Reprinted from the

New York University
Annual Survey
of American Law

Section 21(a) Reports: Formalizing a Functional Release Valve at the Securities Exchange Commission

Neal Perlman

Volume 69 Issue 4

2014

SECTION 21(A) REPORTS: FORMALIZING A FUNCTIONAL RELEASE VALVE AT THE SECURITIES EXCHANGE COMMISSION

*NEAL PERLMAN**

Introduction 888
I. The Functional Origins of Section 21(a) Reports 891
A. The Statutory Basis 891
B. The Early Years: 1934–48 894
1. The Initial Use of Section 21(a) Reports..... 894
2. The Emergence of the Public Benefit Rationale 896
3. Potential for Misuse 897
4. Gaining Focus: Section 21(a) Reports Adopt a Public Benefit Rationale 899
C. Introduction to the Public Benefit Dichotomy: Reports for Investors and Reports for Industry... 899
II. Section 21(a) Reports in Action 900
A. Extrajurisdictional Reports....................... 901
1. Reports Issued to Highlight Misconduct Outside SEC Jurisdiction 901
2. The Public Benefit Rationale 902
B. Politically Fraught Situations..................... 904
1. Reports Issued in Political Situations with Tension Between the Commission and Local and State Government Entities............... 904
2. The Public Benefit Rationale 906
C. Leniency 908
1. Reports Issued to Grant Leniency for Good Faith or Cooperation 908
2. The Public Benefit Rationale 909
3. Reports Issued in the Face of Good Faith Reliance 911
D. Derivative Liability.............................. 913

* J.D. Candidate 2015, N.Y.U. School of Law. The author would like to thank the Hon. Robert Katzmann for providing helpful guidance and suggestions, the N.Y.U. Annual Survey Note-Writing Program for its comments and criticism throughout the drafting process, and the staff of the N.Y.U. Annual Survey of American Law for their work in preparing the piece for publication.

1. Reports Issued in Matters of Derivative Liability 913
2. The Public Benefit Rationale 915
3. Further Examples of Derivative Liability Reports: Brokers and Lawyers 916
E. Legal Ambiguity 919
1. Reports Issued in the Face of Legal Ambiguity 919
2. The Public Benefit Rationale 922
III. The Formalistic Perspective: Section 21(a) Reports in Administrative Law 922
A. The Section 21(a) Report as an Administrative Consent Decree 926
1. The Safeguard of a Public Benefit to Mitigate SEC Self-Interest 927
2. The Safeguard of Consent to Prevent Inappropriate Reputational Harm 929
B. The Industry-Related Public Benefit: The General Statement of Policy 931
C. The Chimeric Section 21(a) Reports 934
D. A Proposal for Reform: Bifurcation of the Reports by Public Benefit 935
Conclusion 936

INTRODUCTION

The Securities and Exchange Commission (SEC or the Commission) is the primary regulator of financial entities, and as such, possesses an institutional expertise in sorting out corporate malfeasance unmatched by any other agency.[1] To ensure a stable and well-functioning financial marketplace, Congress has delegated to the SEC authority to promulgate securities rules and enforce them, either through internal administrative proceedings or in federal court.[2] The enforcement of the securities laws and regulations takes on many forms, but a theme pervasive in the regulatory approach of the Commission is the "assumption that more information is bet-

1. Rachel E. Barkow, *The Prosecutor as Regulatory Agency*, *in* Prosecutors in the Boardroom: Using Criminal Conduct to Regulate Corporate Conduct 177, 192–93 (Anthony S. Barkow & Rachel E. Barkow eds., 2011). This knowledge is often leveraged by prosecutors and state attorneys general seeking to convict white collar criminals for complex financial wrongdoing. *Id.*

2. Roberta S. Karmel, Regulation by Prosecution 92 (1982).

ter than less."[3] By requiring the publication of material facts relevant to a company's wellbeing, the Commission allows a member of the public to review its financial state and make investment decisions based on this knowledge at her own peril. With this approach, the Commission straddles the fine line between protection and paternalism.

A fully informed investor can presumably make prudent allocations of her capital, and if she does not, only she is to blame for any ensuing loss.[4] While this market-based tack may seem uncontroversial today, preceding the enactment of the federal securities laws, so-called state "blue sky" securities laws often required regulators to examine the soundness of a financial offering.[5] Louis Brandeis, writing twenty years prior to the establishment of the Commission, best explained the theory underlining this more laissez-faire approach: "Publicity is justly commended as a remedy for social and industrial diseases. Sunlight is said to be the best of disinfectants; electric light the most efficient policeman."[6] In other words, the rigor of the market will drive capital away from bad actors if they are properly identified.

A requirement that financial entities disclose information or otherwise comply with securities regulations would not be effective without a complementary enforcement mechanism. Since its creation in 1934, the SEC's Division of Enforcement (Enforcement Division) has spearheaded the prosecution of financial wrongdoing with an increasingly diverse range of weaponry.[7] The SEC began with only the authority to pursue civil injunctions in federal court,[8] which later expanded with the addition of cease-and-desist authority in 1990[9] and the authority to impose fines, among other re-

---

3. Troy A. Paredes, *Blinded by the Light: Information Overload and Its Consequences for Securities Regulation*, 81 WASH. U. L.Q. 417, 418 (2003).

4. *But see id.* at 419 (discussing the diminishing usefulness of increasingly large amounts of information as a guide for investor decisionmaking).

5. KARMEL, *supra* note 2, at 41. The origin of the term "blue sky" is uncertain, though see Jonathan R. Macey & Geoffrey P. Miller, *Origin of the Blue Sky Laws*, 70 TEX. L. REV. 347, 359 & n.59 (1991), for some colorful possibilities.

6. LOUIS D. BRANDEIS, OTHER PEOPLE'S MONEY AND HOW THE BANKERS USE IT 92 (1914).

7. *See generally* Daniel M. Hawke, *A Brief History of the SEC's Enforcement Program 1934–1981*, SEC. & EXCHANGE COMMISSION HISTORICAL SOCIETY (Sept. 25, 2002), http://www.sechistorical.org/collection/papers/2000/2002_0925_enforcementHistory.pdf.

8. Roberta S. Karmel, *Creating Law at the Securities and Exchange Commission: The Lawyer As Prosecutor*, 61 LAW & CONTEMP. PROBS. 33, 34 (Winter 1998).

9. Andrew M. Smith, *SEC Cease-and-Desist Orders*, 51 ADMIN. L. REV. 1197, 1198 (1999).

forms.[10] The SEC can also censure and disbar broker-dealers and other associated individuals.[11] These actions, often in combination, are the most common result after the Enforcement Division decides that a regulated entity's conduct has violated the securities laws.

This Note will focus on Reports of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934 (Section 21(a) Reports),[12] a much less common action, in which the SEC decides to publish the information gathered during the course of an investigation. Resolving a matter with the publication of a report is generally restricted to times when the Commission believes that the public would benefit from the information gathered in an investigation, but does not (or cannot) follow the formal enforcement process. These reports are not a formal enforcement action, but rather are emblematic of Brandeis's conception of a market-oriented campaign of publicity[13]: they represent the notion that the publication of facts gathered from an investigation constitutes a sufficient resolution to a given issue.

As a matter of administrative law, it is hard to classify Section 21(a) Reports under the typical dichotomy of rulemaking versus adjudicatory proceedings. The reports are often simultaneously described as having both a prospective character—that is, providing guidance—and a retrospective one—providing a remedy.[14] They are employed sporadically and for reasons that differ based on the SEC's need in a particular case.[15] In form, they disclaim any adjudicatory or punitive nature,[16] though practitioners often see things

10. 6 Thomas Lee Hazen, Law of Securities Regulation § 16.2 (6th ed. 2009).

11. *Id.*

12. Fourteen Section 21(a) Reports published since 1996 are available on the SEC's website. *Reports of Investigations*, Sec. & Exchange Commission, http://www.sec.gov/litigation/investreports.shtml (modified Jan. 24, 2014). Additionally, the author found several Section 21(a) Reports published prior to 1996 through searches in Westlaw and LexisNexis, using varied search parameters meant to capture the language used in the reports. This search tactic allowed the author to find Section 21(a) Reports published prior to 1996 that were otherwise unidentifiable as such by title alone.

13. *See infra* Part I.A.

14. *See* 25 Marc I. Steinberg & Ralph C. Ferrara, Securities Practice: Federal and State Enforcement § 4:16 (2d ed. 2001).

15. *See, e.g.*, Eurex Deutschland, Exchange Act Release No. 70148, 106 SEC Docket, no. 18 (Aug. 8, 2013) [hereinafter Eurex Deutschland Report], http://www.sec.gov/litigation/investreport/34-70148.pdf (dealing with swaps rules); Motorola, Inc., Exchange Act Release No. 46898, 78 SEC Docket 2855, 2856 (Nov. 25, 2002) [hereinafter Motorola Report] (dealing with Regulation FD).

16. *See, e.g.*, Eurex Deutschland Report, *supra* note 15; Motorola Report, *supra* note 15.

differently.[17] In many respects, they most resemble a settlement, a product of executive action.

This Note will seek to bring the tension between the functional, investigatory purpose of the reports and formal administrative law principles to the fore, first by exploring the various circumstances that give rise to the publication of a report and then by turning to how these reports can fit into the established administrative law paradigm. Part I will bifurcate the reports into: (1) those that provide an investor-related benefit, and (2) those that provide an industry-related public benefit. This Part will also explain how the function of the reports issued prior to the "renaissance" of the SEC in the 1960s foreshadowed their use today. Part II further divides the reports into five categories based on the various rationales for issuing a report in lieu of more substantive remedial action: (1) jurisdictional issues; (2) local and state government involvement; (3) good faith; (4) derivative liability; and (5) legal ambiguity. A secondary goal of Part II is to provide a complete catalogue of all published reports.

Part III will examine the reports through the lens of administrative law, ultimately concluding that each public benefit tracks a different type of administrative action, sometimes with deleterious consequences. Part III will then attempt to explain from a normative perspective the SEC's decision to use the reports historically and today. This Part will also examine other critiques of the SEC to understand the reports within their particular regulatory milieu and offer a way to maintain the functional use of the reports while adhering to the principles of administrative law. The reports are an excellent way of clarifying the legal position of the SEC and warning investors of malfeasance; they are less useful as a remedial or quasi-legislative measure.

I.
THE FUNCTIONAL ORIGINS OF SECTION 21(A) REPORTS

A. *The Statutory Basis*

Section 21(a) Reports originate in a provision of the Securities Exchange Act that authorizes the SEC to "publish information concerning any such violations . . . [1] which it may deem necessary or proper to aid in the enforcement of [the securities laws], [2] in the prescribing of rules and regulations under this title, or [3] in securing information to serve as a basis for recommending further legis-

17. Dennis L. Block & Nancy E. Barton, *Securities Litigation: Section 21(a): A New Enforcement Tool*, 7 Sec. Reg. L.J. 265, 266 (1979).

lation concerning the matters to which this title relates" upon completion of an investigation.[18] The second and third prongs of this tripartite framework allow the SEC to use the reports as a fact-finding mechanism to guide the agency or Congress in crafting new rules in a dynamic area of law. The bulk of the reports issue under the first prong—to aid in enforcement—a much broader and less defined mandate.[19] The clearest textual reading of this first provision is to allow the reports to function as a kind of guide for regulated parties, explaining how the SEC will react to new areas of law and warning investors that a financial transgression occurred.

This statutory authority is part of section 21(a) of the Securities Exchange Act, which allows the SEC to "make such investigations as it deems necessary to determine whether any person has violated" a securities law.[20] After the Enforcement Division decides a matter merits a formal investigation, the SEC staffers begin an inquiry that is wide-ranging in scope and can include subpoenas of witnesses and documents, frequently containing information that the entity would rather remain private.[21] An informal investigation is equally serious, though it does not involve the power to subpoena.[22] After an investigation, the Enforcement Division refers the matter to the Commission with a recommendation on whether or not to pursue a public, formal enforcement proceeding.[23] In cases where the Enforcement Division believes the best resolution to be the publication of a Section 21(a) Report, the Commission generally goes along with the staff's recommendation.[24] Investigations are private,[25] meaning the decision to publish a report detailing the facts of the wrongdoing can create significant negative publicity for a company, which is particularly problematic for financial entities dependent on client trust.[26]

---

18. Securities Exchange Act of 1934, 15 U.S.C. § 78u(a)(1) (2012).

19. *See* discussion of specific 21(A) Reports, *infra* Part II.

20. § 78u(a)(1) (2012).

21. Richard M. Philips et al., *SEC Investigations: The Heart of SEC Enforcement Practice*, *in* RICHARD M. PHILIPS, THE SECURITIES AND ENFORCEMENT MANUAL: TACTICS AND STRATEGIES 29, 30 (1997).

22. William R. McLucas et. al., *A Practitioner's Guide to the SEC's Investigative and Enforcement Process*, 70 TEMP. L. REV. 53, 56 (1997).

23. *Id.* at 57.

24. Telephone Interview with Stanley Sporkin, former Director of Enforcement, SEC (Oct. 23, 2013).

25. Philips, *supra* note 21, at 30.

26. Richard M. Philips, *Settlements: Minimizing the Adverse Effects of an SEC Enforcement Action*, *in* RICHARD M. PHILIPS, THE SECURITIES AND ENFORCEMENT MANUAL: TACTICS AND STRATEGIES 193 (1997).

However, the vast majority of investigations do not end in a recommendation for a Section 21(a) Report.[27] An investigation is much more likely to result in administrative proceedings or a civil injunction. Prior to the enactment of the Remedies Act in 1990,[28] the SEC had to choose between its right to seek a civil injunction from the federal courts and very limited administrative proceedings before an administrative law judge.[29] The Remedies Act not only expanded the jurisdiction of the SEC with regard to administrative proceedings, but granted it the authority to seek monetary damages as part of a civil injunctive action.[30] Administrative cease-and-desist orders are generally seen as a milder alternative to an injunctive action, primarily because of the lesser collateral consequences and lack of scienter requirements.[31]

Given this formidable arsenal of enforcement options, it is not immediately evident under what circumstances the SEC would choose to resolve a matter through the publication of a Section 21(a) Report. The difficulty arises in part because the decision arises out of negotiations with the regulated entity, which may seek to avoid the formal enforcement process through the publication of a report, knowing that it does not include admission of guilt or collateral consequences.[32]

For many entities, the issuance of a Section 21(a) Report is the best possible resolution to an SEC investigation. The SEC is also incentivized to publish a report in certain circumstances where the formal enforcement process is unlikely to yield a desired result. The reports issue where an investigation has turned up information that

27. *Id.* (explaining that the SEC only settles matters with a report in "rare instances").

28. Securities Enforcement Remedies and Penny Stock Reform Act of 1990, Pub. L. 101-429, 104 Stat. 931 (1990).

29. Jeffrey B. Maletta & Neil S. Lang, *Sanctions and Collateral Consequences: The Stakes in SEC Enforcement Actions*, *in* RICHARD M. PHILIPS, THE SECURITIES AND ENFORCEMENT MANUAL: TACTICS AND STRATEGIES 137 (1997) ("[T]he Commission's authority to obtain administrative relief was generally limited to broker-dealers, investment advisors, other regulated entities, and their associated persons.").

30. *Id.* at 142–43.

31. *Id.* at 141.

32. Philips, *supra* note 21 ("[A] Section 21(a) report may be the best possible resolution of an enforcement investigation, short of no enforcement action at all."). For example, the report issued following the SEC investigation of the Retirement Systems of Alabama resulted from the negotiations by a state pension fund that sought to resolve an issue by publicizing the facts of an investigation with a report. The Retirement Systems of Alabama, Exchange Act Release No. 57446, 92 SEC Docket 2267 (Mar. 6, 2008) [hereinafter Alabama Report]; Interview with Stanley Sporkin, *supra* note 24.

the public should know, even if the facts do not constitute the basis for legal liability. The following Part will give an overview of the development of Section 21(a) Reports.

B. *The Early Years: 1934–48*

The SEC's early usage of Section 21(a) Reports is enigmatic but also foreshadowed their use today. As is often the case with the creation of complex administration schemes, the initial implementation phase of the financial regulation occasionally deviated from the ultimate result.[33] The anomalies that emerged along the way are a combination of historical artifacts with little precedential value and worthwhile attempts at a regulatory scheme whose abandonment may be a valuable lesson for future reform.

1. The Initial Use of Section 21(a) Reports

The period from the enactment of the securities laws to the start of the Second World War was a heyday of the securities enforcement actions at the SEC.[34] In a report issued in in the matter of White, Weld & Co. (White Report), the SEC attempted to explain the role of the reports in the newly-created regulatory agency.[35] In a legal argument portentous of disputes four decades later, the SEC maintained that the reports were merely a "preliminary inquiry" and did not amount to legal conclusions, despite the extent of the investigatory inquiries needed to issue the report.[36]

During the pre-war era, trial examiners would issue reports to the Commission along with reports from the regulated entity's counsel.[37] The issue at hand in the White Report was that while the trial examiner appeared to have exonerated the company, the

---

33. *See, e.g.*, Marc Winerman, *A Brief History of the FTC*, *in* FTC 90TH ANNIVERSARY SYMPOSIUM 6, 6 (describing how in its initial years the FTC ventured beyond antitrust), *available at* http://www.ftc.gov/sites/default/files/attachments/ftc-90-symposium/90thanniv_program.pdf; *History*, FEDERAL MARITIME COMMISSION, http://www.fmc.gov/about/history.aspx (last visited Apr. 2, 2014) (explaining that the early iteration of the agency contained both promotional and regulatory powers).

34. Hawke, *supra* note 7.

35. Harold T. White, 1 S.E.C. 574 (1936) [hereinafter White Report]. While referred to in later reports as paradigmatic of the scope and intent of the Section 21(a) investigations, it is not clear whether the White Report is truly a Section 21(a) Report. *See* Alleghany Corp., 6 S.E.C. 960 (1940).

36. White Report, *supra* note 35, at 574.

37. Edward Johnson, SEC Trial Examiner, Work of a Trial Examiner, Address before the SEC Local #5 United Federal Workers of America (May 16, 1939), *available at* http://www.sec.gov/news/speech/1939/051639johnson.pdf.

Commission found facts indicating wrongdoing.[38] In doing so, the SEC established that reports do not represent any kind of adjudication,[39] a principle now explicit in most reports today. Despite the significance of the White Report in establishing that reports did not have the force of a judgment, the context of the decision also highlights some disanalogies between prewar practice and the modern era of 21(a) Reports. The White Report seems to have been issued privately without any attempt at guidance and the SEC only distributed it when the regulated entity litigated the report's purpose.[40] That is to say, the report was not issued for any particular public benefit other than to clarify the matter for the press.

Two years later, the SEC issued a report in in the matter of Richard Whitney (Whitney Report).[41] Again, there are several ways in which the context and substance of this report differ from any others subsequently published. While this Note will emphasize the marginal nature of the securities violations alleged in most 21(a) Reports, the Whitney Report atypically dealt with a major crime.[42] Richard Whitney was the former president of the New York Stock Exchange, imprisoned for embezzlement.[43] The SEC successfully requested delay of his sentence in order to carry out its investigation.[44] After examining Whitney's books, the SEC decided to hold a public hearing.[45] Two things are striking about this procedure. The first is that investigatory hearings today are private, though certain commentators have advocated for publicly held hearings.[46] The second is that the report's primary objective seemed to be to furnish information for future rulemaking or legislation,[47] perhaps the only report to explicitly do so.

---

38. *White, Weld & Co. Cite 'Exoneration,'* N.Y. Times, July 8, 1936, at 27, *available at* http://nyti.ms/1CBT3Xk.

39. White Report, *supra* note 35, at 574.

40. *White, Weld & Co. Cite 'Exoneration,' supra* note 38.

41. U.S. Sec. Exch. Comm'n, Report on Investigation Pursuant to Section 21(A) of the Securities Exchange Act of 1934 in the Matter of Richard Whitney et al. (1938) [hereinafter Whitney Report], *available at* http://3197d6d14b5f19f2f440-5e13d29c4c016cf96cbbfd197c579b45.r81.cf1.rackcdn.com/collection/papers/1930/1938_07_USA_004.pdf.

42. *See id.*

43. *New Guilty Plea by Whitney*, N.Y. Times, Mar. 17, 1938, at 22, *available at* http://nyti.ms/1wb50CI.

44. *Whitney to Appear Before SEC Today*, N.Y. Times, Apr. 8, 1938, at 3, *available at* http://nyti.ms/1E2GPLo.

45. Richard Whitney et al., Exchange Act Release No. 1640 (Apr. 16, 1938).

46. Stanley Sporkin is one. *See* Interview with Stanley Sporkin, *supra* note 24.

47. *See* Whitney Report, *supra* note 41, at 4.

2. The Emergence of the Public Benefit Rationale

The public benefit rationale began to assume a more prominent role as the SEC continued issuing Section 21(a) Reports. In an untitled report, the SEC explained that a regulated entity, Consolidated Film Industries, had provided misleading information to its investors.[48] Because the SEC was either unwilling or unable to force Consolidated Film to comply with its regulations on proxy solicitations,[49] it released a Section 21(a) Report to correct the errors from a supplemental filing.[50] Interestingly, the report here seems to have acted as a kind of substantive remedy: when Consolidated Film refused to clarify information in its own filing, the SEC decided that issuing the report would serve to meet the public interest in achieving material disclosure.[51] The report was used as a direct substitute for the regulated entity's incomplete filings. This sort of usage was repeated a decade later, with a report again used to correct misleading filings, this time for a public offering.[52] Rather than allowing the facts of the investigation and legal conclusions of the report to drive investor behavior, in the early days the SEC used Section 21(a) Reports to directly cure the underlying violation.

Issuing Section 21(a) Reports in the early days allowed the SEC to avoid enforcement because the information contained within the reports only supplemented the filing information from the entities to render them compliant with disclosure obligations and no longer in breach of securities laws. The reports were effectively a substantive addition to the SEC toolbox; they could be used to fill in the gaps where the regulated entities had failed, and in so doing, help the SEC avoid the onerous enforcement process. In a yet another example, in the Alleghany Corporation report,[53] the SEC decided that due to changes in management and correction of the

---

48. Consolidated Film Industries, Inc., Exchange Act Release No. 903 (Oct. 22, 1936) [hereinafter Consolidated Films Report].

49. Issues about adequate disclosure in proxy solicitation "had been raised from time to time with about 150 other companies and [ ] in each an amicable agreement was reached," so non-acquiescence represented a new twist for the SEC. *SEC Gives Details of Row on Proxies*, N.Y. TIMES, Oct. 22, 1936, at 35, *available at* http://nyti.ms/1J97mXq.

50. Consolidated Films Report, *supra* note 48.

51. *See id.*

52. Drayson-Hanson, Inc., 27 S.E.C. 838, 839 (1948). ("Since the essential purpose of the Securities Act, to insure disclosure of information adequate to inform investors of their rights, would appear in this case to be accomplished by the distribution of the report, we have determined not to employ the more usual remedy . . . .").

53. Alleghany Report, *supra* note 35.

previous errors, no enforcement was needed.[54] Rather, the harm to the public would be remedied by the publicity from the report.[55]

The three Section 21(a) Reports discussed above all exemplify a kind of public benefit, but one that differs in a significant way from the later reports. The rationale for their issuance was that the publication of the facts contained therein would resolve the underlying matter.[56] If a company failed to disclose certain information, the SEC could simply publish a report to make the public aware of the material information. If information was otherwise misleading, a report could rectify the issue by providing investors with a corrected version. The early reports actively benefitted investors. While many later reports also sought to provide investors with information about wrongdoing, they did so with much more circumlocution.

3. Potential for Misuse

Although these early reports seem to have been focused primarily on resolving the issue at hand, former Commissioner Roberta Karmel believes they also anticipated future Commission abuse of the reports.[57] During her time on the Commission, Karmel gained something of a reputation as pro-industry and wary of SEC overreach generally.[58] She has been perhaps the most vocal critic of the reports, both during her time as a Commissioner[59] and afterwards,[60] believing them to be an exercise of power beyond the statutory authority of the SEC.[61] She particularly focuses her critique on an early report issued in the matter of Ward La France Truck Corporation, which described the non-disclosure of a significant tax

---

54. *Id.* at 5.

55. *Id.* ("[S]ince this report will serve to inform the investing public of past deficiencies, we do not feel that it will be necessary to institute any further proceedings.").

56. *See, e.g.*, *id.*

57. KARMEL, *supra* note 2, at 50.

58. Judith Miller, *Mrs. Karmel, S.E.C.'s Voice of Dissension*, N.Y. TIMES, Feb. 20, 1979, at D1. ("Mrs. Karmel's outspoken opposition to some of the agency's actions have won her plaudits on Wall Street.").

59. *E.g.*, Spartek, Inc., Exchange Act Release No. 15567, 16 SEC Docket 1094 (Feb. 14, 1979) [hereinafter Spartek Report] (Karmel, Comm'r, dissenting); The Commission's Practice Relating to Reports of Investigations and Statements Submitted to the Commission Pursuant to Section 21(a) of the Securities Exchange Act of 1934, Exchange Act Release No. 15664, 17 SEC Docket 18 (Mar. 21, 1979) [hereinafter SEC Guidelines].

60. *E.g.*, Karmel, *supra* note 8, at 42 & n.40; KARMEL, *supra* note 2, at 219–22.

61. KARMEL, *supra* note 2, at 220.

benefit that would accrue to the company during a stock buyback.[62] Because of cooperation by the corporation and restitution to the shareholders after commencement of the SEC investigation, the SEC did not file further enforcement actions.[63] Karmel alleges that this report issued because the SEC had no administrative jurisdiction, and moreover, because the rule in question was not in place when the fraudulent actions took place.[64] While there is some doubt that this was the case in the Ward La France report,[65] both of these issues—a lack of demonstrable SEC jurisdiction and the use of reports to punish behavior not forbidden by SEC regulations—have arisen in latter-day reports.[66]

A harbinger of reports with similar jurisdictional issues was released in McKesson and Roberts, which condemned the audit procedures of a fraudulent entity's external auditor, Price, Waterhouse.[67] As it would in subsequent reports, it appears here that the SEC used the report to censure entities whose conduct was not yet against the law. As a collateral consequence of issuance, another subsidiary of the fraudulent entity sued Price, Waterhouse as a result of its accounting practices.[68] The possibility of a lawsuit as a result of the reports may explain the "no admit or deny clause" appended to later reports to ward off any hint of issue preclusion and to prevent their admission as evidence in subsequent litigation.[69]

62. Ward La France Truck Corp, Exchange Act Release No. 3445 (May 20, 1943).

63. Note, *SEC Action Against Fraudulent Purchasers of Securities*, 59 HARV. L. REV. 769, 769–70 (1946).

64. KARMEL, *supra* note 2, at 50.

65. It appears that the SEC did have jurisdiction over issuers at the time. *SEC Action Against Fraudulent Purchasers of Securities, supra* note 63, at 778 & n.52. Ward La France's actions also appear to have occurred on October 21, 1942, after the SEC's implementation of Rule X-10-B5 on May 21, 1942. *Id.* at 769–70.

66. The Moody's Report, is an example of a report where the wrongdoing was not yet illicit. Moody's Investor Service, Inc., Exchange Act Release No. 62802, 99 SEC Docket 765 (Aug. 31, 2010) [hereinafter Moody's Report].The Spartek Report is an example of a report where there was only partial jurisdiction. *See* Spartek Report, *supra* note 59.

67. McKesson & Robbins, Inc., Exchange Act Release No. 2707 (Dec. 5, 1940) [hereinafter McKesson Report].

68. *M'Kesson Auditors Sued*, N.Y. TIMES, Jan. 30, 1941, at 23, *available at* http://nyti.ms/1tGrf3F.

69. "Hint," because for there to be issue preclusion there needs to be a judgment of "issues actually litigated and determined," which a Section 21(a) Report is not. Lawlor v. Nat'l Screen Serv. Corp., 349 U.S. 322, 326 (1955). For a discussion of the admissibility of SEC settlements without a no admit or deny clause as evidence, see Mary P. Hansen, *"Neither Admit nor Deny" Settlements at the SEC*, NAT. L.

4. Gaining Focus: Section 21(a) Reports Adopt a Public Benefit Rationale

The early Section 21(a) Reports are scattered and individualized, more so even than the reports that have issued since the 1970s. The marked differences among them, however, allow the similarities to stand in starker contrast: early reports issued where the public would benefit from knowing the facts of an investigation. This "public benefit" criterion for the issuance of a 21(a) Report has persisted to the present day. The public benefit of modern reports is much more prominent than it was in the initial reports.

Although the salience of the "public benefit" has increased in the modern era, precisely what constitutes a public benefit has remained an ill-defined concept. The following Part defines the public benefit rationale and how it can assume a different meaning depending on the context and intended audience.

C. *Introduction to the Public Benefit Dichotomy: Reports for Investors and Reports for Industry*

In the context of Section 21(a) Reports, "public benefit" can assume two meanings: one focused on the needs of investors and the other on the practices of regulated industries. However, this duality is not immediately obvious from the statute or pronouncements of the SEC. The Commission states that the reports are published where substantial issues of public concern, widespread investor impact, or other matters of significance relating to the federal securities laws were involved.[70] This pronouncement is both over- and under-inclusive: nearly all enforcement actions are of public concern or are, at the very least, matters of significance; and, not all reports appear to issue for this rationale exclusively. These criteria are inherently imprecise because the decision to publish a report emerges out of the give-and-take negotiations that occur as part of the investigatory process that precedes every enforcement action. In other words, a public benefit is a necessary, but not sufficient requirement for the publication of a report.[71] The public benefit rationale provides an overarching structure that roughly divides the reports into two categories, both of which deal with a certain portion of the public and provide a certain kind of benefit.

The first type of public benefit arises in those reports used to warn companies that transacted with the entity mentioned in the

---

REV., Apr. 3, 2014, *available at* http://www.natlawreview.com/article/neither-admit-nor-deny-settlements-sec-securities-and-exchange-commission.

70. SEC Guidelines, *supra* note 59.

71. *Id.*

report that the entity engaged in misconduct that either was or bordered on a securities violation. The public with a potential interest in learning about this kind of behavior can run the gamut from employees of the company to future business partners, but these reports are most likely to affect the decisionmaking of current and potential investors. Publication of the details of an investigation empowers investors because, turning again to Brandeis, "the investor's servility is due . . . to his ignorance of the facts."[72] In its analysis of individual reports this Note will use the term "investor-related" to refer to this kind of public benefit.

The second type of public benefit arises in those reports that warn regulated entities that the SEC has begun to focus its enforcement on certain practices or to clarify its rules in emerging areas of law. These reports are intended as a warning against future wrongdoing. They often recommend changes or highlight specific areas to which financial entities should pay attention. For example, the Feuerstein Report discussed in Part II.D.3, detailed the misconduct of a legal corporate officer to explain that lawyers would be considered supervisors for certain provisions of the securities regulations.[73] In this sense, the publication of a report serves to publicly benefit certain kinds of financial actors by detailing particular SEC enforcement goals. This Note will use the term "industry-related" to refer to this kind of public benefit.

Most of the reports provide a benefit to both investors and industrial actors. However, in many reports the benefit to one sector of the public predominates over the other. In a minority of reports, there does not seem to be a substantial public benefit at all. These differences can be partially explained by policymaking priorities at the Commission, but they are also indicative of an overpressured agency seeking to resolve issues quickly. Part II explains how adherence to administrative law principles can help cabin the publication of reports to matters where there is an actual public benefit.

II.
SECTION 21(A) REPORTS IN ACTION

Modern Section 21(a) Reports are a functional stopgap, used by a heavily pressured agency to resolve marginal issues quickly. This Part seeks to roughly group the reports by broad rationales, each of which details an area where the SEC would find it difficult or imprudent to pursue a formal enforcement action: (A) ex-

72. BRANDEIS, *supra* note 6, at 99.
73. John H. Gutfreund, 51 S.E.C. 93 (1992) [hereinafter Feuerstein Report].

trajurisdictional reports, (B) reports issued in politically fraught situations, (C) reports issued for the sake of leniency, (D) reports issued in matters of derivative liability, and (E) reports issued in the face of legal ambiguity. The focus of this Part is to explore the variance among the reports and to flesh out the dichotomy of public benefit that this Note posits guides their publication.

A. *Extrajurisdictional Reports*

1. Reports Issued to Highlight Misconduct Outside SEC Jurisdiction

After conducting an investigation, the SEC may conclude that a regulated entity committed acts that seem to run counter to the spirit of the securities laws, but do not constitute an actual violation. The SEC does not have a statutory grant of jurisdiction to bring an enforcement action against these legally permissible, yet undesirable, acts. In these circumstances, the SEC may choose to issue a Section 21(a) Report. Indeed, a common characterization of the reports in the practitioner literature is that when the SEC disapproves of certain actions that lie beyond its geographic or statutorily-granted jurisdiction, it will resort to publishing a report.[74] The SEC often admits as much: in one recent report on the rating agency Moody's (Moody's Report), the Commission stated that "[b]ecause of uncertainty regarding a jurisdictional nexus to the United States in this matter" it would not pursue an enforcement action.[75] It is worth noting the Moody's Report described conduct that was unlawful at the time of publication, though not at the time of the conduct described in the report; Congress had recently expanded the SEC's jurisdiction to cover international events.[76]

As SEC investigations can take up large amounts of staff time and agency resources, there may be internal and external pressure to arrive at some kind of closure even in the face of jurisdictional obstacles.[77] This was particularly true in the case of Moody's, as it was one of the credit rating agencies that came under fire following the financial crisis of 2008.[78] While under the gun to punish these

74. *E.g.*, Steinberg, *supra* note 14 ("Moreover, through the Section 21(a) report procedure, the Commission can avoid the usual requirement of having to find an actual violation . . . ."); Block & Barton, *supra* note 17 ("Particularly when it has discovered a technical, marginal, or isolated violation that is beyond its administrative jurisdiction, the Commission may be tempted to use Section 21(a) . . . .").

75. Moody's Report, *supra* note 66.

76. Edward Wyatt, *No Charges for Moody's in Ratings Violation*, N.Y. Times, Sept. 1, 2010, at B3.

77. Block & Barton, *supra* note 17, at 271.

78. Wyatt, *supra* note 76.

agencies for rubberstamping risky securities with an AAA rating, the SEC was hampered by legislatively enacted hurdles making it difficult to prove wrongdoing.[79] Given the charged regulatory climate in which the Moody's Report was issued, it seems highly likely the SEC would have instituted a formal enforcement action if there had not been jurisdictional barriers in its way. By publicizing the report, the SEC demonstrated that it took its regulatory responsibilities towards ratings agencies seriously.

Another example of an extrajurisdictional Section 21(a) Report, the Spartek Report resulted in former Commissioner Karmel's first dissent to the publication of a report.[80] The Spartek Report detailed the company's failure to disclose material information in a preliminary proxy statement, specifically that the management had a material conflict of interest with the minority shareholders.[81] Karmel condemned the report for its publication of facts concerning obstructionist actions by the chief executive officer of Spartek, whose actions were outside of the SEC's jurisdiction, as well as what she perceived to be a general lack of jurisdiction over the alleged wrongdoing by Spartek.[82] She readily admits that there may have been strong policy reasons for regulatory intervention, but objected because she thought that the SEC should have funneled its actions through statutorily established jurisdictional and procedural channels.[83]

2. The Public Benefit Rationale

The Moody's and Spartek Reports had similar goals. In each, the SEC sought to highlight certain behavior that was beyond its jurisdictional grasp: in the Moody's report, the statute conferring extraterritorial jurisdiction was not yet in force,[84] and in the Spartek report, the CEO lied to the American Stock Exchange,

---

79. *See, e.g.*, Credit Rating Agency Reform Act of 2006, Pub. L. No. 109-291, 120 Stat. 1327 (codified as amended in scattered sections of 15 U.S.C.); Wyatt, *SEC Pursuing More Cases Tied to Financial Crisis*, N.Y. TIMES, July 20, 2010, at B2 ("[T]he Credit Rating Agency Reform Act of 2006 prohibits the S.E.C. from regulating the substance, criteria or methodologies used in credit rating models . . . .").

80. Spartek Report, *supra* note 59.

81. *Id.* at 6. The management was also the controlling shareholder, which had a variety of reasons to not disclose the pending sale of the company to another investment firm. *Id.* at 4.

82. *Id.* at 9 (Karmel, Comm'r, dissenting).

83. *Id.* at 10.

84. Moody's Report, *supra* note 66.

which violated SEC rules for entities, not persons.[85] The Moody's Report served to warn Moody's and other credit ratings agencies that the SEC planned to scrutinize their role in the worldwide financial system.[86] In this sense, the report served an industry-related public benefit, meant to warn credit ratings agencies that the jurisdictional bounds of American securities laws had expanded to include overseas infractions. This report demonstrates how the public benefit rationale differs from the way that guidance is normally conceived in administrative law because it does not modify or clarify existing rules governing the conduct of credit rating agencies. Instead, the Moody's Report serves as a shot across the bow, warning credit rating agencies that the SEC is monitoring their overseas conduct.[87]

The Spartek Report is more complex than the Moody's report. Through publication of the facts of the Spartek matter, the SEC sought to warn investors of the CEO's behavior and generally about the kind of "going private" technique used by Spartek to avoid the requirements of state and federal management-led buyout rules.[88] This is an investor-related public benefit, where the SEC believes that entities that transact with the company subject to the report would prefer to know about the conduct uncovered during the course of investigation. The SEC published the information in the report because it believed it to be a kind of wrongdoing that Spartek's investors and business partners would find relevant when deciding whether to commit to future dealings with the company.[89] Additionally, the report warned other publicly held companies that similarly wanted to skirt federal and state securities laws when going private to beware. The Spartek report had two central areas of public benefit: the warning to investors and the business associates of Spartek that the CEO lied to the New York Stock Exchange and the warning to the industry that the SEC was aware of the novel and fishy technique for going private.

---

85. Spartek Report, *supra* note 59, at 9 & n.5 ("Cable has been included in this proceeding in order for the majority to comment adversely on certain conversations Cable had with certain American Stock Exchange officials. While I do not condone Cable's conduct in dealing with exchange officials, I do not believe the Commission has the authority to sanction his lack of candor in an administrative proceeding instituted under Section 15(c)(4) or Section 21(a).").

86. Moody's Report, *supra* note 66.

87. Brendan Sheehan, *SEC Warns Moody's and Other Rating Agencies*, CORPORATE SECRETARY (Sep. 7, 2010), http://www.corporatesecretary.com/articles/regulation-and-legal/11360/sec-warns-moodys-and-other-ratings-agencies/.

88. Spartek Report, *supra* note 59, at 1104 (Loomis, Comm'r, concurring).

89. *Id.*

The matters underlying the Spartek and Moody's Reports were outside of the statutory jurisdiction of the SEC to prosecute. Both reports served to benefit the public by providing information that would be relevant to the investing public and industry actors. The extrajurisdictional aspect of the reports is most salient here because it is mentioned directly in the reports themselves, but many other reports issue in areas where the SEC's statutorily-granted jurisdictional authority to regulate and prosecute is hazy. The following discussion of reports involving governmental entities is one such area.

B. *Politically Fraught Situations*

1. Reports Issued in Political Situations with Tension Between the Commission and Local and State Government Entities

The SEC must confront unique statutory and constitutional questions when it attempts to enforce its regulations on local and state financial entities.[90] Under the Eleventh Amendment, the SEC is not allowed to regulate the behavior of state-level financial actors,[91] though this restriction does not extend to municipal and other local government entities.[92] The questionable constitutionality of these reports is one of the reasons that former Commissioner Karmel claims that SEC actions in matters involving state or local entities are often yet another example of extrajurisdictional encroachment.[93] In addition to the constitutional issue, Karmel disparages statutory "loopholes" that place certain state-issued bonds, such as industrial revenue bonds, outside of what would otherwise be clear SEC jurisdictional authority.[94] Construed in this light, reports publicizing malfeasance by state and local entities would appear to be similar to the Spartek and Moody's Reports: a condemnation of behavior that lies beyond the SEC's jurisdiction to

90. Stephen Bradford Lyons, *SEC Registration Requirements for Taxable Municipal Securities*, 21 URB. LAW. 223, 242 (1989) (explaining the difficulties of regulating municipal bonds, which can be applied more generally to all regulations of municipal and state government action).

91. U.S. CONST. amend. XI ("The Judicial power of the United States shall not be construed to extend to any suit in law or equity, commenced or prosecuted against one of the United States by Citizens of another State, or by Citizens or Subjects of any Foreign State."); Christine Sgarlata Chung, *Municipal Securities: The Crisis of State and Local Government Indebtedness, Systemic Costs of Low Default Rates, and Opportunities for Reform*, 34 CARDOZO L. REV. 1455, 1534 & n.356 (2013).

92. Jinks v. Richland Cnty., S.C., 538 U.S. 456, 457 (2003) ("[M]unicipalities . . . do not enjoy a constitutionally protected immunity from suit.").

93. KARMEL, *supra* note 2, at 211–16.

94. *Id.* at 213.

formally enforce. Indeed, the SEC used a Section 21(a) Report to publicize the misleading statements by the beneficiary of an industrial revenue bond, conduct that would be illegal if there were no statutory roadblocks to the contrary.[95]

However, when dealing with state and local governments, the political ramifications of an SEC enforcement action often will weigh more heavily than other considerations.[96] For example, in a staff report that acted as a Section 21(a) Report in all but name (New York Report), the SEC published the findings of an investigation into the misleading financial statements made by the mayor, comptroller and other high officials of the City of New York.[97] The report was published in the middle of a mayoral primary, making its contents so highly anticipated that a federal district judge ruled that the report should be turned over to him to determine whether it should be published before the SEC deemed it ready.[98] Beyond the immediate political impact of the report, there were also questions about the propriety of analogizing the role of the mayor and local government to that of a CEO in the context of enforcement of securities laws.[99] Though politicians may benefit from misleading statements about their city's finances, it does not make sense to sanction the cities themselves because the financial impact will be borne by constituents (and often new political leaders), who have little control over the financial impropriety. Avoidance of this political thicket, to appropriate a metaphor, guides the SEC in these situations.

The political nature of SEC decisionmaking in this arena is compounded by officials who are unaware of the regulatory consequences of their statements or the financial rules generally. Though the officials of the City of New York were quite deliberate in their

95. Marine Protein Corp., Exchange Act Release No. 15719, 17 SEC Docket 257 (April 11, 1979) [hereinafter Marine Protein Report].

96. Interview with Stanley Sporkin, *supra* note 24.

97. SUBCOMM. ON ECON. STABILIZATION OF THE H. COMM. ON BANKING, FINANCE & URBAN AFFAIRS , 95TH CONG., S.E.C. STAFF REP. ON TRANSACTIONS IN SECURITIES OF THE CITY OF NEW YORK (Comm. Print 1977) [hereinafter NEW YORK REPORT]. Stanley Sporkin called this Report a Section 21(a) Report. Interview with Stanley Sporkin, *supra* note 24.

98. Michael C. Jensen, *S.E.C. Seeking to Salvage Report, Called Inadequate, on City's Crisis*, N.Y. TIMES, Aug. 17, 1977, at D3.

99. June Rose, Note, *Federal Securities Fraud Liability and Municipal Issuers: Implications of* National League of Cities v. Usery, 77 COLUM. L. REV. 1064, 1072 (1977) (explaining that mayors and other elected officials often make exaggerated statements due to the nature of the job).

efforts to deceive the investing public,[100] often the financial irregularities mentioned in a report describe a government entity unprepared for the regulatory and compliance requirements necessary to act in the sophisticated financial marketplace. For example, the report issued in the Matter of the Retirement Systems of Alabama (Alabama Report) dealt with trading based upon material nonpublic information by a public pension fund.[101] The fund did not have any compliance checks in place to prevent this kind of trading from occurring, which would have been required if the fund were run by an external, potentially more sophisticated, money manager.[102] Again, while this was a serious offense, the SEC chose not to pursue an enforcement proceeding because it knew that any money levied against the fund would come out of the pockets of current and future pensioners.[103] Perhaps even more importantly, the pension fund disgorged the gains from the insider trading and instituted compliance reforms recommended by the SEC.[104]

2. The Public Benefit Rationale

The Alabama Report contains two central areas of public benefit. The first is investor-related: those counterparties who traded with the pension fund were made aware of the fund's ill-gotten gains from trading on material non-public information.[105] More generally, potential counterparties were made aware that public entities often did not have adequate safeguards in place to avoid insider trading and other violations of the securities laws. This relates to the second, industry-related public benefit: other similarly situated public entities were reminded that while they were exempt from many of the requirements of other money managers, they were still liable for insider trading violations arising out of Rule 10b-

100. *See* New York Report, *supra* note 97, at ch. 3, 135 ("The Mayor controlled the budgetary process, and was fully aware of the gamut of unsound budgetary, accounting and financial reporting practices utilized by the City.").

101. Alabama Report, *supra* note 32, at 2268 ("At the time of the events described in this report, RSA had no policies, procedures, training or compliance officer to ensure its compliance with the federal securities laws.").

102. *Id.*

103. Michael K. Lowman, Larry P. Ellsworth & Jennifer M. Lawson, *Insider Trading Compliance Programs in SEC Crosshairs*, Bus. L. Today, July/August 2008, at 64; Interview with Stanley Sporkin, *supra* note 24.

104. Press Release, U.S. Secs. & Exch. Comm'n, SEC Warns Public Pension Funds about Inadequate Compliance Procedures (Mar. 6, 2008) [hereinafter Alabama Press Release], *available at* http://www.sec.gov/news/press/2008/2008-35.htm.

105. Alabama Report, *supra* note 32.

5.[106] The New York Report purported to have similar public benefits.[107]

A third report dealing with a municipality making false and misleading statements drives home how the public benefit dichotomy manifests in the local and state regulatory context.[108] The report detailed the omissions and misrepresentations of public officials about the finances of the City of Harrisburg, which constituted material nondisclosures to the investing public.[109] In an accompanying cease-and-desist proceeding, the SEC for the first time charged a municipality with a Rule 10b violation outside of a primary securities offering.[110] The separate cease-and-desist proceeding provided the investor-related public benefit, warning traders in municipal bonds that the Harrisburg finances were not as robust as advertised. The Section 21(a) Report was meant as the industry-related benefit; it served to warn public officials that their comments, if inaccurate, could result in Rule 10b liability for releasing false and misleading statements about the financial state of their municipality.

An important takeaway of the Harrisburg Report is that the SEC does not necessarily provide both kinds of public benefit through a report. As in the Harrisburg matter, it may choose to use a formal enforcement proceeding to provide the investor-related public benefit, accompanied by the industry-related benefit from the report. In these situations, still published for the public benefit, a Section 21(a) Report is not simply an alternative to enforcement, it also supplements enforcement. For now, this distinction should serve as a reminder that the reports are, above all, a way for the SEC to send a message. The next Part, which explores reports involving

106. *Id.* at 2270.

107. NEW YORK REPORT, *supra* note 97.

108. City of Harrisburg, Pennsylvania, Exchange Act Release No. 69516 (May 6, 2013) [hereinafter Harrisburg Report]. A report with a very similar factual background and in which identical legal conclusions were reached was issued sixteen years earlier about the conduct of county-level officials in Orange County, California. County of Orange, California, Exchange Act Release No. 36761 (Jan. 24, 1996).

109. Harrisburg Report, *supra* note 108.

110. City of Harrisburg, Pa., Exchange Act Release No. 69515, 106 SEC Docket 1198 (May 6, 2013); *see also* Cate Long, *Free Speech or Securities Fraud?*, MUNILAND BLOG (June 25, 2013), http://blogs.reuters.com/muniland/2013/06/25/free-speech-or-securities-fraud/. Section 10(b) of the Exchange Act, and Rule 10b thereunder, prohibit companies from using “manipulative and deceptive devices” in connection with the purchase or sale of securities. Securities Exchange Act of 1934 § 10, 15 U.S.C. § 78j (2012); 17 C.F.R. § 10b-5 (2014).

cooperation and good faith, illustrates another variant of this justification.

C. *Leniency*

1. Reports Issued to Grant Leniency for Good Faith or Cooperation

When the SEC does not have a solid case because of political, jurisdictional, or constitutional issues, but still believes the public would benefit from knowing the facts of the investigation, it may choose to resolve a matter with a Section 21(a) Report.[111] However, the SEC may still issue a report in lieu of enforcement proceedings even where there are none of these roadblocks, when it deems the violation too minor to merit further expenditure of SEC resources. This most often occurs when the entity targeted in an investigation cooperates fully with the SEC. In fact, the most well-known Section 21(a) Report was issued in this context.

In 2001, the SEC issued what is usually referred to as the Seaboard Report, though this name does not appear in the report itself.[112] Similar to the Harrisburg Report, the Seaboard Report was linked to a related enforcement action: a cease-and-desist proceeding against a former corporate controller.[113] Upon learning of the transgression, the parent company (Seaboard) self-reported to the SEC, which decided not to pursue an enforcement action due to Seaboard's cooperation and implementation of new compliance controls.[114] The wrongdoing was clear and there were no jurisdictional, statutory, or political doubts as to the SEC's ability to prosecute. The Commission chose to publish a report because Seaboard had fully cooperated; the report provided thirteen guidelines for future entities wishing to receive credit for cooperation with the SEC.[115] These guidelines give grounds for leniency based on how quickly a regulated entity self-reports malfeasance, at what level the transgression occurred, and what new safeguards were put into place, among other criteria.[116] The Department of Justice later fol-

---

111. *See supra* Part II.A–B.

112. Gisela de Leon-Meredith, Exchange Act Release No. 44969, 76 S.E.C. Docket 220 (Oct. 23, 2001) [hereinafter Seaboard Report].

113. Gisela de Leon-Meredith, Exchange Act Release No. 44970, 76 S.E.C. Docket 223 (Oct. 23, 2001); Floyd Norris, *S.E.C. Sets Rule on Misconduct Reporting*, N.Y. TIMES (Oct. 24, 2001), http://www.nytimes.com/2001/10/24/business/sec-sets-rule-on-misconduct-reporting.html?smid=PL-share.

114. Seaboard Report, *supra* note 112.

115. *Id.*

116. *Id.*

lowed suit in the Thompson Memo, issuing similar guidelines to potential corporate defendants in criminal actions.[117]

Notably, the vast majority of matters in which cooperation was a mitigating factor have not resulted in the publication of a Section 21(a) Report, but rather in leniency in choosing whom to prosecute and which enforcement action to use.[118] That said, in one example, the SEC chose to publish a Section 21(a) Report in lieu of formal enforcement proceedings: the SEC seemed to follow the Seaboard guidelines when electing to publish a report that dealt with the acts of a foreign derivatives exchange, Eurex Deutschland.[119] The exchange failed to register one of its futures offerings, the EURO STOXX bank index, after a shift in the composition of the index placed it within the SEC's jurisdictional ambit.[120] Just like the circumstances that gave rise to the Seaboard report, this seems like a run-of-the-mill transgression. The report does not hedge, stating that Eurex Deutschland "did not comply" with various provisions from the Securities Exchange Act and the Securities Act that prohibit the trade of unregistered securities in U.S. markets.[121] However, the Commission chose to publish a Section 21(a) Report rather than a more serious enforcement action because of the extensive cooperation by Eurex Deutschland.[122] The exchange not only immediately self-reported when it discovered the issue, it also ceased sale of the index and increased other compliance measures.[123]

2. The Public Benefit Rationale

The public benefit of the Seaboard Report was clearly industry-related. It does not even mention the name of the company,[124] a necessary step to warn any potential investors or business associates. The guidelines mentioned in the Seaboard Report have since been

117. Larry D. Thompson, U.S. Dep't of Justice, Principles of Federal Prosecution of Business Organizations (2003), *available at* http://federalevidence.com/pdf/Corp_Prosec/Thompson_Memo_1-20-03.pdf; Christopher A. Wray & Robert K. Hur, *Corporate Criminal Prosecution in a Post-Enron World: The Thompson Memo in Theory and Practice*, 43 Am. Crim. L. Rev. 1095, 1109 (2006).

118. For several examples, see Barry W. Rashkover, *Reforming Corporations through Prosecution: Perspectives from an SEC Enforcement Lawyer*, 89 Cornell L. Rev. 535, 541 n.38 (2004).

119. Eurex Deutschland Report, *supra* note 15, at 1–2.

120. *Id.* at 3.

121. *Id.* at 4–6.

122. *Id.*

123. *Id.* at 7–8.

124. *See* Seaboard Report, *supra* note 112.

augmented through more formal guidance and rules,[125] but their general principles have been followed in numerous actions. The broad scope of the Seaboard Report also differentiates it from other reports, which normally deal with very specific areas of securities law. In fact, the report does not actually mention or explain any securities regulation at all; instead, it delineates the conditions under which the SEC is likely to invoke prosecutorial discretion.[126] In a sense, this demonstrates the functional nature of the reports: the SEC was able to piggyback on the cease-and-desist proceedings against Seaboard's controller to explain why it chose not to prosecute the company for the wrongdoing of its employee.

In the Eurex Deutschland Report, the public benefit is twofold. First, there is an investor-related benefit in alerting those U.S. entities transacting on the exchange that Eurex Deutschland is now in compliance with U.S. securities laws. This issue is very narrow and likely only to matter to a select few investors. The second is to warn other industry actors that would enter into similar futures swaps about the exact contours of the relevant newly enacted provisions of the securities laws.[127] While also a narrowly bounded issue, swaps were at the heart of the financial reforms following the crisis in 2008 and their regulation remains highly contested.[128] The publication of a Section 21(a) Report in this area could serve to remind financial entities that the SEC has partial jurisdiction over the contracts.[129]

There is still one central factor that distinguishes the Eurex Deutschland Report from the extrajurisdictional and local government reports. In the previously mentioned reports, it was questionable whether the SEC would choose to pursue a formal enforcement action, for the jurisdictional and political reasons mentioned above. In the Eurex Deutschland Report, the wrongdoing was clear, but it did not seem very egregious; because the composition of the index had changed, it shifted from being solely regulated by the Commodities Futures Trade Commission (CFTC) to being jointly regulated with the SEC, meaning Eurex Deutschland's only wrongdoing

125. Gideon Mark & Thomas C. Pearson, *Corporate Cooperation During Investigations and Audits*, 13 STAN. J.L. BUS. & FIN. 1, 16 (2007).

126. Seaboard Report, *supra* note 112, at 221–22.

127. Eurex Deutschland Report, *supra* note 15, at 8.

128. *See* Landon Thomas, Jr., *Wall Street Challenges Overseas Swaps Rules*, N.Y. TIMES DEALBOOK (Dec. 4, 2013, 4:30 PM), http://dealbook.nytimes.com/2013/12/04/wall-street-trade-groups-challenge-overseas-swaps-rules/.

129. For a breakdown of the jurisdictional split between the SEC and the CFTC, see Derivatives, SEC. & EXCHANGE COMMISSION, https://www.sec.gov/spotlight/dodd-frank/derivatives.shtml (last visited Jan. 16, 2014).

was its failure to register with the SEC and, consequently, creating swaps as an unregistered party.[130] The shift was unintentional, likely the product of negligence rather than a nefarious scheme to avoid SEC registration. The SEC may have decided that such a minor issue did not merit spending the resources and time needed to undertake an enforcement proceeding, especially given Eurex Deutschland's cooperative measures. In this sense, the Eurex Deutschland Report reiterates the principles put forth in the Seaboard Report by providing the same industry-related public benefit, warning other entities that they should cooperate to remain in the good graces of the SEC. However, the public benefit rationale seems weak; more likely, the SEC wanted to reward Eurex Deutschland for prompt and full cooperation by forgoing a formal enforcement action and publishing a report.

3. Reports Issued in the Face of Good Faith Reliance

In addition to Eurex Deutschland's cooperation and the minor nature of its infraction, the report mentioned Eurex Deutschland's good-faith claim that they were in compliance with the securities regulations due to a no-action letter from the CFTC.[131] The exchange should have monitored its indices to make sure they remained compliant with the securities rules, but it was operating under the assumption that it was acting legally.[132] While this was a secondary argument in the Eurex Deutschland matter, a starker example of a report issued solely because of good-faith reliance was the Motorola Report.[133] Motorola, along with three other major corporations, was accused of violating Regulation Fair Disclosure (Regulation FD).[134] The SEC promulgated Regulation FD to prevent selective disclosure of material information to analysts and not to the general public.[135] Motorola violated the regulation by clarifying to certain preferred securities analysts that the "significant weakness" mentioned in a press release meant a 25% decline in sales and orders.[136] While the SEC instituted and settled cease-and-desist proceedings against the other three corporations,[137] it chose

130. Eurex Deutschland Report, *supra* note 15, at 3.

131. *Id.* at 2–3.

132. *Id.*

133. Motorola Report, *supra* note 15.

134. Jon Jordan, *Corporate Issuers Beware:* Schering-Plough *and Recent SEC Enforcement Actions Signal Vigorous Enforcement of Regulation FD*, 58 U. MIAMI L. REV. 751, 781 (2004).

135. *Id.* at 751–52.

136. Motorola Report, *supra* note 15.

137. Jordan, *supra* note 134, at 781–88.

to issue a Section 21(a) Report in regards to Motorola's actions.[138] Similarly to the Eurex Deutschland matter, there was a clear violation, but because Motorola had relied on the erroneous advice of its counsel, the SEC decided to do no more than publish a report.[139] Aware of the implications of allowing reliance on in-house counsel to limit liability, the report warned of the limits of this defense.[140]

The Motorola Report is emblematic of both types of public benefit. It provided an important investor-related public benefit, as the public learned that Motorola had differed in its explanation of its earnings results depending on its audience. More interesting is the industry-related public benefit, which was presumably not intended to warn other companies about the SEC position on disclosure, given that the other three proceedings sent a clear message about the SEC's view on the subject. Indeed, Regulation FD was controversial at the time of passage and this "sweep" was meant to show that the SEC planned to prosecute violations fully.[141] Instead, the report contained five guidelines clarifying how an entity should act to ensure compliance with Regulation FD, in effect serving as a specialized Seaboard Report in the realm of fair disclosure.[142] Where the actions taken against the other three companies implicated in the sweep demonstrated the Commission's resolve, the report showed the path to avoid running afoul of the Regulation FD mandate.

When the gravity of the infraction decreases, or there is good-faith reliance, the public benefit required to issue a report seems to correspondingly lessen. The Compass Report described a dissident shareholder who sought to gain a place on the company's board and failed to amend his proxy solicitation after making relatively minor changes to his proposals.[143] Commissioner Karmel dissented

138. *See* Motorola Report, *supra* note 15.

139. *Id.*

140. *Id.*, at 2859; *see also* Jordan, *supra* note 134, at 796.

141. Jordan, *supra* note 134, at 781 (This "sweep . . . made a strong statement to the public that Regulation FD would be enforced and that violations would not be tolerated."). "'[S]weep' [is] a term commonly used by the Enforcement Division for a large number of simultaneously filed enforcement actions related to similar violations." *Id.* at 781 n.151.

142. Motorola Report, *supra* note 15, at 2858–59.

143. Compass Investment Group, Exchange Act Release No. 16343, 18 SEC Docket 927, 927–29 (Nov. 15, 1979) [hereinafter Compass Report]. A similar report issued in the matter of Bull & Bear Management Corporation, which reminded entities of their duty to disclose situations that could potentially lead to self dealing, though there did not appear to be any in this specific case. Bull & Bear Management Corp., Exchange Act Release No. 18107 (Aug. 7, 1981).

from the publication of the report, stating that there was no cognizable public benefit from publishing the facts of the matter.[144] There did not appear to be any industry-related public benefit, as the rules had long been in place and were clear. There did not appear to be any investor-related public benefit either; the election was finished and the dissident shareholders had already remedied their erroneous proxy solicitations, and, similarly to the Motorola report, had relied on the recommendation of counsel when crafting the solicitations in the first place.[145] Yet there did not appear to be any detriment to investors, either. Perhaps Motorola's good-faith reliance on its lawyers, the minor nature of its infraction, or its cooperative efforts led to the publication of the report. In any case, the report's intent and effect was not to provide a public benefit.

The Seaboard, Motorola, Compass, and Eurex Deutschland Reports are examples of reports that are issued with little to no investor-related public benefit. To the extent that there is an industry-related benefit, it is to guide the regulated entities' compliance with regulations, not to warn them of new enforcement priorities. Instead of sending a shot across the bow, the SEC uses these reports to provide something similar to procedural guidance or to simply dispose of a minor matter. Reports on derivative liability—discussed in the next section—riff on this functional, though not formally condoned, use, though the public benefit is more prominent than the reports in this section.

D. *Derivative Liability*

1. Reports Issued in Matters of Derivative Liability

The bulk of modern Section 21(a) reports are published in matters of derivative liability:[146] where a corporation or person commits a securities violation and either the employer or another official holding statutory or common law fiduciary duties failed to adequately monitor for illegal conduct. The most common derivative liability reports are those issued in matters of corporate governance:[147] where a board member fails to adequately monitor the behavior of the management. A variation of this kind of report is often issued in cases where a professional, such as a lawyer or auditor, fails to prevent or report illegal conduct. In many of these mat-

144. Compass Report, *supra* note 143, at 932 (Karmel, Comm'r, dissenting) ("I see no public purpose being served by the publication of the facts and staff conclusions about this particular matter.").

145. *Id.*

146. *See supra* note 12.

147. *See supra* note 12.

ters, the SEC brings an enforcement action against the company or specific wrongdoers and uses a report to highlight what it views as the requirements of the monitoring supervisors. Former Commissioner Karmel has criticized these reports as incursions into the state law realm of corporate governance, in addition to her more general critiques that the reports constitute overstepping SEC authority.[148] This is a valid criticism: state law generally governs the relationship between the board of a company, the management, and the stockholders unless there is an express designation by federal statute.[149]

By choosing to issue reports in matters that dealt with corporate governance, the SEC recognized that "new ground . . . was broken," meaning the legal conclusions contained therein represented novel applications of the securities rules.[150] Often, the board's wrongdoing was failing to monitor the activities of the management appropriately.[151] While this kind of omission can often have state level ramifications,[152] it is more difficult to prove that a failure to monitor violates federal securities laws because of their scienter requirements.[153] Because of this high burden of proof, in these matters the SEC generally chooses to be "conservative" and release a Section 21(a) Report instead of a formal enforcement action, a rationale reminiscent of the extrajurisdictional reports.[154] The corporate governance reports are also related to the good faith reports because each deals with behavior that does not rise to the level of intentional malfeasance.

The paradigmatic corporate governance Section 21(a) Reports were issued in a series in the late 1970s and dealt with the monitoring responsibilities of either outside directors or the entire board. The first matter resulted in the publication of a report regarding the issuance of new securities by a bankrupt entity, the Penn Cen-

---

148. KARMEL, *supra* note 2, at 198 & n.17.

149. Cort v. Ash, 422 U.S. 66, 84 (1975) ("Corporations are creatures of state law, and investors commit their funds to corporate directors on the understanding that, except where federal law expressly requires certain responsibilities of directors with respect to stockholders, state law will govern the internal affairs of the corporation.").

150. Harvey L. Pitt & Karen L. Shapiro, *Securities Regulation by Enforcement: A Look Ahead at the Next Decade*, 7 YALE J. REG. 149, 195 (1990).

151. Stanley Sporkin, *SEC Enforcement and the Corporate Board Room*, 61 N.C. L. REV. 455, 457 (1983).

152. *E.g.*, Smith v. Van Gorkom, 488 A.2d 858, 875 (Del. 1985) ("[T]he directors were duty bound to make reasonable inquiry of [management] . . . .").

153. Hillary A. Sale, *Independent Directors as Securities Monitors*, 61 BUS. LAW. 1375, 1397 (2006).

154. Sporkin, *supra* note 151, at 456.

tral Company.[155] The report chastised the board for its failure to monitor management and suggested the imposition of an audit committee.[156] Another matter resulted in the Gould report, which dealt with the lack of inquiry by a company's board before approval of a self-dealing transaction by the company's management.[157] The report reminded directors to perform their own due diligence in the face of self-interested management decision-making.[158] A third matter resulted in the Sterling Drug Report, which dealt with board access to insider information and the applicability of insider trading rules to the board.[159] In yet another report, the SEC chastised directors for their failure to ensure proper disclosure in light of known financial distress.[160] Several other reports issued in the same era, largely on the same topic: the responsibilities of directors in monitoring the behavior of management or ensuring proper disclosure.[161]

2. The Public Benefit Rationale

The Section 21(a) Reports published to explain the scope of director responsibility almost exclusively provided an industry-related public benefit. The reports sought to alter the manner in

---

155. SPECIAL SUBCOMM. ON INVESTIGATIONS OF THE H. COMM. ON INTERSTATE AND FOREIGN COMMERCE , 92ND CONG., S.E.C. STAFF REP. ON THE FINANCIAL COLLAPSE OF THE PENN CENTRAL COMPANY (Subcomm. Print 1972) [hereinafter PENN CENTRAL REPORT], *available at* http://fraser.stlouisfed.org/docs/historical/house/1972house_fincolpenncentral.pdf; Robert E. Bedingfield, *S.E.C.'s Study of Pennsy: Broad New Powers Seen as Agency's Real Objective*, N.Y. TIMES, Aug. 8, 1972, at 41.While this report is not technically called a Section 21(a) Report, it marked the beginning of the publication of Section 21(a) Reports in other corporate governance cases. *See* Sporkin, *supra* note 151, at 455.

156. PENN CENTRAL REPORT, *supra* note 155, at xii.

157. Gould Inc., Exchange Act Release No. 13612, 12 S.E.C. Docket 773 (June 9, 1977) [hereinafter Gould Report].

158. *Id.* at 775.

159. Sterling Drug, Inc., Exchange Act Release No. 14675 (Apr. 18, 1978).

160. National Telephone, Co., Exchange Act Release No. 14380, 13 SEC Docket 1393 (Jan. 16, 1978) [hereinafter National Telephone Report].

161. *E.g.*, Sharon Steel Corp., Exchange Act Release No. 18271, 23 SEC Docket 1519 (Nov. 19, 1981) (dealing with inadequate disclosure); Greater Washington Investors, Inc., Exchange Act Release No. 15673, 17 SEC Docket 40 (Mar. 22, 1979) [hereinafter Greater Washington Report] (same); Stirling Homex Corp., Exchange Act Release No. 11516, 7 SEC Docket 298 (July 2, 1975) (dealing with the failure of the board to ensure disclosure). Additionally, two similarly reasoned reports issued on a failure to monitor two decades later. W.R. Grace. & Co., Exchange Act Release No. 39157, 65 SEC Docket 1240 (Sept. 30, 1997) [hereinafter Grace Report]; Cooper Companies, Inc., Exchange Act Release No. 35082, 58 SEC Docket 591 (Dec. 12, 1994) [hereinafter Cooper Report].

which directors and others viewed their fiduciary duty to monitor, which often suggested structural changes to conform to federal securities laws and enhance the role of the directors in corporate governance.[162] For example, the National Telephone report echoed the Penn Central Staff Report in proposing the creation of a board audit committee.[163] These suggested changes can have ramifications beyond their stated purpose: the Cooper Report, by requiring that the board disclose when management was under criminal investigation, could significantly curtail the ability of the executive office of a company to plead the Fifth Amendment right to avoid self incrimination in a criminal investigation.[164] The investor-related public benefit of the reports was only a general warning that outside directors and boards as a whole were not properly serving shareholder interests to ensure that the management was acting appropriately, a broad and not altogether constructive form of criticism.[165] As in the Harrisburg report, a greater investor-related public benefit resulted from the judicial or administrative proceedings against management or the entity for the primary wrongdoing, which clearly warned investors that there was something amiss at the regulated companies.

3. Further Examples of Derivative Liability Reports: Brokers and Lawyers

Using reasoning similar to the corporate governance reports, the SEC decided to publish a Section 21(a) Report about the fiduciary duties of broker-dealers in the face of fraudulent schemes.[166] The report detailed the interaction between Laser Arms, a fraudulent corporation established by Marshall Zolp that claimed that it had created a "self-chilling beverage can," and its broker-dealers.[167] Zolp was sentenced to twelve years in prison for fraud because his misconduct was clear: he promoted the stock of a corporation involved in what would be admittedly a very lucrative venture, if it

162. Sporkin, *supra* note 151, at 456.

163. National Telephone Report, *supra* note 160, at 1396.

164. David S. Nalven & Thomas A. Bockhorst, *Taking the Fifth with the SEC: No Longer an Easy Option*, 144 Bos. B.J. 12 (1996).

165. *See* Lucian Arye Bebchuk, *The Case for Increasing Shareholder Power,* 118 Harv. L. Rev. 833, 856 (2005) ("[S]hareholders seeking to exercise their theoretical power to replace directors face substantial impediments.").

166. Laser Arms Corp., Exchange Act Release No. 28878, 48 SEC Docket 305 (Feb. 14, 1991) [hereinafter Laser Arms Report].

167. *5 Guilty in Fraud Involving Self-Chilling Can,* N.Y. Times (July 2, 1987), http://www.nytimes.com/1987/07/02/business/5-guilty-in-fraud-involving-self-chilling-can.html.

were not completely fictional.[168] The SEC chose to publish a report in the matter because Zolp's fraud was unintentionally facilitated by the broker-dealers that acted as intermediaries between him and his investors.[169] Rule 15c2-11 requires broker-dealers to issue quotes only with proper documentation from the issuer.[170] Zolp provided the broker-dealers with this documentation, but it was completely falsified.[171] The Laser Arms report served to warn broker-dealers that the burden fell on them to ensure the documentation came from a reliable source.[172]

Just as in the reports on board members' duties, the broker-dealers in the Laser Arms Report appeared to have engaged in a kind of willful myopia, declining to take steps to ensure proper conduct beyond that which was required statutorily. The report warned future broker-dealers that if they did not verify unfamiliar sources, they could be subject to penalties for the violation of Rule 15c2-11.[173] Unlike the reports on the duties of the board, there were no suggestions for appropriate measures to shelter the broker-dealers from allegations of failure to perform due diligence, which likely had the effect of making the broker-dealers err on the side of caution when dealing with dubious issuers. The benefit to investors, on the other hand, was negligible: Zolp was already imprisoned on securities fraud and his scheme was shut down (though investors perhaps should have taken note of his name: this was not the first or last time he would be convicted of violating the securities laws).[174] The public benefit was prospective and meant to show regulated broker-dealers the path required to safely navigate terrain populated by Zolp and his ilk.

Another corporate governance Section 21(a) Report issued in the matter of Gutfreund, better known as the Feuerstein Report after its subject, Salomon Brothers chief legal officer Donald Feuerstein. This report dealt with the expansion of the supervisory liability of compliance officers to certain legal officers.[175] Under Section 15(b)(4)(E) of the Securities Exchange Act, supervisors have the responsibility to monitor the behavior of their employees for any

168. Laser Arms Report, *supra* note 166, at 306–08.

169. *Id.* at 315–16.

170. 17 C.F.R. § 240.15c2-11 (2014).

171. Laser Arms Report, *supra* note 166, at 306.

172. *Id.* at 312.

173. *Id.* at 316.

174. Jayne W. Barnard, *Securities Fraud, Recidivism, and Deterrence*, 113 Penn St. L. Rev. 189, 192 & n.5 (2008).

175. Feuerstein Report, *supra* note 73.

irregularities or "red flags."[176] The report sought to "amplify" the SEC's position on what constituted a supervisor, employing a more expansive fact-based inquiry that would encompass certain legal and compliance officers in an effort to make internal compliance controls more robust.[177] The Feuerstein Report has been cited as conclusive on the subject and as an expansion of SEC jurisdiction.[178] Other industrial actors changed the duties of the high-ranking legal officers as a result.[179] Moreso than the director-focused reports, the Feuerstein Report served to warn of a new area of possible liability for entities regulated by the SEC.[180]

The conduct of the board, broker-dealers, and legal officers are some of the targets for which the SEC has released Section 21(a) Reports in matters of derivative liability.[181] The derivative liability reports go a step beyond the Seaboard Report and others like it. Instead of recommending the appropriate course of action upon discovery of wrongdoing, the reports modify the legal responsibilities of board members or corporate officials. This is a distinction of kind rather than degree: the goal of the Seaboard Report was to shape corporate behavior after the discovery of wrongdoing, while the corporate governance reports redefine what constitutes wrongdoing. This categorical difference will be further explored in Part III. The next Part details reports whose modification of the legal responsibilities of regulated entities takes another step in the direction of a brand of rulemaking.

---

176. *Id.* at 108.

177. *Id.* at 112; *see also* James R. Doty, *Regulatory Expectations Regarding the Conduct of Attorneys in the Enforcement of the Federal Securities Laws: Recent Development and Lessons for the Future*, 48 BUS. LAW. 1543, 1559 (1993). The report appeared to clarify the ambiguity from the Commission's decision in the matter of Huff about who could constitute a supervisor from. Huff, 50 S.E.C. 524, 525–26 (1991).

178. *See, e.g.*, Robert S. DeLeon, *The SEC's Deputization of Non-Line Managers and Compliance Personnel*, 23 SEC. REG. L. J. 271, 282 (1995); Note, *Lawyers' Responsibilities to the Public: Regulating Lawyers in the Regulatory State*, 107 HARV. L. REV. 1605, 1620 (1994).

179. *Lawyers' Responsibilities to the Public: Regulating Lawyers in the Regulatory State*, *supra* note 178, at 1620 & n.117.

180. A report that similarly sought to clarify the scope of the securities laws was issued on what constituted a supervisor in the context of pay to play regulations. JP Morgan Securities, Inc., Exchange Act Release No. 61734, 98 SEC Docket 125 (Mar. 18, 2010).

181. Others focus on the responsibility of a self-regulatory organization in monitoring its members. Nasdaq Stock Market, Inc., Exchange Act Release No. 51163, 84 SEC Docket 2840 (Feb. 9, 2005); NASD, Exchange Act Release No. 37542, 62 SEC Docket 1385 (Aug. 8, 1996) (decrying the lack of independence between the SRO and its market makers).

E. Legal Ambiguity

1. Reports Issued in the Face of Legal Ambiguity

The Feuerstein Report bridges the gulf between reports issued in matters of derivative liability and the extrajurisdictional reports by demonstrating how the SEC can extend its jurisdiction through clarification of an ambiguous statutory term. The extrajurisdictional reports are very similar to the reports examined in this subpart, but instead of seeking to expand the reach of the SEC jurisdictionally, the reports now under discussion try to extend the role of the SEC through novel legal theories or applications of securities regulations. In these reports, the tug-of-war behind the text is most visible, as the SEC is confronted with difficult legal matters that very possibly would have been resolved in the favor of the regulated entity had the agency proceeded with an administrative or judicial action.

As with many of the previously mentioned reports, the extralegal reports often accompany an administrative cease-and-desist order or judicial injunction against a regulated entity. In these reports, the SEC highlights areas of law in which it could try to bring a claim under a novel reading of the regulation or statute. For example, in 2005, the Titan Corporation pled guilty to criminal violations of the Foreign Corrupt Practices Act ("FCPA") for funding the election of the President of Benin.[182] While under investigation, Titan was in the process of merging with a competitor, Lockheed Martin, but failed to disclose the FCPA investigation in its merger agreement, which had the potential to be viewed as a material non-disclosure.[183] Practitioners criticized the report as having a poor legal foundation, because the merger agreement was not meant as a disclosure document and there was ambiguity as to the legality of requiring disclosure of a pending criminal investigation.[184] The underlying FCPA violation was not at issue, only the novel interpretation of a merger agreement as a kind of disclosure.[185]

182. Titan Corp., Exchange Act Release No. 51283, 84 SEC Docket 3327, 3327 (Mar. 1, 2005) [hereinafter Titan Report].

183. *Id.*

184. William W. Horton, *SEC's "Titan Report" Raises the Stakes for Disclosure of Government Investigations*, ABA Health eSource (Apr. 2005), https://www.americanbar.org/newsletter/publications/aba_health_esource_home/horton.html; *see also* Stanley Keller, *The Meaning of the Titan 21(a) Report*, Edwards Wildman (Apr. 7, 2005), http://www.edwardswildman.com/insights/PublicationDetail.aspx?publication=3565.

185. *See* sources cited *supra* note 184.

The most recent Section 21(a) Report[186] was also issued in an ambiguous area of legal doctrine. KPMG settled an administrative proceeding that resulted from an SEC investigation into the provision of non-audit services to its audit clients, a breach of auditor independence rules promulgated to simulate an arms-length transaction between the auditor and the client company.[187] The accompanying report detailed the practice at KPMG of loaning tax professionals to work directly under the roof of their audit clients.[188] Normally, securities regulations prohibit the loan of staff by an auditor,[189] but it appears that KPMG may have believed that it was acting appropriately due to a rule issued in 2003, which clarified that "an accounting firm can provide tax services to its audit clients without impairing the firm's independence."[190] The report in this matter stated that while tax services were exempt from the rules prohibiting the provision of non-audit services, an auditor still could not loan its employees to the client company.[191] In light of the ambiguity caused by these conflicting statements, it is not clear that the SEC would have prevailed on this interpretation in a formal enforcement action.

At a functional level, this means publication of these reports allowed the SEC to skirt the possibility of losing in court while still achieving whatever precedential value is ascribed to the reports. If this newly created legal interpretation is used in subsequent matters, the report would have an industry-related public benefit as it warns companies in merger negotiations of their disclosure requirements.[192] While this may seem similar to the public benefit provided by previous reports, these reports differ because they are novel definitions of the securities laws. In effect, the Titan report created a new legal application of the FCPA which Titan violated;

---

186. As of the date of publication of this Note.

187. Press Release, U.S. Secs. & Exch. Comm'n, SEC Charges KPMG with Violating Auditor Independence Rules, SEC (Jan. 24, 2014), http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370540667080?utm_source=feedburner&utm_medium=feed&utm_campaign=feed%253A§ec%252FlgHO+(SEC.gov+Updates%253A+Press+Releases)#.UuQSKWQo568.

188. KPMG, LLP, Exchange Act Release No. 71390,108 SEC Docket, no. 2 (Jan. 24, 2014) [hereinafter KPMG Report], http://www.sec.gov/litigation/investreport/34-71390.pdf.

189. 17 C.F.R. § 2-01(c)(4)(vi) (2014).

190. KPMG Report, *supra* note 188 (quoting Strengthening the Commission's Requirements Regarding Auditor Independence, 68 Fed. Reg. 6006, 6017 (Feb. 5, 2003)).

191. *Id.*

192. *But see* Horton, *supra* note 184 (describing the ambiguity of the report's message).

the KPMG report created a novel interpretation of the auditing rules which KPMG violated. The quasilegislative nature of these reports will be important in the discussion of the formalistic administrative law principles in Part III. Just as in the derivative liability reports, the investor-related public benefit of these "interpretive" reports is limited because the underlying malfeasance is described at length in the separate accompanying formal enforcement proceeding that dealt with other, more evident, violations of the SEC regulations.

Both the Titan and KPMG reports issued in areas where statutory ambiguity led to what were arguably novel applications of the securities regulations. For the misconduct described in a report published in the Netflix matter, the ambiguity was created by rapidly changing circumstances.[193] Reed Hastings, the CEO of Netflix, wrote on his personal Facebook page that Netflix had reached a benchmark indicative of a high level of success: one billion hours of content streamed in a month.[194] Preliminarily, the Division of Enforcement notified Netflix that this Facebook post constituted a material disclosure, whose dissemination needed to be over an established channel.[195] Again via Facebook, Hastings responded, asserting that his post was not material and, moreover, was public.[196] Academics and practitioners agreed with these points and further pointed out that the SEC generally allowed for a good-faith exemption to violations of Regulation FD.[197] The SEC chose not to file an enforcement action, instead issuing a Section 21(a) Report.[198]

The Netflix report warned the industry that disclosures over social media without prior notification would likely violate Regulation FD, irrespective of the number of followers the entity might have.[199] Just as with the Titan and KPMG reports, the Netflix report was somewhere between a clarification and an amplification of the

193. Netflix, Inc., Exchange Act Release No. 69279 [hereinafter Netflix Report], *available at* http://www.sec.gov/litigation/investreport/34-69279.htm.

194. *Id.*

195. Brian L. Rubin & Caroline A. Crenshaw, *The Social Network Unhinged: #topsocialmediaenforcementissuesinthesecuritiesindustry*, 32 BANKING & FIN. SERVICES POL'Y REP. 1, 4 (June 2013).

196. Netflix Report, *supra* note 193.

197. *See, e.g.*, Sesi Garimella, *Regulation FD and Social Media*, 32 REV. BANKING & FIN. L. 234, 242 (2013); Joseph Grundfest, *Regulation FD in the Age of Facebook and Twitter: Should the SEC Sue Netflix?* (Rock Ctr. For Corporate Governance at Stanford Univ., Working Paper No. 131, 2013), *available at* http://ssrn.com/abstract=2209525.

198. Rubin & Crenshaw, *supra* note 195.

199. Netflix Report, *supra* note 193, at 7.

pertinent securities law. Again, the investor-related benefit was fairly limited in the Netflix report. After its publication, investors needed to be aware that Netflix's use of social media was not permissible under Regulation FD because it should have notified investors that it planned to use the CEO's Facebook page as a channel of disclosure. Given the public defense by Hastings, the SEC would have faced a resource-intensive legal battle in an ambiguous area had it pursued an enforcement proceeding. By issuing the report, it sought to both resolve the issue at hand and to clarify the law. The Netflix report pushes the boundaries more than any of the other extralegal reports: it was not the product of negotiations and was not published with the consent of Netflix, so it serves as a stark contrast with the reports meant to reward cooperation or pardon good faith mistakes.

2. The Public Benefit Rationale

Section 21(a) Reports enlist what Brandeis called "the potent force" of publicity as a "remedial measure."[200] Stanley Sporkin explained the same concept a century later: "the critical thing is you get transparency and say what took place."[201] The public benefit is paramount. The five groupings in this part—Extrajurisdictional Reports, State and Local Government Reports, Good Faith Reports, Derivative Liability Reports, and Extralegal Reports—show instances where the SEC chooses to publish a report when it believes that the public should know the results of its staff investigation, but either cannot or chooses not to proceed with a formal enforcement action. Above all, the goal of this part was to demonstrate that the reports fill a necessary niche in the securities enforcement arsenal. As the next part attempts to fit this kaleidoscopic tool into the primary color world of administrative law, the public benefit rationale will become increasingly important as an adhesive between the functional and the formalistic.

III. THE FORMALISTIC PERSPECTIVE: SECTION 21(A) REPORTS IN ADMINISTRATIVE LAW

The utilitarian end of the reports is clear: Parts I and II showed that they are intended to provide a public benefit to investors, industrial actors, or both. However, the legal means through which the SEC achieves this goal are murkier: it is unclear whether the

200. Brandeis, *supra* note 6, at 92.
201. Interview with Stanley Sporkin, *supra* note 24.

decision to publish a report arises out of the agency's adjudicative, legislative, or executive powers.

Section 21(a) Reports provide the SEC with a way to quickly and efficiently furnish regulated entities and their investors with the information necessary to transact in the dynamic and fast-paced financial marketplace. The reports are the result of a functional approach that makes sense for a regulator seeking to stay abreast of new violations in an environment of scarce resources and heightened public scrutiny. They provide the resource- and time-constrained SEC with a release valve to address an array of issues when it lacks the statutory mandate or financial wherewithal to do so.[202]

Former Commissioner Karmel, whose short tenure coincided with the zenith of the reports' use in the late 1970s,[203] believes that Section 21(a) Reports represent a failure to remain within the bounds of separation of powers principles.[204] Because Section 21(a) Reports are a hybrid action, Karmel believes that usage of reports represents a kind of prosecutorial law-making power, which is problematic because the decision to resolve a matter with a report avoids the adversarial process.[205] She further believes that the implementation of the administrative cease-and-desist orders created a formal mechanism to take over the role played by Section 21(a) Reports, rendering them obsolete today.[206] Her view contrasts with that of her contemporary, former Director of Enforcement Stanley Sporkin, who believes the reports to be a powerful way to resolve difficult issues to the satisfaction of all affected parties.[207] A third view comes from the securities enforcement literature written by practitioners, where Section 21(a) Reports are usually referred to strategically as a kind of "alternative disposition" to a

202. Ralph C. Ferrara et al., *Hardball! The SEC's New Arsenal of Enforcement Weapons*, 47 BUS. LAW. 33, 95 (1991).

203. In 1979 alone, it appears that at least four reports were issued. Compass Report, *supra* note 143; Marine Protein Report, *supra* note 95; Greater Washington Report, *supra* note 161; Spartek Report, *supra* note 59. It is often difficult to distinguish the Section 21(a) Reports from other SEC staff reports. An additional related issue arises in the SEC's ability to seek statements from regulated entities under Section 21(a), a power not addressed in this Note. Richard M. Philips & Michael J. King, *Overview*, *in* RICHARD M. PHILIPS, THE SECURITIES AND ENFORCEMENT MANUAL: TACTICS AND STRATEGIES, 87 (1997).

204. KARMEL, *supra* note 2, at 220.

205. Karmel, *supra* note 8, at 43 ("[T]he Enforcement Division is often in the position to create new law when it is the Commissioners who should be doing so.").

206. *Id.* at 42 & n.40.

207. Interview with Stanley Sporkin, *supra* note 24.

matter, because they avoid the formal enforcement process.[208] All of these interpretations are partially correct: Section 21(a) Reports do embody a kind of prosecutorial rule-making, an efficient resolution to legal conundrums and often are the best result for regulated entities under investigation. That said, it is clear that there is no consensus on what the role of the reports is within the established administrative law scheme.

Examination of the ad-hoc decision-making process leading to the publication of a report does not lend itself easily to a formalistic abstraction that would explain the reports' use as a tool in a manner consistent with administrative law principles. Given the efficient and functional nature of the reports, it may seem unclear why formal categorization is necessary. However, this inquiry has merit beyond mere formalism for formalism's sake.

The categorization of agency actions into previously established administrative channels can provide certain benefits and safeguards to ensure a consistent and equitable usage of the reports. This formalization of agency action has an obvious historical precedent. After the rapid expansion of the administrative state during the New Deal, it quickly became apparent that constraints for agency action were needed, leading to the enactment of the Administrative Procedure Act (APA).[209] The APA and its subsequent judicial interpretation constitute in part an attempt to transfer the tripartite separation of powers present in the Constitution to the bureaucracy.[210] The procedure of the SEC, like that of other federal agencies, is governed by the APA.[211] By funneling agency actions and processes into separate and differentiated categories, regulated entities and reviewing courts are able to ascertain whether the agency acted appropriately and challenge misconduct through corresponding statutory safeguards.

---

208. *E.g.*, Alan R. Bromberg, Lewis D. Lowenfels, & Michael J. Sullivan, *Public Report of Investigation (SEA § 21(a))—Advantages*, *in* 6 Bromberg & Lowenfels on Securities Fraud § 12:50 ("mild sanction"); Steinberg, *supra* note 14 ("a substitute for administrative or civil injunctive suits"); Arthur F. Mathews, *Litigation and Settlement of SEC Administrative Enforcement Proceedings*, 29 Cath. L. Rev. 215, 229 (1979) ("important enforcement alternative"). *But see* Justin P. Klein & Gerald J. Guarcini, *Director Response to Management Misconduct*, 28 Rev. Sec. & Comm. Reg. 7, 71 (1995), ("to warn public companies . . . of its views on certain practices or conduct").

209. Administrative Procedure Act of 1946, Pub. L. 79-404, 60 Stat. 237 (1946) (codified as amended at 5 U.S.C. §§ 500, 551–559, 701–706 (1988)); Martin Shapiro, *APA: Past, Present, Future*, 72 Va. L. Rev. 447, 452 (1986).

210. Shapiro, *supra* note 209, at 453.

211. Alan B. Morrison, *Administrative Agencies Are Just Like Legislatures and Courts-Except When They're Not*, 59 Admin. L. Rev. 79, 82 (2007).

If Section 21(a) Reports are not so constrained, the SEC has nearly unfettered discretion to publish a report because there is no procedure that would allow a regulated entity to appeal for judicial review.[212] Moreover, the reports do not easily fit within any of the processes mentioned within the APA; certainly, they do not require any of the built-in checks like the notice and comment prerequisite to rulemaking or the hearing concomitant to an adjudication. Until recently, potential misuse of the reports has been prevented by informal SEC policy. For example, the SEC has routinely sought the consent of the regulated entity to publish a report[213] and would even occasionally allow the opposing counsel to proofread a report.[214] However, this consent was more to ensure that the opposing counsel felt that they were "treated fairly" than to adhere to the principles of administrative law.[215] In a break from this practice, the SEC issued the Moody's and Netflix reports without consent from either regulated company. As the SEC plans to ramp up usage of the reports,[216] the requirement of formal procedures like consent will be necessary to prevent improper use of the reports to resolve an expanding array of difficult matters.

This part will show that Section 21(a) Reports are an anomaly in administrative law, whose benefits should not be excessively curtailed but whose use should be confined within the appropriate sectors carved out by the APA. This part will begin by explaining how each type of public benefit dovetails with a specific administrative action. The investor-related public benefit most closely maps onto the concept of a judicially-enforced consent decree; the industry-related public benefit corresponds closely to general statements of policy. When the reports are viewed through this formal lens, the built-in safeguards from administrative law will work to limit misuse of the reports. This part will ultimately conclude that the twin pub-

---

212. Only once has the publication of information under Section 21(a) been challenged in court. Kukatush Min. Corp. (N.P.L.) v. SEC, 309 F.2d 647 (D.C. Cir. 1962). Moreover, in *Kukatush*, the information published was not part of a Report, but was merely statutorily defensible under Section 21(a). *Id.* at 650–51 ("We agree with the view of Judge Holtzoff that [Section 21(a)], authorizing the Commission in its discretion to publish information concerning violations of the Securities Exchange Act of 1934, constitutes ample statutory authority . . . .").

213. Interview with Stanley Sporkin, *supra* note 24 ("You don't need consent, [getting consent] was like a belt and suspenders for me.").

214. *Id.*

215. Interview with Stanley Sporkin, *supra* note 24.

216. *SEC Enforcement Update*, King & Spaulding (Mar. 4, 2013), http://www.kslaw.com/imageserver/KSPublic/library/publication/ca030413b.pdf ("[T]he Commission might make greater use of so-called Section 21(a) reports . . . .").

lic benefit rationales should bookend the spectrum of possible uses for the reports to prevent their misuse.

A. *The Section 21(a) Report as an Administrative Consent Decree*

A report usually represents a negotiated evaluation of the situation between the SEC and the regulated entity.[217] As demonstrated in Part II, the choice to forgo a formal action and publish a Section 21(a) Report may be driven by jurisdictional, legal, or political issues; it may also be a reward for cooperation. No matter the rationale, the decision to publish a report has not traditionally been unilateral. With the recognition that a report constitutes a settlement between a regulated entity and the SEC, Karmel's apprehension of circumventing the adversarial process is mitigated, but a new set of issues arises. The SEC must ensure that the reports issue not simply to resolve a matter, but also to provide a public benefit.[218] While the reports constitute a settlement between the SEC and a corporate wrongdoer, they are not the only parties interested at the figurative negotiating table; the investing public also has a stake. The SEC is obligated to simultaneously negotiate an agreement with the regulated entity and to ensure that the report will adequately provide the investing public with the facts necessary for informed decision-making. In other words, if the SEC settles with a regulated entity and decides to publish a report instead of pursuing a formal enforcement action, it must ensure that there is a sufficiently robust investor-related public benefit.

The best way to ensure that a Section 21(a) Report can both resolve a thorny issue and provide an investor-related public benefit is by analogizing report issuance to the process leading up to the judicial order of a consent decree. Consent decrees, or consent judgments, are a settlement mechanism with the enhanced protections of judicial enforcement, often used by agencies to resolve a matter with a regulated entity.[219] After the agency and the regulated entity agree to certain actions by either one or both parties, the judge enters the settlement as a consent decree.[220] In addition

217. Interview with Stanley Sporkin, *supra* note 24.

218. *See* SEC Guidelines, *supra* note 59.

219. Larry Kramer, *Consent Decrees and the Rights of Third Parties*, 87 MICH. L. REV. 321, 325 (1988). For many agencies dealing with corporations, including the SEC, a settlement can often mean entering a consent decree in federal court. Dorothy Shapiro, *Lessons from* SEC v. Citigroup*: The Optimal Scope for Judicial Review of Agency Consent Decrees*, John M. Olin Fellows Discussion Paper Series, Paper No. 50, 12 (March 1, 2013).

220. Kramer, *supra* note 219.

to avoiding a burdensome trial, there are many procedural advantages to consent decrees, such as docket priority and enforcement through the equitable power of contempt.[221] The procedure for the publication of a report is very similar to the process leading up to issuance of a consent decree, but instead of an agency seeking judicial approval of a settlement, the Enforcement staff members go to the Commission to seek permission to publish a report to settle a matter. In effect, the Commission acts as an adjudicator; the staff as the executive enforcer. The key similarities between a report and a consent decree are that both must have a public benefit and should be issued with the consent of all affected parties. Both of these safeguards from the consent decree context can prevent misuse of the publication process and restrict the reports to areas within the bounds of administrative law.

1. The Safeguard of a Public Benefit to Mitigate SEC Self-Interest

The decision to publish the Alabama Report, *supra* Part II.C, is illustrative of how the dynamic negotiation process functions in the Section 21(a) Report context. The press release that accompanied the report explained that the Commission chose to issue it instead of beginning a formal enforcement proceeding because of voluntary, remedial action by the pension fund, its cooperation with the investigation, and the lack of personal profit.[222] As the subpart on good faith reports described, *supra* Part IIE, if a regulated entity is cooperative and takes remedial actions, it may be able to persuade the SEC to limit its enforcement actions to the issuance of a Section 21(a) Report. Sporkin, after joining private practice, successfully used this approach as counsel to the Alabama pension fund,[223] and the municipality of South Miami unsuccessfully attempted this very tactic at the conclusion of a recent SEC investigation.[224] In these cases, the decision to publish a Section 21(a) Report resembles a negotiated agreement.

The decision to end an investigation with the publication of a Section 21(a) Report was not simply an act of leniency by the SEC. Because of the constitutional issues, as well as the unclear jurisdictional authority over public pension funds, the SEC also may have

221. *Id.* at 325–28.

222. Alabama Press Release, *supra* note 104.

223. Interview with Stanley Sporkin, *supra* note 24.

224. Kyle Glazier, *SEC Charges South Miami with Securities Fraud*, Bond Buyer (May 22, 2013), *available at* http://www.bondbuyer.com/issues/122_99/sec-charges-south-miami-with-securities-fraud-1051896-1.html. The SEC chose instead to file a complaint in the Southern District of Florida.

preferred to simply issue a report rather than risk losing an unpopular effort against what was ultimately the retirement savings of the public employees of Alabama. While the specifics may vary in each matter, the rationale remains the same: when the SEC and the regulated entity agree to avoid a more formal enforcement proceeding, they may agree to publish a Section 21(a) Report. Importantly, the Alabama report also benefited the investing public by detailing the misconduct by the pension fund directors as well as outlining the risk of investing with similar financially-unsophisticated funds. The Commission approved the staff recommendation to publish the report, which contained the corresponding investor-related public benefit. This is analogous to an agency proposing a consent decree to a federal judge for approval, but the executive decision to invoke prosecutorial discretion and the judicial power to approve the settlement are combined internally in the SEC.

However, some Section 21(a) Reports fail to take this second step and subsequently lack an investor-related public benefit. In its role as an adjudicator, the Commissioners act as gate-keepers to ensure that the reports issue for the benefit of the public. This function has proved problematic in analogous federal court setting with consent decrees. Judge Jed Rakoff of the Southern District of New York has criticized the role of the adjudicator in these proceedings as nothing more than a "rubber stamp,"[225] problematic because the agency can say "publicly that it had taken action in a very high visibility situation" while not truly acting for the benefit of the public.[226] Judge Rakoff argued that the role of the judge in consent judgments is to ensure that the primary purpose of settlement is the public interest.[227] While the Second Circuit later reversed Judge Rakoff and clarified the role of the judge in the consent decree process,[228] his rulings in the post–financial crisis era have shaped the way the SEC pursues consent decrees.[229]

---

225. Terry Carter, *The Judge Who Said No: Rakoff's Stance on the SEC Deals Draws Fire, Praise-and Change*, A.B.A. J., Oct. 2013, at 50, 52.

226. Jed S. Rakoff, *Are Settlements Sacrosanct?*, 37 LITIGATION 17, 17 (Summer 2010).

227. *Id.*

228. S.E.C. v. Citigroup Global Markets, Inc., 752 F.3d 285, 295 (2d Cir. 2014) ("The primary focus of the [judicial] inquiry, however, should be on ensuring the consent decree is procedurally proper, . . . taking care not to infringe on the S.E.C.'s discretionary authority to settle on a particular set of terms.").

229. Ben Protess & Matthew Goldstein, *Overruled, a Judge Still Left a Mark on the S.E.C. Agenda*, N.Y. TIMES DEALBOOK (June 4, 2014), http://dealbook.nytimes.com/2014/06/04/appeals-court-overturns-decision-to-reject-s-e-c-citigroup-settlement/?_php=true&_type=blogs&_r=0.

The Commission must ensure that it is acting in its adjudicative role when approving the Enforcement Division's decision to publish a report to resolve a matter. Indeed, Judge Rakoff's critique can also apply to the decision to publish a Section 21(a) Report. The mission-oriented SEC staff attorneys may attempt to justify the publication of a report as a way of promoting cooperation and efficiency,[230] which in turn will provide a "public benefit," as the SEC will be enabled to weigh in on more issues as they arise. However, expediency for its own sake is not a tenable rationale. Equating agency efficiency with the public good presumes that what helps the agency helps the investor. Yet because of external pressure, the SEC may be motivated to resolve matters quickly, even when the public would benefit from a more lengthy explanation of an issue. There is nothing inherently wrong with the decision to resolve a matter with a report, so long as the investor's interest is fully represented at the bargaining table. This means, however, that a report cannot *only* be a slap on the wrist; it must also explain to the investor the nature of the misconduct. Just as with a consent decree, the Commissioners should ensure that the publication of a report has a true investor-related benefit, beyond efficient use of agency resources.

2. The Safeguard of Consent to Prevent Inappropriate Reputational Harm

Consent decrees have a second built-in safeguard that the reports should adopt by analogy. By definition, consent decrees require approval by both the parties to the suit. The SEC should not use a report to chastise behavior without obtaining consent because it means that the SEC has unilaterally declared that the regulated entity has committed some kind of wrongdoing. The Netflix report is a telling example. As previously discussed,[231] the CEO of Netflix publicly opposed any enforcement action. The SEC chose to publish the report without the consent of Netflix. The facts of the report were *not* the result of an investigation, but rather constituted a summary of the publicly available information about Netflix.[232] While there was an industry-related public benefit from warning other publicly-traded companies about the SEC's plan to scrutinize social media under Regulation FD, it did not represent an agreement between the SEC and the regulated entity. The unilateral de-

230. Block & Barton, *supra* note 17, at 271.

231. *Supra* Part II.E.1.

232. Netflix Report, *supra* note 193, at 1 n.1.

cision to publish a report is a divergence from the consent judgment model, which requires consent from all parties.

Using a report to condemn the behavior of a regulated entity is problematic because the affected company has no administrative recourse and is not likely to succeed on a claim that a unilateral allegation of malfeasance violates due process principles. Procedural due process is implicated when an agency action impinges upon an entity's liberty or property interests; reputational harm is insufficient by itself.[233] In the corporate setting, this means that an agency action that causes a depression in the stock price or "goodwill" of a company does not invoke procedural due process.[234] In cases of mere reputational harm, agencies need not hold a hearing in the absence of a statutory mandate.[235] The irony here is that for many of the entities regulated by the SEC, reputation is of the highest importance.[236] If the SEC is allowed to publish a report of the facts of its investigations without the consent of the mentioned party—even if it simply republishes already public information, as with the Netflix report—it will hold tremendous leverage over any party under investigation. When the reports are properly viewed as a kind of administrative consent decree, the decision to publish information is driven by the needs of both parties and so mitigates some of the complications that arise from regulating the particularly sensitive financial markets.

The SEC, overburdened and lacking resources, needs to be able to prioritize matters that do not merit the full-court press that accompanies a formal enforcement action. The Section 21(a) Report provides a way to settle marginal issues quickly and move onto the next matter. The Commission must parallel its judicial counterparts in the consent decree context and determine that there is investor-related public benefit as a preliminary requirement before the approval of the report as a settlement; in doing so, agency self-

233. Paul v. Davis, 424 U.S. 693, 712 (1976) ("[W]e hold that the interest in reputation asserted in this case is neither 'liberty' nor 'property' guaranteed against state deprivation without due process of law.").

234. Gen. Elec. Co. v. Jackson, 610 F.3d 110, 121 (D.C. Cir. 2010) (explaining that a reduction in stock price as the result of reputational harm needs to be accompanied by an additional deprivation in order to violate procedural due process).

235. Morrison, *supra* note 211, at 114–15.

236. Philips, *supra* note 21, at 67. However, the Freedom of Information Act may preclude the SEC from publication of a Report containing confidential information. Kathleen Vermazen Radez, Note, *The Freedom of Information Act Exemption 4: Protecting Corporate Reputation in the Post-Crash Regulatory Environment*, 2010 COLUM. BUS. L. REV. 632, 657 (2010).

interest should take a secondary role in the decision-making process preceding the publication of a report. Similarly, just as a judge should not approve a consent decree without the approval of all parties, the Commissioners must ensure that a report only issues where both the regulated entity and the staff have agreed on the facts and legal conclusions in the report.

B. The Industry-Related Public Benefit: The General Statement of Policy

A Section 21(a) Report can function as a kind of settlement, but this is only part of the story. Often, reports issue in tandem with a cease-and-desist order. These reports supplement, rather than replace, the formal enforcement action, and therefore are not primarily settlements. Even without an accompanying enforcement action, there are several reports that seem to have a limited focus on informing the investor of past wrongdoing. Instead, these reports seem much more forward-looking, functioning as the "proverbial warning shot across the bow."[237] In these reports, the SEC seems much less focused on settling a matter and more concerned about shaping future behavior; often, the industry-related public benefit predominates.

The provision of an industry-related public benefit is analogous to an agency using a general statement of policy to warn regulated entities of enforcement priorities. General statements of policy are an exception to the rule-making requirements of the APA and are not final or binding, but merely indicate how an agency plans to apply the law in future rule-makings or adjudications or are a tentative indication of future goals.[238] And just as adhering to the consent decree model provides safeguards and procedures that can prevent abuse of the Section 21(a) publication process, analogizing predominantly industry-benefitting reports to general statements of policy can channel them along lines that would conform with administrative law and equitable principles. Similar to a general statement of policy, these Section 21(a) Reports serve to explain how the agency will react towards future conduct similar to the behavior detailed in the report. They explore the corporate malfeasance, explain potential legal conclusions, and highlight areas where regulated entities should tread carefully.

For example, after the publication of the Harrisburg report, which explained that municipal officers should be cognizant that

---

237. Michael K. Lowman, *Recent Enforcement Trends Underscoring the Need for Corporate Compliance, in* SEC COMPLIANCE BEST PRACTICES (2010).

238. 2 FEDERAL PROCEDURE, LAWYERS EDITION § 2:79.

any public statement needed to accurately describe city finances,[239] made mayors, and elected officials in other locales aware of their potential liability. The Moody's report warned credit ratings agencies that their extraterritorial behavior would soon come within the SEC's jurisdictional ambit.[240] Because the SEC can easily issue a report at the end of an investigation, financial entities are quickly apprised of their regulator's take on novel issues in a rapidly moving marketplace.

Importantly, as a matter of *formal* administrative law, general statements of policy cannot substitute for rulemaking or alter preexisting regulations.[241] However, Section 21(a) Reports can seem to cross the fine line between a clarification of the law, as with a general statement of policy and an expansion of the law, as with the promulgation of a new regulation. For example, the Feuerstein report reclassified legal officers as supervisors[242] and the Netflix report expanded the scope of Regulation FD to social media.[243] A press release accompanying the Netflix report quoted not only the Director of Enforcement, but also the Director of Corporate Finance, who suggested how to apply previous guidance on Regulation FD to social media.[244] The collaboration between the various divisions at the SEC seems to imply that there is a collective approach to the creation of norms that are to be applied prospectively. This use of the reports is problematic because it does not give regulated entities a chance to respond to the new rules. While the majority of reports do not cross the line between clarification of existing rules and legislative action, formalizing them as a kind of general statement of policy—which by definition cannot create new law—would safeguard against excessive deviation from the previously established administrative scheme.

239. Harrisburg Report, *supra* note 108, at 3 ("[P]ublic officials who make public statements concerning the municipal issuer should consider taking steps to reduce the risk of misleading investors.").

240. Moody's Report, *supra* note 66, at 1 ("Recent legislative provisions expressly provide that federal district courts have jurisdiction over Commission enforcement actions alleging antifraud violations when conduct includes significant steps within the United States or has a foreseeable substantial effect within the United States.").

241. Texaco, Inc. v. Fed. Power Comm'n, 412 F.2d 740, 744 (3d Cir. 1969) ("We agree with petitioner that a 'general statement of policy' is one that does not impose any rights and obligations on a [regulated party].").

242. Feuerstein Report, *supra* note 73.

243. Netflix Report, *supra* note 193, at 1.

244. Press Release, U.S. Secs. & Exch. Comm'n, SEC Says Social Media OK for Company Announcements If Investors Are Alerted (Apr. 2, 2013), http://www.sec.gov/News/PressRelease/Detail/PressRelease/1365171513574#.UvUX70JdUv4.

When viewed as a variation on the general statement of policy, a Section 21(a) Report providing an industry-related benefit warns regulated entities about how the SEC plans to apply the securities laws in novel situations or to highlight a change in priorities. Because the reports are fact-specific and often issue in situations where the law is unclear, they may be an unwieldy tool to accomplish this task.[245] However, the timeline of an enforcement action plays an important role in demonstrating why a report is an effective tool to guide regulated entities. As explained previously, the reports issue after the conclusion of an investigation.[246] Other companies wishing to avoid a similar investigation have a strong incentive to understand why the SEC chose not to pursue a formal action. If the SEC were to simply dismiss many of these cases instead of publishing a Section 21(a) Report, many of these regulated entities would be kept in the dark. For example, though the SEC did not have the jurisdictional authority to bring an action against Moody's at the time of its misconduct, the other ratings agencies likely preferred to be put on alert, which the SEC was able to easily accomplish through the publication of a report. A report gives regulated entities a rough guide in a quick and efficient manner to SEC enforcement priorities and legal interpretations.

As guidance, however, it is not obvious why the SEC might not choose a more effective form of interpretive release to communicate its policy, such as a formal guidance document, because the facts of a particular investigation can easily confuse the underlying legal doctrine.[247] That said, using specific factual scenarios to demarcate the law is the bedrock of the common law system and the decision by the Commission to use the reports to explain the future course of action is reasonable. However, to balance the interests of the parties and the public, there must be an industry-related public benefit to justify the publication of a report. It makes sense to use the reports as a general statement of policy, which serves to clarify the priorities at the agency. It makes much less sense to use the reports as a form of rulemaking because the effect of any amplifica-

---

245. *See* Winterbottom v. Wright, 10 Meeson & Welsby 109, 116 (1842) ("Hard cases, it has been frequently observed, are apt to introduce bad law.").

246. David M. Stuart & David A. Wilson, *Disclosure Obligations Under the Federal Securities Laws in Government Investigations*, 64 Bus. Law. 973, 974 (2009).

247. Compass Report, *supra* note 143, at 932 (Karmel, Comm'r, dissenting) ("If the Commission has reason to believe that persons need reminding of this duty, a general interpretative release could have been issued . . . ."); Block & Barton, *supra* note 17, at 272–73 (giving the example of a Section 21(a) Report in which the majority of the facts dealt with the "vicissitudes of breeding fish," rather than the topic at hand, the disclosure requirements for industrial revenue bonds).

tion of the underlying legal doctrine in the text of a Report is unclear. Industry actors will be unsure of the repercussions from a report, which in turn could possibly chill legal behavior.

C. The Chimeric Section 21(a) Reports

The previous two subparts established that a Section 21(a) Report can resemble a consent judgment or a general statement of policy, depending on whether the report is meant to provide an investor- or industry-related public benefit, respectively. This Note established the public rationale duality not only to help understand past reports, but to also provide a guide for future SEC actions. When the SEC decides that a formal enforcement action is unwarranted or unlikely to succeed, but still believes that the public would benefit from the information arising out of its investigation, it should still turn to the reports as a functional method to inform the public.

However, as a preliminary matter, the Commission should decide whether the report is meant to provide information to investors, the industry, or both. If the benefit is industry-related, the SEC should treat the report as a kind of general statement of policy and ensure that it does not cross over into a kind of informal rulemaking. If the benefit is investor-related, the SEC should make sure that there is agreement between all parties and that investors will truly benefit from the publication of a report. By bookending the possible uses of the report with the safeguards from other administrative schemes, the SEC will avoid executive encroachment into what should be exclusively legislative and judicial actions.

There still remains the question about reports that contain both a strong investor- and industry-related public benefit. For example, the Motorola report, *supra* IIE, both provided guidelines for cooperation and warned investors that Motorola had violated Regulation FD. For reports that provide both kinds of benefit, the SEC must ensure that *all* of the safeguards from the analogous administrative legal actions are in place. There must be consent and the investing public must have sufficient facts to benefit from the decision to publish a report. Any legal conclusions must remain within established law in order to ensure that the report serves as a warning that benefits industrial actors, rather than an ambiguous expansion that would confuse and potentially harm them.

Because most reports arise out of a settlement process, anything approaching rule-making rather than a clarification of the existing law is particularly dangerous because it means that the regulated entity and the SEC have agreed on terms that will bind

future financial actors. This fear drove a dissent to the publication of the Grace report, in which former Commissioner Steven Wallman pointed out that with a report there "is no appeal and no court ruling on the law," so the legal interpretations should "be limited to the very specific facts of this very specific case, and go no further."[248] The Commissioner's point is valid and is most applicable to those reports that would expand substantive legal liability in a substitute for legislative action. In the Grace report, this was the expansion of the liability of the directors to include double-checking legal counsel's advice.[249] In contrast, the Seaboard and Motorola reports sought to shape the conduct of regulated entities by explaining how the SEC would reward cooperation. This kind of discussion of prosecutorial discretion is an inherently executive function and does not trigger the same structural issues that the amplification of the definition of a legal term does.

D. *A Proposal for Reform: Bifurcation of the Reports by Public Benefit*

A further safeguard against rule-making by settlement might be an actual bifurcation of the reports: those that are intended to provide an investor-related public benefit and settle a matter could be published under a separate name from those reports published as a warning to industry actors. This would allow for greater precision in the reports themselves as well as their reception by regulated entities and the business press. For example, the Motorola report could have been split into two: one report directed towards investors that warned them of the selective disclosure and another directed towards other publicly traded companies interested in avoiding liability under Regulation FD. While both of these benefits relied on the same facts from the same investigation, each would have a different intended audience. These two separate reports could each explicitly state that their intent is to either provide an industry- or investor-related public benefit, each formulated within its respective administrative law paradigm.

The benefit from publishing separate reports would be enhanced in situations where one benefit predominated over the other. For example, many of the derivative liability reports were predominantly industry-related attempts to guide the behavior of the regulated entities. The investor-related public benefit was often negligible. Because there was only an industry-related benefit, the

248. Grace Report, *supra* note 161, at 1244–47 (Wallman, Comm'r, dissenting).

249. *Id.* at 1242.

SEC would only be able to publish one report, which would take the form of a general statement of policy. Any confusion as to the meaning of the report would be eliminated. Moreover, the drafters of the report would not feel obligated to try to force both kinds of benefit into one report, which can lead to forced rationalizations and further ambiguity. Through the bifurcation of the reports according to their public benefit, the Commission can be sure that the publication of the facts of an investigation abides by the principles of administrative law and provide a clear message to their intended audience.

CONCLUSION

The Securities and Exchange Commission acts in judicial, executive, and legislative capacities to promote the public interest in maintaining a fair and open securities marketplace. Because the Commission can often change roles within a given proceeding,[250] it must take care to remember in which capacity it is making a decision. The publication of a Section 21(a) Report is particularly problematic because it can meet both legislative and enforcement goals. Despite its incongruities with administrative law, the Section 21(a) Report remains a useful tool for the SEC.

The public benefit dichotomy established in the overview of the reports can serve as a guide for the SEC going forward. Each type of public benefit provides a safeguard against the specific problems that can arise from a corresponding administrative action. To the extent that the SEC decides to publish a report to settle a matter, it must ensure it has the consent of the regulated entity, that there is an investor-related public benefit, and it does not do so for expediency's sake. When the SEC publishes a report to serve as a general statement of policy, it must do so to provide a clear and tangible industry-related public benefit without any amplification of the legal doctrine. The best way to both recognize the functional necessities of the report while safeguarding against abuse would be to bifurcate the reports to ensure that each one corresponds to its particular type of public benefit, with a specific nomenclature to designate its role as either an administrative consent judgment or as a general statement of policy.

250. *See* Karmel, *supra* note 8, at 42 ("On rare occasions, the Commission, when acting in its judicial role, will reject theories that it put forth in its prosecutorial role.").