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Showing Loss in Securities Enforcement Actions

Pietro M. deVolpi, Jr.
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INTRODUCTION

The Securities Exchange Act of 1934 (Exchange Act),¹ as amended, provides remedial tools to private plaintiffs, the Department of Justice, and the Securities and Exchange Commission (SEC or the Commission).² This article reviews the Exchange Act’s amorphous requirement that the SEC show loss to secure court-issued civil penalties.³ It recommends that courts follow the rationale which extended loss causation elements from the Private Securities Litigation Reform Act of 1995 (PSLRA)⁴ in Dura Pharmaceuticals, Inc. v. Broudo,⁵ to the U.S. Sentencing Guidelines and restitution calculations in United States v. Rutkoske.⁶

In Dura, the Supreme Court stiffened causality requirements for private plaintiffs alleging losses from securities fraud.⁷ The Court addressed a statutory issue which resembles, in many respects, the calculations necessary to assess penalties sought by the SEC in federal court for violations of Exchange Act § 10(b) and Rule 10b-5.⁸

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3. See SEC v. Henke, 275 F. Supp. 2d 1075, 1084–85 (N.D. Cal. 2003) (grappling with a “paucity of litigated open market securities cases” in its decision to reject a requested $2.6 million penalty by the SEC following investor losses totaling $24.5 million) (citation omitted), aff’d, 130 F. App’x 173 (9th Cir. 2005); George P. Roach, A Default Rule of Omnipotence: Implied Jurisdiction and Exaggerated Remedies in Equity for Federal Agencies, 12 FORDHAM J. CORP. & FIN. L. 1, 48 (2007) (observing that the equitable and legal grounds for issuing civil penalties in the Seventh Circuit remain unexplored in the wake of SEC v. Lipson, 278 F.3d 656 (7th Cir. 2002)).


6. Dura, 544 U.S. at 347.

7. There are also instances where a violation of section 17(a) of the Securities Act of 1933, 15 U.S.C. § 77q(a), and accompanying statutory penalty provisions under 15 U.S.C. § 77t(d)(2)(C), would be compatible with the findings of this article.

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Although the SEC has benefited from equivocal standards, recent decisions have pressured the SEC to adequately establish that a defendant’s actions warranted the penalty. Parallels in statutory construction support applying Dura and Rutkoske rationale to the Exchange Act’s requirement that the SEC prove loss. This article concludes that a uniform approach incorporating traditional forms of statutory construction and practical application of law could serve as a manageable alternative for defendants and the Commission.

Part I provides a cursory discussion of the Supreme Court’s decision in Dura, and distinguishes loss causation in private actions from recent opinions extending Dura to criminal penalties. It then traces the development of SEC enforcement powers over the past two-and-a-half decades, focusing on Congress’s intent when it authorized civil penalties against individuals and corporations. Part II harmonizes this backdrop with current requirements for the SEC to establish a causal connection in claims of misrepresentation to investors who traded in an efficient market, known as “fraud-on-the-market.” Based on trends in recent case law addressing SEC civil penalties, this article recommends that Dura and Rutkoske principles apply where the SEC is required to make “a proper showing” that “such violation directly or indirectly resulted in substantial losses or created a significant risk of substantial losses to other persons.”

9. See Roach, supra note 3, at 29–30 (explaining the rationale for courts granting broad requests for remedies beyond traditional equitable principles as support for the agency’s mission) (citing SEC v. Tex. Gulf Sulphur Co., 446 F.2d 1301, 1308 (2d Cir. 1971)) (quotation omitted).


12. See infra Part II.


14. See infra Parts I.A.-I.B.

15. See infra Part I.C. (distinguishing statutory penalties created over the past twenty-five years).


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I. REACHING RUTKOSKE RESTITUTION

A. Loss Causation and the Dura Decision

Loss causation demonstrates that a defendant’s unlawful misrepresentation or omission caused market losses alleged by a party bringing suit. Upon enactment of the PSLRA in 1995, Congress mandated that a private plaintiff must show loss causation in order to initially proceed and therefrom succeed. One decade later, Justice Breyer clarified the PSLRA standard to plead and prove loss causation in Dura Pharmaceuticals, Inc. v. Broudo.

Dura exemplified a case of fraud-on-the-market. A class of Dura Pharmaceuticals, Inc. stock purchasers filed suit in U.S. district court. These private plaintiffs purchased stock between April 1997 and February 1998, when the price of Dura stock hovered as high as $53 per share.

1. Allegations by the Dura Plaintiff Class

The plaintiff class alleged that press releases originating from Dura during the ten-month purchase period exaggerated the anticipated success for testing and developing a new form of asthma treatment. The plaintiffs further alleged that Dura officials knew that those press releases contained false and misleading statements.

Before the suit, Dura’s performance suffered from two ailments: (1) The Food and Drug Administration’s (FDA) rejection of its experimental asthma spray; and

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Loss causation should not be confused with “transaction causation” (or “reliance”) which private plaintiffs must sometimes prove to show that their purchase was in reliance upon the misrepresentation or omission. See Dura, 544 U.S. at 341–42 (citing Basic, 485 U.S. 248–49); In re CMS Energy Sec. Litig., 403 F. Supp. 2d 625, 630 (E.D. Mich. 2005) (rejecting argument that Dura increased pleading requirements for reliance). See generally Olazabal, supra note 18, at 50–60 (explaining transaction causation).

19. 15 U.S.C. § 78u-4(b)(4) (“[T]he plaintiff shall have the burden of proving that the act or omission of the defendant alleged to violate this title caused the loss for which the plaintiff seeks to recover damages.”).

20. 544 U.S. 336.


23. See Broudo v. Dura Pharmas., Inc., 339 F.3d 933, 936 (9th Cir. 2003), rev’d, 544 U.S. 336 (2005) [hereinafter In re Dura].

24. The device, Albuterol Spiros, delivered medication to asthma patients without requiring simultaneous inhalation. Dura, 339 F.3d at 936 n.2.

(2) Less than expected sales projections for one of its leading antibiotic lines.\textsuperscript{26} Shortly thereafter, Dura management revealed that a decline in sales of a leading antibiotic would decrease the company’s anticipated revenues and earnings per share (EPS).\textsuperscript{27} Dura shares plummeted in value from above $39 to below $21 over the next three days.\textsuperscript{28} This led the company to admit to investment analysts that it knew five months earlier that inventory and distribution issues would hamper anticipated sales for the antibiotic.\textsuperscript{29} Dura then disclosed the FDA’s rejection of its asthma spray for technical and safety reasons.\textsuperscript{30}

2. Deficiencies in the \textit{Dura} Complaint and Loss Causation Analysis

Absent from the \textit{Dura} complaint were allegations that a corrective disclosure preceded a change in the price of Dura Pharmaceuticals, Inc. stock.\textsuperscript{31} Instead, the complaint merely alleged that members of the class paid an “artificially inflated purchase price.”\textsuperscript{32} The Supreme Court ruled that private plaintiffs must adequately plead and prove the causal connection between damages suffered and the defendant’s fraudulent misrepresentation.\textsuperscript{33} The Court distinguished the standard for proving a defendant’s act triggered economic loss from a lesser standard which merely required plaintiffs establish that a defendant’s violation preceded change in a stock’s price.\textsuperscript{34} Below, the U.S. Court of Appeals for the Ninth Circuit had required only that a plaintiff plead “that ‘the price’ of the security ‘on the date of purchase was inflated because of the misrepresentation.’”\textsuperscript{35} The Supreme Court rejected this formula, finding that the degree of causal connection was inadequate to meet the burden of proof proscribed for under the PSLRA.\textsuperscript{36}

In conducting its analysis, the \textit{Dura} Court worked backwards. Before analyzing the pleadings standards for loss causation under the PSLRA, the Court evaluated the elements required to show causal loss.\textsuperscript{37} In Part II-A of its opinion, the Court evaluated the common law heritage for damage assessments,\textsuperscript{38} and the ex-

\begin{thebibliography}{99}
\bibitem{26} \textit{Dura}, 339 F.3d at 939.
\bibitem{27} See id. at 936 (discussing the decrease in anticipated revenues and EPS for the antibiotic Ceclor CD). The plaintiffs also originally alleged that decreased sales of the respiratory sprays Nasarel and Nasalide contributed to the decline. \textit{In re Dura, supra} note 22, at *2.
\bibitem{28} \textit{Dura}, 339 F.3d at 935–36.
\bibitem{29} Id. at 936 (indicating Dura management knew as far back as December 1997).
\bibitem{30} Id.
\bibitem{31} See id. at 938 & n.4.
\bibitem{33} Id. at 347 (requiring plaintiff plead and prove “what the relevant economic loss might be or of what the causal connection might be between [plaintiff’s] loss and the [defendant’s] misrepresentation”).
\bibitem{34} Id. at 343 (distinguishing “loss causation” from that which merely “‘touch(es) upon’ a later economic loss”).
\bibitem{35} Id. at 338 (citation omitted).
\bibitem{36} Id. at 343 (“To ‘touch upon’ a loss is not to cause a loss, and it is the latter that the law requires.” (citing 15 U.S.C. § 78u-4(b)(4))); \textit{see also} Glaser v. Enzo Biochem, Inc., 464 F.3d 474, 479 (4th Cir. 2006) (quoting \textit{Dura}, 544 U.S. at 343) (same), \textit{cert. denied}, 127 S. Ct. 1876 (2007).
\bibitem{37} \textit{Dura}, 544 U.S. at 342–46.
\bibitem{38} See id. at 343–45.
\end{thebibliography}
press intent of Congress to permit recovery only where the plaintiff first showed economic loss and proximate causation.\textsuperscript{39}

The Court observed that the price of stock at the time of sale often reflects the impact of extrinsic factors—and not merely the defendant’s fraudulent act.\textsuperscript{40} According to the Court, attributing a change in price due to external market forces gains even further credence as time passes.\textsuperscript{41} In other words, if too much time passes between the disclosure of corrective information and sale of the stock, an offender cannot (and should not) be punished for all investor losses.

**B. Sending *Dura* to the Criminal World and Back**

1. **Stretching *Dura* Beyond the PSLRA**

At first, courts limited application of *Dura* loss causation principles to private claims alleging fraud-on-the-market.\textsuperscript{42} But within a year, courts began expanding *Dura* causation requirements beyond PSLRA claims.\textsuperscript{43} Damage calculations for common law fraud claims became a prime target for litigators and commentators after *Dura*.\textsuperscript{44} A Florida court of appeals utilized *Dura* to justify, in part, its decision to overturn a $1.58 billion verdict against Morgan Stanley.\textsuperscript{45} Likewise, the Fourth Circuit relied on *Dura* to determine damages for common law fraud under Virginia law in *Glaser v. Enzo Biochem, Inc.*\textsuperscript{46}

\textsuperscript{39} Id. at 345–46 (construing 15 U.S.C. § 78u-4(b)(4)).

\textsuperscript{40} See id. at 343 (describing extrinsic factors including “changed economic circumstances, changed investor expectations, new industry-specific or firm-specific facts, conditions or other events, which taken separately or together account for some or all of that lower [or higher] price”).

\textsuperscript{41} Id.

\textsuperscript{42} See generally Schuster v. Andersen, 413 F. Supp. 2d 983, 1014 (N.D. Iowa 2005) (“*Dura* provides little, if any, guidance, with respect to what a complaint outside of a fraud-on-the-market case must contain.”) (citing Livid Holdings Ltd. v. Salomon Smith Barney, Inc., 416 F.3d 940, 944 n.1 (9th Cir. 2005)).

\textsuperscript{43} See infra notes 44–64 and accompanying text.

\textsuperscript{44} See Brandon F. White, *Dura Pharmaceuticals, Inc. v. Broudo: Supreme Court Case Calls Massachusetts Loss Causation Rule Into Question*, BOSTON B.J., Mar.-Apr. 2006, at 18 passim; cases cited infra notes 45–46.

\textsuperscript{45} Morgan Stanley & Co. v. Coleman (Parent) Holdings, Inc., 955 So.2d 1124, 1130 (Fla. Dist. Ct. App. 2007) (quoting *Dura Pharms., Inc. v. Broudo*, 544 U.S. 336, 342–43 (2005)); see also id. (“[R]ecovering in a securities case ‘require[s] elimination of that portion of the price decline that is the result of forces unrelated to the wrong.’”) (quoting Miller v. Asensio & Co., 364 F.3d 223, 232 (4th Cir. 2004)). The *Dura* citation in *Morgan Stanley* applied to its analysis of compensatory damages, which accounted for $604 million of the $1.58 billion verdict overturned by the Fourth District Court of Appeal. Id. at 1126.


Following *Dura*, defendants prosecuted in criminal proceedings for willing and knowing violations of the Exchange Act\(^{47}\) began to challenge their sentences by arguing that the Court’s analysis warranted application to calculations for pecuniary gain and loss under the U.S. Sentencing Guidelines Manual (Sentencing Guidelines).\(^{48}\)

In *United States v. Olis*, a Fifth Circuit panel emphasized “the importance of thorough analyses grounded in economic reality” in its decision to apply *Dura* principles.\(^{49}\) This reading grew out of other decisions under the Sentencing Guidelines.\(^{50}\) The weight of the Sentences Guidelines shifted dramatically following *United States v. Booker*, 543 U.S. 220, 265 (2005). Today, “district courts, while not bound to apply the Guidelines, must consult those Guidelines and take them into account when sentencing.” \(^{51}\)

Although *Olis* addressed criminal sentencing, district courts in the Fifth Circuit found guidance in the opinion for determining damages in matters litigated under

\[47. \text{See generally } 15 \text{ U.S.C. § 78ff(a) (2000) (authorizing criminal sanctions for willful and knowing violations).}
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\[49. 429 F.3d 540, 547 (5th Cir. 2005).
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\[50. \text{See United States v. Olis, 429 F.3d at 547 (5th Cir. 2005) (citing United States v. Snyder, 291 F.3d 1291 (11th Cir. 2002)) (identifying necessity to consider “numerous extrinsic market influences as well as the soundness of other business decisions by the company”); see also infra note 61 (identifying authorities in accord with United States v. Olis, 429 F.3d 540, 547 (5th Cir. 2005) (citing United States v. Bakhit, 218 F. Supp. 2d 1232 (C.D. Cal. 2002)).}
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\[51. 429 F.3d at 540, 547 (5th Cir. 2005).
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While *Mooney* received some harsh critiques, see Angeli & Ramfjord, supra, at 10 (criticizing the rationale of *Mooney*), the opinion does appropriately acknowledged that the Sentencing Guidelines serve as an initial benchmark before determining an appropriate sentence, see *United States v. Mooney*, 425 F.3d at 1101 (en banc) (emphasizing that the Sentencing Guidelines only “start[ed] the sentencing process ... before considering other statutory factors.”) (citing United States v. Booker, 125 S. Ct. 738, 767 (2005)). The Eighth Circuit rationalized a consistent sentencing scheme for condemning white collar criminals. See id. And the decision appears in accord with a recent order issued by a Second Circuit panel in *United States v. Zafar*, No. 07-4345-cr, 2008 WL 4138219, at *3 (2d Cir. Sept. 4, 2008).
the PSLRA. And the Second Circuit imported Olis into its criminal sentencing proceedings in United States v. Ebbers. In Ebbers, the Second Circuit emphasized that the Department of Justice must prove during sentencing that a defendant’s fraud caused the alleged loss. The underlying rationale appeared to be the court’s recognition that considering market fluctuations is a contentious but necessary matter when assessing loss caused by a defendant.

Following Ebbers, the Second Circuit explicitly recognized the “useful guidance” of Dura in United States v. Rutkoske. The case evolved from alleged chop shop tactics and shady dealings at a brokerage firm. After a trial by jury, the court applied Dura calculations during sentencing to the amount of loss caused by fraud for purposes of calculating a prison term under the Sentencing Guidelines, as well as monetary restitution. Rutkoske found further support in the Ninth Circuit’s opinion United States v. Zolp, which highlighted the impact of extrinsic market factors.

The Second Circuit also went one step further in Rutkoske when the court applied Dura to restitution orders. In criminal actions, restitution measures are based upon the loss “actually caused” by the defendant’s violation. In reaching this conclusion, the court provided only a glimpse of Dura loss application.

55. Id. (citing Olis, 429 F.3d at 547). The Ebbers panel did not cite Dura directly.
56. The Second Circuit originally clamored “[w]orse, there is another variable” when describing the requirements for determining loss in Ebbers, 458 F.3d at 128. But in United States v. Rutkoske, the court rationalized this additional burden given its use in private civil actions. 506 F.3d 170 at 179 (2d Cir. 2007), cert. denied, 128 S. Ct. 2488 (2008). (“[C]onsiderations relevant to loss causation in a civil fraud case should . . . apply, at least as strongly, to a sentencing regime in which the amount of loss caused by a fraud is a critical determinant of the length of a defendant’s sentence.”).
57. 506 F.3d at 178-79.
58. See Mark Hamblett, Factors Other than Fraud Must be Mulled in Penalty, 238 N.Y.L.J. 1 (Oct. 29, 2007).
59. 506 F.3d at 180-81.
60. 479 F.3d 715 (9th Cir. 2007).
61. Id. at 719 (comparing Dura Pharm., Inc. v. Broudo, 544 U.S. 336, 341-42 (2005)). The Ninth Circuit also cited to the Bakhit opinion to support this proposition, see Zolp, 479 F.3d at 719 (citing United States v. Bakhit, 218 F. Supp. 2d 1232 (C.D. Cal. 2002)), one of the opinions which the Fifth Circuit identified to support its original loss causation ruling, see United States v. Olis, 429 F.3d 540, 547 (5th Cir. 2005) (citing Bakhit, 218 F. Supp. 2d 1232).
62. 506 F.3d 170.
63. United States v. Rothwell, 387 F.3d 579, 585 (6th Cir. 2004) (“An award of restitution must be based on the amount of loss actually caused by the defendant’s conduct.” (quoting United States v. Liss, 265 F.3d 1220, 1231 (11th Cir. 2001)); see also United States v. United Sec. Sav. Bank, 394 F.3d 564, 567 (8th Cir. 2004) (“A criminal restitution order is penal, not compensatory.” (citing Kelly v. Robinson, 479 U.S. 36, 52-53 (1986))). But as one commentator “put it bluntly, American lawyers today (judges and law professors included) do not know what restitution is.” Andrew Kull, Rationalizing Restitution, 83 CALIF. L. REV. 1191, 1195 (1995). Therefore, I will limit my analysis to pointing out that criminal restitution is not the same as the equitable remedy of restitution sometimes utilized in civil actions. See RESTATEMENT (THIRD) OF RESTITUTION AND UNJUST ENRICHMENT § 1 cmt. h (Tentative Draft No. 1, 2000).
64. Compare the Second Circuit’s recent holding that when determining whether loss calculations for the price of securities are “legally acceptable” per Rutkoske, error occurred when the court below assumed that the price of a purchase stock was zero for calculating losses. United States v. Leonard, 529 F.3d 83, 93 (2d Cir. 2008).
C. Distinguishing a Quarter-Century of SEC Penalties

The PSLRA requires that private plaintiffs plead and prove loss causation. But just as there is no requirement in criminal securities fraud actions to prove investor losses to secure a conviction, there is no requirement that the SEC plead or prove investor losses in order to show that a defendant violated the Exchange Act. As one court pointedly put it, the Commission "does not stand in the shoes of the purchasers and sellers who it asserts were defrauded."

1. Equitable Remedies in Federal Court

Following trial, proceedings in an SEC enforcement action are bifurcated and are heard before a judge in a manner analogous to a criminal sentencing hearing. Under the exercise of equitable powers, federal district courts wield "broad discretion" to formulate remedies, i.e., disgorgement, in civil enforcement actions. Even though broad discretion exists for formulating disgorgement calculations, some degree of causal connection is required before calculating ill-gotten profits (citing United States v. Sash, 396 F.3d 515, 522-23 (2d Cir. 2005)) (finding error in failure to "deduct[] from the purchase price the actual value of the instruments").


69. See, e.g., SEC v. Smyth, 420 F.3d 1225, 1232 (11th Cir. 2005) (holding due process requires a separate remedies hearing unless "all essential evidence was already of record, and it did not present one of the 'limited circumstances' under which the district court could properly exercise its discretion not to hold a hearing"); SEC v. Solow, 554 F. Supp. 2d 1356, 1366-70 (S.D. Fla. 2008) (indicating separate proceeding held to determine liability and appropriate remedies); see also SEC v. Montana, 464 F. Supp. 2d 772, 787 (S.D. Ind. 2006) (citing SEC v. Church Extension of the Church of God, Inc., 429 F. Supp. 2d 1045, 1048 (S.D. Ind. 2005)) (postponing award of civil penalties until separate hearing held and evidence presented following award of summary judgment to SEC).

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2. Civil Penalties as a Legal Remedy under ITSA, ITSFEA, and Remedies Act Amendments to the Exchange Act

Few opinions directly address the nature of civil penalties available to the SEC. SEC v. Lipson,73 penned by Judge Richard Posner, evaluated and recognized the effectiveness of civil monetary penalties. Judge Posner referred to the statutory remedy as a “heavy punishment” that, when applied to a defendant, could “bring him to his senses.”74 More to the point, Lipson chastised a previous statement by the U.S. Court of Appeals for the Ninth Circuit which presumed civil penalties were a form of equitable relief.75 Judge Posner explained that civil penalties were in fact a legal remedy.76

Lipson is in accord with other authorities which hold that civil penalties are a legal breed of remedial tools.77 In 1984, the Commission sought “civil penalties of relatively small amounts . . . to mitigate the potential harshness of license revocation or suspensions.”78 Congress first responded by authorizing the Commission to pursue monetary sanctions against insider traders via the Insider Trading Sanctions Act of 1984 (ITSA).79 Other remedial measures were included in subsequent

71. Compare, e.g., SEC v. First City Fin. Corp., 890 F.2d 1215, 1231–32 (D.C. Cir. 1989) (requiring a causal connection to distinguish legally obtained gains, but rationalizing a “reasonable approximation” due to difficulty calculating gains), with SEC v. Maxxon, Inc., 465 F.3d 1174, 1179 (10th Cir. 2006) (advocating a reasonable “end-date determination . . . so that the defendant is not required to disgorge profits not ‘causally connected to the violation’”), cert. denied, 127 S. Ct. 2116 (2007), and SEC v. MacDonald, 699 F.2d 47, 53–55 (1st Cir. 1983) (en banc) (requiring calculation based upon change in value of stock held a reasonable time after revealing non-public information). The MacDonald standard was utilized in the RESTATEMENT (THIRD) OF RESTITUTION AND UNJUST ENRICHMENT § 43 cmt. h, illus. 36 (Tentative Draft No. 4, 2005).

72. See SEC v. First Pac. Bancorp, 142 F.3d 1186, 1191–92 (9th Cir. 1998) (asserting that “broad equity powers” guide disgorgement calculations) (citations omitted); see also SEC v. Commonwealth Chem. Sec., Inc., 574 F.2d 90, 102 (2d Cir. 1977) (permitting the SEC to calculate disgorgement through an analysis “not free of inaccuracy, [but] reasonably complete and suitable”). But cf. Roach, supra note 3, at 48 (explaining that disgorgement can be “either a remedy at law or equity”).

73. SEC v. Lipson, 278 F.3d 656 (7th Cir. 2002).

74. See id. at 664 (affirming decision to apply maximum penalty for insider trading under the ITSA, 15 U.S.C. § 78u-1, where “evidence against [defendant] was overwhelming, and his insistence in the fact of it that he is a shorn sheep argues for a heavy punishment to bring him to his senses”).

75. SEC v. Lipson, 278 F.3d at 662 (criticizing SEC v. Clark, 915 F.2d 439, 442 (9th Cir.1990)).

76. See id. (explaining that Clark “assumed, but without discussion, and we think erroneously, that civil penalties in SEC cases are not a form of legal relief.”); see also SEC v. Solow, 554 F. Supp. 2d 1356, 1367 (S.D. Fla. 2008) (citing Tull v. United States, 481 U.S. 412, 422 (1987); and Lipson, 278 F.3d at 662).

77. See Tull, 481 U.S. at 424 (distinguishing the nature of disgorgement from civil penalties); Roach, supra note 3, at 19 & n.59 (citations omitted); see also Securities Exchange Act of 1934 § 28(a), Pub. L. 73-291, 48 Stat. 881, 903 (codified with some differences in language at 15 U.S.C. § 78bb(a) (2000)) (“The rights and remedies provided by this title shall be in addition to any and all other rights and remedies that may exist at law or in equity . . .”).


amendments enacted under the Insider Trading and Securities Fraud Enforcement Act of 1988 (ITSFEA). 80

In 1990, passage of the Securities Enforcement Remedies and Penny Stock Reform Act of 1990 (Remedies Act) empowered the Commission to seek civil penalties for other violations that did not involve insider trading. 81 Unlike the ITSA and ITSFEA, the Remedies Act utilized a tiered penalty structure and included a requirement that the SEC make “a proper showing” to obtain jurisdiction in its pursuit of civil penalties under the Exchange Act. 82 The tiered structure of the Remedies Act, when adjusted for inflation, provides for monetary penalties that increase based upon an accumulation of factors. 83

The first tier requires a violation of the Exchange Act, and qualifies an individual defendant for a penalty up to $6,500 ($65,000 if a corporation or similar entity) or pecuniary gain from the offense, whichever is greater. 84 The second tier applies to a defendant who used fraud, deception, or manipulation, or recklessly ignored a regulation. Such defendant becomes eligible for a penalty not to exceed the higher value of $65,000 ($325,000 if a corporation or similar entity) or defendant’s pecuniary gain from the offense. 85 A jury’s verdict for certain violations of the Exchange Act can determine a defendant’s general eligibility for a first or second tier penalty. 86

Third-tier penalties apply if the defendant’s misconduct further risked or caused a direct or indirect loss to investors, and such loss was substantial. 87 The defendant then qualifies for a penalty not to exceed $130,000 ($650,000 when a


83. Regardless of which tier a defendant’s misconduct further risked or caused a direct or indirect loss to investors, and such loss was substantial. The defendant then qualifies for a penalty not to exceed $130,000 ($650,000 when a


corporation or similar entity) or pecuniary gain from the offense, whichever is greater. In the event a defendant enjoyed pecuniary gains exceeding the prescribed maximum, any tier penalty may be increased to that gross value.

The Exchange Act amendments facilitated the Commission’s ability to pursue two goals: punishment and deterrence. At the time of enactment, Congress indicated a desire that the Remedies Act would provide the Commission with the necessary tools to seek monetary penalties in a flexible and prophylactic manner. Aside from the adjustments for inflation and a mechanism to distribute collected funds to investors, the three-tier scheme to this legal remedy has remained undisturbed by Congress for nearly two decades.

II. APPLYING DURA AND RUTKOSKE PRINCIPLES IN SEC LITIGATION

A. Practical Considerations Under a Trifecta Enforcement Regime

1. The Impact of Extrinsic Factors Following Fraud-on-the-Market

In a case of fraud-on-the-market, the market price will generally absorb all publicly available information and provide a means of causally connecting a defendant’s violation with harm to investors. But even a security purchased in a regulated picture-perfect “efficient market” can be affected by other extrinsic factors. The Supreme Court observed in Dura that where a longer period occurs between transactions, “the more likely that other factors caused the loss.”

88. Id.
90. See Official Comm. of Unsecured Creditors of Worldcom, Inc. v. SEC, 467 F.3d 73, 81 (2d Cir. 2006) (explaining “the dual goals of punishment of the individual violator and deterrence of future violations” (quoting SEC v. Coates, 137 F. Supp. 2d 413, 428 (S.D.N.Y. 2001))).
91. See H.R. REP. NO. 101-616 at 18 (1990), as reprinted in 1990 U.S.C.C.A.N. 1379, 1385 (“The Committee contemplates that the Commission would not seek to impose a civil money penalty in every case.”).
92. Adjustments for inflation are included in the aforementioned figures are based upon 17 C.F.R. § 201.1003. In addition, the “Fair Funds for Investors” provision authorized distribution of collected civil penalties to investors. See Sarbanes-Oxley Act of 2002, Pub. L. 107-204, § 308, 116 Stat. 745, 784-85 (codified at 15 U.S.C. § 7246(a)); see also Unsecured Creditors of Worldcom, Inc., 467 F.3d at 81-82. The underlying nature of this provision, and its connection to the equitable remedy of disgorgement are beyond the scope of this article. See generally U.S. GOVT ACCOUNTABILITY OFFICE, GAO REP. NO. 05-670, SEC AND CFTC PENALTIES: CONTINUED PROGRESS MADE IN COLLECTION EFFORTS, BUT GREATER SEC MANAGEMENT ATTENTION IS NEEDED 11 (2005) (noting that the SEC has sought $1 disgorgement orders in some cases to ensure that civil penalties remain eligible for distribution to investors).
95. Dura, 544 U.S. at 343; see also United States v. Ebbers, 458 F.3d 110, 128 (2d Cir. 2006) (citing Olis, 429 F.3d at 547) (“Many factors causing a decline in a company’s performance may become publicly known around the time of the fraud and be one cause in the difference in price . . . .”), cert. denied, Ebbers v. United States, 127 S. Ct. 1483 (2007); cf. cases cited supra note 71 (comparing standards in the circuit courts for estimating a defendant’s pecuniary gains from insider trading).
Court’s practical view aligns with modern economic theory applying the efficient market theory to price change calculations for public-company shares. Exceptions exist: bubbles and crunches, such as the recent global credit crisis in 2008, deviate from the efficient market that the Dura Court faced.

2. Justification for Expansion of Dura and Rutkoske to SEC Enforcement Actions

Although the government avers that loss causation has no application in civil enforcement actions, no authority has justified exempting the SEC from showing a causal connection (or, alternatively, a “significant risk” of a causal connection) to secure third-tier penalties. Ironically, the SEC has cited to Dura in court filings to analogize the causal connection between a defendant’s actions, inflated purchase prices, and alleged harm to investors. But these citations were in no way indicative of a belief by the SEC that Dura has any application in civil enforcement actions.

When measuring loss, courts generally employ a methodology that ensures a causal link by excluding market effects occurring before and extrinsic from a cor-

96. See Dura, 544 U.S. at 344 (exclaiming “it is not surprising that other courts of appeals have rejected the Ninth Circuit’s ‘inflated purchase price’ approach to proving causation and loss”); id. at 342 (referring to methodology “as a matter of pure logic”); see also Glaser v. Enzo Biochem, Inc., 464 F.3d 474, 478 (4th Cir. 2006) (quoting Dura), cert. denied, 549 U.S. 1304 (2007); White, supra note 44, at 19 (proclaiming Dura “explained the obvious”). In short, Dura appears to advocate practical application of economic theory—regardless of storied “roots in the common law.” See Dura, 544 U.S. at 345; supra note 38 and accompanying text.


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rective disclosure. \textsuperscript{102} \textit{Glaser v. Enzo Biochem, Inc.} explained the underlying rationale for this \textit{Dura} principle:

Assume an investor purchased 100 shares . . . for $12 per share on January 12, 2000, [mere hours] after the alleged misrepresentations were made. If the market had known the truth [prior to a corrective disclosure], instead of trading for $12 per share, the stock would have traded for only $1 per share.

[C]ontending that, on the very day of purchase, the investor has suffered a loss of $1,100—the difference between the price paid ($1,200) and the price that would have been paid ($100) had the true facts been known. . . . [I]gnores the fact that the true facts are not yet known and the hypothetical investor has not yet suffered a loss.

If the stock later drops, as a result of normal market fluctuations, to $6 per share (again assuming the fraud has not yet been disclosed), then the investor owns stock worth only one-half of what was paid for it. If he sells at this point, he has lost $600 of his initial $1,200 investment, to be sure, but this loss was not caused by the fraudulent conduct, because, under the hypothetical, the market is still unaware of the misrepresentations. \textsuperscript{103}

That rationale can likewise apply to the aggregate of investors whom the SEC alleges suffered losses, just as it does to a class of investors filing suit on their own behalf, or investors alleged to have suffered loss for purposes of determining an appropriate criminal sanction. \textsuperscript{104} Often, these values can be presented by expert witnesses through event study methodologies. \textsuperscript{105} Coupled with an event study

\textsuperscript{102} See \textit{Glaser}, 464 F.3d at 479 (advocating the exclusion of market effects before disclosure of fraud to determine losses suffered by investors). \textit{Ebbers}, 458 F.3d at 128 (identifying expert witness arguments that extrinsic market factors affected loss measured in criminal sentencing). \textit{Cf. SEC v. Maxxon, Inc.}, 465 F.3d 1174, 1179 (10th Cir. 2006), \textit{cert. denied}, 127 S. Ct. 2116 (2007) (advocating a disgorgement measurement that includes a reasonable "end-date determination . . . so that the defendant is not required to disgorge profits not 'causally connected to the violation'").

\textsuperscript{103} \textit{Glaser}, 464 F.3d at 478–79 (providing the "simple hypothetical" to explain \textit{Dura}) (footnote omitted).

\textsuperscript{104} \textit{Cf. Dura}, 544 U.S. at 343 (highlighting concern that defendants would otherwise face liability for "changed economic circumstances, changed investor expectations, new industry-specific or firm-specific facts, conditions, or other events, which taken separately or together account for some or all of that lower [or higher] price"); \textit{Olis}, 429 F.3d at 547 (identifying necessity to consider "numerous extrinsic market influences as well as the soundness of other business decisions by the company"). \textit{But see Merritt B. Fox, Understanding Dura}, 60 \textit{Bus. Law.} 1547, 1567 (2005) ("[T]he Court[s]' reasons, when subject to scrutiny, appear to be rather confused and so they unfortunately do not provide much helpful guidance concerning how future courts should decide the open issues delineated above."); \textit{Kauffman, supra} note 17.

\textsuperscript{105} The author emphasizes that this hypothetical does not take into account the various factors such as purchase date, sale, and other variables necessary to determine the losses suffered by shareholders. These calculations are best reserved for economic experts, who may use techniques such as an event study or valuation analysis. \textit{See United States v. Olis}, No. H-03-217-01, 2006 WL 2716048, at *4 (S.D. Tex. Sept. 22, 2006) (accepting the use of event studies for purposes of measuring loss) (citing Imperial Credit Indus., Inc. Sec. Litig., 252 F. Supp. 2d
B. Showing “Substantial Loss” Caused by a Defendant

The Supreme Court in *Dura* indicated that flimsy and ambiguous measurements for causation are inadequate if the statute requires proof of loss. Paralleling this statement in *Dura*, courts should require “proof of significant losses or a risk thereof” before analyzing the imposition of a third-tier penalty.

There are differences in the language Congress used in the PSLRA and Remedies Act. The PSLRA requires that a private plaintiff prove that a defendant “caused the loss for which the plaintiff seeks to recover damages.” To secure a third-tier penalty under the Remedies Act, the Commission must “show” that “such violation directly or indirectly resulted in substantial losses or created a significant risk of substantial losses to other persons.” Thus, alternative grounds exist to permit securing a 15 U.S.C. § 78u(d)(3)(B) third-tier penalty.


The Ninth Circuit noted that the “touches upon” standard for determining causation prior to the Supreme Court’s intervention was “admittedly ambiguous.” Broudo v. Dura Pharms., Inc., 339 F.3d 933, 938 (9th Cir. 2003), rev’d, 544 U.S. 336 (2005). The standard had required only that an investor suffer injury following the purchase of stock, “not... that a [company’s] disclosure and subsequent drop in the market price of the stock have actually occurred.” Id.

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This does not displace the importance of loss. A comparison can be drawn with the Sentencing Guidelines which allow a court to alternatively assess "intended gain."\textsuperscript{113} The D.C. Circuit recently overturned the SEC's attempts to apply third-tier penalties without providing an adequate explanation as to what loss or risk of substantial loss was required in an administrative adjudication.\textsuperscript{114} And language included in the Remedies Act for Exchange Act violations (as well as violations of the Investment Advisers Act of 1940) have led federal district courts to reject an assertion of substantial losses, or similar risk, where "no losses were demonstrated."\textsuperscript{115}

Therefore, litigants should emphasize that the words "significant risk of substantial loss" do not act as a catchall phrase to permit third-tier penalties for misrepresentation\textsuperscript{116} in addition to other defenses which may be raised against Commission arguments that a tier three penalty is warranted.\textsuperscript{117} If the Commission claims

\begin{itemize}
  \item Congress also imposed a similar requirement for proving substantial loss or risk thereof in administrative proceedings, with recovery capped at the prescribed maximum in case of a defendant enjoying "substantial pecuniary gain." \textit{See id.} § 78u-2(b)(3)(B) (requiring in administrative proceedings that, inter alia, "such act or omission directly or indirectly resulted in substantial losses or created a significant risk of substantial losses to other persons or resulted in substantial pecuniary gain to the person who committed the act or omission"); \textit{accord id.} § 80a-9(d)(2)(C)(ii) (corresponds to Investment Advisers Act of 1940, Pub. L. 76-768, 54 Stat. 789 (codified as amended in scattered sections of 15 U.S.C.)) (same); \textit{id.} § 80b-3(i)(2)(C)(ii) (corresponds to Investment Advisers Act of 1940, Pub. L. 76-768, 54 Stat. 789 (codified as amended in scattered sections of 15 U.S.C.)).
\end{itemize}
substantial loss to investors, a blanket accusation of risk will prove inadequate.\textsuperscript{118} But the burden should not be too high for the SEC to meet. In certain instances, a reasonable estimate would suffice to evince loss.\textsuperscript{119}

Would requiring the SEC to provide evidence of loss be unprecedented? Three circuits already require that the Commission show investor losses for purposes of establishing subject matter jurisdiction in extraterritorial claims.\textsuperscript{120} One prong of that test obligates the SEC to prove a defendant’s acts were committed domestically and “directly caused’ the claimed losses.”\textsuperscript{121} Requiring the SEC to provide substantial evidence that a defendant created alleged losses to secure a third-tier penalty presents a similar condition.\textsuperscript{122}


\textsuperscript{118} See cases cited \textit{supra} note 116; \textit{cf.} cases cited \textit{supra} notes 10 & 114.

\textsuperscript{119} \textit{Cf.} United States v. Rutkoske, 506 F.3d 170, 179–80 (2d Cir. 2007), \textit{cert. denied}, 128 S. Ct. 2488 (2008) (noting that “reasonable estimate” of loss provided for under the Sentencing Guidelines might apply “where share price drops so quickly and so extensively immediately upon disclosure of a fraud that difference between pre- and post-disclosure share prices is a reasonable estimate of loss caused by the fraud”). Also, \textit{compare} United States v. Rigas, No. 02 Cr. 1236, 2008 WL 2544654, at *4–5 (S.D.N.Y. June 24, 2008), where the court construed \textit{Rutkoske}, 506 F.3d at 179–80, when it agreed with the government’s “reasonable estimate” that the defendant had caused $100 million in losses for purposes of an enhanced sanction under the Sentencing Guidelines. In \textit{Rigas}, the price of stock decreased twenty-five percent on the day company revealed $2 billion in undisclosed debt, and the court referred to defendant’s argument, which was supported by expert testimony, as “border[ing] on the frivolous.”


\textsuperscript{121} \textit{See Berger,} 322 F.3d at 193 (citations and internal quotations omitted). To meet the “conduct test,” the defendant’s causal act must be “substantial acts in furtherance of the fraud [which] were committed within the United States” under the first prong of the test, and also be “more than ‘merely preparatory’ to a securities fraud conducted” outside the United States under the second prong of the test. \textit{See id.} (quoting \textit{Itoba Ltd. v. Lep Group PLC}, 54 F.3d 118, 121–22 (2d Cir.1995)). By comparison, the Remedies Act provides jurisdiction for federal courts to levy civil penalties where the SEC makes “a proper showing.” 15 U.S.C. § 78u(d)(3)(A); \textit{see also JACOBS, supra note 82 (observing no such requirement for insider trading sanctions).}

\textsuperscript{122} In order to secure a disgorgement order against a defendant the SEC carries an initial burden to show the amount of the defendant’s ill-gotten gains. \textit{See Roach, supra note 3, at 98.} This burden is one of persuasion. \textit{LOUIS LOSS & JOEL SELIGMAN, FUNDAMENTALS OF SECURITIES REGULATION,} 1056 (5th ed. 2004) (citing SEC v. Thomas James Assoc., Inc., 738 F. Supp. 88, 95 (W.D.N.Y. 1990)) (asserting that the SEC carries the burden of persuasion to prove it recommended calculation for the equitable remedy of disgorgement). Thereafter, in equity, a defendant carries the burden of proof to rebut the SEC’s claim for unjust enrichment. Roach, \textit{supra note 3, at 98.} But as Professor Roach observes, the rationale for this burden-shifting scheme does not “operate in reverse, as the defendant has no access to information regarding the plaintiff’s losses.” \textit{Roach, supra note 3, at 97.} Therefore, it may be argued that the burden of proof falls on the Commission to show that a defendant’s violations caused loss, or risk thereof, in a manner that warrants a tier-three penalty. \textit{Cf., e.g.,} United States v. Zolp, 479 F.3d 715, 718 (9th Cir. 2007) (asserting that federal prosecutors carry the burden of proof when seeking a sentencing increase for loss caused by a defendant under the Sentencing Guidelines) (citing United States v. Ameline, 409 F.3d 1073, 1086 (9th Cir. 2005) (en banc)); United States v. Dolan, 701 F. Supp. 138, 139 (E.D.Tenn. 1988) (implying that
C. Risks Abound: Why Alternative Grounds Do Not Absolve the SEC of Statutory Burdens

The SEC frequently alleges that a defendant’s violation significantly risked serious harm to investors. Likewise, federal prosecutors often pursue alternative theories of intended loss under the U.S. Sentencing Guidelines Manual. In United States v. Snyder, the Eleventh Circuit held that where loss could be calculated for purposes of the U.S. Sentencing Guidelines, alternative grounds of measuring gain should not be assessed. Alternative grounds for assessing penalties should not be treated differently between criminal sentencing and civil remedial phases. Notwithstanding Snyder, the Supreme Court noted in Dura that showing loss requires more than merely citing the value of stock on a given day. To show risk,
the Commission should proffer evidence which supports a finding by a preponderance of the evidence.\textsuperscript{128}

1. Broker-Dealer Operations and a Presumption of Risk

It may be argued based upon legislative history accompanying the Remedies Act that Congress perceived that fraud targeting the price of the stock (i.e., fraudulent broker-dealer operations) would create "significant risk of substantial loss."\textsuperscript{129} The Tenth Circuit's subsequent observation that "broker-dealer[s] or investment adviser[s] . . . employing deceptive practices . . . are virtually certain to lead to investor losses" supports that rationale.\textsuperscript{130} Concurrently, federal courts have determined that a defendant's actions are likely to create the risk of substantial loss in transactions related to the fraudulent sales or marketing of securities\textsuperscript{131} and pump-and-dump schemes.\textsuperscript{132}

2. Errors for Risk in Fraud-on-the-Market

Distinguishing fraud-on-the-market from a pump-and-dump may appear nuanced.\textsuperscript{133} But cases alleging fraud-on-the-market that include release of ameliorative information are more readily discernable from the "face-to-face" transactions

\textsuperscript{128} To do so, the SEC could present evidence which shows that odds are one-to-one that the defendant's act would have caused a substantial loss. See JACOBS, supra note 82, at § 20:109 & n.67 (construing "significant risk" under 15 U.S.C. § 78u(d)(3)(B)(iii) to be a probability not exceeding fifty percent). For a discussion of substantial loss, see supra note 106 and accompanying text.


\textsuperscript{130} See Geman v. SEC, 334 F.3d 1183, 1193 (10th Cir. 2003) (reviewing penalty issued by an administrative law judge).


\textsuperscript{133} Fraud-on-the-market cases which involve corrective disclosure can be distinguished from "pump-and-dump" cases, whereas the former involve providing corrective information and the latter often involve driving the price of stock into the ground. See, e.g., cases cited supra note 131.

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that brokers and dealers engage in. Nevertheless, some opinions point toward blurring the distinctive nature of these violations and presuming loss (or risk of loss) occurred by not requiring the SEC to evidence the amount of loss suffered by investors. For example, in SEC v. Daly, the U.S. District Court for the District of Columbia declared that a defendant’s dissemination of false financial information to auditors warranted third-tier penalties based on similar findings by federal district courts. Daly did not require the SEC to evidence the amount of loss suffered by investors and rejected the defendant’s argument that quantifying the loss was impossible to calculate. Nor did it provide an explanation of how the defendant’s specific conduct created risk of loss. Nevertheless, the SEC should first present sufficient evidence to support the imposition of third-tier penalties. The Commission would fare best by arguing that both a substantial loss and a risk of substantial loss occurred to avoid a similar result experienced under the U.S. Sentencing Guidelines in United States v. Snyder.

CONCLUSION

Despite no requirement for the SEC to plead losses suffered by investors for purposes of liability, the Commission should be prepared to meet its statutory burden to show that third-tier penalties are warranted in federal district court. Recent case law, including Dura Pharmaceuticals, Inc. v. Broudo and opinions issued by the circuit courts of appeal have culminated in United States v. Rutkoske. This body of case law supports requiring proof that the defendant’s violation of federal securities laws caused substantial losses alleged by the SEC. The plain language of 15 U.S.C. § 78u(d)(3)(B) supports creating a burden for the SEC to properly

134. See generally Burch, supra note 5, at 363–65 (distinguishing the equitable remedies available to private plaintiffs for fraud committed in face-to-face transactions versus open market transactions); Ribstein, supra note 21, at 147–48 (elaborating upon the rationale of fraud-on-the-market theory and the intervening effect of extrinsic information).


137. Id. at 133, n.4 (citation omitted).

138. Id. at 132 (citing 15 U.S.C. § 78u(d)(3)(B)(i)).


140. See supra notes 123-139 and accompanying text.

141. Alternatively, the SEC could also allege that a defendant’s act significantly risked substantial losses. See generally supra, Part II.C.
show either loss or risk of loss that resulted from a defendant’s offense. The SEC’s enforcement program has done much to protect investors against irreversible harm. But in those instances in which the Commission alleges that a defendant’s actions caused investor losses, a court should first consider the causal link between the defendant’s actions and alleged investor losses.