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4 Ways To Prepare For SEC Or CFTC Penalty Negotiations

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The Commodity Futures Trading Commission issued guidance in May listing the factors its Division of Enforcement will consider when recommending civil monetary penalties.[1] The guidance sets forth broad discretion for the agency in assessing penalties, which is similar to the broad penalty authority of the U.S. Securities and Exchange Commission.

Businesses and individuals should be aware of the discretion that both agencies have when imposing penalties, and the practical impact of that discretion on negotiations at the end of enforcement investigations. In this article, we discuss four key steps that counsel may take when preparing to negotiate a penalty with either agency.

1. Know the statutory limits.

Although the SEC and CFTC have broad authority to impose civil monetary penalties, that authority is not unlimited. A first step for counsel preparing for penalty negotiations is to review the statutory boundaries on the agencies' discretion. In particular, key variables are whether the case involves manipulation, for the CFTC, and the statutory tier of the violation, which is based on the severity of the conduct, for the SEC.

The CFTC has two penalty categories: those for violations that involve manipulation or attempted manipulation, and those that do not. The CFTC may impose penalties in manipulation cases equal to the greater of (1) triple the monetary gain to the person or entity, or (2) up to $1,212,866 per violation.[2]

In cases not involving manipulation, the maximum penalty per violation drops to the greater of triple the monetary gain or (1) $185,242 for actions filed in federal court,[3] (2) $926,213 for administrative proceedings against registered entities or any of their directors, officers or employees,[4] and (3) $168,142 for administrative proceedings against persons other than registered entities.[5]

For SEC cases involving the Exchange Act,[6] the Investment Company Act,[7] the Investment Advisers

Act[8] and violations of the Securities Act brought in federal court,[9] SEC penalties are divided into three tiers of increasing severity:[10]

Maximum Allowable SEC Penalty Per Violation as of Jan. 15

Tier	Individual	Entity
Tier 1: any violation	$9,639	$96,384
Tier 2: any violation involving "fraud, deceit, manipulation, or deliberate or reckless disregard of a regulatory requirement"	$96,384	$481,920
Tier 3: any violation that satisfies Tier 2 and that "directly or indirectly resulted in substantial losses or created a significant risk of substantial losses to other persons or resulted in substantial pecuniary gain to the person who committed the act or omission"	$192,768	$963,837

For actions filed in federal court, the SEC alternatively may seek penalties up to the gross pecuniary gain the defendant received.[11]

For SEC cases in particular, arguing for a lower tier can have a substantial impact on the agency's penalty authority.

2. Determine the number of violations.

As illustrated by the table above, a significant factor in determining the size of a penalty is the number of violations at issue. The statutory amounts cap out at approximately $1.2 million for the CFTC, or triple a defendant's monetary gain, and just under $1 million for the SEC, or a defendant's gross pecuniary gain. Nevertheless, the agencies routinely reach settlements in the tens or hundreds of millions of dollars by imposing these amounts for each violation.

Specifically, the SEC may assess penalties for each act or omission for actions brought in administrative proceedings,[12] and for each violation for actions brought in federal court.[13] The CFTC may impose penalties for each violation.[14]

A critical component of penalty negotiations is determining the number of acts, omissions, or violations. This issue is particularly important because there is little case law on the issue, and whether actions are characterized as separate and distinct violations or part of a single course of conduct can have a significant impact on the maximum permissible penalty.[15]

Counsel should identify opportunities in the factual record to argue that only a limited number of violations occurred.

Agency staff are likely to argue for a high number of acts, omissions, or violations for conduct that

occurred over a period of time, but this can lead to absurdly high penalty authority if a single course of conduct is divided into many discrete components (i.e., each day that the conduct continued, or each day that a filing containing a material misrepresentation is public).

Effective advocacy about the number of violations can have a meaningful impact on the ultimate penalty amount.

3. Know the precedents.

Sometimes, the most important factor when negotiating a penalty is the precedents. In the world of SEC and CFTC enforcement, the relevant precedents rarely are court decisions. Instead, with most cases resolved through settlements, the key precedents are prior settlements with similar facts and violations.

The appropriateness of a penalty amount often is measured, at least in part, by comparing the present conduct to that from prior cases, and reviewing the penalties in those cases. Defense counsel should ask themselves: How does this conduct compare to other cases in this area, and where should the instant case fit within that continuum of prior penalties?

Counsel should also consider whether some precedents might be outliers. Cases involving similar facts might have been filed during a time when the commission was taking either more or less aggressive policy-based positions, and a prior case that might appear to be a helpful model may be less than persuasive to current leadership.

After reviewing this important history, counsel should identify opportunities to argue that the facts of the current case are less severe than conduct in prior cases, and advocate for a penalty that accounts for this comparison.

4. Know the guidance.

The CFTC's recent penalty guidance is notable because the CFTC and SEC do not regularly issue penalty guidance. Consistent with prior guidance from both agencies, the new CFTC guidance seeks to preserve the agency's broad discretion when negotiating a penalty. Combined with an assessment of a party's cooperation, the guidance instructs CFTC staff to consider the following factors as a foundation for any penalty discussion:

- Gravity of the violation: This is "the primary consideration," and the guidance lists three "illustrative" factors: (1) the nature and scope of the violations, including "the number, duration, type and degree of the violations," efforts to conceal them, the respondent's role, whether the respondent worked in concert with others, and the extent of harm to any victims; (2) the respondent's state of mind; and (3) any consequence of the violation, including harm to victims and market participants, any actual or potential benefit to the respondent, and impact on the CFTC's mission.

- Mitigating and aggravating circumstances: The guidance provides a list of seven non-exclusive considerations to assess mitigating and aggravating circumstances. These include: (1) post-violation conduct; (2) whether the respondent self-reported to the CFTC and the extent of cooperation and remediation; (3) timeliness of remediation; (4) efficacy of any preexisting

compliance program; (5) any prior misconduct; (6) pervasiveness of misconduct, including responsibility of mismanagement; and (7) company efforts to discipline culpable individuals.

- Other considerations: The guidance also lists a series of other relevant and non-exclusive considerations, including: (1) the total mix of remedies and monetary relief to be imposed on the respondent across parallel criminal and civil enforcement actions; (2) monetary and non-monetary relief in analogous cases; and (3) conservation of CFTC resources, including timely settlement.

The SEC published a nine-part framework, or penalty statement, in 2006 following its increased imposition of penalties in the mid-2000s.[16] The two principal considerations outlined in the penalty statement, which primarily concerned penalties against public companies, were the presence of a direct benefit to the company as a result of the violation and harm to shareholders.

As at the CFTC, the SEC also takes into account a party's cooperation when considering a penalty, and the factors for consideration of corporate cooperation in particular are described in a separate guidance document, the so-called Seaboard report.[17]

The 2006 penalty statement started a years-long debate among SEC commissioners as to its merits, with application of the guidance changing with the composition of the commission.

For example, in 2013, SEC Chair Mary Jo White stated that the penalty statement "was not then, and is not now, binding policy for the Commission or the staff," but is instead "a useful, non-exclusive list of factors that may guide a Commissioner's consideration of corporate penalties."[18]

In contrast, that same year Commissioner Daniel Gallagher called any question of whether the penalty statement was binding "a red herring," noted that it was "unanimously approved" by the commissioners when it was issued, and described it as "an analysis of the law conferring corporate penalty authority on the Commission," with that law binding the commissioners.[19]

Currently, the penalty statement appears to be a variable that continues to influence the views of some individual commissioners.

The broad penalty guidance offered by the agencies allows for agency staff to apply a great deal of discretion when negotiating penalties. Defense counsel should consider each of the potential negotiation levers outlined in the guidance to determine which may be most beneficial to emphasize based on the particular facts and circumstances at issue.

The policy objectives of the agencies' current leadership, however, can play an even more important role in how the agencies' penalty guidance is applied. Counsel can prepare for negotiations by reading statements, speeches, and testimony by the current SEC and CFTC commissioners and Division of Enforcement leadership to understand their individual priorities for setting penalties.

Counsel should seek to understand agency leadership's policy objectives and seek to frame issues for negotiation in light of those objectives. This can be a particularly important consideration when appealing a penalty proposed by SEC or CFTC staff to the agencies' directors of enforcement, and enforcement practitioners should be mindful that a majority of commissioners must ultimately approve any penalty associated with a settlement.

Conclusion

The determination of penalty amounts in SEC and CFTC enforcement cases is more the function of negotiations and policy objectives than a precise, reliable formula set forth by statute or guidance. Although the agencies have wide latitude, this breadth also presents an opportunity for effective advocacy in settlement negotiations. Enforcement practitioners should consider how they might utilize the four factors outlined here before beginning penalty negotiations.

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[1] Memorandum from James M. McDonald, Director, Division of Enforcement, to Division of Enforcement Staff, Civil Monetary Penalty Guidance (May 20, 2020), https://www.cftc.gov/media/3896/EnfPenaltyGuidance052020/download.

[2] 7 U.S.C. § 13a-1(d)(1)(B) (federal court); 7 U.S.C. § 9(10)(C)(ii) (administrative proceeding against persons other than registered entities); 7 U.S.C. § 13a (administrative proceeding against registered entities).

[3] 7 U.S.C. § 13a-1(d)(1)(A).

[4] 7 U.S.C. § 13a.

[5] 7 U.S.C. § 9(10)(C)(i).

[6] 15 U.S.C. § 78u(d)(3) (federal court); 15 U.S.C. § 78u-2(b) (administrative proceeding).

[7] 15 U.S.C. § 80a-41(e) (federal court); 15 U.S.C. § 80a-9(d) (administrative proceeding).

[8] 15 U.S.C. § 80b-9(e) (federal court); 15 U.S.C. § 80b-3(i) (administrative proceeding).

[9] 15 U.S.C. § 77t(d). For Securities Act violations brought in administrative proceedings, the maximums are slightly lower: (i) $8,824 (individual) and $88,248 (entity) for Tier 1 violations; (ii) $88,248 (individual) and $441,240 (entity) for Tier 2 violations; and (iii) $176,496 (individual) and $853,062 (entity) for Tier 3 violations. 15 U.S.C. § 77h-1(g).

[10] The SEC also can assess penalties of varying amounts for other violations of the securities laws, including for insider trading, 15 U.S.C. § 78u-1(a), and for violations of the Foreign Corrupt Practices Act, id. § 78ff(c).

[11] See 15 U.S.C. § 78u(d)(3) (Exchange Act); 15 U.S.C. § 80a-41(e) (Investment Company Act); 15 U.S.C. § 80b-9(e) (Investment Advisers Act); 15 U.S.C. § 77t(d) (Securities Act).

[12] 15 U.S.C. § 77h-1(g)(2) (Securities Act); 15 U.S.C. § 78u-2(b) (Exchange Act); 15 U.S.C. § 80a-9(d)(2) (Investment Company Act); 15 U.S.C. § 80b-3(i)(2) (Investment Advisers Act).

[13] 15 U.S.C. § 77t(d)(2)(A) (Securities Act); 15 U.S.C. § 78u(d)(3)(B)(i) (Exchange Act); 15 U.S.C. § 80a-41(e)(2)(A) (Investment Company Act); 15 U.S.C. § 80b-9(e)(2)(A) (Investment Advisers Act).

[14] See 7 U.S.C. § 13a-1(d)(1); see also 7 U.S.C. § 9(10)(C) ("each such violation"); 7 U.S.C. § 13a (same).

[15] See Rapoport v. S.E.C., 682 F.3d 98, 108 (D.C. Cir. 2012) (noting that SEC "must determine how many violations occurred," and engage in a parsing of the conduct to determine "whether to treat the entire course of conduct as a single act or as a series of acts, as to which multiple penalties would be appropriate" (internal quotation marks omitted)). See generally Samuel N. Liebmann, Note, Dazed and Confused: Revamping the SEC's Unpredictable Calculation of Civil Penalties in the Technological Era, 69 Duke L.J. 429, 440-441 (2019) (noting that courts have "discretion ... in determining what constitutes an 'act or omission,'" which has been measured by the "duration of the fraud," or the number of (i) "illegal transactions," (ii) "investors injured," (iii) "fraudulent statements made to investors," or (iv) "distinct acts of negligence").

[16] Press Release, Sec. & Exch. Comm'n, Statement of the Sec. and Exch. Comm'n Concerning Financial Penalties (Jan. 4, 2006), https://www.sec.gov/news/press/2006-4.htm.

[17]U.S. Sec. & Exch. Comm'n, Spotlight on Enforcement Cooperation Program (modified Sept. 20, 2016), https://www.sec.gov/spotlight/enforcement-cooperation-initiative.shtml; Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934 and Commission Statement on the Relationship of Cooperation to Agency Enforcement Decisions, Exchange Act Release No. 44,969, Accounting and Auditing Enforcement Release No. 1,470, 76 SEC Docket 220, 2001 WL 1301408 (Oct. 23, 2001), https://www.sec.gov/litigation/investreport/34-44969.htm.

[18] Chair Mary Jo White, Deploying the Full Enforcement Arsenal, Speech to the Council of Institutional Investors fall conference in Chicago, IL (Sept. 26, 2013), https://www.sec.gov/news/speech/spch092613mjw.

[19] Commissioner Daniel M. Gallagher, Remarks at Columbia Law School Conference (Hot Topics: Leading Current Issues in Securities Regulation and Enforcement) (Nov. 15, 2013), https://www.sec.gov/news/speech/2013-spch111513dmg.