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Expanding Disgorgement to Include Specific Restitution in Securities Exchange Commission Enforcement Actions

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EXPANDING DISGORGEMENT TO INCLUDE SPECIFIC RESTITUTION IN SECURITIES EXCHANGE COMMISSION ENFORCEMENT ACTIONS

by Scott L. Warfman*

I. INTRODUCTION

The prevailing judicial interpretation of disgorgement is unduly limited, consequently impairing the effectiveness of the anti-fraud provisions of federal securities laws. Typically, the Securities and Exchange Commission (hereinafter Commission) seeks disgorgement in cases involving stock manipulation and other violations of anti-fraud provisions. In ordering disgorgement, practically all courts have required defendants to return only profits actually received as a result of their fraud, rather than requiring the violators to make the defrauded investors whole.[1] Unfortunately, limiting the remedy of disgorgement to profits actually received by the securities law violator, might potentially encourage fraud. Under a simplified cost benefit analysis, the prospect of merely returning what one has unlawfully received does not outweigh the benefit of committing the fraud. Obviously, there are a plethora of other relevant considerations, but in sum they do not serve as a disincentive to engage in securities fraud.[2] Only

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1. *See, e.g.*, Securities and Exchange Commission V. Blatt, 583 F.2d 1325, 1335 (5th Cir. 1978)("Disgorgement extends only to the amount with interest by which the defendant profited from his wrongdoing.").

2. Historically, the remedies available to the Commission have largely been inadequate to prevent securities fraud. "The Commission has found that to resort to civil injunction and administrative proceeding, no matter how vigorously employed, is not completely effective in halting the operation of boiler rooms." 25 S.E.C. Ann. Rep. 3 (1959), quoted in John D. Ellsworth, *Disgorgement in Securities Fraud Actions Brought by the SEC*, 3 DUKE L.J. 641, 647 n.41 (1977) [hereinafter *Disgorgement in SEC Actions*].

a fraction of securities laws violators are prosecuted by the Department of Justice or state authorities, thereby leaving the Commission with the primary responsibility of enforcing the federal securities laws.[3] Considering that the remedy of disgorgement was judicially created to effectuate the remedial purposes of the securities laws and deter fraud, a limited interpretation of disgorgement may unfortunately, have the opposite effect.

Disgorgement should not be limited to simply returning what one has unlawfully received, but should be expanded to at least restore the parties to their former positions, in other words specific restitution. "Since disgorgement is an equitable doctrine, there is no limit to the various forms and kinds of specific remedies which [the Chancellor] may grant."[4] This article takes the position that the remedy of disgorgement should empower a court to compel a primary violator to disgorge all profits plus all other monies fraudulently obtained from investors so long as there is a causal link between investors' losses and the illegal conduct. Implemented in this manner, victims of manipulated securities transactions may be made whole. Each wrongdoer would be individually responsible for all of the investors' losses regardless of the amounts received by each wrongdoer. This interpretation of disgorgement would provide a more powerful disincentive to violate the securities laws. Not only would manipulating the price of stock become unprofitable, it would become more costly to engage in.

In order for jurists to adopt an expanded interpretation of disgorgement, they will have to employ a perspective different from that generally reflected in the reported cases. Historically, the focus of a disgorgement calculation is the benefit which inures to the wrongdoer. Defining disgorgement to include specific restitution would focus on the harm suffered by the defrauded investors, rather than on the illegal profits garnered by the securities laws violators. This perspective complements the remedial nature of the securities laws. Making reparations to

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A similar sentiment was expressed by Joseph I. Goldstein in recent testimony before the House Subcommittee on Telecommunications and Finance, wherein Goldstein pointed out that penny stock manipulations are often not deterred by the civil remedies available to the Commission, and therefore, the agency has actively sought to enlist the help of criminal prosecutors. *Penny Stock Market Fraud, 1989: Hearings Before the Subcommittee on Energy and Commerce House of Representatives,* 101st Cong., 1st Sess. 54 (1989) (testimony of Joseph I. Goldstein, Director of the Commissions Division of Enforcement).

3. In fiscal year 1989, the Commission instituted 155 administrative proceedings and filed 140 civil actions based on violations of the federal securities laws. During this period, the Commission granted access to its files to federal and state prosecutorial authorities in 226 cases. However, only approximately 76 criminal indictments or information and 72 convictions were obtained by criminal authorities in Commission-related cases. 55 S.E.C. Ann. Rep. 1 (1989).

4. 3 JOHN POMEROY, EQUITY JURISPRUDENCE § 109 at 141 (5th ed. 1941).

defrauded investors will undo the wrong, and thus facilitate the purpose of an equitable remedy. Accordingly, expanding the concept of disgorgement to include specific restitution may often be appropriate in actions brought by the Commission.[5]

The few district courts which have adopted an expanded definition of disgorgement in fixing amounts to be disgorged fail to provide sufficient legal analysis in support of their decisions and essentially ignore judicial precedent. Only sufficient judicial analysis can legitimately broaden the predominant interpretation of disgorgement. A broad interpretation will provide greater deterrence against fraud, promote investor confidence and encourage brokerage firms and securities professionals to more vigilantly guard against fraud or else risk increased civil exposure. These results would be in line with the congressional intent to remove fraud from the securities industry and increase the efficiency of our capital markets.

II. Disgorgement And The Securities Enforcement Remedies And Penny Stock Reform Act Of 1990

In passing recent legislation, Congress was sensitive to the perceived deficiencies of the existing securities laws. On October 15, 1990, President Bush signed the Securities Enforcement Remedies and Penny Stock Reform Act of 1990.[6] One of the most significant aspects of the new law is the provision for civil penalties. Prior to its enactment, the Committee on Energy and Commerce explained that monetary penalties are necessary, in part, to provide increased deterrence against future securities laws violations and to provide the courts and the Commission with increased flexibility to appropriately redress such violations.[7] The Committee noted that "[i]t is today almost inconceivable that Congress would authorize a major administrative regulatory program without empowering the enforcing agency to impose civil monetary penalties as a sanction."[8] Under the new Act, the Commission may request that a district court impose monetary fines in addition to the traditional requests for, among other remedies, injunctive relief and disgorgement.

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5. The nature of the insider trading cases have reinforced a limited interpretation of disgorgement because they involve an impersonal market, wherein the defrauded public and concomitant harm are not easily identified. Specific restitution in these types of cases would be impracticable. Requiring one who trades on inside information to give up illegal profits may be the only logical remedy. In contrast, the stock manipulation cases often have defrauded investors whose losses are readily identifiable. In these types of cases, specific restitution is especially appropriate.

6. Pub. L. No.101-429, 104 Stat. 931 (1990).

7. H.R. Rep. No. 101-616, 101st Cong., 2d Sess., 1379-1387 (1990).

8. *Id.* at 15 (quoting Colin S. Diver, Report to the Administrative Conference of the United States Concerning the Assessment and Mitigation of Civil Money Penalties by Federal Administrative Agencies 1 (May 1979)).

The new law recognizes the important role that disgorgement plays in the regulatory scheme. Section 1(c)(2)(B) of the act states that the effective date for the amendments pertaining to civil penalties, or civil fines, shall not be construed to preclude the Commission from ordering a disgorgement or accounting under the Act. The Act empowers the Commission to seek disgorgement in administrative[9] and cease and desist proceedings.[10] Each section[11] includes a provision that the money penalties in civil actions are not an exclusive remedy but "may be brought in addition to any other action that the Commission or the Attorney General is entitled to bring."[12]

While the Securities Enforcement Remedies Act is important legislation which will promote, among other things, the efficient allocation of capital resources, it is intended to complement, rather than replace, the existing array of regulatory remedies. The Act is not comprehensive partially because the ceiling for civil fines is arbitrarily limited. Pursuant to the Act, a United States district court may not impose a fine in excess of the greater of $100,000 or the amount of pecuniary gain for each violation of the anti-fraud provisions.[13] In a classic manipulation case, wherein millions of dollars are fraudulently obtained from innocent investors, a fine in the amount of $100,000 or the actual pecuniary gain is insufficient. Under the Act, investors' losses should be paramount although they are presently ignored. A court should at least be able to fine a violator in the amount of investors' losses or some multiple thereof.[14] Until this arbitrary ceiling is removed, the remedy of disgorgement, especially if it includes specific restitution, will remain an important regulatory tool to discourage securities fraud.

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9. Sec. 21B(e) of the Securities Exchange Act, 15 U.S.C. sec. 78u-d (as amended in 15 U.S.C. sec 78u-1 (1990)).

10. Section 21C(e) of the Exchange Act, as amended.

11. Title I is "Amendments to the Securities Act of 1933"; Title II is "Amendments to the Securities Exchange Act of 1934"; Title III is "Amendments to the Investment Company Act of 1940"; and Title IV is "Amendments to the Investment Advisers Act of 1940."

12. 15 U.S.C. § 78u(d)(3)(C)(iii) (1990).

13. Compare the penalties authorized under the Insider Trading Sanctions Act of 1984, recodified in Section 21A of the Exchange Act with the enactment of the Insider Trading and Securities Fraud Enforcement Act of 1988, 15 U.S.C.A. § 78u-1 (1988 and Supp. 1991), under which a court is authorized to impose civil penalties upon the person who committed the violation in an amount up to "three times the profit gained or loss avoided", and upon the controlling person in an amount not to exceed $1,000,000 or "three times the profit gained or loss avoided", whichever is greater.

14. *See, e.g., supra* note 13.

III. Disgorgement As A Return Of Unlawful Profits

The term disgorgement first appeared in *Dolgow v. Anderson.*,[15] more than 30 years after passage of the Exchange Act. The plaintiffs in *Dolgow* alleged, among other things, that the defendants manipulated the price of Monsanto Company common stock by buying large blocks of Monsanto at unnecessarily high prices. The court invited the Commission to submit an *amicus curiae* brief discussing whether or not the case should be maintained as a class action. In its brief, the Commission explained that the maintenance of class actions would enable defrauded investors to become whole.

At that time, the Commission sought "to deprive violators of illegal gains" only in "rare cases."[16] In such cases, the goal of returning ill-gotten gains was premised on promoting a policy of deterrence, rather than to compensate defrauded investors. As the Commission stated in its *amicus* brief, "as a law enforcement agency it is requesting *disgorgement* of profits illegally obtained, because effective deterrence requires more than an injunction limited to future violations." (Footnote originally omitted)(Emphasis added).[17] The Commission argued that the class action would "provide the most meaningful method" for investors to reclaim their losses since disgorgement was not "designed to provide compensation to injured investors" and since it was unlikely that individual investors would file separate lawsuits for relatively small losses.[18] (emphasis omitted)

The Commission's interpretation of disgorgement, which was then confined to a return of illegal profits, has, to date, been followed by practically all courts. Had the Commission not defined disgorgement in such a limited fashion, its argument in favor of maintaining the class action would have been less persuasive. In other words, if the Commission had urged a broad interpretation of disgorgement (including specific restitution), then its argument in favor of the class action would have been proportionately diminished. Judicial precedent did not require the Commission to urge a limited interpretation of disgorgement. Therefore, it is possible that certain policy considerations, such as the role played by private litigants in enforcing the federal securities laws and the conservation of Commission resources, influenced the Commission's position on disgorgement at the time of the *Dolgow*

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15. 43 F.R.D. 472 (E.D.N.Y. 1968).
16. *Id.* at 483.
17. *Id.*
18. *Id.*

decision.[19] The Commission's limited approach may have contributed to the narrow interpretation presently given by the courts.

The first reported decision where the Commission litigated the issue of returning ill-gotten gains is *Sec. Exch. Comm'n v. Texas Gulf Sulphur Co.*[20] In *Texas Golf Sulphur Co.* the defendants unlawfully traded common stock of the Texas Gulf Sulphur Company on the basis of non-public information. On appeal, The Second Circuit ordered the return of all profits derived before the date the insider information became public. In doing so, the court held that restitution was an appropriate remedy "to effectuate the purposes of the [Exchange] Act" because it involved remedial relief rather than penalty assessment.

The court linked restitution to the return of illegal profits, which is the same definition that the Commission ascribed to disgorgement in its *amicus curiae* brief submitted in the *Dolgow* case. However, restitution is not so limited. Specific restitution requires that both parties be placed in the status quo as though the transaction never occurred.[21] Restitution is not necessarily confined to the return of illegal gains, but may include other compensation such as damages.[22]

In *Sec. Exch. Comm'n v. Manor Nursing Centers, Inc.*[23] the Second Circuit reaffirmed its position that securities law violators must forfeit their ill-gotten proceeds. The defendants had fraudulently represented that investors' monies would be

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19. The Commission's earliest requests for disgorgement entailed a novel legal argument not previously considered by the courts. Although not specifically authorized by statute, these decisions addressed the propriety of remedies ancillary to those delineated in the statutes. *See* James R. Farrand, *Ancillary Remedies in SEC Civil Enforcement Suits*, 89 HARV. L. REV. 1779 (1976); George W. Dent, Jr., *Ancillary Relief in Federal Securities Law: A Study in Federal Remedies*, 67 MINN. L. REV. 865 (1983).

The novelty of the Commission's legal argument may have contributed to a cautious approach in not seeking more money than actually received by the defendants. Other considerations may have included whether to expand the role of the Commission to act, in essence, as a public collection agency by seeking to make investors whole. Faced with limited resources, the Commission has in the past refused to assume such a role. *See, e.g.*, Speech of then SEC Commissioner Richard B. Smith at the Program of Continuing Legal Education of the California Bar, at Los Angeles, Jan. 12, 1968. "The Commission attempts to avoid being a collection agency for injured investors . . . ." (on file at the SEC library, Washington, D.C.), quoted in *Disgorgement in SEC Actions*, *supra* note 2, at n.15.

20. 446 F.2d 1301 (2d Cir. 1971), *cert. denied*, 404 U.S. 1005 (1971).

21. 3 J. POMEROY, EQUITY JURISPRUDENCE § 910 at 578 (5th ed. 1941); *See also, Disgorgement in SEC Actions*, *supra* note 2, at 651.

22. Comment, *The Measure of Disgorgement in SEC Enforcement Actions Against Inside Traders Under Rule 10b-5*, 34 CATH.U. L.REV. 445, 446 (1985)(citing Basile v United States, 38 A.2d 620 (D.C. 1944)).

23. 458 F.2d 1082 (2d Cir. 1972).

returned if the offering failed to attract a minimum number of investors. Although the offering failed to induce a sufficient number of purchasers, the defendants failed to refund monies due the investors. In furtherance of the objectives of the Exchange Act, the Second Circuit relied upon its *Texas Gulf Sulphur* decision to affirm the trial court's order requiring the defendants to disgorge the monies that each received from the public offering.[24]

The decisions limiting disgorgement to illegal profits are not without exceptions. In two cases, disgorgement liability was assessed on a joint and several basis which is an extension of liability beyond profits actually received. In *Sec. Exch. Comm'n v. R.J. Allen & Assoc.*[25] the district court ordered that the defendants be held jointly and severally liable for all proceeds received from the defrauded investors. The court cited the *Texas Gulf Sulphur* and *Manor Nursing Centers* decisions as precedent to order disgorgement, but did not acknowledge the limitations on disgorgement as elucidated in those decisions. The court emphasized that "[t]he reparation of funds caused by the defalcation and fraud of these defendants is required by natural justice and is within the equity power of this court."[26] Similarly, without adequate legal analysis, the court ordered disgorgement, jointly and severally, of all proceeds received in connection with the fraudulent transactions in *Sec. Exch. Comm'n v. Micro-Therapeutics, Inc.*[27] These cases represent an aberration among the reported decisions between 1968, the date of the *Dolgow* decision, and 1990.

Several years after its *Manor Nursing Centers* decision, the Second Circuit extended the reach of disgorgement to include

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24. *Accord* Sec. Exch. Comm'n v. Golconda Mining Co., 327 F. Supp. 257, 260 (S.D. N.Y. 1971) ("[Enforcement of the securities laws includes] a basic policy that those who have engaged in proscribed conduct surrender all profits flowing therefrom."); *See also*, Haines v. St. Paul Fire and Marine Ins. Co., 428 F. Supp. 435, 441 (D. Md. 1977) ("Disgorgement is limited only to those who profit by their wrongdoing and does not extend beyond that."); Sec. Exch. Comm'n v. Blatt, 583 F.2d 1325 (5th Cir. 1978); Sec. Exch. Comm'n v. Blavin, 760 F.2d 706, 713 (6th Cir. 1985) ("The purpose of disgorgement is to force a 'defendant to give up the amount by which he was unjustly enriched' rather than to compensate the victims of fraud." (quoting, Sec. Exch. Comm'n v. Commonwealth Chemical Sec., Inc., 574 F.2d at 102)); Estate of Pidock v.Sunnyland Am. Inc., [1989-1990 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,703 at 93,734 (S.D. Ga. May 8, 1989) (citing with approval Sec. Exch. Comm'n v. Blatt; Sec. Exch. Comm'n v. Commonwealth Chemical Sec. and Sec. Exch. Comm'n. v. Manor Nursing Centers, Inc. (Defendants ordered to disgorge only the profits actually received).

25. 386 F. Supp. 866 (S.D. Fla. 1974).

26. *Id.* at 880.

27. [1983 Transfer Binder] Fed. Sec. L. Rep (CCH) ¶ 99,086 at 95,180 (S.D. N.Y. February 4, 1983).

"paper" profits,[28] as well as profits actually received. In *Sec. Exch. Comm'n v. Shapiro*[29] an early insider trading case, the court ordered the defendant to disgorge all "paper" profits accumulated as of the date that the inside information became public knowledge. The defendant continued to hold his stock for a period after the inside information became public and the stock declined in value.[30] The trial court's order required disgorgement of monies never realized by the defendant, which the defendant argued was contrary to law.[31] The Second Circuit affirmed the trial court's order and held that to require disgorgement only of actual profits "would emasculate the deterrent effect of Rule 10b-5."[32]

The court held similarly in *Sec. and Exch. Comm'n v. Commonwealth Chemical Sec., Inc.*,[33] a stock manipulation case. The defendants challenged the order of disgorgement by arguing that losses incurred after the Commission suspended trading in the subject securities should have been subtracted from the court's disgorgement order. The court, disagreeing, stated,

> We see no reason why, in determining how much should be disgorged in a case where defendants have manipulated securities so as to mulct the public, the court must give them credit for the fact that they had not succeeded in unloading all their purchases at the time when the scheme collapsed.[34]

Consequently, the *Shapiro* and *Commonwealth Chemical Securities* decisions had the effect of extending the previously limited reach of disgorgement. Although historically disgorgement was limited to a return of illegal profits actually received, and the Commission never sought anything more; these decisions extended the breadth of disgorgement to include profits not realized by emphasizing the public's interest in deterring securities fraud. This broadening of disgorgement liability provides judicial precedent and reasoning for additional disgorgement liability beyond profits actually received. Accordingly, courts are not required to limit disgorgement to monies actually received in order to further the purposes of the securities laws.

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28. A paper profit is "an unrealized profit on a security or other investment still held. Paper profits became realized profits only when the security or other investment is sold." WEST'S LAW AND COMMERCIAL DICTIONARY IN FIVE LANGUAGES 247 (1st ed. 1985).

29. 494 F.2d 1301, 1309 (2d Cir. 1974).

30. *Id.* at 1309.

31. *Id.*

32. *Id.*

33. 574 F.2d 90 (2d Cir. 1978).

34. *Id.* at 102.

IV. Limitations On Disgorgement

Despite the fact that precedent exists to support the broadening of disgorgement, the remedy does have certain boundaries. The reported decisions contain basically three limitations to disgorgement orders. First, disgorgement cannot be punitive in nature. Second, the amount of disgorgement must be causally related to the securities law violation. Finally, securities laws violators are entitled to offset their profits by legitimate business expenses. However, in light of the recent district court decisions discussed below, defendants soon may not be entitled to any offsets, so long as the disgorgement calculation is causally related to the misconduct.

The *Manor Nursing Centers* decision is the first reported case to reverse an order of disgorgement. The trial court had ordered the defendants to disgorge monies earned from investing the illegal proceeds. The Second Circuit relied upon the language contained in *Texas Gulf Sulphur* which states that the Commission may seek disgorgement "so long as such relief is remedial relief and is not a penalty assessment."[35] In *Manor Nursing Centers*, the Second Circuit held that ordering a return of earned profits on the illegal proceeds constitutes a penalty. Accordingly, the court modified the district court's decision. Notwithstanding the arguably additional deterrent provided by an order requiring disgorgement of profits on illegal proceeds, it was a penalty because those defendants who invested wisely would be treated more harshly than defendants who did not invest at all, or who lost the illegal proceeds by making poor investments. This type of disparate treatment, according to the Second Circuit, would constitute an impermissible penalty.

This analysis is consistent with the Second Circuit's opinion in *Sec. and Exch. Comm'n v. Shapiro*, wherein the defendant was ordered to disgorge "paper" profits.[36] According to the Second Circuit, the wrongdoer gets to keep his earned secondary profits, yet he will also be ordered to disgorge monies lost by investing unwisely. Otherwise, "[t]o require disgorgement only of actual profits in cases where the price of the stock subsequently fell would create a heads-I-win-tails-you-lose opportunity for the

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35. Sec. Exch. Comm'n v. Manor Nursing Centers, 458 F.2d 1082, 1104 (2d Cir. 1972) (*quoting* Sec. Exch. Comm'n v. Texas Gulf Sulphur Co., 446 F.2d 1301, 1308 (2d Cir. 1971)).

36. *But cf.* Sec. and Exch. Comm'n v. Blatt, 583 F.2d 1325, 1335 (5th Cir. 1978) ("Any . . . sum [beyond actual profits] would constitute a penalty.") However, in its earlier decision in the same case, the Fifth Circuit, citing Sec. and Exch. Comm'n. v. Shapiro, acknowledged that disgorgement could encompass "paper" profits. *See* Ellsworth, *supra* note 2, at 656, n.95.

violator: he could keep subsequent profits but not suffer subsequent losses."[37]

In ascertaining whether the respective disgorgement orders constituted an impermissible penalty, the *Shapiro* and *Manor Nursing Centers* decisions insisted that securities laws violators be treated equally. The Second Circuit held that if such defendants are treated the same, then the disgorgement order is not a penalty. If defendants within the same class are treated differently, then the disgorgement order will be considered a penalty.

This analysis was followed by the majority opinion in *Sec. and Exch. Comm'n v. MacDonald.*[38] Defendant MacDonald had bought and sold securities on the basis of non-public information. The trial court ordered MacDonald to surrender all profits resulting from his transactions. However, the First Circuit ruled that he would only be required to disgorge an amount based on the value of the securities as of the date that the non-public information became generally disseminated. In so holding, the court stated, "Granted that it may add to the deterrent effect of the Act every time the Commission conceives of a ground for assessing greater liability, to charge one class of insiders more than others who had committed precisely the same fraudulent act does not seem to us to meet any definition of 'equitable.'"[39]

The *MacDonald* decision provides another, related analysis, which is intertwined with the "equal treatment" requirement announced in the *Manor Nursing Centers* decision. The disgorged profits must be "causally related" to the wrongdoing.[40] This is an alternative basis upon which the First Circuit analyzed the *Shapiro* and *Manor Nursing Centers* decisions. According to the First Circuit, subsequent profits and losses by a securities law violator are unrelated to the illegal conduct and should not be included in a disgorgement order.[41]

The above analyses are consistent with requiring securities laws violators to disgorge all monies paid by investors. In the classic stock manipulation case, requiring the defendant to disgorge all monies fraudulently obtained from investors will not lead to unequal treatment of wrongdoers. All of these monies are obtained by fraudulent conduct, and therefore meet the test of being "causally related." From a public policy perspective,

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37. *Shapiro*, 494 F.2d at 1309.

38. 699 F.2d 47 (1st Cir. 1983).

39. *Id.* at 54.

40. *MacDonald*, 699 F.2d at 54. *See also* Sec. and Exch. Comm'n v. First City Fin. Corp., 890 F.2d 1215, 1231 (D.C. Cir. 1989) ("[D]isgorgement need only be a reasonable approximation of profits causally connected to the violation.").

41. *MacDonald*, 699 F.2d at 47.

forcing those who manipulate the prices of securities to make specific restitution to defrauded investors will certainly add to the deterrent effect of the anti-fraud provisions of the securities laws, and would be consistent with the Congressional intent to remove fraud from the securities industry and increase the efficiency of our capital markets. Restitution is a proper objective of the securities laws.[42] "Compensatory awards are 'uniquely suited to redress or cancel unfairness and promote investor confidence in securities transactions.'"[43] Providing restitution to investors who purchase manipulated securities will promote integrity to the marketplace and therefore, improve the efficiency of our capital markets.

Having concluded that public policy and the "equal treatment" and "causal relationship" rationales would comport with full restitution in the manipulation context, the remaining obstacle to specific restitution is that historically securities laws violators have been entitled to credit for legitimate business expenses.[44] The business deduction is premised on a limited interpretation of disgorgement as a return of illegal profits. If one accepts the proposition that disgorgement is not so limited, then the court would be free to disregard the defendant's legitimate overhead and other costs associated with the fraudulent transactions in computing a reasonable disgorgement figure.[45] On the other hand, equity may, on infrequent occasions, make business expenses an appropriate deduction. Eliminating the routine entitlement of a business deduction will certainly be fair to the defrauded investors who should usually not be responsible for the costs associated with the fraud, and it would effectuate the securities laws remedial purposes.

Some defendants may argue that the defrauded investors purchased and received a security, whose value should correspondingly reduce any order of disgorgement. However, it is

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42. *See generally* Sec. and Exch. Comm'n v. World Gambling Corp., 555 F.Supp. 930, 934 (S.D. N.Y. 1983) ("[W]hile disgorgement has been said to serve more important interests than the compensation of investors, [citation omitted], that principle is a far cry from the proposition that restitution is an improper end.").

43. *Id.*, *quoting* James R. Farrand, *Ancillary Remedies in SEC Civil Enforcement Suits*, 89 HARV. L. REV. 1779, 1803 (1976).

44. *See World Gambling Corp.* 555 F. Supp at 934; Sec. and Exch. Comm'n v. Benson, 657 F. Supp. 1122 (S.D. N.Y. 1987).

45. *Compare* Ellsworth, *supra* note 2, at 658, which concludes that business expense set-offs are appropriate, *quoting* MICHAEL EHRICH, THE LAW OF PROMOTERS § 266 at 488 (1916) (". . . it would appear that the principles of equity ought to permit the defendant to offset all of his expenditures against the gross proceeds he received from the challenged transaction in computing his profit.").

However, this analysis fails to consider the difference between litigation involving private litigants and litigation involving the Commission, which is charged with enforcing the public's interest.

usually impracticable to ascribe a value to a manipulated security when the defrauding broker-dealer dominates the market in the subject security, and has assigned an artificially inflated price to such security. "[W]here the nature of a wrong makes damage calculations difficult . . . it is better to give the plaintiff a windfall than to permit the wrongdoer to profit from his wrong."[46] Therefore, investors should generally be entitled to a return of their entire investment in manipulated securities, unless the wrongdoer can establish a legitimate value for the subject security.

V. Recent Decisions

Two recent cases, only one of which was litigated arguably establish investors' losses, rather than profits actually received, as a more appropriate basis upon which to calculate an order of disgorgement. These new decisions represent an obvious departure from the original Commission enforcement actions wherein disgorgement was limited to a return of illegal profits.

In *Sec. and Exch. Comm'n v. Thomas James Assoc., Inc.*[47] the defendants, a brokerage firm and its two equal co-owners, conceded that they had manipulated the prices of certain securities in connection with four initial public offerings. The Commission alleged that the gross receipts from the fraudulent public offerings during the first three days of trading was $3 million. The Commission had limited its request for disgorgement to that time period. The court used $3 million dollars, which represented the investors' funds, as the basis for its disgorgement calculation. In so doing, the court felt bound only to establishing a causal connection between the sum of disgorgement and manipulative conduct. The court stated that it did not "find much guidance . . . in cases stating that the amount to be disgorged is the amount of illegal profits."[48] Ruling that the defendants were entitled to a set-off for fair business expenses[49], the court reduced the gross revenues by approximately 50 percent.[50] After considering other equitable considerations, such as the

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46. *MacDonald*, 699 F.2d at 56. *See also* Ellsworth, *supra* note 2, at 654-5 ("[A]s between the wrongdoing party and the innocent party, any unexpected gains connected with the wrongful transaction ought to go to the latter.").

47. [1990 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 95,307 at 96,432 (W.D.N.Y. May 25, 1990)

48. *Id.* at 96,436.

49. *Id.* at 96,435. These expenses included commissions, telephone charges, underwriting expenses and a proportionate share of overhead.

50. The court's inclusion of a set-off for business expenses is questionable because it did not feel bound to limit disgorgement to profits actually received. *See* Ehrich, *supra* note 45. Accordingly, the court was not theoretically bound to deduct the business expenses. It appears that the set-off was a function of competing equitable considerations, and therefore, perhaps appropriate. *See Thomas James Assoc., Inc.*, *supra* note 47, at 96,435.

issuance of permanent injunctions and their effect on the defendants' professional reputations, and the respective roles played by each of the defendants in the manipulative scheme, the court apportioned the disgorgement sum of $1.5 million unequally among the defendants, without regard for the profits actually received by each of them.

Similarly, the Commission did not limit its request for disgorgement to profits actually received by the defendant in *Sec. and Exch. Comm'n v. Lewis*.[51] In this case, the defendant, a securities broker and former manager of a registered broker-dealer, agreed to disgorge $475,000, which was allegedly "partial recompense for the effect on the market price" of the manipulated security.[52]

Both of these cases are significant because the courts ordered disgorgement in amounts unrelated to profits actually received by the defendants. Inasmuch as the bases of the disgorgement figures were the amounts of monies paid by investors, these disgorgement orders are more consistent with traditional notions of restitution and recoupment than disgorgement as historically sought by the Commission and ordered by the courts.[53] This type of analysis will provide a greater disincentive to violate the securities laws and promote a sense of justice among aggrieved investors.

VI. Conclusion

Expanding disgorgement liability to include specific restitution on a joint and several basis is likely to increase the deterrent effect of the securities laws. If the laws are to deter fraud, they should at least provide an economic disincentive to manipulate the securities market. While the passage of the Securities Remedies and Penny Stock Reform Act is a step in this direction, the Act will be better able to deter fraud when the ceiling on civil fines is at least extended to include all of the investors' losses.

An unarticulated basis for the recent trial court decisions arguably extending disgorgement liability may be that further effort by the Commission is necessary to curb fraud. Given the wholesale fraud in the penny stock market[54], class actions may not

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51. [1990 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶95,393 at 96,939 (S.D.N.Y. August 6, 1990).

52. *Id.* at 96,939.

53. *See* Sec. and Exch. Comm'n v. R.J. Allen and Assoc., Inc., 386 F. Supp. 866, 880-881 (S.D. Fla. 1974).

54. In September 1989, the North American Securities Administrators Association released a report, "The NASAA Report on Fraud and Abuse in the Penny Stock Industry," which concluded, based on a 50-state survey, that, "[p]enny stock swindles are now the No. 1 threat of fraud and abuse facing small investors

be as effective as originally thought in making investors whole. Almost thirty years ago, Professor Loss stated that, "[a]n even more effective device than the class action would be direct enforcement by the Commission of restitution to the victims of violation of the statutes."[55] Perhaps Professor Loss' idea is one whose time has come.

Increasing the scope of disgorgement is not without consequences. The Commission's bargaining power with defendants will be proportionately increased, which will certainly be opposed by those who resist any expansion of Commission authority. In addition, the Commission's budget may preclude the Commission from assuming additional tasks for its enforcement activities without detracting from resources allocated for other parts of the enforcement program.[56] Therefore, even if the Commission determined to pursue specific restitution in manipulation cases, it might not be able to do so without disturbing other parts of the agency's agenda.[57]

This endeavor may in fact require the investment of additional Commission resources. However, it would be difficult to argue that it is not in keeping with the spirit of the Securities Exchange Act of 1934, which was designed to "protect investors and the public

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in the United States." According to the report, investors lose at least $2 billion each year as a result of manipulative schemes involving the low-priced securities. Text of House Report Nos. 101-616 and 101-617, 101st Cong., 2d Sess., at 8, 10 (1990).

55. 3 LOUIS LOSS, SECURITIES REGULATION 1824 (2d ed. 1961).

56. In 1989, Chairman Ruder, in Congressional testimony before a House Appropriations Subcommittee regarding the Commission's 1990 budget, stated that ". . . the agency has difficulty meeting its market oversight responsibilities as a result of limited resources and a thinly-stretched staff." Fed. Sec. L. Rep. (CCH) No. 1329, pt. 2, at 4 (March 13, 1989).

57. Prompted by testimony that the Commission lacked sufficient resources to fulfill its statutory mandate, Congress directed the Commission to study the possibility of the Commission becoming a self-funded agency. Self-Funding Study, prepared by the Office of the Executive Director of the U.S. Securities and Exchange Commission at iv (December 20, 1988). In response, on January 17, 1989, the Commission submitted materials and proposed legislation recommending, among other things, the establishment of a permanent revolving fund to be known as the Securities Exchange Revolving Fund, to be maintained by fees collected by the Commission, and which would enable the Commission to increase its overall effectiveness in regulating capital markets.

On May 2, 1991, Chairman Breeden testified before the House Energy and Commerce Telecommunications and Finance Subcommittee on self-funding. Chairman Breeden urged subcommittee members to approve a self-funding mechanism and lift current pay caps for senior Commission staff. According to Chairman Breeden, lifting pay ceilings results in lower turnover rates. 23 Sec. Reg. & L. Rep. (BNA) No. 18, at 669 (May 3, 1991).

interest" and provided disciplinary powers by the imposition of any "fitting sanction."[58]

Until now, many investors have lost their investments due to stock manipulation. Even if the Commission brings an enforcement action, the individual investors do not usually benefit from a disgorgement order. Broadening the mainstream interpretation of disgorgement to include specific restitution will promote investor confidence, a vital objective of the Commission's agenda.[59] Expansion of the remedy of disgorgement will serve to deterrent purposes in furtherance of the objectives of the Securities Exchange Act and Congress.[60] Less fraudulent activity not only reduces waste of capital, it redirects limited capital resources to more efficient uses, providing a synergy which benefits the national economy. Increased investor confidence and more efficient capital markets are laudable objectives that should not be stymied by an unduly limited interpretation of disgorgement.

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58. Securities Exchange Act of 1934, § 6(b)(5-6), 15 U.S.C.A. § 78(f) (1988 and Supp. 1990) (empowering the Commission to regulate the national securities exchanges to protect investors and the public interest, by prescribing rules that are designed to prevent fraudulent and manipulative acts).

59. Speaking at the American Stock Exchange Conference last October, Chairman Breeden stated that, "the most important element in increasing the supply of equity capital is maintaining and improving public confidence in the U.S. markets. Individual and institutional investors, domestic and foreign, will not invest in U.S. markets unless they are confident that they can do so without becoming a victim of fraud or other abusive market practices." Fed. Sec. L. Rep. (CCH) No. 1418, pt. 2, at 2-3 (October 23, 1990).

60. Sec. and Exch. Comm'n v. World Gambling Corp., 555 F. Supp. 930, 934 (S.D.N.Y. 1983).