

7. *See* 7 U.S.C. § 18(a), (d) (2013); 17 C.F.R. pt. 12 (2014) (describing the CFTC Reparations Program).

8. *See* Stipulated Final Judgment & Order for Permanent Injunction & Other Equitable Relief as to Defendants LifeLock & Davis at 9, FTC v. LifeLock, Inc., No. CV10-530-PHX-NVW (D. Ariz. Mar. 15, 2010) (awarding $11 million to consumers); *see also* FTC v. Mylan Labs., Inc., 62 F. Supp. 2d 25, 36-37 (D.D.C. 1999) (holding that the FTC is able to "pursue monetary relief" in civil actions).

9. The Mandatory Victims Restitution Act of 1996 mandates restitution to (1) victims of violent crimes, as defined in 18 U.S.C. § 16 (2013); (2) victims of an offense against property under title 18, including any offenses committed by fraud or deceit; and (3) victims of offenses defined in 18 U.S.C. § 1365, relating to tampering with consumer products. *See* 18 U.S.C. § 3663A(a), (c)(1)(A)-(B).

10. *See* Black, *supra* note 6, at 319 n.13; Adam S. Zimmerman, *Distributing Justice*, 86 N.Y.U. L. REV. 500, 527 (2011).

11. *See* Margaret H. Lemos & Max Minzner, *For-Profit Public Enforcement*, 127 HARV. L. REV. 853, 882-85 (2014).

12. A back-of-the-envelope comparison of collections and fair fund distributions between 2004 and 2012, based on the SEC's *Congressional Budget Justification* reports from 2005 to 2015, suggests that the SEC distributed between 75% and 90% of all collected sanctions.

13. *See Stats & Data 2013*, FED. TRADE COMMISSION, http://www.ftc.gov/reports/annual-highlights-2013/stats-data-2013 (last visited Jan. 28, 2015); *Stats & Data 2012*, FED. TRADE COMMISSION, http://www.ftc.gov/reports/annual-report-standard/ftc-2013/stats-data-2012 (last visited Jan. 28, 2015). The SEC's collection record is considerably better than that of its peer enforcement institutions, including the DOJ, which collected only about 20% of criminal fines imposed in white-collar cases between 2004 and 2013. Michael Rothfeld & Brad Reagan, *Prosecutors Are Still Chasing Billions in Uncollected Debts*, WALL ST. J. (Sept. 17, 2014, 7:35 PM ET), http://online.wsj.com/articles/prosecutors-are-still-chasing-97-billion-in-uncollected-debts-1410984264.

14. The SEC's enforcement director has described the fair funds provision as "[o]ne of the most frequently used tools" created by the Sarbanes-Oxley Act. Linda Chatman Thomsen & Donna Norman, *Sarbanes-Oxley Turns Six: An Enforcement Perspective*, 3 J. BUS. & TECH. L. 393, 411 (2008).

press.[15] At best, commentators have derided the SEC's contribution offhandedly as an insignificant supplement to private securities litigation and a socially wasteful transfer of funds from one set of innocent shareholders to another.[16] At worst, they have criticized the SEC for wasting resources on duplicative cases,[17] lacking a "coherent policy" regarding distributions,[18] burdening courts with "tortured restructuring and embarrassing consequences" of poorly drafted distribution plans,[19] and frustrating remedies available to creditors in bankruptcy.[20]

Until this study, there has been no inquiry into how the SEC has exercised its fair fund authority. Relying on an analysis of all fair funds created between 2002 and 2013, this Article provides the first comprehensive assessment of the SEC's compensation efforts, supplying the missing empirical foundation to inform the debate on administrative compensation programs like the SEC's fair funds. The study's findings suggest that a few controversial fair fund cases animate the scholarly and popular critiques, but these selected anecdotes are not representative of the whole.[21]

In addition to supporting the primary observation that the SEC distributes a surprisingly large amount of money to harmed investors through fair funds, of-

15. The two exceptions are articles by Barbara Black and Verity Winship. Black, *supra* note 6, at 318-19; Verity Winship, *Fair Funds and the SEC's Compensation of Injured Investors*, 60 FLA. L. REV. 1103, 1103-07 (2008).

16. *See, e.g.*, Black, *supra* note 6, at 335; William W. Bratton & Michael L. Wachter, *The Political Economy of Fraud on the Market*, 160 U. PA. L. REV. 69, 139 (2011); Roberta S. Karmel, *When Should Investor Reliance Be Presumed in Securities Class Actions?*, 63 BUS. LAW. 25, 52 (2007). For a much-cited statement of the circularity problem, see John C. Coffee, Jr., *Reforming the Securities Class Action: An Essay on Deterrence and Its Implementation*, 106 COLUM. L. REV. 1534, 1538 (2006).

17. *See, e.g.*, Black, *supra* note 6, at 342 ("[N]either the SEC nor the courts have addressed whether increased efforts to collect money on behalf of investors has any distorting effect on the agency's selection of enforcement cases."); Winship, *supra* note 15, at 1139-41 (arguing that agencies that seek recovery on behalf of victims should not duplicate private class action litigation). *But see* SEC, REPORT PURSUANT TO SECTION 308(C) OF THE SARBANES OXLEY ACT OF 2002, at 19-20 (2003) [hereinafter SEC 308(C) REPORT] (describing the need for private litigation to complement agency efforts at enforcement and compensation).

18. Black, *supra* note 6, at 335.

19. SEC v. Bear, Stearns & Co., 626 F. Supp. 2d 402, 403 (S.D.N.Y. 2009).

20. *See* David A. Skeel, Jr., *Welcome Back, SEC?*, 18 AM. BANKR. INST. L. REV. 573, 583-84 (2010).

21. *See, e.g.*, Black, *supra* note 6, at 331-35 (concluding, on the basis of four case studies, that the SEC lacks "any coherent policy" and underappreciates the consequences of the large penalties that fair fund distributions impose); Michael D. Sant'Ambrogio & Adam S. Zimmerman, *The Agency Class Action*, 112 COLUM. L. REV. 1992, 2013-14 (2012) (using the Global Research Analyst fair fund as an illustration of deep problems with SEC distributions); Winship, *supra* note 15, at 1127-28 (relying on three fair fund distributions to suggest the existence of a class-wide problem); Zimmerman, *supra* note 10, at 530, 547-48 (relying on case studies of fair funds in the WorldCom, AIG, and Fannie Mae scandals and the Global Research Analyst Settlement as the basis for policy proposals that would govern all fair fund distributions).

ten making defrauded investors whole, the study mostly disproves the conventional wisdom.[22] Specifically, the study refutes the widespread assumption that public and private enforcement of securities laws target and compensate investors for the same misconduct.[23] More often than not, the SEC compensates harmed investors for losses where a private lawsuit is either unavailable or impractical. Relatedly, the study finds that most fair fund distributions cannot be characterized as circular transfers of money from shareholders to themselves.[24] In contrast with private securities litigation, where such critiques may be justified,[25] the majority of fair funds compensate defrauded investors for what can best be described as customer fraud or anticompetitive behavior by financial intermediaries. For example, fair funds have compensated the victims of bid-rigging cartels,[26] undisclosed fees and false advertising,[27] collusive arrangements between investment funds and broker-dealers,[28] brokers' bribery to sell overpriced investments to municipalities,[29] embezzlement,[30] mutual fund mar-

22. *See infra* Part III.A.2. *But see Harmed Investors Got Tiny Fraction of SEC Fair Funds*, WALL ST. J. (Oct. 4, 2005, 12:01 AM ET), http://online.wsj.com/news/articles/SB112839198916759271.

23. *See, e.g.*, Bratton & Wachter, *supra* note 16, at 139-40 (arguing that fair fund distributions "mimic" class actions).

24. *See infra* Parts I.B, III.B.1.

25. *See* Jennifer H. Arlen & William J. Carney, *Vicarious Liability for Fraud on Securities Markets: Theory and Evidence*, 1992 U. ILL. L. REV. 691, 694-95; Coffee, *supra* note 16, at 1556-66; Merritt B. Fox, *Civil Liability and Mandatory Disclosure*, 109 COLUM. L. REV. 237, 280-81 (2009) (describing the circularity problem); Andrew Ross Sorkin, *As JPMorgan Settles Up, Shareholders Are Hit Anew*, N.Y. TIMES DEALBOOK (Sept. 23, 2013, 8:58 PM), http://dealbook.nytimes.com/2013/09/23/as-jpmorgan-settles-up-shareholders-are-hit-anew. *But see* Jill E. Fisch, *Confronting the Circularity Problem in Private Securities Litigation*, 2009 WIS. L. REV. 333, 335-36 (suggesting that compensation is necessary to reward traders); James J. Park, *Shareholder Compensation as Dividend*, 108 MICH. L. REV. 323, 323 (2009) (suggesting that damages for securities fraud are no more circular than dividends).

26. *See* Complaint for Violations of the Federal Securities Laws at 1-2, SEC v. Wachovia Bank, N.A., No. 2:11-cv-07135-WJM-MF (D.N.J. Dec. 8, 2011).

27. *See, e.g.*, Franklin Advisers, Inc., Exchange Act Release No. 50,841, Investment Company Act Release No. 26,692, 84 SEC Docket 1357, 1358 (Dec. 13, 2004) (finding that a mutual fund investment complex used $52 million of fund assets to compensate broker-dealers for marketing those funds).

28. *See, e.g.*, Edward D. Jones & Co., Securities Act Release No. 8520, Exchange Act Release No. 50,910, 84 SEC Docket 1798, 1799-800, 1804 (Dec. 22, 2004) (finding that a broker-dealer only promoted funds that paid kickbacks).

29. *See, e.g.*, J.P. Morgan Sec. Inc., Securities Act Release No. 9078, Exchange Act Release No. 60,928, 97 SEC Docket 139, 139, 144 (Nov. 4, 2009) (finding that managers paid $8.2 million in bribes to brokers working with Jefferson County public officials in exchange for contracts to underwrite $5 billion of bonds and interest rate swaps). Jefferson County, which is the most populous county in Alabama, filed for bankruptcy protection in 2011. *See* Kelly Nolan, *Largest Municipal Bankruptcy Filed*, WALL ST. J. (Nov. 10, 2011), http://online.wsj.com/news/articles/SB10001424052970204224604577028491526654090.

30. *See, e.g.*, Raymond James Fin. Servs., Inc., Initial Decision Release No. 296, 86 SEC Docket 604, 604-05, 633, 639 (ALJ Sept. 15, 2005) (finding that a broker-dealer and

ket timing[31] and late trading,[32] pump-and-dump and other market manipulation schemes,[33] and blatant self-dealing.[34] The prosecution of these violations forces violators to disgorge illicit gains obtained through misconduct, while the subsequent distribution of monetary sanctions to defrauded investors reverses the wrongful transfer of wealth. Moreover, the study reports that individual and secondary defendants contribute to fair funds far more often and in larger amounts than they pay to settle private securities litigation. Unlike in private litigation, targeted individuals generally cannot shift the SEC's sanction to the firm through indemnification and directors and officers (D&O) insurance. Forcing individual defendants to pay out of pocket increases the deterrent effect of the SEC's enforcement action (compared to private litigation) and eliminates the concern that their payment is a circular transfer from shareholder victims to themselves.[35]

This Article makes an important contribution to two different literatures: the literature on private and public enforcement of securities laws, and the burgeoning theoretical literature on large-scale compensation efforts by public agents, including federal prosecutors, administrative agencies, and state attorneys general.[36] The securities enforcement literature largely concludes that compensation for securities violations is circular and thus futile. This Article challenges that consensus by showing that compensation for abuses by financial intermediaries is both possible and desirable. Private litigation for this sort of misconduct is rarely successful, and the SEC is often the only possible source of investor compensation.[37] Because the SEC punishes individual wrongdoers, who largely avoid liability in private lawsuits, its enforcement de-

investment advisory firm failed to prevent its broker from embezzling $16.4 million, despite many red flags).

31. *See, e.g.*, Bear, Stearns & Co., Securities Act Release No. 8668, Exchange Act Release No. 53,490, Investment Company Act Release No. 27,262, 87 SEC Docket 1513, 1514, 1534 (Mar. 16, 2006).

32. *See, e.g.*, *id.* at 1517 (finding that Bear, Stearns touted its "late trading capabilities"). In contrast to market timing, late trading is clearly illegal. *See* 17 C.F.R. § 270.22c-1(a) (2014).

33. *See, e.g.*, Complaint at 2-3, SEC v. Frasier, No. '03 CV 1958 BTM JFS (S.D. Cal. Oct. 2, 2003).

34. Three fair funds were created in enforcement actions for "cherry picking"—allocating cheaply bought securities to the firm's own account and more expensive ones to customers' accounts. *See, e.g.*, Complaint for Injunctive & Other Relief at 2, SEC v. K.W. Brown & Co., 555 F. Supp. 2d 1275 (S.D. Fla. 2007) (No. 05-80367-CIV-MIDDLEBROOKS).

35. *See infra* Part III.B.

36. *See* David Freeman Engstrom, *Agencies as Litigation Gatekeepers*, 123 YALE L.J. 616 (2013); Margaret H. Lemos, *Aggregate Litigation Goes Public: Representative Suits by State Attorneys General*, 126 HARV. L. REV. 486 (2012); Lemos & Minzner, *supra* note 11; Sant'Ambrogio & Zimmerman, *supra* note 21; Adam S. Zimmerman & David M. Jaros, *The Criminal Class Action*, 159 U. PA. L. REV. 1385 (2011); Zimmerman, *supra* note 10.

37. *See infra* Part III.A.2.

ters misconduct more effectively. Finally, the SEC has learned from its own mistakes and improved its settlement and distribution practices.

The large and generally critical body of literature on public compensation that has grown over the last few years has used the SEC's compensation effort as one of its primary examples.[38] The main critiques set out in the literature are procedural: public agencies fail to consult victims before they settle enforcement actions,[39] judges are too deferential when they review public agencies' compensation plans,[40] and agencies fail to police potential conflicts of interest between public agents and private victims.[41] This Article provides evidence that more traditional compensation schemes, in particular private litigation, fail to compensate victims for large classes of harms. The Article concludes that public compensation, in large part, complements private litigation by kicking in where private lawsuits do not compensate. Fundamentally, the Article urges caution before implementing policy changes based on anecdotal evidence.

Part I provides the background on the SEC's compensation approach and concludes with a brief summary of limited prior research. Part II describes the data used in this study, explains the methodology for collecting and analyzing the information, and provides an overview of fair fund distributions, including details about the size of fair funds, the measures of the central tendency, the types of securities violations, the ebb and flow of distributions over time, and the processes used to distribute fair funds. Part III discusses in depth the most serious critiques levied against fair funds specifically and against compensation for securities fraud more generally: small recoveries relative to investors' losses, the circularity of compensation for securities fraud, and duplicative enforcement. Parts II and III refute many of the conventional assumptions about fair fund distributions. The Article concludes in Part IV by offering some reflections on what this study reveals specifically about fair fund distributions and more generally about securities enforcement and public compensation schemes. Besides the already-stated observations that the SEC's distributions are neither small nor, for the most part, circular or duplicative, the Article concludes that the SEC is responsive to critiques and flexible about changing its approach when possible. Looking beyond the fair funds, the Article exposes the limits of private causes of action for securities fraud as an investors' remedy and suggests that public compensation is a necessary supplement.

38. *See, e.g.*, Lemos & Minzner, *supra* note 11, at 854-55; Sant'Ambrogio & Zimmerman, *supra* note 21, at 2006, 2009-10, 2013-14, 2016; Zimmerman, *supra* note 10, at 507.

39. *See, e.g.*, Sant'Ambrogio & Zimmerman, *supra* note 21, at 2009-10; Zimmerman, *supra* note 10, at 507.

40. *See, e.g.*, Zimmerman, *supra* note 10, at 549-50.

41. *See, e.g.*, Lemos & Minzner, *supra* note 11, at 856.

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

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

A. *The Commission's Fair Fund Authority*

The SEC's primary goal is to protect investors and to safeguard the public interest by ensuring that capital markets are "fair, orderly, and efficient."[42] To further these goals, the SEC prosecutes violations of securities laws and sanctions violators using a variety of tools, including cease-and-desist orders, injunctions, bars to individuals serving as officers and directors of public companies, trading suspensions, and monetary sanctions—civil fines, disgorgements of ill-gotten gains, and compensation clawbacks.

The laws regulating the SEC's enforcement proceedings are complicated, perhaps unnecessarily so. The federal securities laws empower the SEC to adjudicate certain matters in administrative proceedings and to resolve others in judicial proceedings. Until very recently, the SEC's authority to impose civil fines in an administrative proceeding was limited to actions against broker-dealers, investment advisors, and clearing agencies.[43] To force other securities violators, in particular issuers and their officers and directors, to pay civil fines, the SEC had to sue in federal court.[44] The Dodd-Frank Act expanded the SEC's authority to impose civil fines in administrative proceedings against all persons, not just regulated industries, but the SEC has used its expanded authority somewhat sparingly.[45]

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42. SEC, STRATEGIC PLAN: FISCAL YEARS 2010-2015, at 1 (2010).

43. *See* 15 U.S.C. § 78u-2 (2013).

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

45. *See* Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 929P, 124 Stat. 1376, 1862-65 (2010) (codified at 15 U.S.C. § 77h-1(g)). Although the SEC has had the authority to fine issuers for accounting violations in administrative proceedings since 2010, it filed all such suits in federal court in 2013. *See* SEC, SELECT SEC AND MARKET DATA FISCAL 2013, at 4 tbl.3 (2014) [hereinafter SELECT SEC DATA 2013]. This may soon change. *See* Gretchen Morgenson, *At the S.E.C., a Question of Home-*

In addition to imposing civil fines, the SEC can order defendants to disgorge any "tangible profit causally connected" to the securities violation.[46] Until 1990, the SEC had no express authority to order securities violators to pay disgorgement. The SEC sometimes asked courts to exercise equitable powers and order "ancillary relief," including disgorgement, to bolster its enforcement efforts.[47] In 1971, in *SEC v. Texas Gulf Sulphur Co.*,[48] a federal appellate court recognized that the SEC had equitable power to "require[] corporate insiders who traded on material nonpublic information to disgorge their illegal trading profits."[49] The measure of the disgorgement remedy is the ill-gotten gain from the victims (similar to restitution[50]), but the SEC views disgorgement as an enforcement tool and not primarily as a means to compensate defrauded investors.[51]

For a long time the SEC did not believe that compensating investors was part of its mission and took the position "that it is not a collection agency for victims of securities fraud."[52] Private litigation was perceived as the appropriate mechanism to compensate defrauded investors.[53] That changed when the Securities Enforcement Remedies and Penny Stock Reform Act of 1990[54] expressly authorized the SEC to order disgorgement in administrative proceedings and distribute disgorgement funds to investors.[55] Such authorization did

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Court Edge, N.Y. TIMES (Oct. 5, 2013), http://www.nytimes.com/2013/10/06/business/at-the-sec-a-question-of-home-court-edge.html (quoting the SEC's enforcement director Andrew Ceresney as saying that the SEC "will be bringing more administrative proceedings").

46. *See* SEC 308(C) REPORT, *supra* note 17, at 33.

47. *See* George W. Dent, Jr., *Ancillary Relief in Federal Securities Law: A Study in Federal Remedies*, 67 MINN. L. REV. 865, 867 (1983); James R. Farrand, *Ancillary Remedies in SEC Civil Enforcement Suits*, 89 HARV. L. REV. 1779, 1779 (1976); James C. Treadway, Jr., *SEC Enforcement Techniques: Expanding and Exotic Forms of Ancillary Relief*, 32 WASH. & LEE L. REV. 637, 639 (1975).

48. 446 F.2d 1301 (2d Cir. 1971).

49. Black, *supra* note 6, at 320 (citing *Tex. Gulf Sulphur*, 446 F.2d at 1307-08).

50. Similar, but not coextensive. The SEC can hold one party liable in disgorgement for the improper profits of another. *See* SEC v. First Jersey Sec., Inc., 101 F.3d 1450, 1475 (2d Cir. 1996).

51. *See* SEC 308(C) REPORT, *supra* note 17, at 3 n.2 ("Restitution is intended to make investors whole, and disgorgement is meant to deprive the wrongdoer of their ill-gotten gain."); *see also* SEC v. Blavin, 760 F.2d 706, 713 (6th Cir. 1985) ("The purpose of disgorgement is to force 'a defendant to give up the amount by which he was unjustly enriched' rather than to compensate the victims of fraud." (quoting SEC v. Commonwealth Chem. Sec., Inc., 574 F.2d 90, 102 (2d Cir. 1978))).

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

53. *See* Zimmerman, *supra* note 10, at 527.

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

55. *Id.* §§ 202(a), 203, 104 Stat. at 937-40 (codified at 15 U.S.C. §§ 78u-2, 78u-3 (2013)). Drafters assumed that the SEC could obtain disgorgement in court proceedings. *See* Black, *supra* note 6, at 321 (citing S. REP. NO. 101-337, at 8 (1990)).

not extend to civil fines; the SEC continued to remit those to the U.S. Treasury as required by statute.[56]

Between 1990 and 2002, the SEC ordered disgorgement and distribution of disgorged funds in two types of cases: (1) cases in which individuals made identifiable profits from the fraud, most commonly from insider trading,[57] and (2) securities offering frauds and Ponzi schemes where the entity had no business purpose beyond the fraud.[58] In the latter cases, the SEC routinely sought emergency relief to shut down the scheme and appoint a receiver to recover any remaining funds for defrauded investors.[59]

The accounting scandals in 2001 and 2002 produced unprecedented investor losses.[60] In their wake, Congress enacted the Sarbanes-Oxley Act, which, among other things, expanded the SEC's power to compensate defrauded investors.[61] Section 308(a) of the Act authorizes the SEC to add civil fines paid in enforcement actions to disgorgement funds—called "fair funds"—and distribute them to the victims of securities violations.[62] This power to distribute civil fines to the victims is unique among federal agencies.[63]

While the fair funds provision considerably expanded the SEC's authority to compensate defrauded investors, there are obvious limits. Most importantly, the SEC can distribute civil fines paid by a defendant only when it also orders *that* defendant to pay disgorgement. To order disgorgement, the SEC has to show that the particular defendant profited from the securities violation.[64] When the defendant is ordered to pay only a civil fine but no disgorgement, the SEC has to remit the payment to the U.S. Treasury.[65] The Dodd-Frank Act re-

56. *See* 15 U.S.C. § 78u(d)(3)(C)(i).

57. *See* SEC 308(C) REPORT, *supra* note 17, at 6-8.

58. *See id.* at 9.

59. *See* Black, *supra* note 6, at 322.

60. WorldCom's accounting fraud wiped out almost $200 billion in investor equity. *See* SEC v. WorldCom, Inc., 273 F. Supp. 2d 431, 431 (S.D.N.Y. 2003).

61. *See* Black, *supra* note 6, at 327 (describing the significance of the change in the SEC's compensation authority by the Sarbanes-Oxley Act).

62. Section 308(a) of the Sarbanes-Oxley Act of 2002 provides,

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

Pub. L. No. 107-204, § 308(a), 116 Stat. 745, 784 (codified as amended at 15 U.S.C. § 7246 (2013)) (emphases added).

63. *See* Black, *supra* note 6, at 319 n.13. The fair funds provision is an exception to the general rule that all civil penalties must be paid to the U.S. Treasury. *See* 15 U.S.C. § 78u(d)(3)(C)(i).

64. SEC 308(C) REPORT, *supra* note 17, at 33.

65. The SEC tried to get around the restriction by adding one-dollar disgorgements to sizeable civil fines in order to create a fair fund, but it was criticized for doing so. *See* U.S.

moved this restriction. In section 929B, the Dodd-Frank Act authorizes the SEC to distribute civil penalties to victims of securities violations even in cases in which no disgorgement is ordered.[66]

The decision to distribute funds to investors is at the discretion of the SEC or, upon the SEC's motion, the court in cases in which the SEC pursues the defendant in a judicial proceeding.[67] The enforcement staff considers whether to propose the creation of a fair fund when it recommends that the SEC approve a negotiated settlement or initiate litigation.[68] The SEC's ultimate decision to distribute collected funds depends largely on two factors: whether there is an identifiable class of investor victims who suffered identifiable harm, and whether the amount of money likely to be collected from the defendant is large enough to justify a distribution given the number of potential victims.[69] The SEC has explained that compensating investors "is not always economically feasible,"[70] though it tries to "return funds to harmed investors" whenever possible.[71] Unlike institutions and agencies that are funded by the fees and sanctions they collect,[72] the SEC must by statutory default remit all payments it collects to the U.S. Treasury unless it distributes them to defrauded investors.[73]

GOV'T ACCOUNTABILITY OFFICE, GAO-05-670, SEC AND CFTC PENALTIES: CONTINUED PROGRESS MADE IN COLLECTION EFFORTS, BUT GREATER SEC MANAGEMENT ATTENTION IS NEEDED 28 (2005) (reporting that the SEC issued guidance to its staff in which it explained that one-dollar disgorgement "can qualify a case as a Fair Fund case and make [civil money penalties] eligible for distribution"); *see also* Black, *supra* note 6, at 330 (chiding the SEC for having "evaded" the Act's limitation by ordering one-dollar disgorgements in order to create a fair fund).

66. Section 929B of the Dodd-Frank Act provides,

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

Pub. L. No. 111-203, sec. 929B, § 308(a), 124 Stat. 1376, 1852 (2010) (codified as amended at 15 U.S.C. § 7246(a)).

67. *See id.*

68. The Office of Distributions also conducts a feasibility study to determine whether a distribution would be cost effective based on thirty different factors. Telephone Interview with Nichola Timmons, Assistant Dir., Office of Distributions, SEC (Dec. 24, 2013).

69. *Id.*

70. 308(C) REPORT, *supra* note 17, at 14.

71. SEC, 2005 PERFORMANCE AND ACCOUNTABILITY REPORT 7 (2005). The SEC's track record appears consistent with its statement. Between 2007 and 2012, the SEC secured $13.83 billion in civil fines and disgorgements but was able to collect only $7.3 billion, despite considerable efforts. *See* SEC, FY 2014 CONGRESSIONAL BUDGET JUSTIFICATION 32, 36 (2013) [hereinafter SEC 2014 BUDGET JUSTIFICATION] (reporting that in fiscal year 2012, the SEC either collected the debt or initiated collection efforts within six months of the due date for ninety-two percent of owed amounts). Of that amount, the SEC distributed more than $4.75 billion through fair funds.

72. The Federal Reserve is funded entirely by proceeds from its vast assets and the fees it charges banks for managing the payment system. *See* Peter Conti-Brown, *The Institu-*

After the SEC settles a case, it can distribute collected funds to investors. In rare cases the order imposing sanctions or the final consent judgment itself directs the defendant to pay disgorgement and civil fines to identified victims,[74] usually where the victims and their losses are known, where the risk that the defendant will file for bankruptcy is low, and where the defendant can be trusted to distribute the funds as ordered.[75] In other cases, the SEC creates and oversees a distribution fund. This includes developing a plan to administer and distribute the funds and overseeing the distribution.[76]

The SEC currently does not have the resources to administer distribution plans in-house, except for the simplest plans where notice and claims processes are unnecessary.[77] In most cases, the SEC's Office of Distributions hires a distribution consultant to develop the distribution plan and a fund administrator to publish notices, send information packets to eligible participants, process claims, prepare accountings, file tax returns, and make distributions from the fund to eligible defrauded investors.[78] During the early years of the program,

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tions of Federal Reserve Independence 21-23 (Rock Ctr. for Corporate Governance, Working Paper Series No. 139, 2013), *available at* http://ssrn.com/abstract=2275759. In addition, the Health Insurance Portability and Accountability Act of 1996 (HIPAA) allows the Department of Health and Human Services, the DOJ, and the FBI to use fines and forfeited assets recovered in cases involving federal health care offenses for further enforcement of health care fraud statutes. *See* 42 U.S.C. § 1395i(k) (2013).

73. *See* SEC 308(C) REPORT, *supra* note 17, at 22. The Dodd-Frank Act created the Investor Protection Fund to fund whistleblower awards. The SEC is authorized to place in the Fund civil fines and disgorgements that it does not distribute to defrauded investors under the fair fund provision, unless the balance in the Fund exceeds $300 million. *See* 15 U.S.C. § 78u-6(g) (2013). In 2011, the SEC deposited more than $450 million into the Investor Protection Fund. *See* SEC 2011 PAR, *supra* note 2, at 9.

74. *See infra* Part III.C.

75. Telephone Interview with Nichola Timmons, *supra* note 68. Nearly all enforcement actions settle without defendants' admission of guilt. A few judges have recently refused to approve such settlements, and it remains to be seen whether the SEC will be forced to try more cases against defendants reluctant to confess. *See* Jean Eaglesham & Chad Bray, *Citi Ruling Could Chill SEC, Street Legal Pacts*, WALL ST. J. (Nov. 29, 2011), http://online.wsj.com/articles/SB10001424052970203935604577066242448635560.

76. The plan must develop the methodology for identifying eligible participants, for approving their claims and handling disputed claims, for sending out checks and keeping track of whether checks have been cashed, and for receiving additional funds. In addition, the SEC must deposit the funds in an interest-bearing account and establish procedures for appointment of the plan administrator, who will oversee the fund, file tax returns, and provide accountings. *See* 17 C.F.R. § 201.1101 (2014).

77. Telephone Interview with Nichola Timmons, *supra* note 68.

78. *See* 17 C.F.R. § 201.1101(b)(6). The SEC's enforcement attorneys used to manage collections and distributions in cases that they prosecuted. As a result, distributions were scattered among eleven regional offices and somewhat haphazard. In 2007, the SEC created the Office of Collections and Distributions to administer distribution funds, yet as of March 2009, the SEC did not have a centralized database for monitoring the administration of distribution funds. *See* U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-09-358, SECURITIES AND EXCHANGE COMMISSION: GREATER ATTENTION NEEDED TO ENHANCE COMMUNICATION AND UTILIZATION OF RESOURCES IN THE DIVISION OF ENFORCEMENT 3-4 (2009). In July 2011, the

the SEC often hired distribution consultants to create customized distribution plans, even in cases with parallel securities class actions, leading a commentator to describe the fair funds provision as a "logistical and administrative nightmare."[79]

B. *Problems with Investor Compensation*

The primary purpose of securities litigation and the SEC's distributions is compensation, but many securities law academics believe that trying to compensate defrauded investors is a pointless exercise for two reasons. First, damages in securities cases are small compared to aggregate investor losses.[80] And second, damages paid in securities class actions are viewed as inefficiently circular payments from shareholder victims to themselves, minus nontrivial transaction costs. This is so because a large majority of securities fraud class actions allege that plaintiffs purchased stock at prices that were artificially inflated by public companies' fraudulent disclosures. The defendants that pay damages in class actions are not former shareholders who sold at inflated prices—they are allowed to keep their gain—but corporations that make false disclosures. Yet the corporation often does not benefit from the misrepresentation. At least some shareholders bear the cost of damages to compensate their own losses from the misrepresentation.[81]

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

79. Geoffrey Christopher Rapp, *Beyond Protection: Invigorating Incentives for Sarbanes-Oxley Corporate and Securities Fraud Whistleblowers*, 87 B.U. L. REV. 91, 147 (2007).

80. *See* Coffee, *supra* note 16, at 1545-46 (showing that securities cases "recover only a very small share of investor losses"); Fisch, *supra* note 25, at 337 n.16 (explaining that Supreme Court precedent limits the damages that investors can recover in private litigation). *But see* Elliott J. Weiss, *The Lead Plaintiff Provisions of the PSLRA After a Decade, or "Look What's Happened to My Baby,"* 61 VAND. L. REV. 543, 558-59 (2008) (reporting that in some well-known cases plaintiffs were compensated for close to fifty percent or more of their losses).

81. *See* Paul S. Atkins & Bradley J. Bondi, *Evaluating the Mission: A Critical Review of the History and Evolution of the SEC Enforcement Program*, 13 FORDHAM J. CORP. & FIN. L. 367, 398 n.171, 399 (2008) ("Fair Fund distribution thus creates a circular situation: the Commission penalizes a corporation to put the money into a fund to reimburse the shareholders who were themselves just indirectly penalized."). The extent to which securities litigation is circular can easily be overstated. Most firms manipulating their financial reports engage in acquisitions, borrow cheaply, and hire superior talent. Thus, shareholders in fraud firms indirectly benefit from the firms' misconduct, at least those that sell at inflated prices. To the extent securities class actions police value transfers from outsiders to the firm, they cannot be described as circular. *See generally* Urska Velikonja, *The Cost of Securities Fraud*, 54 WM. & MARY L. REV. 1887, 1892, 1908, 1910-11 (2013).

The fair fund provision has been criticized on both counts: small recoveries and circularity. The fair fund provision was adopted to augment the pool of funds available to compensate harmed investors.[82] However, sanctions that the SEC obtained in several high-profile accounting fraud cases were tiny compared to class action settlements in the same cases.[83] WorldCom paid a record-breaking $750 million civil fine to settle the SEC's enforcement action, yet the WorldCom class action settled for $6.15 billion; Lucent paid $25 million to the SEC but $517 million to settle the parallel securities class action.[84] Because securities class action damages "dwarf" the SEC's monetary sanctions,[85] commentators have wondered whether it ever makes sense for the SEC to spend its limited resources to compensate investors.[86]

In addition, before this study, a widespread agreement had emerged that the SEC's compensation efforts "mimic" private securities class actions.[87] Fair fund distributions have been described as circular, "every bit as much an exercise in pocket shifting as is payment of a [class action] settlement."[88]

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82. *See* Winship, *supra* note 15, at 1121-22.

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

84. Coffee, *supra* note 16, at 1543 tbl.3.

85. *Id.* at 1543.

86. *See* Black, *supra* note 6, at 345 (arguing that the SEC has "sacrifice[d] legal principles and consistency in its zeal to create large Fair Fund distributions"); Winship, *supra* note 15, at 1136 (reporting that the SEC brought fewer enforcement actions in 2007 because "the SEC has had to divert resources to the distribution function").

87. Bratton & Wachter, *supra* note 16, at 139; *see also* Black, *supra* note 6, at 335-36; Coffee, *supra* note 16, at 1534; Cynthia A. Glassman, Comm'r, SEC, SEC in Transition: What We've Done and What's Ahead (June 15, 2005), *available at* http://www.sec.gov/news/speech/spch061505cag.htm ("I cannot justify imposing penalties indirectly on shareholders whose investments have already lost value as a result of the fraud. Our use of so-called Fair Funds . . . leads to the anomalous result that we have shareholders paying corporate penalties that end up being returned to them through a Fair Fund—minus distribution expenses."). Not surprisingly, management groups also agree. COMM'N ON THE REGULATION OF U.S. CAPITAL MKTS. IN THE 21ST CENTURY, U.S. CHAMBER OF COMMERCE, REPORT AND RECOMMENDATIONS 89 (2007), *available at* http://www.uschamber.com/sites/default/files/reports/0703capmarkets_full.pdf (criticizing the fair funds because they "inappropriate[ly] burden . . . innocent shareholders" and proposing that the SEC offset damages paid in private litigation against the civil fines and disgorgements it imposes and distributes to victims).

88. Bratton & Wachter, *supra* note 16, at 139; *see also* Black, *supra* note 6, at 331. Black acknowledged that disgorgements from third parties, such as accountants and investment banks, are true ill-gotten gains that, if distributed to defrauded shareholders, do not merely shift money from one pocket to another. *See* Black, *supra* note 6, at 329.

C. *The Paucity of Prior Research*

Beyond a handful of critical offhand remarks, the SEC's compensation efforts have received remarkably little scholarly attention.[89] The only two empirical studies of the SEC's distributions to date have been limited studies conducted by federal agencies. Neither study supplies sufficiently detailed information about fair funds to inform the debate about the value of public compensation for securities fraud.

The first is a self-study of a sample of disgorgement funds created between 1997 and 2002 that the SEC conducted as instructed by section 308(c) of the Sarbanes-Oxley Act.[90] The study revealed that the SEC often failed to collect ordered disgorgements and civil fines.[91] The costs to create and administer distribution plans were high, so the SEC exercised its authority sparingly.[92] Between 1997 and 2002, the SEC distributed a little over $1 billion to defrauded investors from 34 disgorgement funds created in judicial actions.[93] Additionally, the SEC distributed or proposed to distribute funds to investors from 16 disgorgement funds created in administrative proceedings.[94] The study suggested that even before the Fair Funds provision was enacted, the SEC tried to compensate investors where possible, but collection obstacles often made such compensation difficult.[95]

The second empirical analysis is a limited study that the U.S. Government Accountability Office (GAO) conducted in 2010 to examine concerns about fair fund distribution delays.[96] Earlier GAO reports suggested that the SEC

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89. The two articles cited above in note 15 are the exception. The SEC's fair fund distributions are not an exception but rather the rule. There is very limited empirical scholarship on representative litigation by public enforcement agencies or public distribution funds. Despite the lack of empirical work, the volume of theoretical scholarship on public litigation and enforcement is now quite large. *See, e.g.*, Deborah R. Hensler, *Goldilocks and the Class Action*, 126 HARV. L. REV. F. 56, 57-58 (2012), http://www.harvardlawreview.org/issues/126/december12/forum_984.php (citing Lemos, *supra* note 36) ("Lemos's analysis is similarly heavy on theory and light on empirics—indeed, her article does not contain any empirical data about the nature and frequency of the litigation that concerns her.").

90. 15 U.S.C. § 7246(c) (2013) ("The Commission shall review and analyze . . . enforcement actions by the Commission over the five years preceding July 30, 2002, that have included proceedings to obtain civil penalties or disgorgements to identify areas where such proceedings may be utilized to efficiently, effectively, and fairly provide restitution for injured investors . . . .").

91. *See* SEC 308(C) REPORT, *supra* note 17, at 1, 6-8.

92. *See id.* at 1.

93. *Id.* at 10.

94. *Id.* at 15-16.

95. *See id.* at 20-21.

96. U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-10-448R, SECURITIES AND EXCHANGE COMMISSION: INFORMATION ON FAIR FUND COLLECTIONS AND DISTRIBUTIONS 3, 22 (2010). The GAO study is the only source of information about fair funds cited in a review of the first ten years of fair funds published in early 2013 by the National Economic Research As-

processed fair fund distributions very slowly, often taking years to return collected funds to harmed investors.[97] The 2010 GAO study reviewed fair funds created between 2001 and 2010. It reported that the SEC initially eagerly used its fair fund authority, but scaled back its efforts after May 2007.[98] The GAO study also included some general information on the number of fair funds created; total amounts ordered, collected, and distributed; and a comparison with 2007 data.[99] It noted that distribution delays remained common but that the SEC had picked up the pace since 2007.[100] Through February 2010, the SEC had ordered $9.5 billion for distribution through fair funds and had distributed $6.9 billion.[101] Beyond that, the study did not provide information about the cases in which fair fund distributions were ordered.

The goal of this study is to examine the population of fair funds to shed light on whether and to what extent the critiques of fair fund distributions are justified. The following Part presents the sources of the data, the methodology used to evaluate the data, and an overview of fair funds.

II. DATA, METHODOLOGY, AND OVERVIEW

A. *Data and Methodology*

The dataset comprises all fair funds created between July 25, 2002, when the Sarbanes-Oxley Act authorized the distribution of civil fines to harmed investors, and December 31, 2013, for a total of 243 funds.[102] The information

sociates (NERA), suggesting that it is the only such study to date. *See* JORGE BAEZ ET AL., NAT'L ECON. RESEARCH ASSOCS., SEC SETTLEMENT TRENDS: 2H12 UPDATE 17-18 (2013).

97. *See* U.S. GOV'T ACCOUNTABILITY OFFICE, *supra* note 65, at 29-30 (reporting that the SEC had collected almost $4.8 billion between 2002 and April 2005 but distributed only $60 million to defrauded investors); *see also* U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-07-830, SECURITIES AND EXCHANGE COMMISSION: ADDITIONAL ACTIONS NEEDED TO ENSURE PLANNED IMPROVEMENTS ADDRESS LIMITATIONS IN ENFORCEMENT DIVISION OPERATIONS 5 (2007) (reporting that the SEC ordered collection of $8.4 billion between 2002 and June 2007 and distributed to investors about twenty-one percent, or $1.8 billion).

98. U.S. GOV'T ACCOUNTABILITY OFFICE, *supra* note 96, at 14-15. The study reported that after 2006, the SEC reduced monetary sanctions against defendants and determined that fair funds were "not appropriate for certain types of cases." *Id.* at 15.

99. *Id.* at 12-19.

100. *See id.* at 13, 15-16. *But see* Bruce Carton, *Mississippi Faults SEC for Delays in $100 Million Morgan Keegan Settlement Distribution*, COMPLIANCE WK. (Aug. 14, 2013), http://www.complianceweek.com/mississippi-faults-sec-for-delays-in-100-million-morgan-keegan-settlement-distribution/article/307428 (reporting that the State of Mississippi filed an amicus brief in a lawsuit that Mississippi victims filed against the SEC for delays in administering the $100 million Morgan Keegan fair fund).

101. U.S. GOV'T ACCOUNTABILITY OFFICE, *supra* note 96, at 13.

102. The SEC often files multiple enforcement actions against corporate and individual defendants on the basis of the same set of facts. Where fines and disgorgements from multiple actions were paid into a single distribution fund, it was counted as one fair fund. Data collection for this Article ended on August 25, 2014.

was drawn from and verified using a variety of sources. The SEC has made information about many distribution funds available on its website.[103] I supplemented the lists with research in LexisNexis, Westlaw, and the SEC's Litigation Releases database for SEC-overseen funds, and in Bloomberg Law and the Public Access to Court Electronic Records (PACER) databases for court-overseen funds.[104] To ensure that the study did not miss any fair fund distributions, I also verified the data for completeness using research reports issued by the National Economic Research Associates (NERA), Cornerstone Research, and the Stanford Securities Class Action Clearinghouse as well as corporate annual reports.

For each fair fund, I reviewed the order imposing sanctions, the order to create a fair fund, the proposed and approved distribution plans, distribution agent status reports, and, where available, orders disbursing funds and terminating the fair fund. The study also collected information about the type of securities violation involved using the SEC's own classification, published in the *Select SEC and Market Data* reports for the relevant period;[105] the size of the fund; amounts paid in civil penalties and disgorgements; amounts paid by individuals and third-party defendants, such as audit firms and investment banks, and whether those amounts were added to the fair fund; whether the firm filed for bankruptcy within two years of the enforcement action (using PACER and news searches); detailed information about parallel securities class actions using the Stanford Securities Class Action Clearinghouse and PACER; and whether the fair fund was distributed pursuant to a separate plan or added to the class action settlement.

The goal of the study is to examine the SEC's use of its newly expanded authority to distribute civil fines collected from securities violators to harmed investors through fair funds. Thus, the dataset does not include disgorgement funds where no civil fine was assessed or collected or where the SEC remitted the civil fine to the U.S. Treasury.[106] This screen required careful sorting be-

103. *See Distributions in Commission Administrative Proceedings: Notices and Orders Pertaining to Disgorgement and Fair Funds*, U.S. SEC. & EXCHANGE COMMISSION, http://www.sec.gov/litigation/fairfundlist.htm (last modified Nov. 5, 2014); *Information for Harmed Investors*, U.S. SEC. & EXCHANGE COMMISSION, http://www.sec.gov/divisions/enforce/claims.htm (last modified Oct. 17, 2013).

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

105. *See About the SEC*, U.S. SEC. & EXCHANGE COMMISSION, http://www.sec.gov/about.shtml (last modified Nov. 12, 2014) (listing reports from 2004 until 2013).

106. This screen excluded virtually all receivership cases, where investors ordinarily recoup cents on the dollar. The SEC always pursues individuals associated with the scheme in a parallel proceeding, securing disgorgement as well as civil fines and requesting that the receiver distribute the funds pursuant to its fair fund authority. Despite the order to distribute the civil fine, that fine is virtually never collected. I reviewed receivership cases, and the dataset includes one such case in which a civil money penalty was collected and distributed. *See* Declaration of Pamela Chattoo at 1-2, SEC v. Credit First Fund, LP, No. CV 05-8741

cause the SEC and courts sometimes use the term "fair fund" as a synonym for a distribution fund or to refer to a fund from which only disgorgement is distributed.[107] For the same reason, the study also excludes enforcement actions where the defendant "voluntarily" set up a distribution plan and the SEC only censured the defendant, without ordering monetary sanctions.[108] The dataset also does not include fair funds that were created but were closed without a distribution, because either a distribution proved to be infeasible[109] or the SEC abandoned its plan to create a fair fund because restitution was ordered in a parallel proceeding.[110] Parallel proceedings include criminal actions, receiverships, and bankruptcies. Parallel proceedings generally are not accompanied by private litigation and only distribute restitution and recovered illicit profits, not civil fines. For that reason, they do not face the same criticism as fair funds. As a result of this screen, the study does not include some well-known victim compensation funds established in parallel proceedings, including securities class actions and criminal actions. For example, Adelphia and the Rigas family

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DSF(PJWx) (C.D. Cal. July 22, 2009) (reporting that the individual defendant paid $32,000 of the $120,000 civil penalty ordered).

107. *See, e.g.*, Motion for Order Approving Proposed Distribution Plan & Proposed Distribution Plan at 1-3, SEC v. Poirier, No. CV 96-2243-PHX-JAT (D. Ariz. Oct. 23, 2013). There, the court ordered defendant to disgorge over $2 million and pay a $100,000 civil penalty, and subsequently agreed to accept $850,000; since disgorgement was not paid in full, no civil fine could be paid, and the fund cannot be described as a "fair fund." The 2003 self-study lists eight enforcement actions in which the SEC filed motions to apply the fair fund provision, but only three of those resulted in a fair fund distribution. Of the remaining five, three were Ponzi schemes where civil fines were ordered but not collected, one was a market manipulation case where the fine and disgorgement were ultimately paid to the U.S. Treasury in 2008 (Lybrand), and one distributed only the disgorgement and ordered the defendant to pay the civil fine to the U.S. Treasury. *See* SEC 308(C) REPORT, *supra* note 17, at 22.

108. In addition, because the SEC does not issue an order creating the distribution fund in these circumstances, it is much more likely that a study would miss many such funds, undermining the validity of its conclusions. *See, e.g.*, Consent of Defendant State Street Bank & Trust Co. at 2, SEC v. State St. Bank & Trust Co., No. 1:10-cv-10172-DPW (D. Mass. Feb. 4, 2010) (giving defendant credit for reimbursing investors and ordering additional compensation); *see also* Claymore Advisors, LLC, Investment Company Act Release No. 30,308, 105 SEC Docket 1037 (Dec. 19, 2012) (reporting that the defendant had established a distribution plan to distribute $45,396,878 and noting that the fund is "not a Commission-ordered distribution plan").

109. *See, e.g.*, Order Directing Payment to the Treasury, SEC v. Lybrand, No. 1:00-cv-01387-SHS-HBP (S.D.N.Y. Nov. 7, 2008); *see also* SEC v. Lybrand, Litigation Release No. 16,448, 71 SEC Docket 1784 (Feb. 24, 2000).

110. *See, e.g.*, Final Judgment as to Defendant David J. Hernandez at 4, SEC v. Hernandez, No. 09-cv-3587 (N.D. Ill. Jan. 26, 2012) (refusing to order disgorgement or a civil penalty in light of the criminal case in which defendant was ordered to pay restitution and was sentenced to jail); Unopposed Motion to Dismiss Monetary Claims Against Defendants C. Keith LaMonda & Jesse W. LaMonda, Jr. at 2, SEC v. ABC Viaticals, Inc., No. 3-06CV2136-P (N.D. Tex. Aug. 31, 2009) (moving to dismiss fines and disgorgement because of restitution ordered and prison sentences imposed in a parallel criminal proceeding); *see also* SEC v. Huber, Litigation Release No. 21,777, 99 SEC Docket 4178 (Dec. 13, 2010).

signed a nonprosecution agreement with the DOJ, settling the criminal case against the firm and the officers. The Rigas family turned over $1.5 billion in assets to the firm, and the firm agreed to pay $715 million to compensate defrauded investors.[111] The SEC participated in the settlement and, in light of the payment in the criminal proceeding, agreed not to seek disgorgement or civil penalties against the Rigas family members or Adelphia.[112]

Finally, the dataset does not include clawback actions for bonuses paid to top executives under section 304 of the Sarbanes-Oxley Act and section 954 of the Dodd-Frank Act.[113] These actions are similar to disgorgements because executives must reimburse the company for any performance-based compensation they received based on financial results that were later restated, but these clawback actions do not require executive wrongdoing.[114]

B. *General Characteristics of Fair Funds*

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

1. *When are fair funds created and what do they look like?*

Between 2002 and 2013, the SEC ordered $14.46 billion distributed through 243 fair funds, of which 143 were created in judicial proceedings and

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111. *See* Press Release, SEC, SEC and U.S. Attorney Settle Massive Financial Fraud Case Against Adelphia and Rigas Family for $715 Million (Apr. 25, 2005), http://www.sec.gov/news/press/2005-63.htm.

112. *See* Declaration of Alistaire Bambach in Support of Motion for Order Authorizing Distribution of Funds Held in Court Registry to Victims of Adelphia Fraud in Accordance with Procedures Adopted by U.S. Department of Justice with Respect to Adelphia Victim Fund at 2-3, SEC v. Adelphia Commc'ns Corp., No. 02 Civ. 5776 (PKC) (S.D.N.Y. Oct. 30, 2008); *see also* Order Dismissing Plaintiff's Claims for Disgorgement, Prejudgment Interest, & a Civil Penalty, SEC v. Shapiro, No. 10-21281-CIV-ALTONAGA/BROWN (S.D. Fla. Nov. 10, 2011) (dismissing claims for disgorgement, prejudgment interest, and civil penalty based on defendant's criminal sentence and restitution order); Final Consent Judgment of Permanent Injunction & Other Relief as to Defendant Computer Associates International, Inc. at 1-2, SEC v. Computer Assocs. Int'l, Inc., No. 04 Civ. 4088 (ILG) (E.D.N.Y. Oct. 1, 2004) (settling the enforcement action for accounting fraud against Computer Associates International, Inc. without disgorgement or civil fines, acknowledging that the firm agreed to pay $225 million in restitution pursuant to a deferred prosecution agreement entered with the U.S. Attorney's Office for the Eastern District of New York).

113. For a review of recent clawback actions, see Lawrence J. Trautman & Kara Altenbaumer-Price, *D & O Insurance: A Primer*, 1 AM. U. BUS. L. REV. 337, 360-63 (2012).

114. *See* 15 U.S.C. § 78j-4 (2013).

100 in administrative proceedings.[115] All but 3 fair funds include both civil money penalties and disgorgements.[116] Of the aggregate amount, $6.19 billion of the funds were disgorgements and (some) prejudgment interest, and $8.28 billion were civil fines. Without section 308(a), civil fines could not be distributed to investors and would be remitted to the U.S. Treasury's general fund.[117]

Whether the SEC moves to distribute monetary sanctions collected in an enforcement action depends on a variety of factors. Cost effectiveness is the most serious limitation: the SEC does not distribute funds when the amount in the fund is small relative to the number of victims.[118] The mean amount deposited in a fair fund was $59.53 million, while the median fund was smaller at $16.48 million. By comparison, during the fiscal year 2011, the mean SEC enforcement action settled for $4.30 million, and the median settlement was $332,163.[119]

The largest fair fund, created in the AIG accounting fraud case, included $816.5 million, while the smallest fair fund was $24,959 for insider trading.[120] The ten largest fair funds distributed, or are in the process of distributing, $5.35 billion, or 37.0% of the total amount.[121]

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115. The figures are based on this study of all distribution funds created between 2002 and 2013.

116. The exceptions are fair funds created in the SEC's enforcement actions against J.P. Morgan, BP p.l.c., and Satyam that were brought between 2011 and 2013, after the Dodd-Frank Act authorized distributions of fines unaccompanied by disgorgement orders. *See* JPMorgan Chase & Co., Exchange Act Release No. 70,458, 2013 WL 5275772, at *19 (Sept. 19, 2013); Final Judgment as to Defendant BP p.l.c. at 2-3, SEC v. BP p.l.c., No. 2:12-cv-2774 (E.D. La. Dec. 10, 2012); Final Judgment Against Defendant Satyam Computer Services Ltd. at 4, SEC v. Satyam Computer Servs. Ltd., No. 11 0672 (D.D.C. Apr. 6, 2011).

117. *See* 15 U.S.C. §§ 78u-1(d)(1), 7246(a).

118. *See* Motion to Pay Funds in Registry to Treasury at 2, SEC v. Bakal, No. 1:03-CV-2909-CC (N.D. Ga. Jan. 29, 2008) (stating that distribution would not be "practicable" given "the small amount of funds available" and "the costs of setting up a claims process").

119. *See* ELAINE BUCKBERG ET AL., NAT'L ECON. RESEARCH ASSOCS., SEC SETTLEMENT TRENDS: 2H11 UPDATE 25 (2012). Average settlements with individual defendants are smaller than settlements with entity defendants—$2.90 million versus $7.35 million. *See id.* Median settlements are considerably smaller, at $175,000 for individuals and $1.47 million for entities. *See id.* The difference between the settlements and fair fund cases is statistically significant at the 1% confidence level.

120. In nominal dollars.

121. They include AIG, WorldCom, BP, Enron, Invesco Funds, Banc of America Capital Management, Fannie Mae, State Street, Time Warner, and J.P. Morgan. The distribution is less left-skewed now than it was in 1997-2002, when only disgorgements could be distributed. *See* Cox et al., *supra* note 83, at 755 ("Specifically, of the 35 financial fraud actions in the SEC study, two separate actions account for over 70 percent of the disgorgement funds ordered.").

TABLE 1
Summary of the SEC's Fair Fund Distributions (2002-2013)

	SEC-Overseen Funds	Court-Overseen Funds	Overall
Number of Plans	100	143	243
Total Amount (in $M)	5,544.7	8,920.0	14,464.7
Disgorgements (in $M)	3,225.2	2,962.8	6,188.0
Civil Fines (in $M)	2,319.5	5,957.2	8,276.7
Mean Plan (in $M)	55.4	62. 4	59.5
Median Plan (in $M)	19.6	10.6	16.5
Maximum (in $M)*	375.34	816.50	816.50
Minimum (in $)*	109,330	24,959	24,959
Most Common Category	Investment Advisor (54 of 99)	Issuer Reporting (67 of 143)	Issuer Reporting (71 of 242)

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

SEC-overseen fair funds ordered a total of $5.54 billion distributed to defrauded investors, while court-overseen funds ordered $8.92 billion to be distributed.[122] As explained above, until 2010 the SEC could only impose civil fines in administrative proceedings against market professionals. Not surprisingly, of 99 SEC-administered fair funds with available information, 54 are associated with investment advisor violations and 33 with broker-dealer violations. During most of the study, judicial enforcement actions were the default statutory category and thus more diverse, so court-overseen fair funds also tend to be more diverse. Nonetheless, a plurality of court-overseen fair funds, 67 of 143, are associated with issuer disclosure and reporting violations (i.e., accounting fraud).

122. The information reported in this section derives from the data collected in this study.

Despite the somewhat greater diversity of court-overseen funds by type of securities violation and size, the mean sizes of SEC- and court-overseen fair funds are similar, about $60 million.[123] The median SEC-overseen fund is $19.6 million, compared with the median for court-overseen funds of $10.6 million. The size of court-overseen cases is more variable than the size of SEC-overseen cases, but the difference in the variability itself between the two subsamples is not statistically significant.[124]

There are other differences between the two subsamples that are statistically significant. Of the amounts deposited in SEC-overseen fair funds, 58.2% came from disgorgements, while only 33.2% of the aggregate amount distributed in court-overseen fair funds came from disgorgements. Conversely, civil fines ordered in court-overseen cases are considerably larger than in the SEC-overseen cases, representing 66.8% of the total compared with 41.8% for SEC-overseen cases.[125] Civil fines are relatively greater in cases in which the fined firm did not directly benefit from the securities violation. The largest such category of cases is for accounting fraud, categorized here as issuer reporting and disclosure cases. Because issuers often do not directly profit significantly from fraudulent disclosure, the total disgorgements ordered in issuer reporting and disclosure violations, and thus court cases overall, are correspondingly smaller. By contrast, the SEC employs administrative proceedings to prosecute securities violations in which broker-dealers and investment advisory firms obtained ill-gotten profits by defrauding their customers. In these cases, the SEC often orders defendant firms to pay a civil fine equal to the amount of disgorgement.

Unlike private securities litigation, which predominantly targets fraudulent disclosure by public companies,[126] the SEC targets a wide variety of securities violations, including fraudulent disclosure in primary and secondary markets, the sale of unregistered securities, Ponzi and related schemes, insider trading, market manipulation, investment company and investment advisory improprieties, broker-dealer violations, foreign bribery, and corruption.[127] The cases in which a fair fund distribution is ordered are similarly varied.

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

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

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

126. From 2006 to 2010, more than 60% of class action settlements and more than 90% of all damages paid in class actions were for accounting fraud. *See* CORNERSTONE RESEARCH, ACCOUNTING CLASS ACTION FILINGS AND SETTLEMENTS: 2011 REVIEW AND ANALYSIS 1, 11-12 (2012).

127. *See, e.g.*, SELECT SEC DATA 2013, *supra* note 45, at 3 tbl.2 (listing enforcement actions by type of securities violation).

TABLE 2
Fair Funds by Type of Securities Violation

SEC Classification*	Number of Funds (n=239)	Total Amount in Funds (in $M)	Median Fund (in $M)	Mean Fund (in $M)	Percent of Fair Funds (by number)	Percent of Fair Funds (by amount)	Percent of Enforcement Actions[128]
Broker Dealer	51	2,260.7	19.1	44. 3	21.1	15.6	17.2
Insider Trading	15	100.9	2.6	6.7	6.2	0.7	8.5
Investment Advisor/Company	65	3,869.4	17.9	59.5	26.9	26.8	16.6
Issuer Reporting and Disclosure	71	6,339.1	23.6	89.3	29.3	43.8	25.8
Market Manipulation	9	25.7	1.4	2.9	3.7	0.2	6.5
Securities Offering	21	1,451.4	4.9	69.1	8.7	10.0	16.8
Municipal	7	240.2	34.3	31.5	2.9	1.7	n/a

* Classification for 1 fair fund is not yet available. The Table does not include 4 miscellaneous fair fund distributions that do not fit in any of the above categories.

128. The percentage is calculated using the annual percentage of cases averaged over the ten-year period, excluding delinquent-filing enforcement actions and FCPA cases. Enforcement actions in the former category result in censure or delisting and impose only very modest monetary sanctions. *See* BUCKBERG ET AL., *supra* note 119, at 25.

Enforcement actions for some categories of securities violations generally result in smaller monetary sanctions, either because defendants are individuals, who pay smaller fines than firms, or because defendants are more likely to be bankrupt.[129] The size of the settlement fund is an important determinant of whether a distribution is possible, so one would expect some types of cases to be underrepresented among fair fund distributions relative to the number of enforcement actions and others to be overrepresented.

Market manipulation and insider trading enforcement actions tend to target individuals and yield smaller fines and disgorgements. Median fair funds in these cases were $1.4 million ($2.9 million mean) and $2.6 million ($6.7 million mean), respectively, compared with the overall median of $16.5 million ($59.5 million mean). As a result, there are relatively fewer fair fund distributions related to market manipulation than there are enforcement actions. By contrast, enforcement actions against investment advisors and against issuers for reporting and disclosure violations (i.e., accounting fraud) often result in large monetary settlements and are overrepresented in the study relative to the number of enforcement actions. Accounting fraud cases represent 25.8% of the SEC's enforcement actions during the study period but 29.3% of all fair fund distributions; investment advisor violations represent 16.6% of enforcement actions but 26.9% of all fair fund distributions.[130] Securities offering cases are underrepresented in the population of fair funds—16.8% of enforcement actions and 8.7% of fair funds—because many, if not most, such cases involve sales of unregistered securities. In these cases the SEC seeks to freeze the defendants' funds and appoint a receiver. Any recovered funds and disgorgements are then distributed by the receiver, not the SEC, and are excluded from the fair funds census. Finally, the SEC has declined to distribute fair fund assets to noninvestor victims.[131] As a result, although the SEC has collected large fines in Foreign Corrupt Practices Act (FCPA) enforcement actions, it has remitted those funds to the U.S. Treasury.[132]

The survey of all fair funds thus refutes the critique that the SEC compensates harmed investors for the same type of misconduct as securities litiga-

129. *See* 15 U.S.C. § 78u-2(d) (2013) (authorizing the SEC to consider defendant's ability to pay in setting penalties); BUCKBERG ET AL., *supra* note 119, at 25 (showing different mean and median settlements by category of securities violation).

130. The total tally of enforcement actions excludes FCPA and delinquent-filings cases, as this research shows the SEC does not create fair funds in such cases.

131. *See* Petition for Relief Pursuant to 18 U.S.C. § 3771(d)(3) & Objection to Plea Agreements & Deferred Prosecution Agreement at 11, United States v. Alcatel-Lucent Fr., S.A., No. CR-20906 (S.D. Fla. May 2, 2011) (explaining that the SEC refused to create a fair fund in a government agency bribery case).

132. *See* Foreign Corrupt Practices Act of 1977, Pub. L. No. 95-213, 91 Stat. 1494 (codified as amended in scattered sections of 15 U.S.C.); Total, S.A., Securities Act Release No. 69,654, 2013 WL 2326682, at *11 (May 29, 2013) (directing the respondent to "pay disgorgement of $153 million to the United States Treasury").

tion.[133] Issuer accounting fraud cases are an important category of cases in which fair funds are distributed, but they are a minority of fair fund distributions: 29.3% by number and 43.8% by amount. By contrast, 60% of class action settlements and 90% of settlement dollars are in accounting fraud cases.[134]

2. *Fair fund distribution patterns have varied over time*

The SEC's distribution activity has varied over time, tracking market developments and enforcement actions that were brought during the preceding years. Mutual fund market-timing scandals erupted in 2003, and the SEC pursued and quickly settled more than two dozen enforcement actions with investment advisors and broker-dealers. As a result, almost half of all funds created[135] in 2004, 14 out of 31, were associated with mutual fund market timing and late trading, a trend that continued into 2005. Although the major accounting scandals broke in 2001 and 2002, accounting fraud cases take longer to investigate and ultimately settle.[136] Nine of 25 funds created in 2006 and 7 of 18 created in 2007 were associated with accounting frauds. Market-timing and accounting fraud enforcement actions resulted in large settlements, so the aggregate amount for funds created in those years is correspondingly large. In 2012 and 2013, the SEC settled a number of large financial crisis cases, which are reflected in the number and the amounts deposited into associated fair funds.

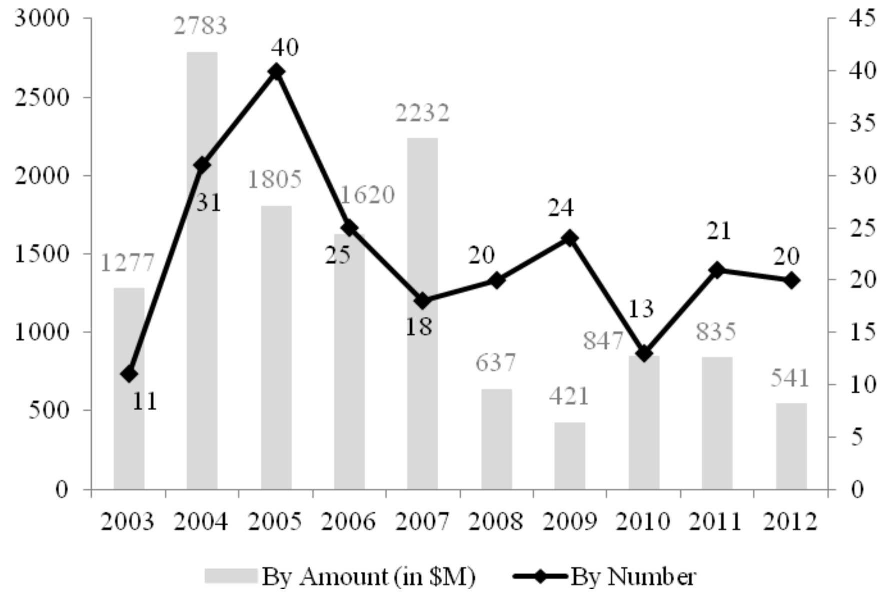
133. *See, e.g.*, Bratton & Wachter, *supra* note 16, at 139-40 (asserting that fair fund distributions "mimic" class action settlements).

134. *See* CORNERSTONE RESEARCH, *supra* note 127, at 11-12.

135. A fair fund is "created" when the SEC makes a definitive determination that the collected sanctions will be distributed to defrauded investors. That decision is usually made after the enforcement action is settled.

136. There are additional explanations for longer delays. First, an overwhelming majority of accounting fraud enforcement actions included individual defendants. Individuals whose reputations and livelihoods are on the line fight the SEC's investigations harder, so one would expect a longer lag. Second, even where the SEC settled early, it sometimes waited for the class action to survive the motion to dismiss before it set up a fair fund and directed the monies to the class action account. *See, e.g.*, Order Approving a Fair Fund Distribution to Investors & Appointing a Fund Administrator at 1, 3, SEC v. Take-Two Interactive Software, Inc., No. 1:05-CV-05443 (DLC) (S.D.N.Y. Mar. 21, 2011) (creating a fair fund in 2011 for a case that settled in 2005, and including distribution of funds from the class action, which settled in late 2010).

FIGURE 1*
Fair Fund Distributions (2003-2012)



* Fair funds are tallied by calendar year, not by the SEC's fiscal year (October 1-September 30).

The 2010 GAO study suggested that the number of fair funds and the amounts distributed through fair funds declined after 2007 because the SEC decided "that Fair Funds are not appropriate for certain types of cases."[137] One could read the chart reproduced above as providing support for the GAO's proposition. But a closer look at the enforcement actions and the fair funds data suggests that the SEC did not change its criteria for establishing a fair fund during the study period.[138] What changed was the SEC's enforcement activity.

Much of the decline is attributable to a change in the type and the number of enforcement actions brought since 2007 and the ability of the SEC to collect monetary sanctions.[139] Between 2003 and 2006, the SEC ordered defendants to

137. U.S. GOV'T ACCOUNTABILITY OFFICE, *supra* note 96, at 15.

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

139. According to the *Select SEC and Market Data* reports, civil fines imposed between 2007 and 2009 were much smaller than civil fines imposed before that period. *Compare* SEC, SELECT SEC AND MARKET DATA FISCAL 2009, at 2 tbl.1 (2010), *and* SEC, SELECT SEC AND MARKET DATA FISCAL 2008, at 2 tbl.1 (2009), *with* SEC, SELECT SEC AND MARKET DATA FISCAL 2007, at 2 tbl.1 (2008), SEC, SELECT SEC AND MARKET DATA FISCAL 2006, at 2 tbl.1 (2007), *and* SEC, SELECT SEC AND MARKET DATA FISCAL 2005, at 2 tbl.1 (2006).

pay more than $3 billion per year in monetary sanctions;[140] aggregate sanctions imposed in 2007 and 2008 were considerably smaller, at $1.60 billion and $1.03 billion, respectively.[141] Moreover, the SEC's collection amounts have varied during the period, ranging from a low of $521 million in 2008 to a high of $2.3 billion in 2005.[142] The SEC cannot distribute funds that it has not collected, and so defendants' inability to pay reduces the amounts available for investor compensation.

Ponzi schemes constitute a common class of securities violations with low collection rates because the perpetrators dissipate the assets before the scheme is unmasked. After the Bernard Madoff Ponzi scheme in 2009, the SEC increased its efforts to detect similar violations at the expense of more vigorous prosecution of issuers for fraudulent disclosure and investment advisors.[143] In addition, funds recovered in Ponzi schemes are typically distributed through receiverships, not fair funds, and are thus outside the scope of this study. Finally, in some recent cases, the SEC has allowed defendants to compensate investors in lieu of the SEC ordering them to pay disgorgement.[144] Investors received compensation as a result of the SEC's enforcement, but not through a fair fund. Overall, it appears that fair fund distributions track enforcement activity, but the SEC's enforcement activity declined and changed between 2007 and 2012.[145]

Whatever the reason for the decline, the tide may have turned. During the first five months of 2014, the SEC created fair funds to distribute $1.14 billion, with several other large cases in the pipeline.

Moreover, the SEC's collections during those fiscal years were relatively low: $979 million in 2007, $521 million in 2008, and $1.694 billion in 2009. *See* SEC, IN BRIEF: FY 2013 CONGRESSIONAL JUSTIFICATION 30 (2012).

140. $3.3 billion in 2003 is $4.2 billion in 2013 dollars. This calculation was performed using the Bureau of Labor Statistics calculator. *CPI Inflation Calculator*, BUREAU LAB. STAT., http://www.bls.gov/data/inflation_calculator.htm (last visited Jan. 28, 2015).

141. Aggregate monetary sanctions were collected from the *Select SEC and Market Data* reports for the years 2004-2013. *See About the SEC*, *supra* note 105.

142. *See* SEC 2014 BUDGET JUSTIFICATION, *supra* note 71, at 36; SEC, SEC PERFORMANCE BUDGET FOR 2007, at GPRA-20 (2006). All figures are reported in nominal dollars. Real-dollar differences are even larger.

143. The SEC has also targeted more individuals, whose settlements are on average considerably smaller, and has more than doubled enforcement actions against Ponzi schemes to ninety-two per year (almost thirteen percent of all enforcement actions brought in 2012). *See* BAEZ ET AL., *supra* note 96, at 5, 11.

144. *See, e.g.*, Claymore Advisors, LLC, Investment Company Act Release No. 30,308, 105 SEC Docket 1037 (Dec. 19, 2012) (reporting that the defendant had established a distribution plan administered by a third party for $45,396,878).

145. *See* BAEZ ET AL., *supra* note 96, at 4-5, 18.

III. ANALYSIS OF FAIR FUND DISTRIBUTIONS

The primary purpose of the SEC's enforcement activity is deterrence.[146] Using the census of fair funds just described, this Part considers to what extent the SEC compensates defrauded investors for their harms in addition to deterring misconduct. This approach is the mirror image of the approach taken by empirical literature on private securities litigation, which examines whether private actions deter securities misconduct in addition to compensating investors as their raison d'être.[147]

Thus, this Part assesses *to what extent* monetary recoveries distributed through fair funds compensate investors for their losses by reviewing the data on fair fund distributions and on parallel securities class actions based on the same set of underlying facts. Then the Part turns to the circularity critique of investor compensation and considers *whether* compensation through fair funds is an inefficiently circular transfer of wealth from shareholders to themselves. It does so by assessing fair funds based on the type of securities violation, the identity of the settling defendant, and whether the availability of D&O insurance and indemnification shifts the cost of the SEC's enforcement against individual officers and directors to firms (and, indirectly, their shareholders). Finally, the Part reports that most fair fund distributions do not duplicate class action settlement distributions. In most cases with both a class action and a fair fund distribution, the SEC directs the funds to the class action account and avoids wasting resources on duplicating the cost of the distribution.

A. *Amounts of Fair Fund Distributions*

This Subpart considers whether amounts distributed through fair funds are small or large relative to investors' losses. Public commentary has suggested that the SEC's compensation efforts are not worth the candle, and that private litigation recoveries dwarf the SEC's contribution.[148]

The results reported in this study suggest that despite the many different classes of securities violations that the SEC and private litigants can pursue, the universe of securities violations can be divided into two very different subsamples: (1) issuer reporting and disclosure violations and (2) all others. All issuer reporting and disclosure fair funds are accompanied by private litigation, and the SEC's contribution in such cases is small (15.1% of the aggregate amount distributed to investors). In all other securities violations, including insider trading, securities offering, market manipulation, investment advisor, and broker-

146. *See* SEC, STRATEGIC PLAN: FISCAL YEARS 2014-2018, DRAFT FOR COMMENT 16-18 (2014).

147. James Cox and Randall Thomas have asked and analyzed the mirror-image question: what role private litigation plays in enforcement of securities laws. *See* Cox et al., *supra* note 83, at 763.

148. *See supra* notes 82-86 and accompanying text.

dealer violations, either the SEC's distribution is the only source of compensation (in 71.3% of cases) or the fair fund distribution itself dwarfs all other sources of victim compensation, including private litigation.

1. *Some fair funds undercompensate investors*

Shortly after the fair fund provision was enacted, commentators expressed doubt that the provision would achieve the desired result of compensating harmed investors.[149] As a general matter, securities fraud, particularly accounting fraud, is an inefficient way to steal: victims' losses often exceed any benefit to the wrongdoers by several orders of magnitude.[150] The SEC is also severely resource constrained. It cannot pursue all serious securities violations and certainly cannot compensate all defrauded investors.[151] When it does, securities laws limit the monetary sanctions—disgorgements and civil fines—that the SEC can impose and potentially distribute to compensate defrauded investors.

Disgorgements are limited to "the amount by which [defendants] were unjustly enriched" by the violation.[152] The SEC can hold one party liable in disgorgement for the improper profits of another, but the amount cannot exceed the third-party benefit.[153] Civil fines, likewise, are limited. The most recent inflation adjustment authorizes the SEC to fine individuals up to $160,000 and firms up to $775,000 for each violation, or the "gross amount of pecuniary gain" from the violation, whichever is greater.[154] The term "violation" is not defined by statute. Arguably, the SEC can multiply the maximum fine by the number of individual violations and come out with a very large total fine.[155] In fraudulent disclosure cases, courts have interpreted the language "gross amount of pecuniary gain" to mean the amount by which the issuer overstated its earnings (although the issuer did not benefit from the overstatement) and have authorized the SEC to order civil fines in excess of $10 billion.[156] The language authorizing the fine up to the "gross amount of pecuniary gain" authorizes the SEC to impose a civil fine that equals the amount of disgorgement, doubling the total monetary sanction against the defendant, but not more.[157] The SEC

149. *See supra* Part I.B.

150. *See generally* Velikonja, *supra* note 81 (detailing the categories and the extent of economic losses from fraudulent disclosures).

151. *See* Cox et al., *supra* note 83, at 757-58.

152. SEC 308(C) REPORT, *supra* note 17, at 3.

153. *See* SEC v. First Jersey Sec., Inc., 101 F.3d 1450, 1475 (2d Cir. 1996).

154. 15 U.S.C. §§ 77t(d)(2)(C), 78u(d)(3)(B)(iii) (2013); 17 C.F.R. § 201.1005 (2014); 17 C.F.R. pt. 201 subpt. E tbl.V.

155. *See* Winship, *supra* note 15, at 1126 & n.119.

156. *See* SEC v. WorldCom, Inc., 273 F. Supp. 2d 431, 434-36 (S.D.N.Y. 2003) (acknowledging that the SEC could seek a fine between $10 billion and $17 billion, but authorizing $2.25 billion due to bankruptcy law restrictions).

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

settles issuer reporting and disclosure enforcement actions for well below the statutory ceiling. In other types of securities cases, however, the statutory constraint on monetary sanctions is real.

As a result of these limitations, ceteris paribus, one would expect the SEC's distributions to be smaller than damages in parallel private litigation, since the latter do not face similar legal ceilings (other than the amount of loss the plaintiffs suffered). The best way to assess to what extent fair fund distributions compensate defrauded investors would be to collect information on the magnitude of the harm caused by the violation and the amounts distributed to investors. Unfortunately, investors' losses are rarely quantified (or even quantifiable) in the SEC's enforcement actions.[158] Some actions specify the amount of gain to the wrongdoer, but illegal gain rarely equals the aggregate amount of loss to the victims.

Instead, we must rely on circumstantial evidence, which suggests that the SEC's contribution is negligible for some types of fraud but large for others. The aggregate and average figures for fair fund distributions, when compared with those for class action settlements, are consistent with the proposition that the SEC as a resource-constrained public agency can bring relatively few enforcement actions. Between 2003 and 2012, the SEC created 223 fair funds (20 were created in 2013 and 2014) and distributed almost $13 billion to defrauded investors (in 2013 dollars). During the same period, 920 securities class actions settled for a combined total of $60.9 billion.[159] Individual fair fund distributions are similar in size to class action settlements: their respective means are $59.5 million for fair funds ($16.5 million median) and $56.0 million for securities class actions ($8.4 million median).[160] Both populations are skewed to the left, meaning that most cases are small, but a few large settlements increase the population mean. About half of all class action settlements and fair funds are smaller than $10 million.[161] Settlements in excess of $100 million, also described as "mega-settlements," account for nearly 75% of all distributed amounts in class actions and fair funds but only about 15% of cases.[162] In addition to the much larger number of settlements and distributed amounts, the oth-

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158. One order imposing sanctions noted that the defendant "collected tens of millions of dollars" from illegal conduct, Edward D. Jones & Co., L.P., Securities Act Release No. 8520, Exchange Act Release No. 50,910, 84 SEC Docket 1798, 1799 (Dec. 22, 2004), but most orders do not.

159. *See* ELLEN M. RYAN & LAURA E. SIMMONS, CORNERSTONE RESEARCH, SECURITIES CLASS ACTION SETTLEMENTS: 2012 REVIEW AND ANALYSIS 2 fig.1 (2013). Figures have been adjusted to 2013 dollars.

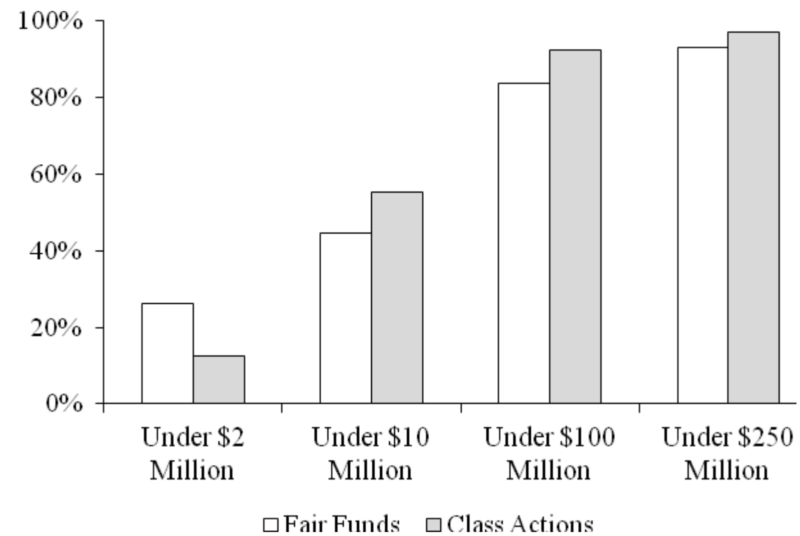
160. *See id.* at 3 fig.2 (reporting mean figure for the period 1996-2011). Figures have been adjusted to 2013 dollars.

161. 55.3% of class action settlements and 45.3% of fair funds are smaller than $10 million. *See id.* at 5 fig.4.

162. *See id.* at 4 & fig.3 (noting that in 2012, mega-settlements accounted for 11% of all settlements and 74% of all settlement dollars). There have been 39 fair funds that distributed $100 million or more; 16% of funds distributed 73% of all fair fund dollars.

er meaningful difference between class actions and fair funds is at the right tail of the distribution. The largest securities class action settlements are considerably larger than the SEC's fair funds: $7.23 billion (Enron settlement) versus $816.5 million (AIG fair fund).

FIGURE 2[163]
Fair Funds and Class Action Settlements by Size



From 2006 to 2010, more than 60% of class action settlements and more than 90% of all damages paid in class actions were for accounting fraud.[164] Fraud at a large firm like Enron or WorldCom can cause tens of billions of dollars in market capitalization to evaporate.[165] The average class action for accounting fraud settles for a tiny fraction of that loss—4.6%[166]—which has led commentators to conclude that the "securities class action fails as a mechanism for compensation."[167] Because the SEC's settlements in issuer reporting and disclosure cases are generally even smaller than the relatively small class action

163. The information about fair fund distributions is based on this study. The source of the data on class action settlements is RYAN & SIMMONS, *supra* note 159, at 5 fig.4.

164. *See* CORNERSTONE RESEARCH, *supra* note 127, at 11 & fig.9, 12 & fig.10.

165. *See* Velikonja, *supra* note 81, at 1913-14 (reporting that upon disclosure of the truth, fraudulent firms' stock market losses are considerable).

166. Between 1996 and 2012, median class actions in cases alleging accounting violations settled for 4.6% of the market capitalization loss upon disclosure of fraud. *See* RYAN & SIMMONS, *supra* note 159, at 12 fig.12. This percentage understates what share of plaintiffs' loss is covered by damages because only buyers are included in the class (not those who held on to securities and suffered the loss) and entitled to damages. *See id.* at 7, 12 fig.12, 22 n.7.

167. Coffee, *supra* note 16, at 1545-47.

settlements, the SEC's relative contribution to investor compensation for accounting fraud is small (albeit totaling $6.34 billion), consistent with the conventional wisdom that fair fund distributions in accounting fraud cases undercompensate investors.[168]

2. *Some fair funds fully compensate investors*

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

This conclusion is based on three findings in the study. First, eligible participants who filed claims with the fund administrator were fully compensated for their losses in several fair fund distributions.[169] This does not imply that the SEC forced the wrongdoer to pay monetary sanctions equal to the social cost of its misconduct. It is likely that some (or perhaps many) of the victims did not file claims and/or that they filed claims but not all of their losses were eligible for compensation, a common result in large-scale compensation schemes, including class action litigation.[170] But the finding suggests that some investors are made whole through fair fund distributions.

Second, the study identified eighteen cases in which the order imposing sanctions directed the defendant to pay defrauded investors specified amounts of money. Penalties in most such cases were set at the level that would appear to fully compensate investors identified in the order or consent decree.[171] Again, the orders likely did not include all of the victims.

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168. *See also infra* Part III.A.3.

169. *See, e.g.*, Order re: Final Payment of Funds, SEC v. Agora, Inc., No. MJG-03-1042 (D. Md. Sept. 12, 2012) (providing full compensation to all victims); Final Report of Distribution Agent at 2 & exh. A, SEC v. McCloskey, No. 1:04 CV 01294 (RMC) (D.D.C. Dec. 17, 2010) (providing full compensation to twelve investors who sold to individuals trading on inside information); Distribution Agent's Notice of Final Accounting & Motion for Order Closing Fund & for Discharge of Distribution Agent at 3-4, SEC v. Concorde Am., Inc., No. 05-80128-CIV-ZLOCH/SNOW (S.D. Fla. Mar. 24, 2010) (providing full compensation to 1335 investors defrauded by market manipulation); Final Report of Receiver Richard J. Yurko & Application to Make Payments to Claimants & of Receiver's Fees at 2-3, 6, SEC v. SG Ltd., No. 00-11141-GAO (D. Mass. Sept. 3, 2004) (compensating all 426 claimants, although 11 claimants had yet to cash their checks).

170. *See* Catherine Weiss et al., Op-Ed., *States Provide Model for Handling Controversial Class Action Awards*, NAT'L L.J. (Nov. 25, 2013), http://www.nationallawjournal.com/id=1202629234128/States-Provide-Model-for-Handling-Controversial-Class-Action-Awards (noting the ongoing controversy about leftover funds in class action settlements).

171. *See, e.g.*, Final Judgment as to Defendant GE Funding Capital Market Services, Inc. at 2-3 & att. A, SEC v. GE Funding Capital Mkt. Servs., Inc., No. 11-7465 (D.N.J. Jan.

Finally, evidence from settled parallel securities class actions suggests that the SEC came very close to fully compensating defrauded investors in two dozen market-timing and late-trading cases as well as in seven cases against New York Stock Exchange (NYSE) specialist firms for improper trading practices.[172] The SEC settled its enforcement actions and distributed the monies in the fair funds years before the class actions were settled. The SEC's settlements were larger than class action settlements by an order of magnitude because the class action courts took into account monies that investors had already received as compensation.[173] At least in these cases, the SEC's fair fund distributions crowded out parallel private litigation.

In response to fair fund distributions in market-timing cases, some management groups have complained that fair funds *over*compensate investors.[174] Their complaint appears to be unfounded. Both the courts and the SEC take into account parallel compensation proceedings when distributing funds to inves-

23, 2012) (directing the defendant to pay identified municipal entities specific amounts as compensation); Consent of Defendant State Street Bank & Trust Co., *supra* note 108, at 2 (giving defendant credit for reimbursing investors and ordering additional compensation).

172. For example, Strong Capital Management, Inc. and affiliated companies paid $140 million to settle the SEC enforcement action for market timing, but only $13.5 million in a subsequent class action settlement. *See* Strong Capital Mgmt., Inc., Exchange Act Release No. 49,471, Investment Company Act Release No. 26,448, 82 SEC Docket 3178, 3190 (May 20, 2004); Stipulation of Settlement at 9, *In re* Mut. Funds Inv. Litig., No. 04-md-15864 (D. Md. May 29, 2009). Banc of America Capital Mgmt., Inc. paid $375 million to settle with the SEC and $18.4 million to settle a subsequent class action. *See* Banc of Am. Capital Mgmt., LLC, Securities Act Release No. 8538, Exchange Act Release No. 51,167, Investment Company Act No. 26,756, 84 SEC Docket 2780, 2796 (Feb. 9, 2005); Strong/BAS Severed Agreement & Stipulation of Settlement, *In re* Mut. Funds Inv. Litig., MDL No. 1586 (Jan. 28, 2010); *see also* John C. Coates IV, *Reforming the Taxation and Regulation of Mutual Funds: A Comparative Legal and Economic Analysis*, 1 J. LEGAL ANALYSIS 591, 593 n.3 (2009) (arguing that several fair funds "were larger than any plausible loss to affected mutual funds").

Similarly, stock exchange specialists paid $247 million in 2004 to settle SEC enforcement actions and $18.5 million in 2012 to settle parallel securities litigation. *See* Stipulation of Settlement at 4, *In re* NYSE Specialists Sec. Litig., No. 03-CV-8264 (RWS) (S.D.N.Y. Oct. 25, 2012); Press Release, SEC, Distributions Begin to Victims of Improper Trading at NYSE Specialist Firms (July 19, 2006), http://www.sec.gov/news/press/2006/2006-120.htm.

173. *See In re* Mut. Funds Inv. Litig., 608 F. Supp. 2d 677, 678-79 (D. Md. 2009) (granting summary judgment to defendants because any damages caused by market timing in benefit plans were "fully offset by the restitution paid by defendants [through a fair fund] pursuant to the regulatory settlements").

174. *See, e.g.*, COMM. ON CAPITAL MKTS. REGULATION, INTERIM REPORT OF THE COMMITTEE ON CAPITAL MARKETS REGULATION 82 (2006), *available at* http://capmktsreg.org/app/uploads/2014/08/Committees-November-2006-Interim-Report.pdf ("At present, however, there are no limitations on recoveries in concurrent, private lawsuits even after the SEC has made a Fair Funds distribution, raising the possibility of a wasteful double-recovery by shareholders.").

tors. And both have refused to distribute to investors more than the amount necessary to compensate the full extent of their losses.[175]

However, large fair fund distributions (relative to investors' likely losses) that predate class action settlements have the potential to dilute the SEC enforcement action's deterrence.[176] According to the policy expressed in its settlements, the SEC allows defendants to offset damages paid in a class action against the disgorgement amount in the enforcement action, but it denies credit against the civil fine part of the sanction. The purpose of the prohibition is to "preserve the deterrent effect of the civil penalty."[177] But most parallel class actions settle years after the SEC has settled its enforcement action, and often after the SEC has distributed the fair fund to investors.[178] Despite the prohibition against offsetting the civil fine, defrauded investors cannot receive in a subsequent class action settlement damages that would exceed their uncompensated losses.[179] Where investors have been fully compensated from the fair fund, it is possible that a court would dismiss the parallel lawsuit.[180] Recent SEC settlements require defendants to pay the SEC any amount by which awarded damages in a class action were reduced because of a distribution of the civil penalty, which would appear to include class actions that were dismissed because investors have been fully compensated.[181]

175. *See In re* Am. Int'l Grp., Inc. Sec. Litig., 293 F.R.D. 459, 462 (S.D.N.Y. 2013); Plaintiff Securities & Exchange Commission's Memorandum in Support of its Motion for Distribution of Settlement Funds & Appointment of Distribution Agent at 7, SEC v. Buntrock, No. 02 C 2180 (N.D. Ill. Aug. 26, 2005) ("[T]o the extent that all injured investors have been made whole, whatever is left in the Fair Funds should revert to the Treasury.").

176. An issue I do not address in this Article is that because of the offset rule, fair fund distributions potentially reduce damages in class actions and legal fees awarded in such cases. Investors might benefit from lower legal fees relative to total compensation in particular cases, but reduced fees could diminish plaintiffs' law firms' incentive to litigate cases—in particular, cases against financial intermediaries.

177. *See, e.g.*, Franklin Advisers, Inc., Exchange Act Release No. 50,841, Investment Company Act Release No. 26,692, 84 SEC Docket 1357, 1363 (Dec. 13, 2004) ("To preserve the deterrent effect of the civil penalty, Respondents agree that they shall not, after offset or reduction in any Related Investor Action based on Respondent's payment of disgorgement in this action, further benefit by offset or reduction of any part of Respondent's payment of a civil penalty in this action ('Penalty Offset').").

178. *See infra* Part III.C.

179. *See, e.g.*, TD Bank, N.A., Securities Act Release No. 9453, 2013 WL 5306684, at *7 (Sept. 23, 2013) ("To preserve the deterrent effect of the civil penalty, Respondent agrees that in any [private lawsuit], it shall not argue that it is entitled to, nor shall it benefit by, offset or reduction of any award of compensatory damages by the amount of any part of Respondent's payment of a civil penalty in this action ('Penalty Offset').").

180. The issue has yet to be decided by a court. In *In re Mutual Funds Investment Litigation*, the court granted the defendant's motion for summary judgment because it concluded that the disgorged amount fully compensated the victims. 608 F. Supp. 2d 677, 678-79 (D. Md. 2009).

181. *See, e.g.*, *TD Bank*, 2013 WL 5306684, at *7.

The only situation where one could argue that fair fund distributions *overcompensate* investors is where the sanctioned firm is bankrupt and investors receive more than they should under bankruptcy law. Consistent with the principle of absolute priority, § 510(b) of the Bankruptcy Code subordinates shareholders' damages claims for securities fraud to claims of the bankrupt company's creditors.[182] Because bankrupt firms are by definition insolvent, the Bank-Bankruptcy Code effectively precludes equity holders with securities fraud claims from recovering anything from the bankrupt estate.[183] As a result, securities class actions against bankrupt companies are ordinarily dismissed.[184]

The SEC may pursue an enforcement action against a bankrupt firm (as well as against its officers,[185] auditors,[186] and other aiders and abettors[187]), but the automatic stay in bankruptcy stops it from collecting any money judgment from the firm.[188] The SEC's claim for civil fines and disgorgement is treated as an unsecured creditor claim and is distributed pro rata, along with other unsecured creditors.[189] However, § 510(b) does not preclude the SEC from distributing civil fines and disgorgements to defrauded shareholders through a fair fund. When the SEC distributes monetary sanctions it collects from the bankrupt company to defrauded shareholders, the ultimate result is that unsecured creditors' recoveries are smaller as a result of the monetary penalties paid in the

182. 11 U.S.C. § 510(b) (2013). The idea behind the provision is that equity holders should not receive anything until all creditors have been paid in full.

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

184. Cases continue against individual defendants, D&O insurers, auditors, and underwriters, though. *See* James J. Park, *Securities Class Actions and Bankrupt Companies*, 111 MICH. L. REV. 547, 551, 561 (2013).

185. *See, e.g.*, SEC v. First Fin. Grp. of Tex., 645 F.2d 429, 431 (5th Cir. Unit A May 1981).

186. Grant Thornton LLP, Securities Act Release No. 8355, Exchange Act Release No. 49,101, 81 SEC Docket 3441, 3441 (Jan. 20, 2004) (alleging that the auditor aided and abetted financial reporting and offering fraud by a mortgage banking company that filed for bankruptcy in 1999).

187. *See, e.g.*, Complaint at 1-2, SEC v. First Bancorp, No. 1:07 CV 07039 (S.D.N.Y. Aug. 7, 2007) (alleging that the defendant helped Doral Financial misrepresent its financial health in exchange for more than $100 million in fees).

188. 11 U.S.C. § 362(b)(4) (2013).

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

SEC's enforcement action, while shareholders' recoveries are greater because of the fair fund distribution.[190]

The abstraction described above became reality for WorldCom, which filed for bankruptcy protection soon after it revealed a massive accounting fraud.[191] The SEC collected $750 million from the bankruptcy estate as a civil fine and distributed it to defrauded shareholders, who would otherwise have received nothing.[192] This outcome gave rise to considerable scholarly and popular criticism.[193]

Yet WorldCom is the exception, not the rule, for fair fund distributions. Thirty-one companies that were primary defendants in the fair fund sample filed for bankruptcy within two years of the SEC's enforcement action.[194] Of those, sixteen were issuer reporting and disclosure cases, in which priority conflicts between creditors and shareholders are particularly likely.[195] In enforcement actions against those sixteen, however, the SEC imposed a financial penalty against only two companies: Nortel Networks and WorldCom. Nortel paid $35 million while WorldCom settled for $750 million, and these civil fines were distributed to defrauded shareholders. But Nortel paid the civil fine fourteen months before filing for bankruptcy, and the fine did not directly reduce creditors' recoveries in bankruptcy.[196] In all other cases the SEC either did not

190. *See* SEC v. WorldCom, Inc., 273 F. Supp. 2d 431, 435 (S.D.N.Y. 2003) (approving a revised settlement that required a distribution agent to collect $750 million in penalty payments and distribute them to qualifying claimants).

191. *See id.* at 431-33.

192. *See* Christensen, *supra* note 183, at 356.

193. *See, e.g.*, Black, *supra* note 6, at 332-33; Roe & Tung, *supra* note 183, at 1285-86 (explaining that fair fund distributions "directly contradict[]" bankruptcy priority); Skeel, *supra* note 20, at 583-84 ("The bankruptcy laws ordinarily subordinate a shareholder's securities claims, but the SEC has evaded this rule and ignored the priority framework."); Christensen, *supra* note 183, at 375 (arguing that Congress should amend the fair fund provision to prevent it from "alter[ing] the well-established distributional priorities of the Bankruptcy Code").

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

195. Bankrupt companies were somewhat overrepresented in the sample compared with securities class actions. James Park found that 16% of class actions were filed against bankrupt companies, Park, *supra* note 184, at 561, whereas 22.9% of fair funds created in issuer and disclosure cases include bankrupt companies.

Eight of the remaining fifteen cases against bankrupt companies were unregistered offerings, pump-and-dumps, and Ponzi schemes. Defrauded investors in these cases, who are the recipients of the fair fund distribution, are usually the only claimants against the bankrupt estate.

196. Nortel Networks paid a $35 million civil fine to the SEC in November 2007 and filed for bankruptcy protection in January 2009. The accounting frauds that the SEC prosecuted occurred in 2000-2003. *See* Complaint at 2-6, SEC v. Nortel Networks Corp., No. 07-CV-8851 (S.D.N.Y. Oct. 15, 2007). The fair fund distribution to shareholders may have reduced creditors' recoveries indirectly because the funds would have been available for distribution to creditors when Nortel filed for bankruptcy in January 2009. But Nortel Networks

pursue the bankrupt debtor at all or did not order the company to pay monetary sanctions.[197]

Instead, the SEC prosecuted individuals and third-party defendants (auditors and investment banks), who paid $280 million and $492 million, respectively, and the SEC distributed that $772 million to harmed investors through fair funds. The SEC's settlements with executives and third parties were not part of the bankruptcy estate and could not deplete the monies earmarked for unsecured creditors. The same defendants that settled with the SEC often ended up settling with the bankruptcy trustee and paying additional damages to compensate creditors.[198]

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

3. *Parallel litigation is relatively uncommon*

There are several reasons to believe that the SEC's fair fund distributions would often be accompanied by parallel securities litigation. SEC enforcement suggests that misconduct was serious. Moreover, the SEC can only distribute collected monetary penalties in cases in which the size of the fund is large relative to the number of victims. Large potential recoveries draw litigation where legal fees are assessed at a set percentage of the aggregate recovery. As a result, one would expect that events that gave rise to an SEC fair fund distribution would usually trigger securities litigation.

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also could have spent the money otherwise before filing for bankruptcy. *See* Sara Silver & Joann S. Lublin, *Nortel Networks Files for Chapter 11*, WALL ST. J. (Jan. 15, 2009, 12:01 AM ET), http://online.wsj.com/articles/SB123193994047481129.

197. For example, the SEC sued the executives of the American Home Mortgage Investment Corporation. Final Judgment as to Defendant Michael Strauss, SEC v. Strauss, No. 09 CIV 4150 (S.D.N.Y. Apr. 29, 2009); *see also* Final Judgment Against Defendant Peregrine Systems, Inc. at 5, SEC v. Peregrine Sys., Inc., No. 03cv1276-JM-LSP (S.D. Cal. July 23, 2003) (appearing to not require civil penalties or disgorgement in light of the firm's Chapter 11 bankruptcy); SEC v. Gardner, Litigation Release No. 20,942, 95 SEC Docket 1142 (Mar. 11, 2009) (reporting a settlement with several executives); SEC v. Dunlap, Litigation Release No. 17,710, 78 SEC Docket 1139, 2002 WL 2018739, at *1 (Sept. 4, 2002) (unpublished table release) (settling with the defendant for a $500,000 civil penalty).

198. For example, audit firm Deloitte & Touche paid $50 million to settle the SEC's enforcement action for repeated audit failure in Adelphia's bankruptcy and $210 million to settle parallel securities litigation. *See* Stipulation & Agreement of Settlement Between Class Members & Deloitte & Touche at 1, 8, 17, *In re* Adelphia Commc'ns Corp. Sec. & Deriv. Litig., No. 03 MD 1529 (LMM) (S.D.N.Y. May 23, 2006); Press Release, SEC, SEC Charges Deloitte & Touche for Adelphia Audit (Apr. 26, 2005), http://www.sec.gov/news/press/2005-65.htm.

The data collected in this study reveal that parallel private litigation is less common than one might expect[199]: parallel securities class actions were filed in 64.7% of cases in which the SEC established a fair fund (154 of 238 with available information)[200] and settled for nonzero monetary damages in only 46.8% of cases (108 of 231).[201] In more than half of the fair fund distributions—53.2%—defrauded investors received no compensation from private litigation, the traditional source of compensation.

Fair fund cases without filed parallel private lawsuits are on average smaller than cases with parallel litigation: eighty-four such fair funds distributed \$1.08 billion (7.5% of the aggregate fair fund amount), with a mean fund of \$12.8 million and a median of \$1.7 million (compared with a \$59.5 million mean and a \$16.5 million median for all fair funds). This group includes three categories of cases. The first and largest category comprises cases involving smaller frauds, predominantly against individual defendants, including insider trading, certain broker-dealer and investment advisor violations (e.g., failure to supervise a rogue employee), and other market manipulations.[202] What these cases have in common is that it does not appear to be cost effective for private litigants to bring a lawsuit, because the likely recovery is small and the likelihood of certifying a class and surviving a motion to dismiss pursuant to the standards set by the Private Securities Litigation Reform Act of 1995 (PSLRA) and the Supreme Court is low.[203] In the second, related category are cases in which the primary violator is judgment-proof because it is in receivership, liquidated (if a firm), or convicted (if an individual), making private litigation futile. Finally, in the third category are a dozen or so cases in which the enforcement action and the ensuing fair fund distribution fully compensate defrauded investors. Moreover, the nature of the violation is such that plaintiffs could not detect the fraud and litigate before the SEC announced its enforcement action,

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199. The study collected data only on federal securities class actions, potentially understating the amounts of compensation from private litigation for cases that do not involve "covered securities." That might include some securities offering cases, but the probable effect is small. As explained, most securities offering cases involve Ponzi schemes that are outside the scope of the study. Others involve Rule 506 offerings, which as "covered securities" must be litigated in federal courts. *See* 15 U.S.C. § 77r(b)(4)(D) (2013).

200. Two cases with parallel litigation are not included in the count of parallel securities class actions. In one case, there was a derivative lawsuit that was removed to state court. In another, an ERISA class action claim was filed, but not a securities class action.

201. In eight cases, it could not be determined whether a parallel class action was filed. Analyzing a related question, Cox and Thomas found relatively little overlap between SEC enforcement actions and private class actions. *See* Cox et al., *supra* note 83, at 745.

202. *See id.* at 750 tbl.2 (reporting limited class actions in cases against investment advisors, against broker-dealers, and for market manipulation).

203. Unlike large cases in which plaintiffs can sometimes establish the strong inference of scienter that the PSLRA requires to survive the defendant's motion to dismiss by relying on news articles in the *Wall Street Journal*, these cases do not attract the same sort of attention. *See, e.g.*, Complaint for Violation of the Federal Securities Laws at 12-13, Pflugrath v. Bear Stearns Cos., No. 03 CIV 8864 (S.D.N.Y. Nov. 7, 2003).

by which point the statute of limitations may have passed. This category includes a handful of cases against investment banks for market timing and against broker-dealers for failures to supervise rogue employees.

TABLE 3
Parallel Securities Litigation in Fair Fund Cases
(2003-2012)

Outcome of Parallel Litigation	Number (n=238)
No Parallel Litigation	84
Parallel Securities Litigation	154
Dismissed	29
Monetary Settlement	108
Nonmonetary Settlement	3
Different	7
Ongoing	6
Unknown	1

Of 154 cases with accompanying private securities litigation, 108 cases included a monetary settlement in at least one of the filed class actions, 29 cases saw all filed class actions dismissed, and the remainder either are still ongoing or have settled for nonmonetary relief. The reasons for dismissal are not surprising. With the aim of weeding out weak cases, Congress enacted the PSLRA in 1995 and significantly raised pleading requirements for securities class actions under Rule 10b-5.[204] The PSLRA requires that the complaint allege with specificity (1) the statement or omission that is false or misleading and why;[205] (2) if pleaded on information and belief, particularity as to facts on which that belief is formed;[206] and (3) "facts giving rise to a strong inference that the defendant acted with the required state of mind."[207] The PSLRA also requires plaintiffs to plead and prove loss causation[208] and generally precludes discovery pending resolution of a motion to dismiss.[209]

204. *See* Amanda M. Rose, *Reforming Securities Litigation Reform: Restructuring the Relationship Between Public and Private Enforcement of Rule 10b-5*, 108 COLUM. L. REV. 1301, 1318-19 (2008).

205. 15 U.S.C. § 78u-4(b)(1) (2013).

206. *Id.*

207. *Id.* § 78u-4(b)(2)(A); *see* Tellabs, Inc. v. Makor Issues & Rights, Ltd., 551 U.S. 308, 313-14 (2007).

208. 15 U.S.C. § 78u-4(b)(4); *see* Dura Pharm., Inc. v. Broudo, 544 U.S. 336, 341-42 (2005).

209. 15 U.S.C. § 78u-4(b)(3)(B).

While the PSLRA screens eliminate many unmeritorious suits, they also bar many meritorious suits, in particular those that do not fit neatly in the mold of material misrepresentation followed by subsequent correction and price effect. Class actions against securities-market intermediaries are among those particularly likely to be dismissed, despite a successful parallel SEC enforcement action or even criminal conviction—suggesting that plaintiffs' allegations had merit.[210] Several class actions with parallel fair fund distributions were dismissed for failure to plead scienter with sufficient specificity;[211] others failed to plead "loss causation"—a causal connection between the fraud and the economic loss—as required by the Supreme Court's decision in *Dura Pharmaceuticals, Inc. v. Broudo*;[212] and some were dismissed because of the statute of limitations.[213] Finally, a handful of class actions were dismissed because the court concluded there was no private cause of action.[214]

In sum, in more than half of the fair fund distributions—53.2%—defrauded investors did not receive compensation in parallel securities litigation, either because no private action was filed or because the litigation became victim to one of the PSLRA screens. As a result, in the majority of fair fund cases, the fair fund is the only source of investor compensation.[215]

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210. The results of this study find that class actions against broker-dealers and investment advisors are dismissed at higher rates than class actions against issuers for securities fraud. *See, e.g.*, Stipulation of Dismissal, with Prejudice, of Claims Asserted Under Sections 34(b), 36(a) & 48(a) of the Investment Company Act of 1940 at 2, *In re* Hartford Mut. Funds Fee Litig., No. 04-cv-00344 (AWT) (D. Conn. Dec. 6, 2007).

211. *See, e.g.*, Order at 2, *In re* Biogen Idec, Inc. Sec. Litig., No. 05-10400 (D. Mass. Sept. 14, 2007).

212. 544 U.S. at 342; *see, e.g.*, Memorandum & Order at 9, Swack v. Lehman Bros., Inc., No. 03-10907-NMG (D. Mass. Aug. 17, 2005).

213. *See, e.g.*, *In re* MBIA Inc. Sec. Litig., No. 05 Civ. 3514 (LLS), 2007 WL 473708, at *9 (S.D.N.Y. Feb. 14, 2007).

214. *See, e.g.*, Stipulation of Dismissal with Prejudice, *In re* Hartford Mut. Funds Fee Litig., No. 04-cv-00344 (AWT) (D. Conn. Jan. 30, 2008) (concluding there is no private cause of action for undisclosed revenue sharing between investment advisors and inferior investment funds they were promoting or for receiving kickbacks for such promotions).

215. In four cases, investors received additional compensation from a receivership. In a few others, defendants were also convicted, and criminal sanctions included restitution. While FINRA, which licenses, regulates, and oversees brokerage firms and registered securities representatives, has the authority to levy fines against registered individuals and firms and brings twice as many enforcement actions as the SEC (1541 in 2012, compared with 734 SEC enforcement actions in the same year), its fines are considerably smaller than the SEC's. In 2012, FINRA levied fines amounting to $69 million (compared with $3 billion for the SEC) and paid $34 million as restitution to defrauded investors (compared with $815 million for the SEC, excluding receiverships). *Compare* FIN. INDUS. REGULATORY AUTH., FINRA 2012 YEAR IN REVIEW AND ANNUAL FINANCIAL REPORT 8 (2013), *with* SEC, FY 2012 ANNUAL PERFORMANCE REPORT & FY 2014 ANNUAL PERFORMANCE PLAN 33 (2013). In 2011, FINRA's fines totaled $71.9 million, of which $19.4 million were distributed to defrauded investors. *See* FIN. INDUS. REGULATORY AUTH., FINRA 2011 YEAR IN REVIEW AND ANNUAL FINANCIAL REPORT 2 (2012). In the aggregate, FINRA's contribution to investor compensation for large-scale frauds is nominal and is likely to remain so. *See* Andrew F.

Aggregate damages in parallel securities class actions amounted to $39.6 billion. The median successful class action accompanied by a fair fund distribution settled for $32.1 million. Mean class action recovery is much larger, $370.2 million, but the mean is skewed by a handful of very large class action settlements in notorious accounting fraud cases (WorldCom, Enron, and Tyco).[216] Two-thirds of class actions settled *after* the SEC settled its enforcement action against the securities violators.[217] Class actions that settled before the SEC's settlement settled for less—$196.4 million compared with $455.3 million for class actions that settled later—but the difference is not statistically significant.[218]

In cases where investors received compensation from both a fair fund and a parallel class action, the average share of total compensation that came from the fair fund was 41.3% (median 33.6%). (In all other cases, of course, investors receive all of their compensation from the fair fund.) But aggregate numbers conceal real diversity in the underlying cases. All fair funds created in issuer reporting and disclosure cases were accompanied by parallel securities litigation, and accompanying class actions were also very likely to prevail. Of 108 class actions with monetary settlements, 61 were in accounting fraud cases. Only 5 class actions that alleged accounting fraud were dismissed, while 61 of 66 (92.4% of actions with known outcomes) settled for $35.6 billion in the aggregate. Accounting fraud class action settlements accounted for 89.8% of aggregate class action recoveries in the study—consistent with the findings of other studies of class action settlements.[219] Large class action settlements dwarf fair fund distributions in accounting fraud cases.

By contrast, parallel securities litigation is less likely to be filed and to prevail in all other categories of securities violations. Of 167 fair funds created in cases that did not allege issuer reporting and disclosure violations, 84 were accompanied by parallel private litigation (50.3%), and 47 parallel class actions yielded monetary settlements (28.1%). For example, only 2 of 14 insider trading cases were accompanied by private litigation, and both class actions were dismissed.[220] Two of 9 market manipulation cases were accompanied by private litigation; one action was dismissed, while the other settled for

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Tuch, *The Untouchables of Self-Regulation*, 83 GEO. WASH. L. REV. (forthcoming Feb. 2015) (manuscript at 77-78), *available at* http://ssrn.com/abstract=2432601.

216. These three settlements represent 47.3% of all class action recoveries in the study.

217. Thirty-five class actions settled before the SEC settled, seventy-two settled after, and, in one case, both actions settled on the same day.

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

219. *See* CORNERSTONE RESEARCH, *supra* note 127, at 1, 11-12.

220. *See* Memorandum of Decision on Motions to Dismiss at 10, Brodzinsky v. FrontPoint Partner LLC, No. 3:11cv10 (WWE) (D. Conn. Apr. 25, 2012) (dismissing the complaint because the plaintiffs lacked standing to sue); Order at 2, *In re* Biogen Idec, Inc. Sec. Litig., No. 05-10400 (D. Mass. Sept. 14, 2007) (dismissing the complaint for failure to plead scienter).

$775,000.[221] Seven of 20 securities offering cases[222] were accompanied by private litigation, and 4 succeeded, settling for an aggregate of $416 million. About half of enforcement actions against investment advisors were accompanied by private litigation (33 of 64), and 20 of those settled for an aggregate $471 million in damages. By contrast, fair funds in investment advisor cases distributed $3.87 billion to defrauded investors.

TABLE 4
Outcomes in Parallel Private Litigation

	Filed Class Action in Fair Fund Cases	Successful Class Action in Fair Fund Cases	Aggregate Class Action Recoveries (in $M)	Fair Fund Distribution as Percent of Total Recovery
Insider Trading	2 of 14	0 of 14	0.0	100.0
Market Manipulation	2 of 9	1 of 9	0.9	96.7
Investment Advisor	33 of 64	20 of 64	471.1	90.4
Broker-Dealer	34 of 49	16 of 41	632.9	78.9
Securities Offering	7 of 20	4 of 19	416.4	77.8
Municipal Securities	5 of 7	4 of 6	103.6	69.9
Issuer Reporting and Disclosure	71 of 71	61 of 66	35,564.8	15.1

As Table 4 makes clear, the SEC's contribution to compensation in issuer reporting and disclosure cases is relatively small (even if large in absolute terms). By contrast, in all other cases, private litigation fails to compensate defrauded investors for their losses. Small potential damages reduce the economic incentive to file a class action for some securities violations. Moreover, class actions are harder to certify in cases that do not allege accounting violations,

221. Final Judgment, Final Judgment of Fees & Expenses, & Order of Dismissal at 5, *In re* Spear & Jackson Sec. Litig., No. 04-80375-CIV-MIDDLEBROOKS/JOHNSON (S.D. Fla. May 14, 2007). Note that the reported figure is in nominal dollars while Table 4 reports the figure in 2013 dollars.

222. I was unable to determine whether a parallel class action was filed in two cases.

and are much more likely to be dismissed, even though the allegations of misconduct are no less serious (as the SEC enforcement actions indicate). As a result, fair fund distributions are the dominant source of compensation for securities violations except for issuer reporting and disclosure violations.[223]

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

B. *The Circularity of Fair Fund Distributions*

The most common and serious critique of the SEC's efforts to compensate defrauded investors through fair funds has been that such distributions are circular. The claim is that when a firm pays a penalty for secondary market fraud, the money comes from the firm's current shareholders, who are ostensibly the victims of the fraud. These payments add "injury to injury" and victimize the victims for the second time.[224]

This Article does not take a position on whether compensation for accounting fraud is always circular when the firm pays damages,[225] nor does it assume that circularity necessarily implies that securities litigation serves no purpose. But even if one were to assume that such payments are circular and ought to be avoided, the majority of fair fund distributions cannot be criticized on this basis.[226]

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223. *See supra* Part III.A.1.

224. Sorkin, *supra* note 25.

225. *See supra* note 81 and accompanying text.

226. Even if the payment of damages were circular, that does not imply that securities class actions serve no purpose. Jill Fisch has offered a compensatory rationale for securities litigation. *See* Fisch, *supra* note 25. Others have suggested that litigation can deter misconduct even if damage payments are circular. Managers and directors fear and dislike securities litigation. Even if they do not pay damages out of pocket, the threat of litigation increases compliance with securities laws. *See, e.g.*, Karen K. Nelson & Adam C. Pritchard, *Carrot or Stick? The Shift from Voluntary to Mandatory Disclosure of Risk Factors* 28 (Univ. of Mich. Law & Econ. Research Paper Series, Paper No. 14-013, 2014), *available at* http://ssrn.com/abstract=2447066; James P. Naughton et al., Private Litigation Costs and Voluntary Disclosure: Evidence from Foreign Cross-Listed Firms 9-10 (May 2, 2014) (unpublished manuscript), *available at* http://ssrn.com/abstract=2432371.

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

1. *Classification of securities violations*

The circularity critique is most appropriate for cases that involve fraudulent disclosures by public companies. Management overstates the company's performance, which pushes up the company's stock price. Unless the firm issues new stock or trades in its own stock during the period of overstatement, its gain from the misrepresentation is often minimal.[227] Forcing the firm to pay the penalty for accounting fraud forces its current shareholders, many of whom suffered losses from the fraud, to bear the cost of that penalty. If the penalty is then distributed to defrauded shareholders through a fair fund, shareholders in effect pay the penalty to compensate themselves. Moreover, shareholders can largely eliminate the cost of such fraud by diversifying their holdings and actively trading. At least ex ante, they are as likely to buy overpriced stock as they are to sell it, so their expected loss from accounting fraud is zero.[228]

Circularity is thus potentially a problem for fair fund distributions in issuer reporting and disclosure cases where the fraud-committing firm pays the civil fine as the primary defendant. Seventy-one fair funds, or 29.3% of all funds, were created in issuer reporting and disclosure cases and distributed to defrauded investors $6.34 billion, or 43.8% of all monies distributed through fair funds. Of that amount, issuers paid $5.1 billion in monetary sanctions, or 35.2% of the total amount distributed through fair funds.[229] Several of the largest fair funds were created in massive accounting frauds—seven of the ten largest fair funds—and in all but one (Enron), the fraud-committing firm paid the bulk of the monetary sanction distributed through the fair fund. With regard to

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

228. Ex post, of course, investor losses will vary, and there will necessarily be winners and losers.

229. Individual and third-party defendants paid the balance.

these cases—AIG, WorldCom, BP, Fannie Mae—the circularity critique may be appropriate.[230]

But the salience of these cases distorts their significance—they are not representative of the class, and one cannot extrapolate from these cases to evaluate the population of fair funds. Many of the fair funds in the issuer reporting and disclosure category are not like AIG or Fannie Mae. In 29 of 71 issuer reporting and disclosure cases, the *fraud-committing firm paid no monetary sanction* into the fair fund.[231] Third-party defendants—officers, the auditor, and investment banks—contributed to the fair fund in 61 of 71 issuer reporting and disclosure cases, and paid $1.24 billion in settlements, or 19.6% of amounts that were distributed through fair funds in these cases.[232]

The circularity critique does not extend easily to other fair funds. Distribution of payments from individual defendants to defrauded investors is never circular.[233] Overall, individual defendants paid 64.7% of monetary sanctions deposited into fair funds created in market manipulation cases, and 37.2% in insider trading cases.[234]

Moreover, not all sanctions ordered against firms and subsequent distributions to defrauded investors are circular, even under the most liberal definition of circularity. In the case where a firm sells securities to investors based on fraudulent information about the quality of those securities, the firm *itself* wrongfully benefits from the sale at the expense of the purchasers.[235] Similarly, investment banks wrongfully benefit from pressuring their research analysts to issue favorable reports about companies to help investment banks win those

230. *See supra* note 25.

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

232. This is in stark contrast with securities class actions, where third-party defendants were included in the settlement in only 7.6% of cases and contributed an even smaller percentage of aggregate damages. *See* Park, *supra* note 184, at 562, 563 tbl.3.

233. This statement assumes that individuals pay sanctions out of pocket, which they usually do in settlements with the SEC. *See infra* Part III.B.3.

234. The firm paid a monetary sanction in three of fifteen insider trading fair funds, and where it did, the firm itself was a conduit of the securities violation. *See* Final Judgment as to Relief Defendants at 2, SEC v. Skowron, No. 10-CV-8266 (DAB) (S.D.N.Y. Nov. 16, 2011) (ordering hedge funds that benefited from insider trading to disgorge $33 million).

235. *See, e.g.*, Complaint at 3-4, SEC v. J.P. Morgan Sec. LLC, No. 1:12-cv-01862 (D.D.C. Nov. 16, 2012) (alleging that J.P. Morgan sold and underwrote mortgage-backed securities claiming that 0.04% of loans were delinquent despite knowing that 7% were in fact delinquent); Complaint for Violations of the Federal Securities Laws at 1-2, SEC v. Wachovia Bank, N.A., No. 2:11-cv-07135-WJM-MF (D.N.J. Dec. 8, 2011) (explaining how several investment banks formed a cartel to fix interest rates paid to municipalities for reinvestment of municipal bond proceeds, which yielded millions to banks in illegal profits); Complaint at 5-6, SEC v. State St. Bank & Trust Co., No. 1:10-cv-10172-RGS (D. Mass. Feb. 4, 2010) (alleging that fund offering documents and marketing materials understated the fund's exposure to subprime mortgage securities).

companies' securities business.[236] Where the wrongdoer firm is publicly held, the penalty is ultimately borne by that firm's (arguably innocent) shareholders, but that does not make the sanction against the firm inefficiently circular or unfair. The firm's payment in such a case is no different from damages for price fixing or for polluting drinking water. It forces the firm to internalize the costs of its activities and improves shareholders' incentives to monitor management.[237] And it gives management—whose compensation is benchmarked against firm performance and stock price—proper incentives to prohibit and detect employee misconduct.[238] Without imposing fines against firms for securities violations from which the firms benefit, their shareholders (and managers furthering shareholders' interests) would have an incentive to ignore or even encourage lucrative misconduct.[239]

Finally, the circularity critique depends in large part on the fact that diversified shareholders are both the victims of fraudulent disclosures and the ones paying damages. But most defendants in SEC enforcement actions are not publicly held firms, particularly in cases against broker-dealers, investment advisors, hedge funds, and other privately held entities.[240] Their shareholders, who bear the cost of the penalty, are often insiders, who also manage these firms and

236. *See* Press Release, SEC et al., Ten of Nation's Top Investment Firms Settle Enforcement Actions Involving Conflicts of Interest Between Research and Investment Banking (Apr. 28, 2003), http://www.sec.gov/news/press/2003-54.htm.

237. *See* Coffee, *supra* note 16, at 1562; Amanda M. Rose & Richard Squire, *Intraportfolio Litigation*, 105 NW. U. L. REV. 1679, 1694 (2011) (explaining theoretically why corporate payments in such cases are efficient).

238. *See, e.g.*, Complaint for Injunctive & Other Relief, *supra* note 34, at 1-2 (contending that the broker's compensation structure created an improper conflict of interest with customers and gave him an incentive to steer more profitable trades to the firm's trading account); Gen. Am. Life Ins. Co., Securities Act Release No. 8832, Exchange Act Release No. 56,229, Investment Company Act Release No. 27,925, 91 SEC Docket 751, 751-53 (Aug. 9, 2007) (finding that William Thater received a $130,000 performance bonus, and his employer received sizeable management and advisory fees, for allowing a privileged customer to benefit from late trading at the expense of other mutual fund investors); Pilgrim Baxter & Assocs., Ltd., Investment Company Act Release No. 26,470, 83 SEC Docket 363, 364-66 (June 21, 2004) (finding that the president of Pilgrim Baxter established a hedge fund in order to engage in market timing and late trading in mutual funds he managed); Robertson Stephens, Inc., Exchange Act Release No. 47,144, 79 SEC Docket 850, 850-51 (Jan. 9, 2003) (finding that a senior research analyst issued misleading reports about companies in which he and other senior executives of the investment advisor owned stock worth several million dollars).

239. *See, e.g.*, Fidelity Nat'l Capital Investors, Inc., Exchange Act Release No. 49,824, 82 SEC Docket 3503, 3504-05 (June 8, 2004) (sanctioning the firm for failing to flag a Ponzi scheme and noting that eight percent of total commissions from between 2800 and 3000 brokerage accounts came from the one account that Mark Drucker used for his Ponzi scheme).

240. *See* Stavros Gadinis, *The SEC and the Financial Industry: Evidence from Enforcement Against Broker-Dealers*, 67 BUS. LAW. 679, 700-12 (2012) (showing that most enforcement actions for broker-dealer violations target small brokerage firms).

are frequently themselves sanctioned by the SEC for the same misconduct.[241] Defendants bearing the cost of monetary sanctions paid to the SEC are not the same individuals as defrauded customers, who are entitled to compensation. Compensation is further justified because brokerage customers and mutual fund investors (unlike shareholders harmed by fraudulent disclosures) cannot self-insure through diversification against the risk that their broker will charge excessive commissions, execute trades to benefit the broker-dealer firm, or allow preferred clients to dilute the value of the customer's mutual fund investment.[242] Diversification is either impossible or illegal,[243] and thus the argument for compensation is much stronger.

With this analytical preface in mind, let us turn our attention to the SEC's fair fund distributions. Unlike private plaintiffs, the SEC consciously brings enforcement actions in all areas within its jurisdiction.[244] The case mix of fair funds tracks enforcement actions. As is the case in private securities litigation, issuer reporting and disclosure cases are overrepresented in the fair fund sample relative to the number of enforcement actions. (25.8% of enforcement actions and 29.3% of fair fund distributions are associated with issuer reporting fraud.) Unlike securities litigation, however, the majority of cases in which a fair fund is created and distributed are not for issuer reporting violations. Most fair funds target profitable customer fraud and anticompetitive behavior by financial intermediaries that harm their customers. For example, all broker-dealer cases involve schemes designed to swindle unsuspecting customers: allowing certain preferred clients to time the market and engage in after-hours trading at the expense of mutual fund investors in exchange for excess advisory and management fees,[245] undisclosed kickbacks to brokers for recommending more expensive investment products to their customers,[246] pressuring research analysts

241. *See, e.g.*, Plan of Distribution at 2, 12, Pilgrim Baxter & Assocs., Ltd., Administrative Proceeding File No. 3-11524 (SEC Oct. 6, 2006), 2006 WL 3392479, at *1, *9.

242. *See supra* notes 27-32 and accompanying text.

243. Only accredited investors—individuals with a net worth of more than $1 million or with an annual income of $200,000 for individuals and $300,000 for married couples—can legally purchase certain private company securities, including hedge funds. *See* 17 C.F.R. § 230.501 (2014).

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

245. *See* Press Release, SEC, Daniel Calugar and Security Brokerage, Inc. to Pay over $150 Million to Settle SEC Fraud Action for Late Trading and Market Timing (Jan. 9, 2006), http://www.sec.gov/news/press/2006-5.htm; *see also* Can. Imperial Holdings, Inc., Securities Act Release No. 8592, Exchange Act Release No. 52,063, Investment Company Act Release No. 26,994, 85 SEC Docket 3031, 3037 (July 20, 2005) (explaining that Canadian Imperial Holdings earned $43 million from market-timing and late-trading customers and that World Markets earned $28 million plus millions in other fees).

246. *See* Morgan Stanley DW Inc., Securities Act Release No. 8339, Exchange Act Release No. 48,789, 81 SEC Docket 1993, 1993-94, 1996-97 (Nov. 17, 2003).

to issue favorable reports about companies to help investment bankers win those companies' securities business,[247] and churning.[248]

Enforcement actions against investment advisors and investment companies, the largest class of SEC-overseen fair funds, are similar to broker-dealer cases in that they police illegal transfers of wealth from outsiders to insiders and investment advisory firms: using mutual fund investors' funds to bribe brokers for promoting investments in those funds,[249] charging investors for expenses that the fund did not incur,[250] allowing investment advisors' employees to self-deal with mutual funds that they supervise at the expense of mutual fund investors,[251] cherry picking (i.e., allocating cheaply bought securities to the firm's own account and more expensive ones to customer's accounts),[252] etc.

TABLE 5
Fair Fund Distributions by Type of Violation (2003-2012)

SEC Classification	Distributed Amount (in $M)	Percent of Distributions (by Amount)	Percent of Distributions (by Number)
Issuer Reporting and Disclosure	6,339.1	43.8	29.3
Investment Advisor/Company	3,869.4	26.8	26.9
Broker-Dealer	2,260.7	15.6	21.1
Securities Offering	1,451.4	10.0	8.7
Municipal	240.2	1.7	2.9
Insider Trading	100.9	0.7	6.2
Market Manipulation	25.7	0.2	3.7

247. *See* Press Release, SEC et al., *supra* note 236.

248. Press Release, SEC, Broker Accused of Defrauding Elderly Nuns Settles Case with SEC (Jan. 6, 2011), http://www.sec.gov/news/press/2011/2011-2.htm.

249. *See* Franklin Advisers, Inc., Exchange Act Release No. 50,841, Investment Company Act Release No. 26,692, 84 SEC Docket 1357, 1358-59 (Dec. 13, 2004).

250. *See* Value Line, Inc., Securities Act Release No. 9081, Exchange Act Release No. 60,936, Investment Company Act Release No. 28,989, 97 SEC Docket 145, 146 (Nov. 4, 2009).

251. *See* Putnam Inv. Mgmt. LLC, Investment Company Act Release No. 26,255, 81 SEC Docket 1913, 1914 (Nov. 13, 2003).

252. *See* Complaint for Injunctive & Other Relief, *supra* note 34, at 1-2.

Compensation for these violations is neither circular nor futile. Sanctioned firms received real benefits at the expense of defrauded customers who suffered real losses. The overlap between shareholders who bear the cost of the penalty and those who are harmed by the misconduct is, at most, minimal.[253] The circularity critique could be justified with regard to the $5.1 billion paid by issuers and distributed to defrauded investors through fair funds created in issuer reporting and disclosure violations. While this amount is large, it represents 35.2% of dollars distributed through fair funds. Other fair funds distributions cannot be described as circular.

2. *Defendants in enforcement actions*

The SEC's enforcement actions usually target the firm as the primary defendant. Firms as primary defendants paid 86.5% of monetary amounts distributed through fair funds. The firm as primary violator is much more likely to pay a monetary sanction in SEC-overseen cases than in court-overseen cases. Firms pay monetary sanctions in 55.9% of court-overseen cases and in 83% of SEC-overseen cases.[254] It is not uncommon for the firm to pay no monetary sanction for accounting fraud, insider trading, or market manipulation—cases that are typically resolved in judicial proceedings. If the firm is sanctioned, however, the amount of monetary sanction it pays is similar in SEC- and court-overseen cases—on average $62.0 million and $93.3 million, respectively.[255]

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

Individuals were sanctioned in 164 of 243 fair funds, or 67.5%. Individuals paid monetary sanctions into 145 or 59.7% of fair funds. These figures are consistent with prior studies of SEC enforcement activity against individual defendants.[256] Overall, individual defendants contributed $1.33 billion or 9.1% of the total amount distributed through fair funds.

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253. Most fair funds exclude from eligibility for the fair fund distribution the directors, officers, their family members, and entities they and their family members control; employees who were terminated for cause or resigned in connection with the violations, their family members, and controlled entities; and aiders and abettors in the scheme and their officers, directors, terminated employees, and related persons. *See, e.g.*, Motion to Approve the Distribution Plan at 6-7, SEC v. MBIA Inc., No. 07 Civ. 658 (LLS) (S.D.N.Y. Sept. 12, 2008) (listing ineligible claimants).

254. The difference is statistically significant at the 1% confidence level.

255. The difference is not statistically significant.

256. For example, Michael Klausner and Jason Hegland report that 93% of enforcement cases include an individual defendant and that individuals pay monetary penalties in about

Individuals are considerably more likely to pay monetary sanctions in court-overseen fair fund cases than in SEC-overseen cases. Settlements with individuals were included in fair funds in 72.7% of court-overseen cases and 41% of SEC-overseen cases,[257] and individuals paid 10.4% and 7.2% of aggregate fair fund amounts in each subsample. The average contribution by individual defendants, however, is similar in SEC- and court-overseen cases, at $9.7 million and $8.9 million, respectively.[258] The higher likelihood of individual contribution in court-overseen fair funds is attributable to the SEC's determination to charge individual defendants for issuer disclosure and reporting violations, and to the fact that market manipulation and insider trading, which are resolved in court, are largely in the domain of individual wrongdoers (though they often use firms as conduits).

Enforcement actions against third-party defendants for aiding and abetting the primary violator or for professional misconduct are less common.[259] The majority of such cases are against auditors and investment banks, which paid monetary sanctions in 18 fair fund cases, for total payments of $627 million. As with individual defendants, third-party defendants were considerably more likely to contribute in court-overseen funds.[260] Third-party defendants are usually sanctioned where the corporation as the primary violator did not benefit from the misconduct and/or is judgment-proof. The obvious example is accounting fraud, and 12 of 18 cases where third parties contributed to a fair fund were issuer reporting and disclosure cases. The remaining 6 such payments were in cases where the primary violator was offering unregistered securities, engaged in a Ponzi scheme, or otherwise embezzling investor funds, and was bankrupt by the time the SEC initiated enforcement proceedings.

70% of cases in which the SEC alleges accounting violations, consistent with data reported here. *See* Michael Klausner & Jason Hegland, *SEC Practice in Targeting and Penalizing Individual Defendants*, HARV. L. SCH. F. ON CORP. GOVERNANCE & FIN. REG. (Sept. 3, 2013, 9:23 AM), http://blogs.law.harvard.edu/corpgov/2013/09/03/sec-practice-in-targeting-and-penalizing-individual-defendants.

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

258. Payments by individual defendants are aggregated by case. The reported means thus combine payments into a fair fund by all individual defendants.

259. The study uses the term "aider and abettor" consistent with the U.S. Supreme Court's understanding of the term: individuals or entities "who do not engage in the proscribed activities at all, but who give a degree of aid to those who do." Cent. Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A., 511 U.S. 164, 176 (1994).

It is worth noting that the distinction becomes hazy outside of the issuer reporting and disclosure cases. For example, mutual fund market-timing cases could all be designated as aider and abettor cases because the investment advisors and broker-dealers helped hedge funds trade and dilute the mutual fund assets (and earn large fees in the process).

260. The difference is statistically significant at the 1% confidence level.

TABLE 6
The Source of Monies Deposited into Fair Funds

	Firm	Individual Defendants	Secondary Defendants
Overall			
Percent of Funds	66.3	59.7	7.4
Percent of Aggregate Amount	86.5	9.2	4.3
Aggregate Payment (in $M)	12,512.1	1,325.9	626.6
SEC-Overseen Funds			
Percent of Funds	83.0	41.0	1.0
Percent of Aggregate Amount	92.8	7.2	0.0
Aggregate Payment (in $M)	5,143.1	399.5	2.1
Court-Overseen Funds			
Percent of Funds	54.5	72.7	11.9
Percent of Aggregate Amount	82.6	10.4	7.0
Aggregate Payment (in $M)	7,369.0	926.5	624.6

TABLE 7
The Source of Monies in Fair Funds by Violation Type

SEC Classification	Individual Defendants (in $M)	Percent Paid by Individual Defendants	Third-Party Defendants (in $M)	Percent Paid by Third-Party Defendants	Percent of Total Paid by Non-firm Defendants
Market Manipulation	16.6	64.6	0	0	64.6
Insider Trading	37.5	37.2	0	0	37.2
Issuer Reporting and Disclosure	640.0	10.1	603.6	9.5	19.6
Investment Advisor/Company	398.4	10.3	12.3	0.3	10.6
Broker-Dealer	200.3	8.9	0	0	8.9
Securities Offering	32.2	2.2	3.5	0.2	2.5
Municipal	0.0	0.0	0	0	0.0

One might argue that the reason for the differences between administrative and judicial proceedings is that courts police the SEC's enforcement choices. But with the exception of Judge Rakoff's two recent refusals to approve SEC settlements and a handful of other cases, courts have been reluctant to overturn the SEC's settlements.[261] It appears unlikely that judicial oversight causes the SEC to adopt vastly different settlement practices. Rather, the differences can best be explained by the types of cases that securities laws funnel to courts versus those that the SEC adjudicates.

Overall, individual and third-party defendants contributed to fair funds in 62.6% of cases. In the aggregate, they contributed 13.5% of all amounts distributed through fair funds. Individuals and third-party defendants did not contribute much in securities offering cases (including municipal securities), but they contributed significant amounts in market manipulation, insider trading, and issuer reporting and disclosure cases. Sanctioned individuals are usually well-paid executives, but their resources are limited compared to those of the firms that employ them. By any measure, nonissuer defendants were ordered to pay a considerable share of monetary sanctions distributed to defrauded investors through fair funds, in particular in accounting fraud cases.

3. *Availability of insurance and indemnification*

The fact that individuals are ordered to pay damages or fines for securities fraud does not imply that they pay out of pocket. Individuals are nearly always listed as defendants in securities class actions, but they virtually never contribute to class action settlements because of D&O insurance and corporate indemnification.[262] If corporations, and indirectly their shareholders, bear the cost of the sanction against individual defendants, the sanction effectively targets the corporation, not its officers or directors. Shifting the cost to the firm undermines the deterrent effect of sanctions against individuals and increases the risk that the payment of damages is inefficiently circular for defrauded shareholders.[263]

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261. *See Rakoff's Revenge*, ECONOMIST (Apr. 13, 2013), http://www.economist.com/node/21576132 (describing Judge Rakoff's rejection of the SEC's settlement with Citicorp). *See generally* Hillary A. Sale, *Judges Who Settle*, 89 WASH. U. L. REV. 377, 377 (2011) (arguing that judges are not "doing their jobs" of policing settlements).

262. *See* Michael Klausner et al., *How Protective Is D&O Insurance in Securities Class Actions? An Update*, PLUS J., May 2013, at 1, 3-4 (reporting that while CEOs and CFOs were named as defendants in 93% and 80%, respectively, of securities class actions filed between 2006 and 2010, officers paid out of pocket in only 2% of those cases).

263. As the preceding Subpart discusses, shifting the sanction to the firm will not always lead to circularity. Where the firm benefited from intentional misconduct or misconduct stemming from failure to supervise its employees, it is efficient to force the firm to bear the cost of the sanction. Issuer disclosure and reporting violations pose a circularity risk.

Unlike in private litigation,[264] D&O coverage for SEC enforcement actions is either unavailable or very limited.[265] Some D&O insurers cover defense costs associated with an SEC investigation as a rider, but many do not offer it.[266] In general, D&O insurance policies exclude fines and penalties from the definition of covered losses, as well as matters deemed uninsurable under applicable law.[267] Thus, civil fines paid to the SEC generally are not covered by D&O policies.[268] As for disgorgement, many courts and insurance carriers take the position that disgorgement represents the return of ill-gotten gain and is not a loss that can be covered—it represents the return of an amount that the corporation or the officer or director should never have received in the first place.[269]

While D&O insurance policies generally do not cover monetary sanctions imposed in enforcement proceedings, corporations are authorized under section 145(a) of the Delaware General Corporation Law to indemnify officers and directors for any amounts paid to settle actions where the officer or director "acted in good faith and in a manner the person reasonably believed to be in or not opposed to the best interests of the corporation."[270]

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

265. *See* Trautman & Altenbaumer-Price, *supra* note 113, at 355-57; Jon N. Eisenberg, *How Much Protection Do Indemnification and D&O Insurance Provide?*, HARV. L. SCH. F. ON CORP. GOVERNANCE & FIN. REG. (May 28, 2014, 9:02 AM), http://blogs.law.harvard.edu/corpgov/2014/05/28/how-much-protection-do-indemnification-and-do-insurance-provide.

266. *See* Trautman & Altenbaumer-Price, *supra* note 113, at 348-49.

267. *See* Eisenberg, *supra* note 265; *see also* Chubb Grp. of Ins. Cos., Specimen Insurance Policy § 2(E), at 2 (Feb. 2008) (on file with author) (noting that the definition of "loss" excludes "fines or penalties" and "any amount not insurable under the law").

268. *See* J.P. Morgan Sec. Inc. v. Vigilant Ins. Co., 992 N.E.2d 1076, 1079 (N.Y. 2013) ("Bear Stearns did not seek coverage for the $90 million SEC penalty.").

269. *See id*. at 1080 (citing the plaintiff, who was seeking insurance coverage, as acknowledging "that it is reasonable to preclude an insured from obtaining indemnity for the disgorgement of its own ill-gotten gains"); *see also* Level 3 Commc'ns, Inc. v. Fed. Ins. Co., 272 F.3d 908, 910 (7th Cir. 2001) ("[A] 'loss' within the meaning of an insurance contract does not include the restoration of an ill-gotten gain . . . ."); Eisenberg, *supra* note 265. New York's highest state court recently concluded that an investment advisor was not precluded as a matter of law from seeking coverage for disgorgement of the illegal gains of its customers; in its enforcement action against the investment advisor, the SEC ordered it to disgorge its own as well as the hedge funds' profits from market timing. *J.P. Morgan Sec. Inc.*, 992 N.E.2d at 1082-83.

270. DEL. CODE. ANN. tit. 8, § 145(a) (2014). Most SEC actions are settled without the admission of guilt and are thus eligible for indemnification under section 145(a). *See* James B. Stewart, *S.E.C. Has a Message for Firms Not Used to Admitting Guilt*, N.Y. TIMES (June

Although indemnification may be permitted under Delaware law, several factors suggest it is not the norm for firms to indemnify officers and directors for monetary sanctions that the SEC imposes (in contrast with private litigation). First, the SEC has adopted a clear policy against allowing indemnification.[271] Some SEC settlements and many settlement offers extracted from defendants include language prohibiting indemnification or insurance coverage.[272] Even where they do not, settlements with the SEC are negotiated with firms and individuals in the shadow of threatened repercussions if a firm decides to indemnify individuals.[273] Second, where the sanctioned individual is also the sole shareholder of the firm, as is the case in an important minority of enforcement actions against broker-dealers and investment advisors, indemnification itself would be circular and is thus unlikely.[274] Effectively, these individuals paid monetary sanctions to the SEC out of their own pockets. Third, where the defendant firm is bankrupt, we can, likewise, assume that individual defendants were not indemnified and so paid monetary sanctions out of pocket.[275] Fourth, section 145(a) authorizes the board of directors to indemnify

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21, 2013), http://www.nytimes.com/2013/06/22/business/secs-new-chief-promises-tougher-line-on-cases.html.

271. *See, e.g.*, 17 C.F.R. § 230.461(c) (2014) (authorizing the SEC to refuse to accelerate the effective date of the registration statement for registered investment companies that insure or indemnify "any director or officer of the company against any liability to the company or its security holders" for willful or reckless securities violations). The provision does not prevent indemnification where the officer or director settled the case with the SEC without admitting guilt, which is the normal practice. *See supra* note 270 and accompanying text.

272. *See, e.g.*, Consent of Defendant Jack Benjamin Grubman ¶ 6, SEC v. Grubman, No. 03 Civ. 2938 (WHP) (S.D.N.Y. Apr. 29, 2003) ("Defendant agrees that he shall not seek or accept, directly or indirectly, reimbursement or indemnification, including but not limited to payment made pursuant to any insurance policy, with regard to all amounts that Defendant shall pay . . . .").

273. In May 2004, the SEC fined Lucent $25 million for failure to cooperate; Lucent advanced defense costs to some employees facing an SEC enforcement action without being required to do so by law or corporate charter. *See* Pamela S. Palmer & H. John Shin, *The Fifth Circuit Rejects "Group Pleading" Under the PSLRA*, SEC. LITIG. & PROF. LIABILITY PRAC. (Latham & Watkins, Los Angeles, Cal.), 2004, at 1, 8.

274. *See, e.g.*, Weiss Research, Inc., 88 SEC Docket 810, 810 (June 22, 2006) (reporting that the individual defendant "owns and controls" the investment advisor); Veras Capital Master Fund, Securities Act Release No. 8646, Exchange Act Release No. 53,011, Investment Company Act Release No. 27,197, 86 SEC Docket 2381, 2382-83 (Dec. 22, 2005) (noting that individual defendants owned and managed the investment advisory firm that launched funds).

275. *See, e.g.*, Final Judgment of Permanent Injunction & Other Relief Against Jeremy R. Lent at 2, SEC v. Lent, No. C-04-4088-CW (EMC) (N.D. Cal. Oct. 26, 2006) (sanctioning an individual defendant in an accounting fraud case involving NextCard); Agreed Final Judgment Against James R. Powell at 6-7, SEC v. Powell, No. 4:06cv311 (E.D. Tex. Aug. 10, 2006) (sanctioning an individual defendant in a case alleging accounting fraud at Daisytek); Final Judgment Against Defendant Roger Covey at 4-5, SEC v. Sys. Software Assocs., Inc., No. 00 C 4240 (N.D. Ill. Oct. 3, 2002) (sanctioning an individual defendant in a case alleging accounting fraud at System Software Associates).

sanctioned individuals but does not require indemnification unless the individual was acquitted and did not merely settle.[276] The vast majority of individuals subject to an SEC enforcement action for fraud are terminated.[277] Unless required to, firms are not eager to indemnify disgraced former executives, in particular when firms are trying to rebuild their reputations.[278]

It is likely that individuals pay considerable amounts out of pocket to settle enforcement actions, with their payments added to fair funds for distribution to defrauded investors. This result increases the deterrence of the SEC's enforcement and reduces the circularity of its compensation.

C. *Contrary to Current Thinking, Fair Fund Distributions Are Not Duplicative*

A common criticism of fair funds, at least until this study, has been that the SEC wastes resources on repetitive cases by creating customized distribution plans where damages are also distributed in a parallel class action.[279] A review of distribution plans indicates that the criticism is not supported by evidence.

The study identified the process that the SEC has used to distribute the funds in 222 cases.[280] In 18 cases, the order instituting proceedings or the final consent judgment identifies the victims and their harms, orders the defendant to compensate them, often in full, and directs the defendant to make payments within a short period of time. For example, the SEC's settlement with Goldman Sachs directed the company to pay $150 million to Deutsche Industriebank AG and $100 million to the Royal Bank of Scotland N.V. instead of paying the entire civil fine to the SEC or U.S. Treasury.[281] Monetary sanctions in these enforcement actions are usually set at the level that would fully compensate classes of defrauded investors identified during the SEC's investigation. More than half of direct-payment fair funds have been created since 2010.

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276. Only officers and directors who are successful on the merits against the SEC are entitled to reimbursement for expenses, including attorneys' fees. *See* DEL. CODE ANN. tit. 8, § 145(c) (2014).

277. *See* Jonathan M. Karpoff et al., *The Consequences to Managers for Financial Misrepresentation*, 88 J. FIN. ECON. 193, 201 tbl.3 (2008) (showing that 88.4% of CEO defendants and 93.4% of all individual defendants had been terminated by the time the SEC sanctioned them).

278. *See* Eisenberg, *supra* note 265. *But see* Floyd Norris, *Former Xerox Executives to Pay $22 Million*, N.Y. TIMES (June 6, 2003), http://www.nytimes.com/2003/06/06/business/06XERO.html (reporting that Xerox announced it was contractually required to indemnify officers for $19 million of $22 million in fines and disgorgements that the SEC ordered them to pay, including for disgorgement of millions of insider trading gains).

279. *See* Black, *supra* note 6, at 336, 338.

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

281. Final Judgment as to Defendant Goldman, Sachs & Co. at 2-3, SEC v. Goldman, Sachs & Co., No. 10-CV-3229 (BSJ) (S.D.N.Y. July 20, 2010).

TABLE 8
Fair Fund Distribution Plans (2002-2013)

	Number of Plans (n=222)	Fair Fund Amount (in $M)
SEC Settlement Directs Payment	18	1,160.7
Fair Fund Distributed in Parallel Proceeding	55	2,133.4
Class Action	48	1,998.7
Receivership & Bankruptcy	4	18.1
Criminal	3	116.6
SEC Customized Distribution Plan	149	9,607.8
No Parallel Class Action	61	567.3
Class Actions Without Monetary Settlement (Including Ongoing)	29	1,342.9
Class Action Not Sufficiently Similar	8	423.8
Earlier Parallel Class Settlement	6	197.9
Later Parallel Class Settlement	40	6,963.3
Unable to Determine	5	112.5

In 48 cases, the SEC developed the fair fund distribution plan with reference to the class action that was based on the same set of underlying facts and that had already settled or was about to be settled.[282] In all these plans, the SEC directed the funds to the class action account and proposed that the funds be distributed following the same or a very similar process as the distribution of the class action settlement. To avoid duplicating the administrative cost, the SEC used the same distribution agent (sometimes identified as a fund or claims administrator) to identify and notify the eligible participants, process their claims, and distribute the funds.[283]

In 7 cases, a court ordered restitution in a parallel criminal proceeding, appointed a receiver, or initiated bankruptcy proceedings against the same de-

282. *See, e.g.*, Order at 1, SEC v. i2 Techs., Inc., No. 3:04-CV-1250-P (N.D. Tex. Feb. 24, 2006) (directing the funds to the class action settlement fund for pro rata distribution in accordance with that plan).

283. The universe of distribution agents is small. The majority of non-SEC-administered funds were administered by four firms: A.B. Data, the Garden City Group, Gilardi, and Rust Consulting. To expedite the process, "[o]n July 15, 2013, the Commission approved a pool of nine firms from which future fund administrators will be appointed to administer the distribution of disgorgement or fair funds." 78 Fed. Reg. 46,498, 46,498 n.1 (Aug. 1, 2013).

fendant. In those cases, the SEC directed the fair funds to the parallel proceeding.

These findings refute the scholarly consensus, which holds that the SEC does not even attempt to coordinate its actions with parallel private litigation.[284] It is true that the SEC does not consider the existence of parallel private litigation when it investigates and settles enforcement actions.[285] However, once an enforcement action concludes, the SEC usually coordinates the distribution of collected funds with parallel proceedings.

The SEC created a customized distribution plan in 149 cases. Unlike in private litigation, the cost of distributing the fair fund is often borne by the sanctioned firm and does not reduce investors' recoveries.[286] Sixty-one of the cases where the SEC created a customized plan were not accompanied by parallel securities litigation. Of 88 cases with parallel private litigation, private actions were dismissed or resulted in nonmonetary recovery in 27 cases; an additional 2 cases are still ongoing. Eight cases settled with sufficiently different classes of victims that parallel distribution would not be practical.[287] In the aggregate, the SEC did not duplicate distribution in 171 of 217 fair fund cases, or 78.8% of the time. Thus, the claim that the SEC wastes resources on duplicative compensation proceedings is unfounded. In a large majority of cases where the SEC created a separate distribution plan, the SEC's action was the only source of compensation from the defendant (based on this study).

This leaves 47 cases where private and public settlement and distribution proceedings proceeded in parallel and the SEC created a customized distribution plan—cases that can fairly be described as duplicative. In all but 6 of these cases, private litigation was settled after the SEC's enforcement action—on av-

284. *See* Zimmerman, *supra* note 10, at 557.

285. Telephone Interview with Nichola Timmons, *supra* note 68.

286. *See* U.S. GOV'T ACCOUNTABILITY OFFICE, *supra* note 97, at 29 n.39 (reporting that 70% of fair funds "have provisions whereby fund proceeds are used to pay administrative expenses," while the defendants "pay Fair Fund expenses" in the remaining 30% of cases); *see also* Proposed Plan of Distribution at 6-7, Strong Capital Mgmt., Inc., Administrative Proceeding File No. 3-12448 (SEC Aug. 3, 2011), 2011 WL 3342436, at *3-4; Millennium Partners, L.P., Securities Act Release No. 8639, Exchange Act Release No. 52,863, Investment Company Act Release No. 27,172, 86 SEC Docket 1889, 1896 (Dec. 1, 2005) (providing that Millennium pay up to $5 million to the distribution consultant and fund administrator); *Questions and Answers Regarding the Distribution Funds in the Analysts Cases*, U.S. SEC. & EXCHANGE COMMISSION, http://www.sec.gov/news/press/globaldistqa.htm (last modified Aug. 19, 2003) ("The firms will pay *all* of the Distribution Fund Administrator's fees, costs, and expenses . . . . Investors will not have to bear *any* of this expense.").

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

erage more than five years later.[288] The SEC collected $6.84 billion in civil fines and disgorgements in enforcement actions that settled before class action settlements. Although the SEC could have waited for the outcome of parallel securities litigation, the wait would have been very long. Since the SEC had been criticized for distributing fair funds slowly,[289] it responded by distributing the funds to defrauded investors through customized distribution plans.[290]

This haste was not without problems. In its zeal to settle quickly, the SEC sometimes failed to identify securities violations with sufficient specificity to identify potentially eligible participants in the subsequently created fair fund. The most notorious example is the Global Research Analyst Settlement and subsequent fair fund distribution. In 2003 and 2004, the SEC settled enforcement actions against ten investment banks and two individuals for pressuring research analysts into issuing falsely optimistic reports about companies in order to win their investment banking business.[291] The defendants agreed to pay almost $1.4 billion to settle enforcement actions, of which $432.75 million was to be distributed to defrauded investors through several fair funds.[292] Some of the settlements identified specific fraudulent research reports and subsequent overpriced public offerings, whereas others failed to do so, even though the defendants and the SEC had access to information that would permit them to identify defrauded investors and their losses.[293] As a result of that failure, the fund administrator could not draft distribution plans and distribute funds in 3 of 12 fair funds.[294] The court reviewing the Global Research Analyst Settlement and fair fund distribution described the process as "embarrassing."[295] Instead of compensating victims (who existed, but were not identified in the orders imposing sanctions), the court remitted almost $79 million in civil fines and disgorgements to the U.S. Treasury.[296]

It appears that the SEC took the court's harsh words to heart after the Global Research Analyst Settlement and learned from its mistakes. Its recent

288. Mean class action settlement delay for forty class actions settled after the SEC settled its enforcement action in the same case was 1873 days; the median was 1897 days.

289. *See supra* Part I.C.

290. This group includes two notorious fair fund cases, the WorldCom case and the Global Research Analyst Settlement. In both cases, the fair fund distribution plan was litigated. The court reviewing the WorldCom fair fund declared it was fair and reasonable. Official Comm. of Unsecured Creditors of WorldCom, Inc. v. SEC, 467 F.3d 73, 83-84 (2d Cir. 2006).

291. *See* SEC v. Bear, Stearns & Co., 626 F. Supp. 2d 402, 404 (S.D.N.Y. 2009).

292. *See id.*

293. *See id.* at 411.

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

295. *Id.* at 403.

296. A total of $432.75 million was included in the fair fund. The fund distributed almost $378 million to investors. *See id.* at 403, 409-10.

settlements provide more detail about the misconduct to facilitate the subsequent distribution of funds to defrauded investors. Where the defendant is solvent and trustworthy and the victims identifiable without a notice and claims process, the SEC has ordered the defendant (as part of the settlement) to compensate the victims directly—eliminating the need to create and administer a distribution fund. For example, all of the studied settlements in municipal bid-rigging cases have identified harmed municipalities and municipal institutions and directed investment banks to pay more than $240 million in civil fines and disgorgements directly to the victims as compensation. The same is true for several large market-timing fair funds.

There have been recent proposals to include victims in the settlement process between defendants and public agencies.[297] The SEC does not generally consult defrauded investors when it crafts the settlement with the defendant, but it publishes the proposed distribution plan for notice and comment. The SEC's recent settlements directing investment banks to pay harmed investors directly suggest that the SEC has made an effort to identify victims during the settlement process.[298] In most investment advisor, broker-dealer, securities offering, and municipal securities cases, the SEC relies heavily on defendants' records to compile the lists of eligible participants. Participants' claims regularly have the same seniority status and fewer conflicts than are common in private litigation, so victim participation is unlikely to improve the distribution in most of the SEC's funds.[299] Additionally, victim participation is less important in the SEC's distributions because the failure to participate in a distribution does not waive private rights to litigate. Eligible participants who did not submit claims still have the right to sue.[300] Because the potential benefits of giving victims a voice for developing a fair and efficient distribution plan are relatively low, less process than in private settlements is reasonable.[301] Finally, in cases where the fair fund is directed to the class action for distribution, victims did participate in the parallel class action, where they had a say in the design of the distribution plan. "Class action settlements have long observed rules that encourage [victim] participation," including individualized notice, opportunities to intervene

297. *See* Lemos, *supra* note 36, at 487; Sant'Ambrogio & Zimmerman, *supra* note 21, at 2010; Zimmerman, *supra* note 10, at 563-68.

298. Unlike most fair funds, where a settlement of the enforcement action is followed by a distribution plan that describes the classes of eligible participants, in these cases the settlement itself directs the defendant to compensate specific victims specified amounts.

299. In cases in which victims clearly suffered more than small financial loses, victim participation itself may have value beyond improving the distribution. Ponzi schemes and affinity fraud are a good example in securities. They are usually resolved through receiverships, where victims have more say than they do in SEC-administered distribution funds.

300. The right to sue does not imply recovery. As Part III.A.3 explains in more detail, securities litigation often makes little economic sense for a plaintiff who must bear his or her own litigation costs.

301. *See generally* Adam S. Zimmerman, *The Corrective Justice State*, 5 J. TORT L. 189, 222 (2012) (concluding that the more uniform, low-value, and nonpreclusive the public settlement, the less victim participation matters to ensuring fairness and efficiency).

or object, and division of "members with different interests into subclasses that are each entitled to separate representation in settlement" and distribution negotiations.[302] Usually, the fair fund that is directed to a class action is distributed under the same distribution plan as the class action settlement. As a result, harmed investors have a voice in how the fair fund is distributed, even if the SEC's rules do not give them a final say.[303]

IV. FURTHER IMPLICATIONS

A. *What the Results Tell Us About Fair Fund Distributions*

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

First, the contention that the SEC wastes resources on repetitive cases is largely without empirical support. It is true that issuer reporting and disclosure cases are invariably accompanied by parallel litigation. But for other types of securities violations, the SEC's fair fund distribution is often the only source of compensation for defrauded investors. Successful class actions accompany 46.3% of fair funds distributions overall and 28.1% of distributions in cases *not associated* with issuer reporting and disclosure violations.[304] The economics of the feasibility of a distribution are similar in class actions and in fair funds; mean and median fair funds and class actions are, likewise, similar. Moreover, SEC enforcement signals more serious misconduct. So one would expect nearly all fair funds to be accompanied by successful class actions—contrary to the findings reported in this study. Fair fund distributions also dwarf class action recoveries except in accounting fraud cases.

Second, only distributions of monetary sanctions paid by firms in issuer disclosure and reporting cases, representing 35.1% of all fair funds by amount, could be described as circular. In all other cases, circularity is not a concern because of the nature of the violation or because individual and third-party defendants pay monetary sanctions that are distributed through a fair fund.

Where the firm pays to settle an enforcement action for a securities violation from which it profited, the sanction prevents wrongdoer firms and their shareholders from profiting from misconduct. Without imposing fines against firms for securities violations from which the firms benefit, their shareholders (and managers furthering shareholders' interests) would have an incentive to ignore or even encourage lucrative misconduct. The subsequent distribution to

302. *See* Zimmerman, *supra* note 10, at 546.

303. *See* 17 C.F.R. § 201.1106 (2014) ("[N]o person shall be granted leave to intervene or to participate or otherwise to appear in any agency proceeding or otherwise to challenge [a distribution plan, eligibility determination, or disbursement].").

304. FINRA has made some effort to compensate defrauded investors, but its overall contribution has been nominal at best. *See supra* note 215.

defrauded investors compensates them for losses that they could not avoid or mitigate, and is not inefficiently circular.

The SEC's enforcement is more varied than class actions and far more likely to target individuals. Many enforcement actions in the fair fund sample are not accompanied by private litigation.[305] In those cases, the SEC's action is the only source of compensation *as well as deterrence*.

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

B. *Fair Fund Distributions as Evidence of Administrative Flexibility*

The SEC mismanaged the Global Research Analyst Settlement and subsequent distribution.[306] The SEC failed to identify specific misconduct in the enforcement action, and as a result it was unable to draft a coherent distribution plan for compensating defrauded investors. It remitted to the U.S. Treasury almost $79 million that otherwise could have been distributed to defrauded investors, and the court justifiably chided the SEC for the avoidable failure.[307] The SEC was also widely criticized for its fair fund distribution to shareholders of bankrupt WorldCom.[308]

But subsequent enforcement actions and related distribution funds suggest that the SEC has learned from its mistakes. Its recent settlements provide more details about misconduct, facilitating subsequent distribution. Where the defendant is solvent and trustworthy and the victims identifiable without a notice and claims process, the SEC has ordered the defendant (as part of the settlement) to compensate its victims directly—eliminating the need to create a distribution fund.[309] Where victims are more difficult to identify, the SEC coordinates its distribution with parallel proceedings whenever possible.[310] In issuer disclosure and reporting cases, which are always accompanied by securities class actions, the SEC has directed fair funds to class action settlements instead of creating customized plans. This reduces the administrative cost associated with the distribution.

And since WorldCom, the SEC has not sanctioned firms pushed into bankruptcy by accounting fraud. Instead, it has aggressively pursued individual and secondary defendants and distributed more than $772 million it recovered from nonfirm defendants to compensate defrauded shareholders. In addition, the

305. *See supra* Part III.A.3.
306. *See supra* Part III.C.
307. *See supra* Part III.C.
308. *See supra* Part III.A.2.
309. *See supra* Part III.C.
310. *See supra* Part III.C.

SEC generally has shown a willingness to forgo a fair fund distribution in accounting fraud cases by not insisting on a one-dollar disgorgement, which would allow the SEC to distribute the entire pot.[311]

The SEC implemented these changes within a year or two of its initial missteps. By contrast, securities class actions today target the same defendants for the same misconduct (fraudulent disclosures) as securities class actions did twenty years ago, when the PSLRA tightened the pleading and class certification requirements. The only things that change are the names of the defendant companies. If there is a securities violation and the reward is worth the cost of pursuing it, the class action will be brought.[312] The most lucrative *and* successful class actions are those associated with restatements and accounting irregularities, representing 60% of settlements and more than 90% of damages. Plaintiffs' attorneys rationally bring class actions with the highest expected value—issuer reporting and disclosure violations—and far fewer in cases not associated with fraudulent disclosures. Private plaintiffs' (and their attorneys') strategies change only when the Supreme Court or Congress modifies the pleading requirements and thus the availability of private securities litigation.[313] By contrast, the SEC's experience shows that public compensation efforts can be considerably more flexible.

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

Since the 1970s, the Supreme Court and Congress have limited the availability of private securities litigation.[314] It is unclear whether class action suits that are filed today are more meritorious than before the Supreme Court and

311. *See* Final Judgment as to Defendant Citigroup Inc. at 2-4, SEC v. Citigroup Inc., No. 10-cv-1277-ESH (D.D.C. Oct. 8, 2010) (authorizing the SEC to create a fair fund with $75,000,001, though it has yet to do so); Final Judgment as to Defendant Diebold, Inc. at 3-4, SEC v. Diebold, Inc., No. 10-0908 (D.D.C. June 14, 2010) (ordering a $25 million civil penalty without disgorgement to be remitted to the Treasury); Final Judgment as to General Electric Co. at 4, SEC v. Gen. Elec. Co., No. 3:09cv1235(RNC) (D. Conn. Aug. 10, 2009) (agreeing to a $50 million penalty without adding a nominal disgorgement).

312. Rose, *supra* note 204, at 1329; *see also* A. Mitchell Polinsky, *Private Versus Public Enforcement of Fines*, 9 J. LEGAL STUD. 105, 107 (1980) (arguing that in many cases, financially motivated private enforcement will result in underdeterrence, particularly where the external damage from the violation is large and enforcement costs are high); Steven Shavell, *The Fundamental Divergence Between the Private and the Social Motive to Use the Legal System*, 26 J. LEGAL STUD. 575, 578 (1997) (showing that private enforcement can overdeter as well as underdeter).

313. *See* CORNERSTONE RESEARCH, SECURITIES CLASS ACTION FILINGS: 2012 YEAR IN REVIEW 14 & n.11, fig.12 (2013).

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

Congress intervened.[315] This study suggests, however, that private securities litigation targets only one type of securities violation—accounting fraud. In part, the reason is economics. Accounting fraud cases with the potential for large damages attract private attorneys to file class actions and cover litigation expenses, with the hope of large contingency fee recoveries. In part, the Supreme Court has interpreted section 10(b) of the Securities Exchange Act to effectively limit private remedies to fraudulent disclosure.[316] The original language and intent of section 10(b) were not so circumscribed.[317] As a result of this (mis)interpretation, the likelihood of certifying a class and surviving the motion to dismiss is considerably higher for class actions alleging accounting fraud than for those alleging other securities violations, as this study demonstrates.[318] Defrauded investors file class actions in cases against investment advisors, broker-dealers, and investment banks, yet those class actions have much higher dismissal rates than class actions filed in issuer reporting and disclosure cases. Whether by design or by happenstance, statutory and judicial screens eliminate entire classes of meritorious private suits, in particular those against market professionals for a variety of low-visibility, high-profit securities violations.[319]

This study suggests that the SEC is compensating defrauded investors in cases where private litigation is not serving its compensatory function. There is no evidence that the SEC consciously brings fewer accounting fraud cases because it believes that private litigation can pick up its slack. Rather, the SEC has broad enforcement authority in various areas of securities regulation and tries to bring enforcement actions in all areas of its authority. Fair fund distributions are merely a fortunate byproduct. Nonetheless, this Article argues that public compensation should persist and even increase as the availability of private litigation declines. The collateral benefit of the shift toward more public

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

316. *See* Steve Thel, *The Original Conception of Section 10(b) of the Securities Exchange Act*, 42 STAN. L. REV. 385, 463-64 (1990).

317. *See id.*

318. *See also* Coffee, *supra* note 16, at 1544-45 ("[A]llegations of accounting irregularities bec[ame] the predominant claim in class actions filed after the passage of the PSLRA and allegations of false forward-looking statements declin[ed] as a percentage.").

319. For example, the SEC ordered Morgan Stanley DW to pay $50 million, Morgan Stanley DW Inc., Securities Act Release No. 8339, Exchange Act Release No. 48,789, 81 SEC Docket 1993, 2001 (Nov. 17, 2003), Franklin/Templeton $20 million, Franklin Advisers, Inc., Exchange Act Release No. 50,841, Investment Company Act Release No. 26,692, 84 SEC Docket 1357, 1362 (Dec. 13, 2004), and Hartford Investment Financial Services $55 million, Hartford Inv. Fin. Servs., LLC, Securities Act Release No. 8750, Exchange Act Release No. 54,720, Investment Company Act Release No. 27,549, 89 SEC Docket 643, 649 (Nov. 8, 2006), while parallel class actions were dismissed. In market-timing cases, federal prosecutors secured criminal convictions against individual securities violators.

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

CONCLUSION

The study in this Article provides several conclusions. The most important for legal academics and policymakers is also the most obvious: salient anecdotes do not make data and should not be the basis for policy change. Just because the SEC took money from creditors to compensate shareholders of bankrupt WorldCom does not imply that this is the SEC's modus operandi. Just because the SEC botched the Global Research Analyst Settlement and fair fund distributions does not imply that the SEC's distributions are a logistical nightmare. And just because the SEC creates large fair funds in accounting fraud cases that are accompanied by private litigation does not imply that all, or even most, fair fund distributions waste the SEC's resources on repetitive cases.[320] Anecdotal evidence and quotations from court opinions are not substitutes for comprehensive research.

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

As the Supreme Court continues to limit the availability of private class actions for securities fraud, public compensation may increase in importance. If the SEC's enforcement resources increase, investors may see no net loss in compensation but better deterrence of securities violations.

320. *See* Brief of the Securities Industry & Financial Markets Ass'n & Futures Industry Ass'n as Amici Curiae in Support of Respondents at 25-26, Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc., 552 U.S. 148 (2008) (No. 06-43), 2007 WL 2363256.