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Worlds are Colliding: A Critique of the Need for the Additional Criminal Securities Fraud Section in Sarbanes-Oxley

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WORLDS ARE COLLIDING:

A CRITIQUE OF THE NEED FOR THE ADDITIONAL CRIMINAL SECURITIES FRAUD SECTION IN SARBANES-OXLEY

On July 30, 2002, Congress passed H.R. 3763, better known as the Sarbanes-Oxley Act of 2002[1] ("Sarbanes-Oxley" or "the Act"), in an effort to "protect investors by improving the accuracy and reliability of corporate disclosures made pursuant to the securities laws, and for other purposes."[2] This legislation was in response to the onslaught of corporate scandals that resulted in the near annihilation of former corporate superpowers such as Enron, Arthur Anderson, and WorldCom. In passing the bill, Congress sought to "protect the people of this country . . . [and to] make sure corporate America can do its best to help our economy."[3] Congress attempted to "create tough new penalties for securities fraud and . . . preserve evidence of fraud to make sure there is accountability for crimes that not only cheat investors but rob the markets themselves of the public trust."[4]

One commentator has referred to the Act as "the most far-reaching series of changes to the laws on corporate governance and disclosure and accounting oversight since the federal securities laws were enacted 70 years ago."[5] While its goal is commendable, this legislation is broad and overreaching for several reasons. While the SEC has recently come under fire for proposing rules pursuant to Sarbanes-Oxley which may compromise the attorney-client privilege and conflict with state ethical codes,[6] a less publicized provision of the Act may have similar, far-reaching effects

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1 Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (2002) (to be codified at 15 U.S.C. § 7201) [hereinafter Sarbanes-Oxley].

2 *Id.* at preamble.

3 148 CONG. REC. S6437 (daily ed. July 9, 2002) (statement of Sen. Daschle).

4 *Id.*

5 John J. Falvey Jr. and Matthew A. Wolfman, *The Criminal Provisions of Sarbanes-Oxley: A Tale of Sound and Fury*, 13 INS. COVERAGE LITIG. REP. 23 (December 11, 2002) [hereinafter *Sound and Fury*].

6 Implementation of Standards of Conduct for Attorneys, 17 C.F.R. pt. 205 (2003).

on securities markets, securities lawyers, securities professionals, and others who must quickly comply with the newly enacted legislation. Title VIII, section 807 of Sarbanes-Oxley is entitled "Criminal penalties for defrauding shareholders of publicly traded companies"[7] and is designed to implement an allegedly new "no tolerance" policy in the securities industry by punishing fraudulent statements and transactions in securities markets.[8]

In Senator Leahy's section-by-section analysis of Sarbanes-Oxley presented to the Senate on July 26, 2002, the Senator stated that "[c]urrenty, unlike bank fraud or health care fraud, there is no generally accessible statute that deals with the specific problem of securities fraud."[9] Senator Leahy went on to assert that federal prosecutors are left to resort to a "patchwork of technical . . . offenses and regulations" or to treat the violations as "generic mail or wire fraud cases and to meet the technical elements of those statutes, with their five year maximum penalties."[10] As this Comment will point out, Senator Leahy's comments on this subject are misguided and ignore the presence of a plethora of criminal securities fraud statutes which are neither "technical" nor "patchwork" when compared to the section enacted under the umbrella of Sarbanes-Oxley.

Part I of this Comment will analyze the legislative history of Sarbanes-Oxley and discuss the new criminal provision for securities fraud contained in section 807 of the Act. Part II of this Comment will address section 17 of the Securities Act[11] and section 10 of the Exchange Act,[12] the two main already-existing securities fraud statutes available to federal prosecutors. Further commentary will point to several other federal statutes commonly used to prosecute securities fraud and briefly comment on how those have historically been applied. Finally, Part III will address the weaknesses of the Sarbanes-Oxley securities fraud statute, demonstrating that there is little or no difference between that statute and the securities fraud laws already in place.

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7 Sarbanes-Oxley, *supra* note 1, § 807.

8 *Id.* § 807. The statutory language of this section and a detailed discussion are contained in Part I of this Comment, *infra*.

9 148 CONG. REC. S7418 (daily ed. July 26, 2002) (statement of Sen. Leahy).

10 *Id.*

11 15 U.S.C. § 77q (2002).

12 *Id.* § 78j.

I. AN OVERVIEW OF SARBANES-OXLEY SECURITIES FRAUD PROVISIONS

It is unmistakable that the introduction and passage of the Sarbanes-Oxley Act of 2002 was sparked by the various corporate accounting scandals around the country, most notably the misdeeds in accounting treatment at Enron and WorldCom, as well as officer and director greed contributing to the downfall of Tyco and Adelphia.[13] These scandals contributed not only to the rapid downward trend in the stock market over the past three years, but also in thousands of lost jobs rippling out from the companies themselves to hundreds of other companies who depended on these corporate giants for business.[14] It was against this background that Sarbanes-Oxley was introduced and ultimately sped through Congress on a 99-0 vote in the Senate and a 423-3 vote in the House. In signing the law, President Bush remarked, "No more easy money for corporate criminals — just hard time."[15]

President Bush was, of course, referring to the new white-collar criminal penalties introduced by the Act in order to deter the types of conduct typified by the highly publicized corporate scandals over the past few years. What follows is a brief overview and summary of the Act's key securities fraud provision, section 807, in order to establish a context for further discussion of the federal securities law statutes.

The new criminal securities fraud provision in Sarbanes-Oxley is contained in section 807 of the Act and is entitled "Criminal penalties for defrauding shareholders of publicly traded companies."[16] This section states:

> Whoever knowingly executes, or attempts to execute, a scheme or artifice-
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> (1) To defraud any person in connection with any security of an issuer with a class of securities registered under section 12 of the Securities Exchange Act of 1934 (15 U.S.C. 78l) or

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13 *See Sound and Fury*, *supra* note 5.

14 *See* 148 CONG. REC. S10,563 (daily ed. October 16, 2002) (statement of Sen. Levin). In his remarks, Sen. Levin opined that the only people who emerged from the Enron fiasco unscathed were corporate executives who escaped with millions of dollars. Sen. Levin further noted that corporate scandals have infected not only Wall Street, but also everyday America, where over half of American households have equity security investments.

15 Press Release, Office of the Press Secretary of the White House, President Bush Signs Corporate Corruption Bill (July 30, 2002) (on file with author).

16 Sarbanes-Oxley, *supra* note 1, § 807.

that is required to file reports under section 15(d) of the Securities Exchange Act of 1934 (15 U.S.C. 78o(d)); or

(2) to obtain, by means of false or fraudulent pretenses, representations, or promises, any money or property in connection with the purchase or sale of any security of an issuer with a class of securities registered under section 12 of the Securities Exchange Act of 1934 (15 U.S.C. 78l) or that is required to file reports under section 15(d) of the Securities Exchange Act of 1934 (15 U.S.C. 78o(d));

Shall be fined under this title, or imprisoned not more than 25 years, or both.[17]

Senator Leahy, the primary author and major impetus behind the Act's criminal provisions, stated in his floor remarks on the bill that the Act's terms do not embrace the technical definitions in the securities laws but rather are intended to provide "the needed enforcement flexibility in the context of publicly traded companies to protect shareholders and prospective shareholders against all types of schemes and frauds which inventive criminals may devise in the future."[18]

Historically, federal regulation of securities transactions has been accomplished through the Securities Act of 1933 (Securities Act) and the Securities Exchange Act of 1934 (Exchange Act) and the rules and regulations promulgated under the authority of those acts. However, the criminal securities fraud provision under Sarbanes-Oxley will not be included as an amendment to these Acts or codified alongside them. Instead, the new criminal securities fraud provision stands independent and is codified at 18 U.S.C. §1348. Furthermore, as the following Section of this Comment will demonstrate, the ingenuity of section 807 is minimal and was an unnecessary addition to the Act.[19] Even a brief examination of federal securities jurisprudence reveals that fraudulent conduct and transactions proscribed by section 807 have been illegal and prosecuted under federal laws in place since 1933.

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[17] *Id.*

[18] 148 CONG. REC. S7418 (daily ed. July 26, 2002) (statement of Sen. Leahy).

[19] *See* John F.X. Peloso and Stuart M. Sarnoff, *Securities Litigation and Enforcement, The Sarbanes-Oxley Act of 2002: Whom Does It Affect and How?*, 228 N.Y. L.J. 3 (2002) (stating that the enactment of section 807 in Sarbanes-Oxley may be an example of legislative overkill).

II. EXISTING FEDERAL SECURITIES LAWS IN PLACE TO PREVENT FRAUDULENT SECURITIES PRACTICES

A. *The Securities Act of 1933 and Relevant Criminal Sanctions*

The Securities and Exchange Commission (SEC) and the Department of Justice since 1933 under the Securities Act have had several provisions available to prosecute and convict individuals suspected of securities fraud, irrespective of Sarbanes-Oxley. The "hub" provision in this respect is section 24, which states:

> Any person who willfully violates *any provision of this title, or the rules and regulations promulgated by the Commission under authority thereof*, or any person who willfully, in a registration filed under this title, makes any untrue statement of a material fact, or omits to state any material fact required to be stated therein or necessary to make the statements therein not misleading, shall upon conviction be fined not more than $10,000 or imprisoned not more than five years, or both.[20]

The statement "any provision of this title, or the rules and regulations promulgated by the Commission" brings the whole Securities Act within the scope of section 24 and makes it a federal crime to violate any section, rule, or regulation of the Securities Act. Most importantly, this section brings within its scope violations of sections 5 and 17 of the Securities Act.[21]

Section 5 has three main requirements integral to improving disclosure in securities transactions. First, it requires that a registration statement be filed with the SEC before any offers to sell, solicitations of offers to buy, or offers to buy may be made.[22] Second, it requires that a registration statement be in effect before any sales of securities may be consummated.[23] Third, it regulates the content of prospectuses used in the sale of securities and mandates the availability of these disclosure mechanisms at some point during the sale of securities.[24]

Section 17 of the Securities Act is aimed at deceptive practices in the sale of securities to purchasers. This section makes it unlawful, in the sale of securities, to:

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20 15 U.S.C. § 77x (2002) (emphasis added).
21 *Id.* § 77e, q.
22 *Id.* § 77e(c).
23 *Id.* § 77e(a).
24 *Id.* § 77e(b).

(1) employ any device, scheme, or artifice to defraud, or

(2) to obtain money or property by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements make, in light of the circumstances under which they were made not misleading; or

(3) to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser.[25]

In their treatise on securities regulation, Professors Louis Loss and Joel Seligman[26] note that section 17 marked an advance over other criminal statutes formerly used to prosecute securities fraud, namely the mail fraud statute.[27] They point out that section 17 was "specifically tailored to the securities field," and that the law speaks in terms of "material misstatements" and "half truths."[28] Thus, by applying section 24 to section 17 violations, it is clear that section 17 violations can be prosecuted under federal law, and that such violations, by encompassing material misstatements and half-truths, are designed to prevent and punish fraudulent securities transactions. The penalty for such a violation, contained in section 24, is five years imprisonment or a fine of $10,000, or both.[29] Sentencing in such cases is now subject to the Federal Sentencing Guidelines.

From the foregoing, it is evident that prior to the passage of Sarbanes-Oxley federal prosecutors had ample opportunity to require disclosure and prosecute punish fraud in the securities markets by resorting to sections 5 and 17 of the Securities Act of 1933. Furthermore, as will be more fully developed in Part III of this Comment, applications of these sections are rather simple and straightforward and cast a wide net to prevent fraud and to protect investors.

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[25] *Id.* § 77q.

[26] LOUIS LOSS & JOEL SELIGMAN, SECURITIES REGULATIONS § 9-A-1 (3d ed. 2001).

[27] 18 U.S.C. § 1341 (2002). The federal wire fraud statute, 18 U.S.C. § 1343, has also been frequently been used to prosecute deception in connection with securities transactions.

[28] LOSS & SELIGMAN, *supra* note 26, § 9-A-1.

[29] 15 U.S.C. § 77x.

B. *The Securities Exchange Act of 1934 and Relevant Criminal Provisions*

The Securities Exchange Act of 1934[30] contains anti-fraud protection similar to that found in section 17 of the Securities Act. Section 32(a) of the Exchange Act serves the same purpose as section 24 of the Securities Act and makes it unlawful for one to violate any provision of the Securities Act.[31] Within its proscriptions is section 10(b), which makes it unlawful for any person to:

> Use or employ, with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations . . . for the protection of investors.[32]

Under the authority to adopt rules and regulations pursuant to Exchange Act section 10(b), the SEC adopted Rule 10b-5 containing language similar to that found in Securities Act section 17. Rule 10b-5 makes it unlawful for any person:

> (1) to employ any device, scheme, or artifice to defraud,
>
> (2) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading, or
>
> (3) to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.[33]

Under section 32(a), the penalties for violating Rule 10b-5 are up to twenty years imprisonment, a fine of up to $5 million, or both.[34] Similar to violations of the Securities Act, sentencing for these crimes is subject to the Federal Sentencing Guidelines. As will be discussed in the following Sections, the application and interpretation of Rule 10b-5 is substantially similar to that of section 17 of the Securities Act.[35] Furthermore, there is a plethora of case law interpreting the terms used in Rule 10b-5 as applied to

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30 *Id.* § 78.
31 *Id.* § 78ff(a).
32 *Id.* § 78j(b).
33 17 C.F.R. § 240.10b-5 (2002).
34 15 U.S.C. § 78ff(a).
35 *See* discussion *infra* Part II.C.

securities violations, and, despite Senator Leahy's statements to the contrary, this rule has been used frequently to prosecute and send securities violators to federal prison.[36]

C. *Applications of the Criminal Sanctions in the Securities and the Exchange Acts*

In interpreting and applying the criminal sanctions contained in the 1933 Securities Act and the 1934 Exchange Act, it becomes important to define and focus on the conduct which is proscribed. By flushing out the meaning of terms such as "willfully," "knowingly," "fact," "falsity," "materiality," "misstatements," and "half-truths," which are used in both the Securities Act and the Exchange Act anti-fraud provisions,[37] one can see that many of the violations inherent in the corporate frauds over the past few years were subject to prosecution under already-existing federal securities laws.

As with many legislative enactments, the proscriptions contained in section 17 of the Securities Act and rule 10b-5 of the Exchange Act are modeled after the common law, specifically common law notions of fraud and deceit.[38] Loss and Seligman argue that the most liberal notions of common law deceit should be applied to these statutes, given the "gross inequality of bargaining power between the professional securities firm and the average investor."[39] Courts have frequently held that the anti-fraud provisions in the Securities Act and the Exchange Act are not limited to conduct which would give rise to a common law action for fraud or deceit.[40] In addition, judicial opinions on the subject have wisely resisted constructing a hard and fast definition of fraud for fear of enabling the most wily of violators to conceive of ways to

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[36] For example, a defendant convicted of violating section 17 and Rule 10b-5 in connection with manipulating the market price of a security to reap profit from appreciation of the price was sentenced to a concurrent three-year prison term for his role in the fraud. United States v. Rubinson, 543 F.2d 951 (2d Cir. 1976).

[37] 15 U.S.C. §§ 77q, 77x, 78ff(a), 78j.

[38] *See* LOSS & SELIGMAN, *supra* note 26, § 9-A-2 (stating that "[s]tatutes build on the common law and, especially when statutes are new, judges and lawyers who are trained in the common law are apt to look to it for guidance").

[39] *Id.*; *see also* Marketlines, Inc. v. SEC, 384 F.2d 264, 266 (2d Cir. 1967) (stating that it is the SEC's duty to protect the gullible, and thus, advertisements may be judged by their impact on the market segment at which they are targeted).

[40] *Marketlines*, 384 F.2d at 266 (citing Charles Hughes & Co. v. SEC, 139 F.2d 434 (2d Cir. 1943)).

evade the law.[41] To this end, courts have found it the better practice to deal with each case on its own facts.[42]

In determining whether a statement is true or false, one must first determine whether the statement is in fact capable of being true or false; namely, whether it purports to be a statement of fact or is merely the declarant's opinion.[43] In 1896, the Supreme Court stated in a case brought under the Federal Mail Fraud statute that to make a promise which one does not intend to perform or to declare a baseless opinion as to future events is a fraud and may be punished as a scheme or artifice to defraud despite the fact that it is a representation and promise about the future.[44] Following this lead, the SEC has held valuations, geological reports, and similar statements that, though they may be regarded as opinions, to be based on implied representations that professional standards have been followed.[45] If one holds oneself out to be an expert and does not follow these standards, an implied factual misrepresentation is involved.[46] The notion of "puffing" has virtually become extinct in the securities law context.[47] Thus, in the securities field, if one desires to boast about the value, performance, or qualities of one's goods or services, one must be sure that such a statement is clearly a statement of opinion and based on reasonable and justifiable facts.[48] While such good-faith representations may be shielded from liability, the district court in *Alfaro v. E.F. Hutton & Co.*[49] held that some expressions of opinion may still be actionable under section 10(b) and rule 10b-5 where such "opinions or predictions [are] not made in good faith or made with knowledge that are not based upon a sound, factual or historical basis."[50]

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41 SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180 (1963); State v. Whiteaker, 118 Or. 656 (1926).

42 LOSS & SELIGMAN, *supra* note 26, § 9-A-2.

43 Given that the notion of fraud as used in these statutes is based on the common law, the distinction between opinion and fact becomes relevant due to the common law definition of fraud: A false representation of a material fact, known to be false, made for the purpose of inducing one to rely on it, and on which the person does so rely with resulting damage. *Id.*

44 Durland v. United States, 161 U.S. 306, 313 (1896).

45 Hughes v. Dempsey-Tegeler & Co., 534 F.2d 156 (9th Cir. 1976); Alfaro v. E.F. Hutton & Co., 606 F. Supp. 1100 (E.D. Pa. 1985); *see also* LOSS & SELIGMAN, *supra* note 26, §9-A-2.

46 LOSS & SELIGMAN, *supra* note 26, §9-A-2.

47 *Id.*; *see also* Knox v. Anderson, 159 F. Supp. 795, 806 (D. Haw. 1958) ("Buyer beware lingers now only in the argument of the lawyers.").

48 *See* Apple Computer Sec. Litig., 672 F. Supp. 1552, 1563 (N.D. Cal. 1987) (holding that statements about "unequalled strength" and "expertise," defined by the court as "aren't we great egoism that characterizes much of corporate America," are clearly statements of opinion and that, under SEC law, "a reasonable and justified statement of opinion, one with a sound factual or historical basis, is not actionable."), *aff'd & rev'd in part on other grounds*, 886 F.2d 1109 (9th Cir. 1989).

49 606 F. Supp. 1100 (E.D. Pa. 1985).

50 *Id.* at 1104.

In determining what facts may be designated as "material," the Supreme Court stated in *TSC Industries, Inc. v. Northway, Inc.*[51] that in the proxy rule context, a fact is material if "there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote."[52] This definition has been followed in other securities law cases, including suits brought under Rule 10b-5.[53] In fact, the Supreme Court in *Basic v. Levinson*[54] expressly adopted the *TCS Industries* standard of materiality in applications of section 10(b) and rule 10b-5.[55] There is also precedent for the view that a matter is material if "the maker of the representation knows or has reason to know that its recipient regards or is likely to regard the matter as important . . . although a reasonable man would not so regard it."[56] Furthermore, omissions of material facts in statements made to persons with financial sophistication are not excused by the recipient's financial acumen.[57]

The issue of materiality has frequently arisen in the context of merger negotiations. A typical situation addressing the sensitivity of corporate responsibilities in merger negations arose in *Basic Inc. v. Levinson*,[58] where the Supreme Court addressed the issue of materiality in this context. The Court held that information does not become material simply because of a public statement denying it, but that "once a statement is made denying the existence of any discussions, even discussions that might not have been material in absence of the denial are material because they make the statement made untrue."[59] Ultimately, many courts have adopted what has become known as the "mosaic theory," under which each individual piece of information at issue must be evaluated in the context of the overall impression created by the statements as a whole.[60] In determining materiality, "[w]hat might be considered innocuous 'puffery' or a mere statement of opinion standing alone may be actionable as an integral part of a representation of a material fact

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51 426 U.S. 438 (1976).

52 *Id.* at 449. For the proxy rules, see 17 C.F.R. § 240.14a (2002). The proxy rules bar the use of proxy statements that are false or misleading with respect to the disclosure or omission of material facts. In *TCS*, the plaintiffs claimed that the defendant companies issued proxy statements without disclosing the amount of control exerted by the acquiring company over the target. *Id.* at 441-42.

53 LOSS & SELIGMAN, *supra* note 26, §9-A-2.

54 485 U.S. 224 (1998).

55 *Id.* at 232.

56 *Id.* (quoting RESTATEMENT (SECOND) OF TORTS § 538(2)(b)(1980)).

57 Nye v. Blyth Eastman Dillon and Co., 588 F.2d 1189 (8th Cir. 1978).

58 485 U.S. 224.

59 *Id.* at 237.

60 LOSS & SELIGMAN, *supra* note 26, §9-A-2.

when used to emphasize and induce reliance upon such a representation."[61]

The meaning of the terms "willfully" and "knowingly" becomes critical when assessing culpability under both the Securities Act and the Exchange Act. Under section 24 of the Securities Act, one cannot be found guilty absent a showing of a willful violation of a provision of the Securities Act.[62] Similar terms are found in the Exchange Act where willful and knowing violations of that Act are proscribed.[63]

As applied in section 5 of the Securities Act, which provides for itemized disclosure control over securities transactions, the term "willfully" refers to the violator's knowledge of the absence of a registration statement or the failure to deliver a prospectus. In the context of conspiring to sell unregistered securities, the Court of Appeals for the Second Circuit has held that the elements of knowledge and willfulness under federal securities law require a showing that the defendant either knew, or deliberately closed his eyes to, the necessity of registering the stock before selling it.[64] In *United States v. Rubinson*, the prosecution satisfied this requirement by showing that the defendants, *inter alia*, engaged in "furtive and roundabout dealings," received warning of illegality from their lawyers, and that the defendants "laundered" their stock through a company in an attempt to avoid registration.[65] For his part in the securities scheme, defendant Rubinson was sentenced to a three-year consecutive term in federal prison.[66]

As applied in the anti-fraud provisions of the Securities and Exchange Acts, "willfully" refers to knowledge of the falsity or omission with gross negligence or indifference as to the facts.[67] Occasionally, when applying the penal provisions of the Securities and Exchange Acts, courts have struggled with the question of whether "willfully" and "knowingly" refer to a knowledge of the underlying facts *and* of the law being violated, or if those terms merely require knowledge of the facts giving rise to the violation.

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61 Casella v. Webb, 883 F.2d 805, 808 (9th Cir. 1989).

62 15 U.S.C. § 77x (2002).

63 *See* 15 U.S.C. § 78ff(a) ("[N]o person shall be subject to imprisonment under this section for the violation of any rule or regulation if he proves that he had no knowledge of such rule or regulation").

64 United States v. Rubinson, 543 F.2d 951, 959 (2d Cir. 1976).

65 *Id.*

66 *Id.* at 954. It is important to note that Rubinson was simultaneously charged and convicted for conspiracy to violate section 17(b) of the Securities Act. Rubinson's co-defendants were charged with and convicted of conspiracy to violate sections 5 and 17(b). Two of them received concurrent three-year sentences, while the fourth defendant in the matter received an eighteen-month sentence. *Id.*

67 *Id.*

Some courts have found that the terms must be applied separately and require independent proof.[68] However, in subsequent cases, the same courts change their decisions and hold that the terms "willfully" and "knowingly" do not require the government to prove the element of specific intent to defraud.[69] Other courts have held that a conviction under section 32(a) can be both "willful" and "knowing" when based upon "reckless, deliberate indifference to or disregard for truth and falsity."[70]

An examination of case law demonstrates that the willfulness and knowledge requirements do not present an unattainable burden for prosecutors in punishing fraudulent securities transactions. In *United States v. Lilley*,[71] the district court held that the defendants could not avail themselves of the "no knowledge" clause in section 32(a) of the Exchange Act because proof of "no knowledge" can only mean ignorance of the substance of the rule. In other words, the defendant must be completely unaware of the illegality of his actions.[72] In *Lilley*, the defendants manipulated the prices of certain securities while at the same time purchasing substantial amounts of those securities in order to create the appearance of an active market in the stock.[73] Such conduct was generally proscribed by sections 17(a) of the Securities Act and section 10(b) of the Exchange Act as fraudulent. While the defendants admitted they were aware that securities fraud was illegal, they contended that they were unaware of the specific section under which their conduct was illegal, namely section 9(a)(2) of the Exchange Act[74] which proscribes price manipulation. The court found this argument unpersuasive and held that it was enough that each defendant knew his conduct was manipulative and that securities fraud was illegal. It did not matter that the defendants alleged no knowledge that manipulative conduct was fraudulent.[75]

68 *See* United States v. Peltzn, 433 F.2d 48, 54-55 (2d Cir. 1970).

69 *See* United States v. Schwartz, 464 F.2d 499, 509 (2d Cir. 1972) ("Proof of a specific intent to violate the law is not necessary to uphold a conviction under § 32(a) of the [Exchange] Act, provided that satisfactory proof is established that the defendant intended to commit the act prohibited.").

70 United States v. Weiner, 578 F.2d 757, 786-87 (9th Cir. 1978).

71 291 F. Supp. 989 (S.D. Tex. 1968).

72 *Id.* at 993.

73 *Id.* at 991.

74 15 U.S.C. § 78i(a)(2) (2002).

75 *Lilley*, 291 F. Supp. at 993.

III. ADDRESSING THE NEED FOR CRIMINAL SECURITIES PROVISIONS IN SARBANES-OXLEY

Against the background laid out in Parts I and II, the glaring hole in Senator Leahy's statement that there are no criminal penalties for securities fraud becomes evident. It also raises the question: "Why did the legislature insert this section into the Act when it adds nothing to the already existing securities fraud laws?" In fact, an examination of the language contained in section 807 of Sarbanes-Oxley reveals that it covers virtually identical transactions and conduct as the language in the Securities Act and Exchange Act, and in some cases, is substantially *less* protective of investors than its counterpart provision in the Securities Act.

First of all, it is important to recognize Congress's good intentions in attempting to strengthen the penalties for defrauding investors in a securities market in desperate need of renewed investor confidence. However, instead of further complicating securities law by inserting this new criminal provision into Sarbanes-Oxley, the same ends could have been attained via different and simpler means – merely amending the current provisions of the Securities Act to raise the penalties for violations of the anti-fraud provisions already on the books. Currently, the penalty for violating section 24 of the Securities Act is up to five years imprisonment, a $10,000 fine, or both.[76] In contrast, a violation of section 807 may result in a prison sentence of up to twenty-five years in addition to a substantial fine.[77] However, the substantive anti-fraud language in section 807 adds nothing new to existing securities law, except for increased fines and jail terms.

Section 807(1) proscribes attempts to defraud any person in connection with the securities of an issuer who has a class of securities registered under section 12 of the Exchange Act or that is required to file reports under section 15 of the Exchange Act and is substantially similar to subsections (1) and (3) of rule 10b-5 under the Exchange Act and subsection (1) of section 17 under the Securities Act.

As noted in Part II of this Comment, rule 10b-5(1) makes it unlawful for one to "employ any scheme, device, or artifice to defraud."[78] If this were not enough, the rule goes even further, proscribing any attempt to "engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon

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[76] 15 U.S.C. § 77x.

[77] Sarbanes-Oxley, *supra* note 1, § 807.

[78] 17 C.F.R. § 240.10b-5(1) (2002).

any person, in connection with the purchase or sale of any security."[79] Reading these two sections together, there would appear to be no securities transaction that would be found unlawful under section 807(1) of Sarbanes-Oxley that would not also be found unlawful under rule10b-5 subsections (1) and (3).

Additionally, section 17(a)(1) of the Securities Act provides further protection against fraudulent securities transactions and would operate in a substantially greater number of circumstances than either rule 10b-5 or section 807. Recall from Part II of this Comment that section 17(a)(1) makes it unlawful for one to "employ any device, scheme, or artifice to defraud."[80] Furthermore, subsection (3) of that section makes it unlawful for one "to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser."[81] This language is substantially similar to that found in rule 10b-5 and would seem to operate in the same instances as the provisions in that rule and in section 807. However, the protections afforded those transacting in securities is even greater under section 17 and rule 10b-5 than those granted under section 807. While section 807 is only applicable to transactions in securities of companies registered under section 12 of the Exchange Act or companies required to file reports under section 15(d) of the Exchange Act,[82] neither section 17 nor rule 10b-5 contain such limiting language. Thus, the anti-fraud provisions of section 17 would cover any securities transaction, regardless of the size of the transaction or the size of the company against whom the security represents a claim, and regardless of the type of security changing hands.[83]

While section 807(1) would seem to muddy the securities waters enough, Congress also included within Sarbanes-Oxley section 807(2) which makes it unlawful for one "to obtain, by means of false or fraudulent pretenses, representations, or promises, any money or property in connection with the purchase or sale of any security of an issuer."[84] This section creates an even greater problem for those who wish to comply with securities law than the section previously discussed.

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[79] *Id.* § 240.10b-5(3).

[80] 15 U.S.C. § 77l(a)(1).

[81] *Id.* § 77l(a)(3).

[82] *Id.* at § 78; Sarbanes-Oxley, *supra* note 1, § 807.

[83] This proposition is strengthened by section 2(a)(3) of the Securities Act, which defines "security" as used in the Securities Act. This definition encompasses instruments ranging from interests oil, gas or other mineral rights to puts, calls, and straddles, options and privileges on any security, to any instrument or interest commonly known as a "security." 15 U.S.C. § 77b(a)(3).

[84] Sarbanes-Oxley, *supra* note 1, § 807(2).

At the outset, subsection (2) contains several words that are vague and undefined within the Act. The problem follows that, until case law is developed to define words such as "false or fraudulent pretenses" and "false promises," those transacting in securities will be skating on thin ice while wondering whether their transactions fall within the ambit of the law.

Furthermore, section 807 adds nothing to already existing securities law. Securities professionals have already begun to comment that the "new" securities laws are little more than "sound and fury signifying nothing."[85] In fact, in the months leading up to the passage of Sarbanes-Oxley, then-Chairman of the SEC Harvey Pitt testified before Congress that he saw no need for new laws prohibiting securities fraud and that laws were already on the books which have been available to adequately protect investors from fraudulent practices.[86] Furthermore, the SEC's Associate Director of Enforcement Thomas Newkirk remarked after the passage of Sarbanes-Oxley that "the underlying difficulties in criminal prosecutions are going to remain relatively the same despite the new provisions."[87]

At first blush, the new law seems to alter existing securities law in two respects. First, the new law does not explicitly require proof of "willfulness" on the part of the violator in order for section 807 to apply.[88] However, the statute does require proof of an intent to deceive investors. Only time will tell how courts will choose to interpret the word "intent" as used in this context, but clearly it is hard to imagine that it will be interpreted in such a manner which would make it significantly easier to show "intent" as opposed to the "willfulness" requirement under the Securities Act and the Exchange Act.

Second, the new law applies to fraudulent practices "in connection with any security," whereas traditional securities law has dealt with fraud linked to the purchase or sale of securities.[89] However, this distinction is just as unlikely to have a significant effect on securities law prosecutions. First of all, once a prosecutor is able to show fraud with respect to financial statements or in any other context, it is not hard to make an additional showing that

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[85] *See Sound and Fury*, *supra* note 5, at 24.

[86] *Hearing on the Enron Matter Before the House Subcommittee on Capitol Markets, Insurance and Government Sponsored Enterprises*, 107th Cong. (2002) (statement of Harvey L. Pitt, Chairman, U.S. Securities and Exchange Commission).

[87] Richard Hill, *SEC Official Tells Seminar New Law May Not Increase Successful Prosecutions*, 34 BNA SEC. L. & REG. REP. 33, at 1380 (Aug. 19, 2002).

[88] *See Sound and Fury*, *supra* note 5, at 24-25.

[89] *Id.* at 25.

the fraud was in connection with the "purchase and sale of any security."[90] Furthermore, the Supreme Court has recently refused to adopt a narrow interpretation of the "purchase or sale" requirement in securities law in *SEC v. Zandford*.[91] In *Zandford*, the defendant-broker sold securities from his clients' accounts and then used the proceeds from the sale for his own benefit without the clients' knowledge or consent. Initially, the court reiterated its position that rule 10b-5 should not be technically construed, but should be read to "effectuate its remedial purpose."[92] The Court further stated that "neither the SEC nor this Court has ever held that there must be a misrepresentation about the value of a particular security in order to run afoul of the Act." Ultimately, the Court held that " in the context of a violation of §10(b) of the [Exchange Act], it is enough that the scheme or artifice to defraud and the sale of securities coincide."[93]

However, the new law is not completely devoid of novel coverage of securities transactions. In a situation where fraud is present in a securities transaction which does not contain either the purchase or sale of securities, the new laws would provide relief where section 17 and rule 10b-5 did not. Such a case may exist in a hypothetical situation where a corrupt broker tricks a client into transferring him ownership of the client's securities without actually purchasing or selling securities as part of the fraud.[94] This type of transaction, while not covered by the Securities or Exchange Acts, would still be prosecuted under the mail or wire fraud statutes, so to the extent that lawmakers intended to create new criminal liability in this area, the statute misses the point.

CONCLUSION

This Comment is not intended to minimize the importance of Sarbanes-Oxley in the context of improving disclosure by public corporations and restoring public confidence in the securities markets and the business world as a whole. However, this Comment emphasizes that when the legislature desires to address such a situation, and it does so through broad and sweeping legislation, it should take the time to make sure that it is actually doing what it purports to do.

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90 *Id.*
91 535 U.S. 813 (2002).
92 *Id.* at 819.
93 *Id.* at 903-04.
94 *Sound and Fury*, *supra* note 5, at 25.

It became evident when scandals such as Enron began to break that definitive action would have to be taken to cure the ills of corporate America. To this end, Congress came together, held hearings, subpoenaed documents, and passed legislation in an attempt to prevent future scandals and punish those that precipitated the current crises.[95] However, it is far less clear that the proper response is to pass what is essentially an "off the cuff" response to these problems without first taking the time to reflect and analyze the best possible methods to remedy any given situation. While the duplicity of federal securities fraud statutes is a somewhat innocuous problem,[96] only time will tell how the rest of the Act and the rules promulgated under its authority will affect not only corporate America, but the average, everyday American who is left to endure the harsh reality of an economy driven by individual deception and greed.

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95 *See* 148 CONG. REC. S10,563 (daily ed. October 16, 2002) (statement of Sen. Levin) (stating that Sarbanes-Oxley was a strong response to these corporate misdeeds, but that Congress's work was far from over).

96 *See Sound and Fury*, *supra* note 5, at 25 (noting that while the previous securities fraud statutes will probably remain on the books, prosecutors will be more inclined to bring cases under section 807 given the gravity of its maximum penalties and the deterrent value it carries).

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