A Newsletter from Chicago Underwriting Group, Inc.
Underwriters of D & O and Professional Liability Insurance

Issue 92 **May 2014**

In this issue … *a recently released research paper that suggests the Securities and Exchange Commission's (SEC) distribution of money from its "fair funds" to defrauded investors may be a significant —and often underappreciated— source of investor compensation.*

Introduction

The backdrop against which Directors & Officers liability insurance plays out is largely formed by three factors: the U.S. Congress, the U.S. Supreme Court, and the SEC. Because of that, many of these newsletters are concerned with the effect of one or more of these key influences. Congressional legislation of the securities industry started with the Securities Act of 1933 and the Securities Exchange Act of 1934. Since that time, there has been a succession of federal statutes that have governed oversight of the securities business and the direction of securities litigation. The Supreme Court, as arbiter and interpreter of those federal statutes, has also been active in recent years, with cases such as *Basic*, *Dura Pharmaceuticals*, *Dabit*, *Tellabs*, and *Stoneridge* all bearing upon securities litigation.

The role of the SEC is to implement federal securities legislation, and to spearhead civil enforcement. Support and approval for the SEC has not always been universal: In September 2011 this newsletter considered some of the agency's well-publicized shortcomings, as well as its virtues.

One of the tasks undertaken by the SEC has been the creation and distribution, following congressional mandate, of so-called "fair funds" to help compensate defrauded investors. This generally little-known activity is the subject of a recent research paper entitled "Public compensation for private harm: evidence from the SEC's fair funds distribution" by Urska Velikonja, Assistant Professor of Law at Emory University School of Law. Formal publication in the Stanford Law Review is not scheduled until next year, but a copy of the paper is available on the *Social Science Research Network*. This issue of our newsletter provides a broad overview of this revealing study. *(All subsequent data are taken from the paper.)*

Background

The "fair funds" originated with the federal Securities Enforcement Remedies and Penny Stock Reform Act of 1990. Prior to this, the SEC assumed the mantle of enforcement, rather than as a collection agency for victims of securities fraud —a role that instead fell to private securities litigation. That 1990 act allowed the SEC to pursue disgorgement of ill-gotten gains and to distribute those sums to harmed investors through the vehicle of "fair funds;" any civil fines collected by the SEC were remitted to the U.S. Treasury. Twelve years later, the Sarbanes-Oxley Act diverted those civil fines from the Treasury to the SEC's disgorgement pot, and the Dodd-Frank Act took it a step further by allowing distribution of civil fines even where there had been no disgorgement. The research paper examines that period from Sarbanes-Oxley in 2002 to almost the present day (December 2013), and the 236 fair funds created during that time.

The Paper

According to the author, the fair funds have received little attention from scholars, politicians, and the press, and that attention has been generally negative. The paper claims to show by empirical study that far from being a waste of time, money, effort, and resources, fair funds have played a meaningful part in providing compensation for defrauded investors.

Here are just three of the charges sometimes leveled against the fair funds, and the paper's responses:

1. ***Distributions from fair funds duplicate those from private class actions.***
   Professor Velikonja notes that fair funds are commonly criticized for duplicating damages distributed in parallel securities class actions. In analyzing the distribution of 218 fair funds, she subdivided those funds into eight separate categories. Professor Velikonja determines that "In the aggregate, the SEC did not duplicate distribution in 172 of 218 fair fund cases, or 78.9% of the time." Her conclusion is that: "The evidence refutes the assertion that the SEC wastes resources on duplicative compensation proceedings. Most of the time the SEC 's action is the only legal proceeding instituted against the defendant."

2. ***The compensation the funds provide is circulatory.***
   The charge of circularity —that when a defendant firm pays a penalty, the money ultimately comes from the shareholders, who are also the ostensible victims: they suffer from the fraud and then pay to themselves any fine that is imposed— is, according to Professor Velikonja, "the most common and serious critique of the SEC's efforts to compensate defrauded investors." Circularity, the author writes, may be potentially a concern for cases involving issuer reporting and disclosure fraud. While in these instances it is the defendant firm that generally pays the civil fine as the primary defendant, there are still monies collected from non-issuer sources.

   Out of the seventy fair funds created in reporting and disclosure cases, third-party defendants —such as executives, auditors, investment banks— contributed towards sixty of these funds, paying a total of $1.24 billion, nearly twenty percent of the total amounts distributed. For funds that do not address reporting and disclosure fraud, the circularity issue has less validity, and as the author comments, "distribution of payments from individual defendants to defrauded investors is never circular." In summation, she writes:

   > *The circularity critique may be justified with regard to $5.09 billion paid by issuers and distributed to defrauded investors through fair funds created in issuer and reporting and disclosure violations. While the amount is large, it represents only 35.5% of all fair-funds distributions.*

3. ***The amount of compensation is small compared to private actions.***
   As the author puts it, "Public commentary suggests that the SEC's compensation efforts are not worth the candle, and that private litigation recoveries dwarf [the SEC's] contribution." Between 2002 and 2012 the SEC created 222 funds and distributed a total of $12.98 billion (in 2013 dollars) or an average of $58 million per fund. During the same period, 920 securities class actions settled for $60 billion, an average of $65 million for each action. After dissecting the data, the author concludes:

   > *A few large class action settlements …obscure the importance of fair funds distributions as a source of compensation in the average securities case. …With the exception of a handful of very large accounting frauds, fair funds distributions are the most important, if not the only source of investor compensation.*

COMMENT

While looking like an apologia on behalf of the SEC, this interesting and well-researched paper —though sometimes hard to follow— does help to restore some credibility to the SEC's mission of both investor protection and enforcement against securities fraud. To demonstrate a balanced approach, the paper also mentions what could be described as two fund distribution failures by the SEC: the Global Research Analyst settlement, and the settlement following the *WorldCom* case.

Although probably not intended as a direct criticism of the securities class action process, comparison with securities class actions as the chief shareholder compensatory mechanism does result in some side-swipes, for example pointing out that culpable individuals are more likely to pay a price following SEC enforcement than under securities class action lawsuits: “Individuals virtually never contribute to class action settlements because of D&O insurance and corporate indemnification.” A footnote (#42) comments that the pending Supreme Court decisions on *Roland v. Green*, and *Erica P. John v. Halliburton* may result in limiting the availability of securities class actions.

It should be remembered that impartial regulatory actions of an agency of the federal government are very different from private securities class action lawsuits brought by the self-serving plaintiffs’ bar on behalf of investors. They may share a common feature in seeking to provide money for defrauded shareholders, but apples and apples they are not. Nonetheless, by examining the often-overlooked history and impact of the SEC’s fair funds, the author has made a useful contribution to the literature on securities fraud and the available sources for investor compensation. ❖

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Chicago Underwriting Group, Inc.

Web: www.cug.com
Email: info@cug.com
Phone: (312) 750-8800
Fax: (312) 750-8965

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