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SEC's Authority to Temporarily Freeze Assets Under Sarbanes-Oxley

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THE FEDERAL securities laws were a legislative response to the stock market crash of 1929 and the ensuing corporate and economic turmoil during the early 1930s. Since that time, significant corporate scandals with media focus and resulting episodes of financial distress have occasioned angry and expectable legislative enhancements to the regulatory architecture of the Depression-era construct.

Most recently, the Enron debacle, other cases of corporate and accounting fraud, and the bursting of the stock-market bubble created extreme public pressure (and for public-spirited legislators a deliciously self-righteous opportunity to show a sensitivity to the need to deter amorality and greed in the corporate setting), resulting in the swift passage of the wide-ranging Sarbanes-Oxley Act of 2002.[1] While the act's announced goals - protecting investors through enhanced reliability and accuracy of corporate disclosures - are worthy, certain of its provisions raise serious questions of fairness and constitutionality.

Section 1103 of the act is but one troubling example. That provision, which broadly empowers the U.S. Securities and Exchange Commission (SEC or commission) to obtain a temporary freeze of assets during the course of an SEC investigation, contains neither discernible limitations as to scope nor requires even a reasonable showing of cause.

Hopefully, this expanded remedy will be used by the SEC for sincere and justifiable motives, but there is a risk that it will be used for strategic reasons alone. Because the temporary freeze provision does not seek in any way to restrain the commission's newly expanded authority, it is certain to have significant ramifications for issuers or individuals who are involved directly or even tangentially in SEC investigations or criminal securities law prosecutions, arguably violating their Due Process rights and likely affecting their ability to mount and finance a defense.

Prior Commission Practice

Before the enactment of Sarbanes-Oxley, the SEC increasingly used asset freezes during its investigations and litigations. In the fall of 2002, SEC Chairman Harvey Pitt even boasted that the commission was using asset freezes to protect investors' funds at an extraordinary rate,[2] and, by the end of its 2002 fiscal year, the commission had obtained 63 such freezes (as compared to 43 in 2001).[3] According to public statements by Mr. Pitt and other SEC commissioners, asset freezes had been pursued by the commission to prevent individuals from profiting from securities fraud and other violations, and to preserve investor funds for recovery.

Significantly, however, the commission was required to make a two-pronged showing before any assets could be frozen or seized. Specifically, under 21(d) and 21C(c)(1) of the Exchange Act of 1934, the commission was required to demonstrate both a legitimate concern that the respondent will dissipate the assets sought to be frozen or transfer them beyond the jurisdiction of the United States and a basis to infer that the respondent engaged in a violation of law.[4] Similarly, prior to the enactment of Sarbanes-Oxley, courts held that the civil asset freezes sought by the commission must be limited to the amounts that ultimately could be collected for a securities law violation.[5] In other words, before Sarbanes-Oxley, the Commission [wa]s not entitled to freeze assets unrelated to its investigation[6] and, because the imposition of an asset freezes constituted remedial relief and not a penalty assessment,[7] the amount of funds frozen could not exceed the SEC's estimated recovery[8]

New Temporary Freeze Authority

Section 21C(c)(3) of the Exchange Act, added by 1103 of Sarbanes-Oxley, expands the commission's already substantial authority to freeze assets by providing that during the course of a lawful investigation into possible securities law violations by an issuer or any of its directors, officers, partners, controlling persons, agents, or employees, the Commission may petition a Federal district court for a temporary order requiring the issuer to escrow ... [extraordinary] payments [to statutorily enumerated parties] in an interest-bearing account for 45 days[9]

Despite its seemingly limited duration (and, therefore, seemingly limited potential for harm), the initial 45-day freeze may be extended for an additional 45 days for good cause and, if a proceeding is initiated by the SEC prior to expiration of the temporary order, the freeze may be extended indefinitely pending resolution of the commission's legal proceeding.

In a recent study required by 308(c) of Sarbanes-Oxley, the commission indicated that it will vigorously utilize this latest weapon[10] Specifically, the commission noted that it will more aggressively seek temporary freeze orders, and that it intends to use Section 1103 of the Sarbanes-Oxley Act as an adjunct to its historical basis for seeking emergency relief to preserve assets that will be used to compensate injured investors. [11]

As support for the commission's new and aggressive posture, the study highlighted the pre-Sarbanes-Oxley enforcement proceeding brought by the SEC against WorldCom. In that action, the commission petitioned the court to issue an order prohibiting WorldCom from making any extraordinary payments, including severance payments, bonus payments or indemnification payments[12] The freeze sought by the commission was not contested by WorldCom or the recipients of any of the so-called extraordinary payments, and the parties ultimately stipulated that, until a corporate monitor was appointed, WorldCom would not (i) make any payments in excess of $100,000 to any present or former affiliate, officer, director or employee or (ii) make payments of any amount to any present or former affiliate, officer director or employee, other than those WorldCom [was] required to make by virtue of a legal obligation that had been established 45 days prior to entry of the order. Even this broad order, however, did not reach as far as the freezes apparently permitted by the terms of Sarbanes-Oxley, passed just weeks later. The order is thus of limited precedential value in interpreting 1103, and does not necessarily indicate that the SEC will curb its own discretion in determining the outer limits of 1103.

Problems and Questions

The potential danger of the Sarbanes-Oxley asset-freeze provision lies in the statute's uneasy vagueness and the fundamental uncertainty regarding how it might be employed. On all issues of critical importance, the statute is either entirely silent or ambiguous. Indeed, the statute utterly fails to provide meaningful standards for its application, or even define its own terms, raising concerns about the statute's potential breadth and highlighting the provision's constitutional infirmities.

For example, despite the statute's provision for notice and opportunity for a hearing, 21C(c)(3) nonetheless fails to provide necessary due process protections before depriving, albeit temporarily, individuals or issuers of expected assets or payments[13] Unlike Exchange Act 21(d) or 21C(c)(1) - the source of the SEC's pre-Sarbanes-Oxley asset freeze authority - 21C(c)(3) does not require the SEC to demonstrate a risk of dissipation of assets, a likelihood of prevailing in any enforcement claims or even a nexus between the requested asset freeze and purported conduct by the affected parties[14]

On its face, the statute only seems to require that it appear to the Commission that an issuer under lawful investigation is likely to make extraordinary payments. But, neither lawful investigation nor extraordinary payments is defined in the Sarbanes-Oxley Act or, for that matter, anywhere else in the securities laws. Without such definitions, the SEC could decide that a mere instance of investigative scrutiny constitutes a lawful investigation, or the commission could require the entry of a formal order of investigation. Likewise, the commission could make a determination that a payment is extraordinary simply due to its size or could decide that a particular type of payment is extraordinary, regardless of its amount. In short, the SEC's power to freeze assets temporarily is virtually unbounded, and any asserted statutory constraint is entirely illusory. In light of the commission's recent pronouncement that it intends to use this new-found authority more aggressively, the absence of meaningful standards in 21C(c)(3) is certain to result in the arbitrary and capricious imposition of temporary freezes by the SEC[15]

This concern regarding the possible arbitrary and far-ranging application of 1103 is not merely an academic one. In the WorldCom enforcement action, the SEC was able to secure a stipulated order that essentially defined extraordinary payments as either payments greater than $100,000, or any payment to a present or former affiliate, officer, director or employee that WorldCom was not required to make by virtue of a legal obligation established before a date 45 days prior to the order. Both the $100,000 threshold and the 45-day limitation are purely arbitrary - there is no guarantee that similar numbers or standards will be used in the future. Indeed, the SEC could employ an entirely different regime, defining extraordinary payments in a manner not discussed by the WorldCom case. Because the statute does not prescribe any guidelines or limits for the exercise of this freeze authority, the commission even appears to be authorized to freeze assets that are completely unrelated to the subject matter of its investigation or that are well in excess of any amounts ultimately recoverable by the SEC at the conclusion of an enforcement action.

In addition to the more abstract concerns about the arbitrary application of this vague statute, the use of 21C(c)(3) portends more concrete problems for potentially affected constituents. First, the statute provides that if the commission charges the issuer under investigation with violating federal securities law, the freeze may remain in effect until the conclusion of enforcement proceedings - a period that may last from a few months to a number of years. Even if an intended beneficiary of a frozen payment is not charged with a violation, the terms of the statute permit freezes to remain in effect as long as the issuer (or another individual affiliated with the issuer) is charged. Thus, a temporary freeze could result in lengthy deprivation of significant assets, without any charges being filed against an intended recipient of the payment. Second, if the commission freezes indemnification or reimbursement payments to officers, directors or employees of companies under investigation (as it sought to do in WorldCom), those individuals' ability to afford independent counsel could be severely limited. This problem will be particularly acute for individuals who are the subject or target of an SEC or criminal investigation or prosecution. Third, because asset freezes arguably could be sought even prior to a formal SEC investigation and could involve assets beyond the scope of such an investigation, there is significant potential for criminal prosecutors to collaborate with the SEC to obtain a previously unavailable and improper prosecutorial advantage over an issuer or an individual.

Nuclear Addition

The SEC's new temporary freeze authority is a potentially nuclear addition to the commission's already-significant arsenal. While constitutional attacks could provide interesting and fruitful challenges to this legislation, such efforts in general will be difficult to mount. Unless and until the constitutional issues are resolved, hopefully there will be common sense fairness and forbearance at the commission and a willingness on the part of the courts to reasonably limit the application of the temporary-freeze authority created by the Sarbanes-Oxley Act.

1. Pub. L. No. 107-204, 107th Cong., 2d Sess., 116 Stat. 745 (2002).

2. See Chairman Harvey L. Pitt, Remarks before the Department of Justice Corporate Fraud Conference, Sept. 26, 2002 (text available at http:// www.sec.gov/litigation/litreleases/lr17494.htm).

3. See SEC Annual Report for Fiscal Year 2002, at 17 (text available at http://sec.gov/pdf/annrep02/ar02full.pdf).

4. See SEC v. Gonzalez de Castilla, 145 FSupp2d 402, 415 (S.D.N.Y. 2001), citing SEC v. Unifund SAL, 910 F2d 1028, 1041 (2d Cir. 1990).

5. Unifund SAL, 910 F2d at 1041.

6. SEC v. Bremont, 954 FSupp 726, 733 (S.D.N.Y. 1997).

7. SEC v. Manor Nursing Centers, Inc., 458 F2d 1082, 1104 (2d Cir. 1972).

8. See SEC v. Robinson, 2002 WL 1552049, at * 9 (S.D.N.Y. July 16, 2002) (the commission is required to prove that a proposed disgorgement amount reasonably approximates the amount of unjust enrichment).

9. 15 USC 78u-3(c)(3)(A)(i).

10. SEC, Report Pursuant to Section 308(c) of the Sarbanes Oxley Act of 2002, at 22 (text available at: http://www.sec.gov/news/studies/sox308creport.pdf).

11. Id. at 23.

12. See SEC v. WorldCom, Inc., Litig. Release No. 17,594, Release No. AE-1586, 77 S.E.C. Docket 3121 (June 28, 2002).

13. Even the opportunity for a hearing may be eliminated if the court determines that notice and hearing prior to entry of the order would be impracticable or contrary to the public interest. 15 USC 78u-3(c)(3)(A)(i).

14. See, e.g., United States v. 303 West 116th Street, 901 F2d 288, 292-93 (2d Cir.1990) (Due process requires the government to demonstrate probable cause that a criminal defendant's property was connected to illegal drug activity prior to allowing a pre-judgment seizure of property).

15. See, e.g., Richmond Medical Center for Women v. Gilmore, 55 FSupp2d 441, 497 (E.D. Va. 1999), aff'd 224 F.3d 337 (4th Cir. 2000) (holding that term substantial portion in statute was unconstitutionally vague because [t]he Act provides no indication as to whether physicians are to equate 'substantial portion' with specific parts, or instead percentages of the size or weight or length of the fetal body'); City of Chicago v. Morales, 527 US 41, 52 (1999) (statute unconstitutionally vague); Grayned v. City of Rockford, 408 US 104, 108 (1972) (same).