Barry Law Review

Volume 12
Issue 1 *Spring 2009*

Article 1

2009

Showing Loss in Securities Enforcement Actions

Pietro M. deVolpi, Jr.

SHOWING LOSS IN SECURITIES ENFORCEMENT ACTIONS

Pietro M. deVolpi, Jr.[*]

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]

---

* J.D., 2008, American University Washington College of Law; B.A., International Affairs, with an Economics Minor, 2005, The George Washington University. In the interest of full disclosure, the author notes that he worked as a law clerk for Pepper Hamilton LLP on the *SEC v. Snyder* matter *infra* note 10.

1. Pub. L. No. 73-291, 48 Stat. 881 (1934) (codified as amended in scattered sections of 15 U.S.C.).

2. Single provisions permit civil actions by both the injured investor and the regulator. The statute also empowers the Attorney General to level corporate fraudsters. *See generally* Margaret V. Sachs, *Harmonizing Civil and Criminal Enforcement of Federal Regulatory Statutes: The Case of the Securities Exchange Act of 1934*, 2001 U. ILL. L. REV. 1025, 1026 (2001) (comparing civil and criminal claims under the Exchange Act).

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)).

4. Pub. L. No.104-67, § 101(b), 109 Stat. 737, 743–49 (1995) (codified as amended at 15 U.S.C. § 78u-4 (2000)).

5. 544 U.S. 336 (2005). *See generally* Elizabeth Chamblee Burch, *Reassessing Damages in Securities Fraud Class Actions*, 66 MD. L. REV. 348, 349 n.1 (2007) (defining open market transactions as those "where investors trade securities with one another through the publicly traded securities market") (citing Steven A. Fishman, *Duty to Disclose Under Rule 10b-5 In Face-to-Face Transactions*, 12 J. CORP. L. 251, 256–57 (1987)).

6. 506 F.3d 170, 178–79 (2d Cir. 2007), *cert. denied*, 128 S. Ct. 2488 (2008).

7. *Dura*, 544 U.S. at 347.

8. 15 U.S.C. § 78j(b); 17 C.F.R. § 240.10b-5 (2007). 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.

Although the SEC has benefited from equivocal standards,[9] recent decisions have pressured the SEC to adequately establish that a defendant's actions warranted the penalty.[10] Parallels in statutory construction support applying *Dura* and *Rutkoske* rationale to the Exchange Act's requirement that the SEC prove loss.[11] 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.[12]

Part I provides a cursory discussion of the Supreme Court's decision in *Dura*,[13] and distinguishes loss causation in private actions from recent opinions extending *Dura* to criminal penalties.[14] 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.[15] 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."[16] 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."[17]

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).

10. *See, e.g.*, SEC v. Smath, 277 F. Supp. 2d 186, 188 (E.D.N.Y. 2003) (declaring "enough is enough" in decision to award only $1 in nominal damages to the SEC following felony conviction in criminal proceedings, rejecting requests for disgorgement and civil penalties); SEC v. Gann, No. 3:05-CV-0063-L, 2008 WL 857633, at *12 (N.D. Tex. Mar. 31, 2008) (denying the SEC's request for a maximum third-tier penalty based on evidentiary findings during trial, finding a lower penalty "adequate and consistent with the evidence adduced at trial and with the purpose of the statute"); SEC v. Snyder, No. H-03-04658, 2006 U.S. Dist. LEXIS 81830, at *33–37 (S.D. Tex. Aug. 22, 2006) (denying SEC request for civil penalties based upon failure of the Commission to assert facts satisfying discretionary factors utilized by district courts) (citing SEC v. Lybrand, 281 F. Supp. 2d 726, 730 (S.D.N.Y. 2003); *cf.* SEC v. Slocum, Gordon & Co., 334 F. Supp. 2d 144, 186 (D.R.I. 2004) (denying SEC's request for maximum civil penalties where statutory burden not met under § 209(e) of the Investment Advisers Act of Act of 1940). For a further discussion of the *Lybrand* factors, see *infra* note 117.

11. *See* 15 U.S.C. § 78u(d)(3)(B)(iii) (2000).

12. See infra Part II.

13. 544 U.S. 336 (2005).

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

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

16. *Cf.* Merritt B. Fox, *After* Dura*: Causation in Fraud-on-the-Market Actions*, 31 J. CORP. L. 829, 831-32 (2006) (distinguishing fraud-on-the-market claims from victim losses suffered following "face-to-face" purchases or initial public offerings). *See generally* Sachs, *supra* note 2, at 1026 (comparing civil and criminal claims under the Exchange Act). Fraud-on-the-market, in this context, refers to claims by the SEC that a misrepresentation resulted in losses to investors who relied on that misinformation. *See generally* Basic, Inc. v. Levinson, 485 U.S. 224, 241–242 (1988) (defining the fraud-on-the-market theory for application in private plaintiff actions) (citation omitted).

17. 15 U.S.C. § 78u(d)(3)(A), (B)(iii)(bb). *But see* Michael J. Kauffman, *At a Loss: Congress, The Supreme Court and Causation under the Federal Securities Laws*, 2 N.Y.U.J.L. & BUS. 1, 42 (2005) (asserting *Dura* "does not address SEC actions, which are not at all governed by the PSLRA").

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.[18] 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.[19] One decade later, Justice Breyer clarified the PSLRA standard to plead and prove loss causation in *Dura Pharmaceuticals, Inc. v. Broudo.*[20]

Dura exemplified a case of fraud-on-the-market.[21] A class of Dura Pharmaceuticals, Inc. stock purchasers filed suit in U.S. district court.[22] These private plaintiffs purchased stock between April 1997 and February 1998, when the price of Dura stock hovered as high as $53 per share.[23]

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.[24] The plaintiffs further alleged that Dura officials knew that those press releases contained false and misleading statements.[25]

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

18. Ann Morales Olazabal, *Analyst and Broker-Dealer Liability Under 10(b) for Biased Stock Recommendations*, 1 N.Y.U. J.L. & BUS. 1, 61–62 (2004); *see also* Dura Pharms., Inc. v. Broudo, 544 U.S. 336, 342 (2005) (identifying elements of an action brought pursuant to the PSLRA, including "economic loss" and "*loss causation*," *i.e.*, a causal connection between the material misrepresentation and the loss" (citing 15 U.S.C. § 78u-4(b)(4))).
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.

21. *See* Larry E. Ribstein, *Fraud on a Noisy Market*, 10 LEWIS & CLARK L. REV. 137, 147–154 (2006) (observing that *Dura* represents the Supreme Court's first time applying the fraud-on-the-market theory since *Basic*, 485 U.S. 224). Trial and appellate briefs filed by the SEC have also relied upon *Dura* to analogize the causal connection between a defendant's actions, inflated purchase prices, and alleged harm to investors. *See* Brief of the Securities and Exchange Commission, Respondent at 57, Rockies Fund, Inc. v. SEC, 428 F.3d 1088 (D.C. Cir. 2005) (No. 04-1255), 2005 WL 1387142 (citation omitted); SEC's Response to Court's March 23, 2006 Order Requesting Additional Briefing from SEC, to the SEC's Motion for Summary Judgment Against Jordan's Estate at 7–8 & n.7, SEC v. Pietrzak, No. 1:03CV01507, 2006 WL 1793576 (N.D. Ill. Jun. 26, 2006), 2006 WL 1679740 (citation omitted).

22. *In re* Dura Pharms., Inc. Secs. Litig., No. Civ. 99CV0151-L, 2001 WL 35925887 (S.D. Cal. Nov. 2, 2001), *rev'd sub nom.* Broudo v. Dura Pharms., Inc., 339 F.3d 933, 936 (9th Cir. 2003), *rev'd*, 544 U.S. 336 (2005) [hereinafter *In re Dura*].

23. *See* Broudo v. Dura Pharms., Inc., 339 F.3d 933, 936 (9th Cir. 2003), *rev'd*, 544 U.S. 336 (2005).

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

25. *See id.* at 935–36. Excerpts from six press releases appear in the Ninth Circuit's opinion.

(2) Less than expected sales projections for one of its leading antibiotic lines.[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).[27] Dura shares plummeted in value from above $39 to below $21 over the next three days.[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.[29] Dura then disclosed the FDA's rejection of its asthma spray for technical and safety reasons.[30]

2. Deficiencies in the *Dura* Complaint and Loss Causation Analysis

Absent from the *Dura* complaint were allegations that a corrective disclosure preceded a change in the price of Dura Pharmaceuticals, Inc. stock.[31] Instead, the complaint merely alleged that members of the class paid an "artificially inflated purchase price."[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.[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.[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.'"[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.[36]

In conducting its analysis, the *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.[37] In Part II-A of its opinion, the Court evaluated the common law heritage for damage assessments,[38] and the ex-

26. *Dura*, 339 F.3d at 939.

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. *In re Dura*, *supra* note 22, at *2.

28. *Dura*, 339 F.3d at 935–36.

29. *Id.* at 936 (indicating Dura management knew as far back as December 1997).

30. *Id.*

31. *See id.* at 938 & n.4.

32. Dura Pharms., Inc. v. Broudo, 544 U.S. 336, 346–47 (2005).

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").

34. *Id.* at 343 (distinguishing "loss causation" from that which merely "'touches upon' a later economic loss").

35. *Id.* at 338 (citation omitted).

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))); *see also* Glaser v. Enzo Biochem, Inc., 464 F.3d 474, 479 (4th Cir. 2006) (quoting *Dura*, 544 U.S. at 343) (same), *cert. denied*, 127 S. Ct. 1876 (2007).

37. *Dura*, 544 U.S. at 342–46.

38. *See id.* at 343–45.

press intent of Congress to permit recovery only where the plaintiff first showed economic loss and proximate causation.[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.[40] According to the Court, attributing a change in price due to external market forces gains even further credence as time passes.[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.[42] But within a year, courts began expanding *Dura* causation requirements beyond PSLRA claims.[43] Damage calculations for common law fraud claims became a prime target for litigators and commentators after *Dura*.[44] A Florida court of appeals utilized *Dura* to justify, in part, its decision to overturn a $1.58 billion verdict against Morgan Stanley.[45] Likewise, the Fourth Circuit relied on *Dura* to determine damages for common law fraud under Virginia law in *Glaser v. Enzo Biochem, Inc.*[46]

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

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").

41. Id.

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)).

43. *See infra* notes 44–64 and accompanying text.

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.

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.

46. Glaser v. Enzo Biochem, Inc., 464 F.3d 474, 479 (4th Cir. 2006) (citing Dura Pharms., Inc. v. Broudo, 544 U.S. 336, 343 (2005)), *cert. denied*, 127 S. Ct. 1876 (2007). The court of appeals rejected arguments that *Dura* was too narrow to apply beyond PSLRA claims. *See id.*("[N]othing in the Dura Court's analysis of the common law loss causation requirements . . . justifies a different standard for plaintiffs' common law fraud claim under Virginia law."). *But see* Grand v. Nacchio, 147 P.3d 763, 774–75 (Ariz. Ct. App. 2006) (rejecting the assertion that *Dura* provided a single formulaic approach to calculate loss causation); *cf.* Merill Lynch & Co., Inc. v. Allegheny Energy, Inc., 500 F.3d 171, 181–83 (2d Cir. 2007) (refusing to apply *Dura* loss causation requirements to a fixed instrument distinct from securities). In *Glaser*, the Fourth Circuit ultimately relied on the Supreme Court's analogy to common law torts to rationalize its application. 464 F.3d at 478 (citing *Dura*, 544 U.S. at 341).

2. Causation and Loss Under the U.S. Sentencing Guidelines Manual

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 before *Dura*.[50] Therefore, the panel opted to apply *Dura* when defining "loss" under Sentencing Guidelines section 2B1.1.[51] Criticizing the district court's failure to "take into account the impact of extrinsic factors on [the company's] stock price decline," the panel required lower courts to "take [] seriously the requirement to correlate the defendant's sentence with the actual loss caused in the marketplace, exclusive of other sources of stock price decline."[52]

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

47. *See generally* 15 U.S.C. § 78ff(a) (2000) (authorizing criminal sanctions for willful and knowing violations).

48. *See* U.S. SENTENCING GUIDELINES MANUAL §2B1.1 (2006) (fraud); *id.* § 2B1.4 (insider trading). The weight of the Sentencing 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." *Id.* at 264 (citing 18 U.S.C. § 3553(a)(4)-(5) (Supp. IV 2004)).

49. 429 F.3d 540, 547 (5th Cir. 2005).

50. *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)). *Snyder*, a pre-*Dura* opinion penned by The Honorable Judge Donald P. Lay, rejected using intended gain by a defendant where victim losses were reasonably calculable. *See* United States v. Snyder, 291 F.3d 1291, 1295 (11th Cir. 2002) (citing U.S. SENTENCING GUIDELINES MANUAL § 2F1.1 cmt. n.9, and United States v. Orton, 73 F.3d 331, 334 (11th Cir.1996)).

Incidentally, Judge Lay (with Judges Bye and Bright) cited *Olis* as grounds for rehearing the Eighth Circuit's tangentially-related *United States v. Mooney* opinion. 425 F.3d 1109 (8th Cir. 2005) (en banc) (Lay, Bright and Bye, JJ., dissenting). Judge Lay also joined in the dissent in the original en banc opinion. *See generally* United States v. Mooney, 425 F.3d 1093, 1104 (8th Cir. 2005) (en banc) (Bright, J., dissenting), *reh'g and reh'g en banc denied*, 425 F.3d 1109 (8th Cir. 2005).

But *Mooney* was an insider trading case addressing "gain resulting from the offense" under the Sentencing Guidelines. *See Mooney*, 425 F.3d at 1099 (construing U.S. SENTENCING GUIDELINES MANUAL §2B1.4 & cmt. background (2002)); *id.* at 1100 n.6 (rejecting *Dura*); *see also* David H. Angeli & Per A. Ramfjord, *Reexamining "Loss" and "Gain" in the Wake of* Dura Pharmaceuticals v. Broudo - *New Ammunition for Securities Fraud Defendants*, CHAMPION, May 2006, at 10 (praising *Olis* and the *Mooney* dissent).

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).

51. 429 F.3d at 540 (construing U.S. SENTENCING GUIDELINES MANUAL §2B1.1 (2001)).

52. *See id.* at 547–49.

the PSLRA.[53] And the Second Circuit imported *Olis* into its criminal sentencing proceedings in *United States v. Ebbers*.[54] In *Ebbers*, the Second Circuit emphasized that the Department of Justice must prove during sentencing that a defendant's fraud caused the alleged loss.[55] 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.[56]

Following *Ebbers*, the Second Circuit explicitly recognized the "useful guidance" of *Dura* in *United States v. Rutkoske*.[57] The case evolved from alleged chop shop tactics and shady dealings at a brokerage firm.[58] 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.[59] *Rutkoske* found further support in the Ninth Circuit's opinion *United States v. Zolp*,[60] which highlighted the impact of extrinsic market factors.[61]

The Second Circuit also went one step further in *Rutkoske* when the court applied *Dura* to restitution orders.[62] In criminal actions, restitution measures are based upon the loss "actually caused" by the defendant's violation.[63] In reaching this conclusion, the court provided only a glimpse of *Dura* loss application.[64]

---

53. *E.g.*, Romero v. US Unwired, Inc., No. 04-2312 C/W 04-2436, 2006 U.S. Dist. LEXIS 60589, at *30 (E.D. La. Aug. 11, 2006) (citing *Olis*, 429 F.3d at 546); *In re* Sourcecorp Sec. Litig., No. 3:04-CV-2351-N, 2006 U.S. Dist. LEXIS 41381, at *22–23 (N.D. Tex. June 6, 2006) (citing *Olis*, 429 F.3d at 546).

54. 458 F.3d 110, 128 (2d Cir. 2006) (citing *Olis*, 429 F.3d at 547), *cert. denied*, 127 S. Ct. 1483 (2007).

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 Pharms., 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.[65] But just as there is no requirement in criminal securities fraud actions to prove investor losses to secure a conviction,[66] there is no requirement that the SEC plead or prove investor losses in order to show that a defendant violated the Exchange Act.[67] As one court pointedly put it, the Commission "does not stand in the shoes of the purchasers and sellers who it asserts were defrauded."[68]

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.[69] Under the exercise of equitable powers, federal district courts wield "broad discretion" to formulate remedies, *i.e.*, disgorgement, in civil enforcement actions.[70] 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").

65. Dura Pharms., Inc. v. Broudo, 544 U.S. 336, 345–46 (2005) (citing 15 U.S.C. § 78u-4(b)(4)).

66. United States v. Haddy, 134 F.3d 542, 551 (3d Cir. 1998) (declining to require that federal prosecutors prove "transaction causation," also known as "reliance"); United States v. Brown, No. 04 CR 159, 2006 WL 898043, at *3 (E.D.N.Y. Apr. 4, 2006) (rejecting the argument that *Dura* requires federal prosecutors "prove a causal connection between the fraudulent conduct and the victims' economic loss"), *reh'g denied sub nom.* United States v. Goldenberg, No. 04-CR-159, 2006 WL 1229152 (E.D.N.Y. May 5, 2006).

67. SEC v. Rana Research, Inc., 8 F.3d 1358, 1363 n.4 (9th Cir. 1993); SEC v. Credit Bancorp, Ltd. 195 F. Supp. 2d 475, 490–91 (S.D.N.Y. 2002); SEC v. Pace, 173 F. Supp. 2d 30, 33 (D.D.C. 2001) (citing Graham v. SEC, 222 F.3d 994, 1001 n.15 (D.C. Cir. 2000))).

68. *See* SEC v. Penn Cent. Co., 450 F. Supp. 908, 916 (E.D. Pa. 1978) (distinguishing disgorgement calculations that require a defendant to surrender ill-gotten gains).

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, 1366–67 (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).

70. *See, e.g.*, SEC v. First Pac. Bancorp, 142 F.3d 1186, 1192 (9th Cir. 1998) (citations omitted); SEC v. First Jersey Sec., Inc., 101 F.3d 1450, 1474–75 (2d Cir. 1996) (citing SEC v. Lorin, 76 F.3d 458, 4461–62 (2d Cir. 1996) (per curiam)); *In re* Smith, 365 B.R. 770, 793–94 (Bankr. S.D. Ohio 2007) (citations omitted). As explained by the Ninth Circuit in *First Pacific Bancorp*, "[d]isgorgement is designed to deprive a wrongdoer of unjust enrichment, and to deter others from violating securities laws by making violations unprofitable." 142 F.3d at 1191.

from insider trading.[71] This requirement is far from stringent given its purpose to merely displace a defendant's earnings from a former wrong.[72]

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 . . . .").

78. *See* SUBCOMM. ON OVERSIGHT AND INVESTIGATION OF THE H. COMM. ON ENERGY AND COMMERCE, 100TH CONG. 2D SESS., SEC RESPONSES TO THE TREADWAY COMMISSION 147 (Comm. Print 1988). For a congressional account of the history of SEC civil penalties, see S. REP. NO. 101-337, at 4–8 (1990), 1990 WL 263550.

79. *See* Pub. L. No. 98-376, 98 Stat. 1264 (codified as amended in scattered sections of 15 U.S.C.).

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

80. *See* Pub. L. No. 100-704, 102 Stat. 4677 (codified as amended in scattered sections of 15 U.S.C.). For example, amendments included provisions for levying hefty sanctions on "controlling persons." *See* 15 U.S.C. § 78u-1(a)(3) (penalizing "controlling persons" for higher value of $1 million, pecuniary gains, or losses avoided); 17 C.F.R. § 201.1003 (2005) (increasing base penalty to $1.275 million). Also, § 3(a)(2) of the ITSFEA reassigned the ITSA to Exchange Act § 21A, 15 U.S.C. § 78u-1 (2000).

81. *See* Pub. L. No. 101-429, §§ 201–202, 104 Stat. 931, 935–38 (1990) (codified as amended at 15 U.S.C. §§ 78u(d)(3)(A) (authorizing the SEC to pursue penalties for violations of the Exchange Act in federal district court), 78u-2 (authorizing the SEC to pursue penalties for violations of the Exchange Act in federal district court) (2000)).

82. *See* 15 U.S.C. § 78u(d)(3)(a)-(b); ARNOLD S. JACOBS, DISCLOSURE AND REMEDIES UNDER THE SECURITIES LAWS § 20:119 & nn.39–51 (2009) (noting the differences between the ITSA and Remedies Act, and evaluating the ambiguous nature of "the court shall have jurisdiction to impose, upon a proper showing, a civil penalty"), *available at* WL, SECDRSL § 20:119. The SEC can seemingly navigate around this ambiguity by alleging that a defendant's actions both caused and risked investor losses. *See, e.g.*, Complaint at 21, SEC v. Faria, No. 06 CA 10657 RCL (D. Mass. Apr. 13, 2006), 2006 WL 1353694; Complaint at 23–24, SEC v. Selden, No. 1:05-cv-11805-NMG (D. Mass. Sept. 1, 2005), 2005 WL 2862259; Complaint at 7–9, SEC v. Converge Global, Inc., No. 04-80841 Civ-Middlebrooks (S.D. Fla. Sept. 2, 2004), 2004 WL 2663218.

83. Regardless of which tier a defendant's violation qualifies, a penalty may alternatively be assessed for pecuniary gains attributable to the alleged act. 15 U.S.C. § 78u(d)(3)(B).

84. *See* 15 U.S.C. § 78u(d)(3)(B)(i); 17 C.F.R. § 201.1003 (2005).

85. *See* 15 U.S.C. § 78u(d)(3)(B)(ii); 17 C.F.R. § 201.1003.

86. *Compare* Rule 10b-5, 17 C.F.R. § 240.10b-5 (2007), *with* 15 U.S.C. § 78u(d)(3)(B)(i)-(ii). A general verdict form may also provide authority for the court to impose a penalty for multiple violations. *See* SEC v. Solow, 554 F. Supp. 2d 1356, 1366–68 (S.D. Fla. 2008) (construing Miles v. Indiana, 387 F.3d 591, 598 (7th Cir. 2004)). Concurrently, repeated violations of the same statutory provision can warrant multiple penalties. *See* SEC v. Church Extension of the Church of God, Inc., 429 F. Supp. 2d 1045, 1048 (S.D. Ind. 2005) (asserting right to impose penalties for multiple instances of a violation (citing SEC v. Henke, 275 F. Supp. 2d 1075, 1086 (N.D. Cal. 2003), *aff'd* 130 Fed App'x 173 (9th Cir. 2005))).

87. *See* 15 U.S.C. § 78u(d)(3)(B)(iii); 17 C.F.R. § 201.1003.

corporation or similar entity) or pecuniary gain from the offense, whichever is greater.[88] In the event a defendant enjoyed pecuniary gains exceeding the prescribed maximum, any tier penalty may be increased to that gross value.[89]

The Exchange Act amendments facilitated the Commission's ability to pursue two goals: punishment and deterrence.[90] 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.[91] 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.[92]

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.[93] But even a security purchased in a regulated picture-perfect "efficient market" can be affected by other extrinsic factors.[94] The Supreme Court observed in *Dura* that where a longer period occurs between transactions, "the more likely that other factors caused the loss."[95] The

88. *Id.*

89. *See* 15 U.S.C. § 78u(d)(3)(B)(i)-(iii).

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 as 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. GOV'T 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).

93. *See* William O. Fisher, *Does the Efficient Market Theory Help Us Do Justice in a Time of Madness?*, 54 EMORY L.J. 843, 847 (2005).

94. *See, e.g.*, Dura Pharms., Inc. v. Broudo, 544 U.S. 336, 343 (2005); United States v. Olis, 429 F.3d 540, 548 (5th Cir. 2005); Samuel W. Buell, *Overlapping Jurisdictions, Overlapping Crimes: Reforming Punishment of Financial Reporting Fraud*, 28 CARDOZO L. REV. 1611, 1640 (2007) (recommending that courts consider whether events unrelated to a defendant's fraud altered the price of stock when weighing criminal sanctions).

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[96] view aligns with modern economic theory applying the efficient market theory to price change calculations for public-company shares.[97] Exceptions exist: bubbles and crunches, such as the recent global credit crisis in 2008, deviate from the efficient market that the *Dura* Court faced.[98]

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,[99] 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.[100] 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.[101] 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.

97. Twenty-five years ago, there were questions whether financial disclosures required by the Commission affected market efficiency. *See* Natural Res. Def. Council, Inc. v. SEC, 606 F.2d 1031, 1058 (D.C. Cir. 1979) (citing George Benston, *An Appraisal of the Costs and Benefits of Government-Required Disclosure: SEC and FTC Requirements*, 41 LAW & CONTEMP. PROBS. 30, 53 (1977)). Since that time, embrace of the efficient market view has become the norm. *E.g.*, *Basic Inc. v. Levinson*, 485 U.S. 224, 244, 247 n.24, 248, n.27 (1988); BURTON G. MALKIEL, A RANDOM WALK DOWN WALL STREET: THE TIME-TESTED STRATEGY FOR SUCCESSFUL INVESTING 242–74 (W. W. Norton& Company, Inc. 2003) (1973). *But see* Ribstein, *supra* note 21, at 154–165 (arguing the limitations of *Dura* and fraud-on-the-market theory in behavioral-based irrational markets); William O. Fisher, *Does the Efficient Market Theory Help Us Do Justice in a Time of Madness?*, 54 EMORY L.J. 843, 908–930 (2005) (arguing that behavioral theory explains markets during stock bubble periods). For example, the Commission now acknowledges that when it promulgates disclosure rules, those rules "'would be a cost to the overall market efficiency and capital formation.'" *See* SEC v. Siebel Sys., Inc., 384 F. Supp. 2d 694, 701 (S.D.N.Y. 2005) (quoting Selective Disclosure and Insider Trading, Securities Act Release No. 7881, Exchange Act Release No. 43,154, Investment Company Act Release No. 24,599, 65 Fed. Reg. 51,716, 51,718 (proposed Aug. 24, 2000) (to be codified at 17 C.F.R. pt. 240, 243, 249)).

98. *See, e.g.*, *Credit and Blame*, THE ECONOMIST, Sept. 11, 2008, *available at* http://www.economist.com/finance/displaystory.cfm?story_id=12209655.

99. *See, e.g.*, SEC's Response to Court's March 23, 2006 Order Requesting Additional Briefing from SEC, to the SEC's Motion for Summary Judgment Against Jordan's Estate at 8 n.7, SEC v. Pietrzak, No. 03C-1507 (N.D. Ill. Apr. 4, 2006), 2006 WL 1679740; Brief for the United States as Amicus Curiae Supporting Petitioners at 1, Dura Pharms., Inc. v. Broudo, 544 U.S. 336 (2005) (No. 03-932), 2004 WL 2069564.

100. *But cf.* Rockies Fund, Inc., Exchange Act Release No. 54,892, Investment Company Act Release No. 25,829, 2006 WL 3542989, at *12, n.43 (Dec. 7, 2006) (exercising discretion to issue a second-tier penalty, but stating that a broker-defendant's violation "by its nature created a significant risk of substantial loss to investors" warranting third-tier penalties as originally "contemplated by Congress").

101. *See* briefs cited *supra* note 21.

rective disclosure.[102] *Glaser v. Enzo Biochem, Inc.* explained the underlying rationale for this *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.[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.[104] Often, these values can be presented by expert witnesses through event study methodologies.[105] Coupled with an event study

102. *See Glaser*, 464 F.3d at 479 (advocating the exclusion of market effects before disclosure of fraud to determine losses suffered by investors). *Ebbers*, 458 F.3d at 128 (identifying expert witness arguments that extrinsic market factors affected loss measured in criminal sentencing). *Cf.* SEC v. Maxxon, Inc., 465 F.3d 1174, 1179 (10th Cir. 2006), *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'").

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

104. *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"); *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"). *But see* Merritt B. Fox, *Understanding* Dura, 60 BUS. LAW. 1547, 1567 (2005) ("[The 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."); Kauffman, *supra* note 17.

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. *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

analysis, a court could determine whether a defendant's violation caused or severely risked a "substantial loss" to investors.[106]

B. Showing "Substantial Loss" Caused by a Defendant

The Supreme Court in *Dura* indicated that flimsy and ambiguous[107] measurements for causation are inadequate if the statute requires proof of loss.[108] 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.[109]

There are differences in the language Congress used in the PSLRA and Remedies Act.[110] The PSLRA requires that a private plaintiff prove that a defendant "caused the loss for which the plaintiff seeks to recover damages."[111] 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."[112] Thus, alternative grounds exist to permit securing a 15 U.S.C. § 78u(d)(3)(B) third-tier penalty.

1005, 1014 (C.D. Cal. 2003), *aff'd,* Mortensen v. Snavely, 145 F. App'x 218 (9th Cir. 2005)) (citation history added); Madge S. Thorsen et al., *Rediscovering the Economics of Loss Causation*, 6 J. BUS. & SEC. L. 93, 95 (2006) (explaining that event studies can be further supported by valuation analysis). For a futher discussion of event studies, see for example Ribstein, *supra* note 21, and Mark L. Mitchell & Jeffry M. Netter, *The Role of Financial Economics in Securities Fraud Cases: Applications at the Securities and Exchange Commission*, 49 BUS. LAW. 545 (1994).

106. A cursory search of LEXIS and Westlaw yielded values exceeding $4 million where a defendant's violation caused or seriously risked "substantial losses" to qualify for a third-tier penalty. *E.g.*, SEC v. Marker, 427 F. Supp. 2d 583, 593 (M.D.N.C. 2006) ($4.6 million); SEC v. Church Extension of the Church of God, Inc., 429 F. Supp. 2d 1045, 1049 (S.D. Ind. 2005) ($30 million); SEC v. Lawbaugh, 359 F. Supp. 2d 418, 426 (D. Md. 2005) ($4 million); SEC v. Lybrand, 281 F. Supp. 2d 726, 731 (S.D.N.Y. 2003) ("millions of dollars in losses" for purchasers of unregistered securities), *aff'd,* SEC v. Kern, 425 F.3d 143 (2d Cir. 2005); SEC v. Henke, 275 F. Supp. 2d 1075, 1084–85 (N.D. Cal. 2003) ($2.6 million in claimed losses not disputed to warrant third tier penalty), *aff'd*, 130 F. App'x 173 (9th Cir. 2005); SEC v. Global Express Capital Real Estate Inv. Fund I, LLC, No. 2:03-cv-01514-KJD-LRL, 2006 U.S. Dist. LEXIS 96477, at *70 (D. Nev. Mar. 28, 2006) ($50 million in losses claimed by investors). *But see* SEC v. Opulentica, LLC, 479 F. Supp. 2d 319, 322, 331 (S.D.N.Y. 2007) (slightly under $444,000 in losses to investors from sale of unregistered securities); JACOBS, *supra* note 82 (arguing, without example or citation, that "$100,000 clearly is ample and a lesser amount in the proper context easily could be 'substantial.'") The SEC has not promulgated any rule to provide guidance on the definition of "substantial loss," whether such loss is risked or actual. *See generally* 12 C.F.R. § 340.2(h) (2007) (providing a definition of "substantial loss" for determining eligibility to purchase assets from the Federal Deposit Insurance Corp.).

107. 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.*

108. *See* Dura Pharms., Inc. v. Broudo, 544 U.S. 336, 343 (2005) ("To 'touch upon' a loss is not to *cause* a loss, and it is the latter that the law requires."); Glaser v. Enzo Biochem, Inc., 464 F.3d 474, 479 (4th Cir. 2006) (quoting *Dura*, 544 U.S. at 343) (extending *Dura* to the common law of Virginia), *cert. denied*, 127 S. Ct. 1876 (2007).

109. *See* SEC v. Stringer, No. CV-02-1341-ST, 2003 U.S. Dist. LEXIS 25523, at *18 n.2 (D. Or. Apr. 24, 2003), *enforced*, No. CV-02-1341-ST (D. Or. Sept. 3, 2003).

110. *See infra* notes 104–105 and accompanying text.

111. Private Securities Litigation Reform Act of 1995, Pub. L. No. 104-67, 109 Stat. 737, 747 (codified as amended at 15 U.S.C. § 78u-4(b)(4) (2000)).

112. 15 U.S.C. § 78u(d)(3)(B)(iii) (2000); *accord id.* § 77t(d)(2)(C)(II) (corresponds to Securities Act of 1933, Pub. L. 73-22, 48 Stat. 74 (codified as amended in scattered sections of 15 U.S.C.)); *id.* § 80a-41(e)(2)(C)(II) (corresponds to Investment Company Act of 1940, Pub. L. 76-768, 54 Stat. 789 (codified as

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."[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.[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."[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[116] in addition to other defenses which may be raised against Commission arguments that a tier three penalty is warranted.[117] If the Commission claims

---

amended at 15 U.S.C. §§ 80a-1 to 80a-52)); *id.* § 80b-9(e)(2)(C)(II) (corresponds to Investment Advisers Act of 1940, Pub. L. 76-768, 54 Stat. 847 (codified as amended at 15 U.S.C. §§ 80b-1 to 80b-21)).

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." *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"); *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); *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.))

113. *Cf.* United States v. Snyder, 291 F.3d 1291, 1295 (11th Cir. 2002) ("When calculating the monetary value of the victims' loss under Sentencing Guideline § 2F1.1(b)(1), substitution of defendants' gain is not the preferred method because it ordinarily underestimates the loss." (citing U.S. SENTENCING GUIDELINES MANUAL § 2F1.1 cmt. n.9, and United States v. Orton, 73 F.3d 331, 334 (11th Cir. 1996))).

114. *See* Rockies Fund, Inc. v. SEC, 428 F.3d 1088, 1093, 1099 (D.C. Cir. 2005) (rejecting on grounds that SEC's lack of explanation constituted an arbitrary and capricious application of sanctions under the Administrative Procedure Act (APA), 5 U.S.C. § 706(2)(A) (2000) (citing Jost v. Surface Transp. Bd., 194 F.3d 79, 85 (D.C. Cir. 1999))). The SEC brought the action pursuant to the Investment Advisers Act of 1940, which provides for statutory penalties under language which resembles—with some differences—third-tier penalties under the Remedies Act. *Rockies Fund, Inc.*, 428 F.3d at 1098. *See also* statutes cited *supra* note 112.

Under the APA, 5 U.S.C. § 706(2)(A), an agency decision may be overturned if "arbitrary, capricious, an abuse of discretion or otherwise not in accordance with the law." The Supreme Court has previously explained that on review, a court must consider "whether the [agency's adjudicatory] decision was based on consideration of the relevant factors and whether there has been a clear error of judgment." Citizens to Pres. Overton Park, Inc. v. Volpe, 401 U.S. 402, 416 (1971) (citations omitted); *see also* SEC v. Chenery Corp., 318 U.S. 80, 87 (1943) ("The grounds upon which an administrative order must be judged are those upon which the record discloses that its action was based.").

115. SEC v. Slocum, Gordon & Co., 334 F. Supp. 2d 144, 186 (D.R.I. 2004); *accord* SEC v. Inorganic Recycling Corp., No. 99 Civ. 10159 (GEL), 2002 WL 1968341, at *4 (S.D.N.Y. Aug. 23, 2002).

116. *See* SEC v. Platforms Wireless Int'l Corp., No. 04 CV 2105 JM (MB), 2007 U.S. Dist. LEXIS 30919, at *40 (S.D. Cal. Apr. 25, 2007) (rejecting "conclusory argument[s]" that defendants' press releases, which violated Rule 10b-5, created a significant risk of substantial loss to investors) , *aff'd in part, vacated in part on reconsideration*, 559 F. Supp. 2d 1091 (S.D. Cal. 2008).; SEC v. Abacus Int'l Holding Corp., No. C 99-02191 TEH, 2001 U.S. Dist. LEXIS 12635, at *15 (N.D. Cal. Aug. 16, 2001) (imposing third-tier penalty of $110,000 where "actions were clear departures" from regulation and "created a significant risk of substantial loss to investors who purchased fraudulent securities through [defendant's] website"); SEC v. Todt, No. 98 Civ. 3980 (JGK), 2000 U.S. Dist. LEXIS 2087, at *39 (S.D.N.Y. Feb. 25, 2000) (refusing to impose third-tier penalty where neither actual loss nor significant risk of substantial loss occurred when defrauded investors "[n]ever seriously entertained transferring funds" to purchase fraudulent securities), *aff'd*, 7 F. App'x 98 (2d Cir. 2001).

117. In evaluating the facts and circumstances of the case, courts weigh factors including:

substantial loss to investors, a blanket accusation of risk will prove inadequate.[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.[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.[120] One prong of that test obligates the SEC to prove a defendant's acts were committed domestically and "'directly caused' the claimed losses."[121] Requiring the SEC to provide substantial evidence that a defendant created alleged losses to secure a third-tier penalty presents a similar condition.[122]

> (1) the egregiousness of the violations at issue, (2) [the degree of] defendants' scienter, (3) the repeated nature of the violations, (4) defendants' failure to admit to their wrongdoing; (5) whether defendants' conduct created substantial losses or the risk of substantial losses to other persons; (6) defendants' lack of cooperation and honesty with authorities, if any; and (7) whether the penalty that would otherwise be appropriate should be reduced due to defendants' demonstrated current and future financial condition.

SEC v. Lybrand, 281 F. Supp. 2d 726, 730 (S.D.N.Y. 2003) (citations omitted), *aff'd sub nom.* SEC v. Kern, 425 F.3d 143 (2d Cir. 2005); *cf.* SEC v. Sargent, 329 F.3d 34, 41–42 (1st Cir. 2003) (listing factors considered for insider trading penalties) (citations omitted).

118. *See* cases cited *supra* note 116; *cf.* cases cited *supra* notes 10 & 114.

119. *Cf.* United States v. Rutkoske, 506 F.3d 170, 179–80 (2d Cir. 2007), *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, *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 *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 *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."

120. SEC v. Berger, 322 F.3d 187, 193–94 (2d Cir. 2003) (requiring the SEC show a causal connection to alleged investor losses to establish subject matter jurisdiction under the "conduct test"); *accord* Robinson v. TCI/US W. Commc'ns, Inc., 117 F.3d 900, 905 (5th Cir. 1997); Zoelsch v. Arthur Andersen & Co., 824 F.2d 27, 29–30 (D.C. Cir. 1987). *But see, e.g.*, SEC v. Kasser, 548 F.2d 109, 114 (3d Cir. 1977) (requiring lesser showing of material and substantial conduct for purposes of establishing subject matter jurisdiction).

121. *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. *See id.* (quoting 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); *see also* JACOBS, *supra* note 82 (observing no such requirement for insider trading sanctions).

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. *See* Roach, *supra* note 3, at 98. This burden is one of persuasion. 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, *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." 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. *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.[123] Likewise, federal prosecutors often pursue alternative theories of intended loss under the U.S. Sentencing Guidelines Manual.[124] 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.[125] Alternative grounds for assessing penalties should not be treated differently between criminal sentencing and civil remedial phases.[126] Notwithstanding *Snyder*, the Supreme Court noted in *Dura* that showing loss requires more than merely citing the value of stock on a given day.[127] To show risk,

---

the government carries the burden of proof for any adjustment under the Sentencing Guidelines where the government has "as much access to this information as the defendant"), *aff'd sub nom.* United States v. Barrett, 890 F.2d 855 (6th Cir. 1989).

123. *See infra* Part II.C.2.

124. The aftermath of the Fifth Circuit's recent opinion in United States v. Olis, 429 F.3d 540, 545 (5th Cir. 2005) (construing U.S. SENTENCING GUIDELINES MANUAL §2B1.1 (2001)), may provide guidance to foresee future interpretations of "significant substantial loss" and "significant risk of substantial loss" in SEC enforcement actions. In *Olis*, the court noted the analogous standard for criminal sanctions under Sentencing Guidelines section 2B1.1 that "courts must take a 'realistic approach to determine what losses the defendants truly caused or intended to cause.'" *Id.* at 546 (quoting United States v. W. Coast Aluminum Heat Treating Co., 265 F.3d 986, 991 (9th Cir. 2001)).

On remand in *United States v. Olis*, the Honorable Judge Sim Lake followed this methodology to (1) evaluate event studies presented by a government expert and (2) eventually reject a "neat, but overly simplistic" methodology for alleging loss. *See* United States v. Olis, 98 A.F.T.R.2d (RIA) 6846, 6854–55 (S.D. Tex. 2006) (explaining that prosecutors failed to prove with "a reasonable degree of certainty the actual loss to shareholders caused by" material omissions in financial disclosures). Judge Lake found it nearly impossible to estimate losses with reasonable certainty, whereas calculations used "unprovable assumptions that yield speculative results." *Id.* at 6854. Judge Lake's words were not hyperbole, and should not be taken to indicate frustration with the Fifth Circuit's judgment. Instead, the facts *Olis* were too unique to apply the circuit court's calculations. *See id.* at 6855. *See generally* United States v. Rothwell, 387 F.3d 579 (6th Cir. 2004) (defining intended loss as "'pecuniary harm that would have been impossible or unlikely'" (quoting U.S. SENTENCING GUIDELINES MANUAL § 3B1.1 cmt. n.2(A)(ii) (2002)). Because adequate evidence support allegations of intended loss, the court adopted the government's proposed calculation. *See Olis*, 98 A.F.T.R.2d (RIA) at 6855–56 (citing "uncontroverted testimony" to adopt government's proposed calculation, resulting in penalty which avoided sentencing multiplier).

125. 291 F.3d 1291 (11th Cir. 2002).

126. *Compare* United States v. Zolp, 479 F.3d 715, 720–21 (9th Cir. 2007) (rejecting the government's proposed grounds for calculating a criminal defendant's intended loss), *with* Frank O. Bowman III, *The 2001 Federal Economic Sentencing Reforms: An Analysis and Legislative History*, 35 IND. L. REV. 5, 84 (2001) (describing "risk of substantial loss" under the Sentencing Guidelines as the "[u]nrealized losses risked by the offense").

Unlike intended loss, "risk of substantial loss" exists as a departure factor under the Sentencing Guidelines, albeit without specifying if the risk must be "significant." *See generally* U.S. SENTENCING GUIDELINES MANUAL § 2B1.1 cmt. n.19(A)(iv) (2007) (recommending an increase from the sanction recommended by the Sentencing Guidelines in the event that "substantial risk of harm" is proven). Prior to the change in the departure scheme, some courts measured "loss" by including risk of loss with actual loss in cases of loan and investment fraud. *See id.* at 83–84 & nn.381–82 (2005) (citing United States v. Najjor, 255 F.3d 979, 985 (9th Cir. 2001) and United States v. Munoz, 233 F.3d 117, 1138 (9th Cir. 2000)). Unfortunately, criminal cases have not evaluated risk to a degree that might offer a further basis for comparison to enforcement actions brought by the SEC.

127. *See* Dura Pharms., Inc. v. Broudo, 544 U.S. 336, 343 (2005) ("Given the tangle of factors affecting price, the most logic alone permits us to say is that the higher purchase price will *sometimes* play a role in bringing about a future loss.").

the Commission should proffer evidence which supports a finding by a preponderance of the evidence.[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."[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.[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[131] and pump-and-dump schemes.[132]

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

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

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.

129. S. REP. NO. 101-337, at 9–10 (1990), 1990 WL 263550 (indicating broker-dealer or investment company's violation may create "serious risk of loss"); H. REP. NO. 101-616, at 17 (1990), *as reprinted in* 1990 U.S.C.C.A.N. 1379, 1384 (same); *see also* SEC v. Milan Capital Group, Inc., No. 00 Civ. 0108 (DLC), 2001 WL 921169, at *3 (S.D.N.Y. Aug. 14, 2001) (finding third-tier penalties totaling $10 million warranted for defendants whose "fraud[ulent broker-dealer operations] resulted in potential losses to investors of over $8 million"); Rockies Fund, Inc., Exchange Act Release No. 54,892, Investment Company Act Release No. 25,829, 2006 WL 3542989, at *7 & n.43 (Dec. 7, 2006) (exercising discretion to issue a second-tier penalty, but stating that the broker-defendant's violation "by its nature created a significant risk of substantial loss to investors" warranting third tier penalties as originally "contemplated by Congress").

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

131. SEC v. Coates, 137 F. Supp. 2d 413, 428–30 (S.D.N.Y. 2001) (finding fraudulent sale of securities involving "misrepresentations and omissions concerning the durability and marketability of the [securities sold] created a greater amount of risk to investors than they were aware" to impose third-tier penalty, but reducing to $10,000 per violation in light of rescission with purchasers); SEC v. Poirier, 140 F. Supp. 2d 1033, 1049 (D. Ariz. 2001) (indicating price created risk of substantial loss in case where defendants formed company to issue unregistered securities); SEC v. Friendly Power Co., 49 F. Supp. 2d 1363, 1373 (S.D. Fla. 1999) (entering third-tier penalty for creating "substantial risk that investors would lose their investments" by failing to register securities); SEC v. Kenton Capital, Ltd., 69 F. Supp. 2d 1, 46 & n.15 (D.D.C. 1998) (stating "significant risk of substantial losses" satisfied by fraudulent sale of unregistered securities); SEC v. Softpoint, Inc., 958 F. Supp. 846, 868 (S.D.N.Y. 1997) (same), *aff'd in unpublished table decision*, 159 F.3d 1348 (2d Cir. 1998).

132. *See* SEC v. Mandaci, No. 00 Civ. 6635 (LTS) (FM), 2004 U.S. Dist. LEXIS 19143, at *40 (S.D.N.Y. Sept. 27, 2004); SEC v. Rosenfeld, No. 97 Civ. 1467 (WHP) (RLE), 2001 U.S. Dist. LEXIS 166, at *3, 13 (S.D.N.Y. Jan. 9, 2001), *enforced* No. 97 Civ. 1467 (S.D.N.Y. Feb. 8, 2001).

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.

that brokers and dealers engage in.[134] 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.[135] 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.[136] *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.[137] Nor did it provide an explanation of how the defendant's specific conduct created risk of loss.[138] Nevertheless, the SEC should first present sufficient evidence to support the imposition of third-tier penalties.[139] 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*.[140]

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[141] 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).

135. *See* SEC v. Daly, 572 F. Supp. 2d 129, 133 (D.D.C. 2008) ("shareholder loss is more than sufficient to establish substantial harm" (quoting parenthetically SEC v. Koenig, 532 F. Supp. 2d 987, 990 (N.D. Ill. 2007))).

136. *Id.* (citing SEC v. Levine, 517 F. Supp. 2d 121, 141–43 (D.D.C. 2007), and SEC v. Kenton Capital, Ltd., 69 F. Supp. 2d 1, 17 (D.D.C. 1998), and SEC v. Lawbaugh, 359 F. Supp. 2d 418, 421–22, 426 (D. Md. 2005)).

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

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

139. 17 C.F.R. § 201.1003 (2005) (increasing penalties to $130,000 for natural persons and $650,000 for all others); *see, e.g.*, SEC v. Marker, 427 F. Supp. 2d 583, 593 (M.D.N.C. 2006) (imposing third-tier penalty of $500,000 "[g]iven the egregiousness of the fraud committed" and noting "Defendants' actions were both fraudulent and deceitful and resulted in losses to individual investors of over $ 4.6 million"); SEC v. Lawbaugh, 359 F. Supp. 2d 418, 426 (D. Md. 2005) (citing 17 C.F.R. § 201.1002) (applying third-tier penalty of $120,000 when investor losses totaled $4 million from defendant); SEC v. Lybrand, 281 F. Supp. 2d 726, 731 (S.D.N.Y. 2003) (imposing third-tier penalty on defendants in fraudulent action resulting in "millions of dollars in losses" for purchasers of unregistered securities), *aff'd sub nom.* SEC v. Kern, 425 F.3d 143 (2d Cir. 2005); SEC v. Converge Global, Inc., No. 04-80841-CIV, 2006 U.S. Dist. LEXIS 17581, at *18 (S.D. Fla. Mar. 10, 2006) (awarding third-tier penalty despite no investor losses based upon Commission's arguments that defendant's misrepresentation in a press release created "significant risk of substantial losses").

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.