

THE ROAD NOT TAKEN: THE ELUSIVE PATH TO CRIMINAL PROSECUTION FOR WHITE-COLLAR OFFENDERS

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In the control of stock fraud, criminal prosecution is the road not taken: only six of every hundred parties investigated by the Securities and Exchange Commission ultimately stand in judgment before a criminal court. This paper examines the role of criminal prosecution in controlling securities violations. It traces the SEC enforcement process in which most stock swindlers are diverted from criminal prosecution and treated civilly or administratively or spared legal action entirely. It finds that the criminal process attracts the most significant offenses, but also those about which little else can be done. In this light, the paper reconsiders the controversial finding that upper status white-collar offenders fare no better and often worse than their lower status counterparts at criminal sentencing. It finds a double standard, but one with some surprising implications.

I. INTRODUCTION

The metaphors of the funnel and leaky sieve are popular in criminological discourse. They capture the perception that few suspected criminals are ultimately incarcerated, while the majority are diverted from the criminal justice system by discretionary decisions of victims, police officers, prosecutors, juries, and judges.¹

Researchers have ventured approximations of the dimensions and contours of this criminal processing funnel for various types of crimes and jurisdictions. When the

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¹ To the extent that funneling exists, it raises potentially serious problems of sample selection bias in quantitative studies of criminal sentencing (Klepper *et al.*, 1983).

underreporting of crimes and failure to clear by arrest are taken into account, it appears that less than 1 percent of all common crimes committed end with incarceration. Victimization surveys report that anywhere from a third (auto theft) to three-quarters (larceny) of common crimes are excluded from the criminal justice process because of victim non-reporting (U.S. Department of Justice, Bureau of Justice Statistics, 1983: 309). The FBI Uniform Crime Reports suggest that anywhere from one-quarter (murder) to 85 percent (burglary, auto theft) of the remaining crimes drop out because police agencies are unable to clear them (U.S. Department of Justice, Federal Bureau of Investigation, 1983: 161). The funnel continues to narrow after arrest. One study of local prosecutors' offices found that, of 100 typical felony arrests, 20 are rejected at initial screening; 30 are dismissed by the prosecutor or court; 1 leads to acquittal; and only 29 result in incarceration in jail or prison (Boland *et al.*, 1983: 1). Other studies suggest that this estimate is rather high, finding ratios of incarceration to arrest of one in ten, at best (Clark, 1970: 102; Forst *et al.*, 1977; Boland *et al.*, 1983: 2).

These figures are, of course, gross estimates that vary with the type of crime. Whatever their methodological weaknesses, however, they are far better than the information we have had about the funneling process as it applies to "white-collar" or "corporate" crimes. Here we lack not only baseline victimization data, but also information about the enforcement process. As Jack Katz observed in his study of federal prosecutors (1979), the control of common crimes, as compared to white-collar ones, is characterized by greater separation of the investigative (police) and prosecutorial functions, more visible decision-making, and greater procedural formality. As a result of these differences, Katz argues, the official record overrepresents the decisions not to prosecute common crimes and underrepresents those not to prosecute white-collar ones. For many of the white-collar offenses that Katz studied, the widest part of the funnel, representing the first observable stage in the formal enforcement process, would begin with indictment—a point at which roughly 95 percent of all common crimes have already dropped out of the criminal justice system. Reconstructing the processual map of white-collar enforcement is therefore much more elusive.

In addition to these "technical" problems that cast a fuzzy shadow over the white-collar enforcement process, there are other reasons to expect that the processual funnel for white-

collar crimes will be quite different from what it is for various common crimes (Nagel and Hagan, 1982: 1440-42). Given the subtlety and complexity of white-collar offenses, the possibility of masking illicit activities in everyday routines or hiding them in the privacy of corporate suites or complicated inter-organizational networks, the opportunities to manipulate the time over which events unfold, the frequently consensual nature of the illicit behaviors, and the often diffused quality of victimization, one might expect the dark figure of undetected violations greatly to overshadow that of most serious common crimes.

Once white-collar offenses have been discovered, other factors that might differentiate the white-collar law enforcement process from that for common crimes come into play. These include: (1) the enhanced ability to identify and locate suspects connected with organizations; (2) the rich evidence that is often available where violations are ongoing for considerable periods of time and leave in their wake a lengthy paper trail and a complement of potentially talkative conspirators and less culpable facilitators; (3) the considerable resources the white-collar accused can often bring to bear to impede investigation, to challenge subpoenas, and, if necessary, to litigate formal charges; (4) civil and administrative modes of processing white-collar offenders that may be treated as alternatives to the criminal justice system; and (5) the reluctance of many judges to incarcerate "respectable" first offenders convicted of white-collar crimes.

Because of problems of access to data and the informality and low visibility of the processing of white-collar offenses, most empirical studies rely on highly selected samples of official records or materials in the public domain. They are based on enforcement actions initiated and completed (Clinard and Yeager, 1980), the decisions of courts and administrative commissions (Sutherland, 1949), the sanctions imposed by regulatory agencies (Thomforde, 1975; Ewick, 1984), presentence investigations of convicted offenders or court data on sentences actually imposed (Wheeler *et al.*, 1982; Nagel and Hagan, 1982)—reflecting the last or second-from-last stage in the social control process.

The results of this research typically report little or no support for the expected relationships (Clinard and Yeager, 1980: 110-32; Nagel and Hagan, 1982) or, on occasion, significant relationships away from the hypothesized direction (Wheeler *et al.*, 1982; Ewick, 1984). However, these results are all

vulnerable to sample selection bias in that unmeasured variables that prevent offenders from escaping the enforcement process may also explain the results observed (Nagel and Hagan, 1982: 1441, 1454; Wheeler *et al.*, 1982: 657). For example, at least two studies made the anomalous discovery that possessing a white collar does not help these convicted offenders stay out of prison or even reduce the length of their incarceration (Wheeler *et al.*, 1982; Nagel and Hagan, 1982), and it appears from one that both the likelihood and length of incarceration may *rise* with the occupational status of the white-collar defendant (Wheeler *et al.*, 1982).² But this finding might be explained if upper status offenders who are good candidates for lenient treatment never reach the sentencing stage, while lower status criminals who do not merit stringent punishment do. This possibility may be evaluated if we can enter the world of white-collar enforcement, model the process, measure the funneling effect, and account for the selection of cases from one stage to the next.³ It is this I attempt to do.

The focus of this paper is on the United States Securities and Exchange Commission (SEC), the major protector of the capital markets in this country, with responsibility for the regulation of publicly owned corporations, the securities markets, and the professionals who service them. The agency may draw on both criminal and civil as well as administrative enforcement mechanisms. While criminal dispositions are often appropriate, they are rarely pursued to the sentencing stage. Out of every 100 suspects investigated by the SEC, 93 have committed securities violations that carry criminal penalties. Legal action is taken against 46 of them, but only 11 are selected for criminal treatment. Six of these are indicted; 5 will be convicted and 3 sentenced to prison. Thus, for Securities and Exchange Commission enforcement, criminal prosecution most often represents the road not taken. Of those found to have engaged in securities fraud, 88 percent never have to contend with the criminal justice system at all. The problem, therefore, is not to account for attrition within the

² A study of administrative sanctions imposed by the Securities and Exchange Commission against registered broker-dealers found a similar pattern: "Net of all other effects, traders receive less severe sanctions than their higher-status counterparts within the organization: they are prohibited from doing business for shorter periods of time and they are less likely to be barred from the industry" (Ewick, 1984: 12).

³ Relatively technical—in the words of a National Academy of Sciences report, "formidable"—econometric techniques and experiments have been developed to cope with the potential of sample selection bias as well. See Klepper *et al.* (1983: 75-79).

criminal justice process, but rather to explain why enforcers so rarely opt for criminal dispositions and to assess what factors enter into this selection process.

The theme of offense seriousness, so central to explanations of variability in sentencing both white-collar and common criminals (Wheeler *et al.*, 1982; Blumstein *et al.*, 1983: 11), plays a powerful role in accounting for attrition in the SEC investigative caseload—affecting decisions both to close the inquiry without taking any legal action and to target the offender for criminal prosecution. But the impact is mediated by the other legal options available to SEC enforcers. When civil or administrative prosecutorial options are available, fewer stock swindlers escape SEC investigation without some legal proceeding, but a larger proportion are diverted from criminal processing. When non-criminal prosecutorial options do not exist, larger proportions of offenders are both subject to criminal treatment and spared legal action entirely. These findings are reminiscent of a jury simulation study by Vidmar (1972), which found that the presence of intermediate verdict options in a homicide case diminished both acquittal rates and convictions for first degree murder.

The themes of offense seriousness and prosecutorial options interact in SEC enforcement. The selection effects created by the availability of civil and administrative options are different for significant and trivial violations. This article will tease out these relationships and then inquire about the effect on sentencing disparity if both the opportunities to commit serious violations and the availability of non-criminal legal options vary by the status of the offender.

The Research

This article is based on observation of the enforcement activities of the SEC at its headquarters and at one of its regional offices during 1976 and 1977 as well as on an examination of a random sample of 499 investigations (of the activities of 2,101 suspects) initiated between 1948 and 1972.⁴ The sample contains one of every eight investigations that ended in a referral for criminal prosecution and one of every sixteen non-criminal cases opened during this period. Because criminal prosecution is so rare, it was necessary to double the sampling fraction for these investigations in order to obtain sufficient numbers of cases for meaningful analysis (non-

⁴ See Shapiro (1980; 1984) for a fuller discussion of the research design.

criminal cases are weighted double in subsequent analyses to correspond to population parameters).⁵ Still, the number of cases is sufficiently small to preclude many enlightening multivariate analysis techniques.

When they suspect that a securities violation has been committed or is underway, SEC officials, after a brief preliminary inquiry, usually open a formal investigation and assign a docket number by which all subsequently gathered investigative materials are filed.⁶ These non-public enforcement files are the repository of several hundred pages (and often considerably more) of information which forms the paper trail of an SEC investigation. The files gather the forms that open and close the investigation, quarterly progress reports, memoranda, correspondence, records of telephone conversations, evidence, transcripts of testimony, work papers, investor questionnaires, recommendations to the Commission for investigative subpoenas or other legal action, criminal reference reports, civil complaints, indictments, reports of administrative proceedings, pre-sentence investigations, and press releases. From the vast official documentation, as well as informal notes, memoranda, and rough drafts of documents included in enforcement files, it is possible to discover unstated selection criteria and thereby reconstruct the SEC enforcement process.

From each file, quantitative and qualitative data were systematically coded concerning the nature, execution, and magnitude of the offense, characteristics of offenders and victims, the way in which the violations were detected, the nature of the investigative process, the case disposition, and the reasons that agency enforcers give for the action taken. The

⁵ Readers familiar with my book, *Wayward Capitalists: Target of the Securities and Exchange Commission*, will note a disparity between the size of the sample reported there and that analyzed here. The difference comes from the methodology required by the special focus of this article—the role of criminal prosecution in SEC enforcement. For this article, I doubled the criminal sample (adding 55 cases, 385 suspects) and excluded all investigations of offenses that, as a practical matter, do not carry criminal penalties (usually technical violations like failure to maintain proper books and records or to file timely SEC reports—82 cases, 218 suspects).

⁶ The sample was drawn from the list of all SEC headquarters and regional office docketed investigations. Unfortunately, there is no documentation on the number or nature of suspicions that are never docketed—useful data for an analysis of sample selection processes. Investigations are always docketed before the SEC staff requests that the Commission grant subpoena power or consider taking legal action (and usually considerably earlier). That docketing is not merely a delayed response to the demands of investigating or prosecuting serious and complicated offenses is shown in the proportions of docketed cases for which subpoena power or legal action is never requested (67% and 55%, respectively).

data allow a sociological account of what actually happened, both at the SEC and in the social world of the alleged securities swindlers.

II. THE SEC ENFORCEMENT PROCESS

Offenses investigated by the SEC that carry criminal penalties most often involve the misrepresentation of information about a corporation's financial condition, business operations, future prospects, risks, use of investment funds, and the like, or the failure of stockbrokers, investment advisers, investment companies, or firms issuing securities to register with the agency. Less frequently, stock frauds involve the misappropriation of investment funds or the assets of publicly held corporations, self-dealing (including insider trading), stock manipulation, and ponzi and other deceptive investment schemes.⁷ The majority of securities offenders investigated are drawn from organizations that either issue or broker securities. They represent small fledgling firms, often promising incredible investment opportunities, more frequently than they do large Wall Street or Fortune 500 companies, whose misdeeds are far more subtle and sophisticated. The median offense is committed by three individuals and/or organizations and victimizes 26 to 50 investors at a cost of \$100,000.

SEC enforcers most often learn of possible securities violations from the complaints or inquiries of investors or other social control agencies (especially state securities commissions and self-regulatory agencies like the stock exchanges, National Association of Securities Dealers, and Better Business Bureaus). They only rarely discover offenses from the confessions of offenders or the disclosures of non-complicit securities professionals (stockbrokers, lawyers, accountants, journalists, etc.). Most of the enforcers' own discoveries come from inspections or scrutiny of the filings of actual or would-be

⁷ *Self-dealing* is the exploitation of insider positions for personal benefit—for example, directing corporate business to firms in which the insider has a financial interest, using legitimate discretion to favor the insider's private interests, exploiting organizational resources to create new opportunities from which the insider can benefit, or using corporate information for personal advantage. *Insider trading* refers to the personal investment decisions made by insiders in publicly held corporations on the basis of non-public information to which they have access. *Stock manipulation* includes a variety of activities in which the price or trading market of a stock is artificially manipulated to induce others to buy or sell these securities. A *ponzi scheme* is like a pyramid scheme, in which no real profits are realized, but early investors are paid dividends from the contributions of subsequent investors. See Shapiro (1984) for examples of these and other types of securities violations.

registrants. Relatively few potential cases develop from agency surveillance of the securities markets or from ongoing investigations.⁸

The Division of Enforcement in SEC headquarters and nine regional offices together initiate an average of 313 investigations each year. For more than a year, teams of lawyer and accountant investigators interview suspects, their business associates, clients, investors, and victims. They inspect corporate books, records, and minutes, examine SEC records and filings, and consult with other social control agencies. Much less frequently, investigators scrutinize bank, tax, telephone, or credit card records, stock market trading data and newspapers, or consult with journalists, engineers, and other specialists. To facilitate their investigations, the Commission often grants a Formal Order of Investigation, which creates subpoena-like powers to produce documents and compel testimony.

Most investigations conclude with the determination that a violation of SEC statutes or regulations was committed by one or more of the suspects scrutinized. In about one-tenth of the investigations, suspicions of illegality, as in the following examples, prove unfounded:

In one case, the SEC market surveillance branch observed the bid price for stock in a sulfur mining company rise from 5 7/8 to 9 1/2 over a one-month period. Suspecting insider trading or stock manipulation, agency enforcers opened an investigation, subsequently determining that legitimate market forces—the high demand for sulfur—not illegality, contributed to the rise.

A second investigation was opened after the agency received more than twenty inquiries from investors solicited by a Canadian mining company as well as a report from two financial journalists that they had been offered a substantial bribe from a Toronto stockbroker to write favorably about (in SEC parlance, to “tout”) these securities. Investigators subsequently discovered that an investment advisory publication was

⁸ Although it is impossible to estimate the magnitude of undetected securities fraud (which is undoubtedly considerable), one can speculate about the sample bias implicit in the offenses selected for official attention as a result of detection procedures. Different SEC detection strategies catch different kinds of violations. Examining this relationship between types of detection and attributes of the offenses they discover, on the one hand, and factors related to rates of use and output of various detection strategies (agency priorities and resources, disclosure incentives, etc.), on the other hand, makes it possible to speculate about biases in the pool of detected offenses. See Shapiro (1984) for details.

already touting the stock and feared that bribes had been paid to someone in the advisory firm. On the basis of testimony from the suspects and their business colleagues, examination of the publication, books and records, phone and bank records, mail and telegrams, as well as consultations with Canadian regulatory officials, no evidence could be found that investment advisory officials had accepted any compensation, knew the bribing broker, or had any dealings with his firm. Investigators also concluded that, although some information in the publication was a bit exaggerated, nothing was fraudulent.

Given the subtlety and complexity of many securities violations, the fact that so many investigations follow the disclosures of relatively unseasoned investors, and the use of creative inferential models (like market surveillance) to identify potential offenders, an error rate of one in ten is surprisingly low.

When, at the conclusion of an investigation, enforcers find formal legal action appropriate, they prepare a detailed memorandum (stating the facts of the case, the nature of the evidence, and the recommended form of action) for the SEC commissioners, who make all prosecutorial decisions. The commissioners have four options: They may institute administrative proceedings before SEC administrative law judges, initiate civil proceedings in the federal district courts, refer the case to the U.S. Department of Justice or to a U.S. Attorney directly for criminal prosecution, or choose not to take any legal action.

Administrative proceedings are generally available for persons or organizations with some kind of ongoing relationship to the SEC. These include registrants (stockbrokers, investment advisers, or investment companies), their employees, and professionals who practice before the agency (generally, lawyers and accountants). Administrative proceedings occasionally involve lengthy public or private hearings in which considerable evidence is presented. Usually, however (61 percent of the cases in the sample), charges are settled by consent or default. Ninety-two percent of the defendants are ultimately found in violation.

In my study, 86 percent of those found in violation by administrative law judges were sanctioned. Most often, they received the most severe sanction available. Six percent of the defendants were censured, and 31 percent received some form of suspension. The latter sanctions include suspension of SEC registration, orders to halt business operations for a period of

time (usually up to 10 days), temporary bars from working for a regulated firm (usually for 20 to 30 days), and, in the case of members of a stock exchange or the National Association of Securities Dealers (NASD), suspension from membership (usually for 20 to 30 days).⁹ For a larger number of defendants, restrictions on employment or business operations were permanent: 30 percent of the defendants were expelled from membership in a stock exchange or the NASD or barred from any future employment with a regulated firm; 36 percent were barred from any future practice before the Securities and Exchange Commission or had their SEC registration revoked—actions that virtually preclude any interstate participation in licit securities markets. Fifteen percent of the defendants consented to ancillary remedies as well, usually cancelling or withdrawing their SEC registration; altering business practices, internal corporate procedures, or personnel assignment; or staying out of the securities business entirely.

Civil actions, conducted by SEC staff in the federal district courts, typically take the form of injunctive proceedings that seek to abort illicit activities and enjoin offenders from future violations of the securities laws. There are no restrictions on the parties subject to civil action. They may be individuals or organizations, securities issuers, professionals, or ordinary citizens. For most injunctive actions (87 percent of those in my sample), civil defendants do not contest the charges against them. In these so-called “consent injunctions,” offenders neither admit nor deny any wrongdoing, but agree that they will not violate the securities laws in the future. Whether by consent or litigation, 92 percent of all civil defendants are ultimately enjoined. Failure to abide by an injunctive decree can result in criminal contempt proceedings.¹⁰

⁹ Membership in these self-regulatory organizations is far from symbolic. They confer important economic and competitive benefits on their members.

¹⁰ Criminal contempt proceedings are rarely used, however. From rather incomplete SEC annual reports, spanning the agency’s 50-year history, it appears that there is less than one contempt conviction for every 100 injunctions. About 2% of the suspects in my sample who had been previously enjoined were named in contempt proceedings. Indeed, they were only slightly more likely to be prosecuted than other (often first-time) offenders (53% vs. 49%) and barely more vulnerable to criminal prosecution (16% vs. 12%). These estimates are only meaningful when compared with data on the extent to which civil defendants fail to abide by injunctive decrees, data impossible to gather, given SEC docketing and detection practices. An unreliable but conservative estimate (the number of suspects in the sample previously enjoined, according to relatively incomplete investigative records, multiplied by the sampling fraction, divided by the total number of parties enjoined during the period studied) would put the figure at 13%.

Injunctions carry no other sanctions, although they may bar defendants from the securities industry or disqualify them from SEC registration. However, parties named in SEC injunctions can be ordered by the court to take ancillary action. This occurred in 17 percent of the civil proceedings in my sample.¹¹ In 6 percent of the injunctive actions, ancillary remedies required additional investigation and disclosure—for example, amended or supplemental SEC filings or the commission of special outside audits of the business operations that led to the misdeeds. Two percent of the injunctive decrees ordered that the assets of the company or individuals enjoined be frozen. In 7 percent of the proceedings, defendants were required to make restitution to victims, rescind illicit transactions, or disgorge their profits. In 1 percent of the cases, orders placed restrictions on future business practices or barred certain individuals from employment in the securities world. More than a quarter of the ancillary remedies (5 percent of the injunctions) were even more radical: they required that a company's management be reorganized, that a receiver be appointed to replace incumbent management, or that the offending firm be liquidated.

As in civil proceedings, there are no restrictions on the kind of parties subject to criminal prosecution. Criminal actions are instituted in the federal district courts by the Justice Department. Cases referred by the SEC are assigned to local U.S. Attorneys, who have the discretion to accept or decline the case for criminal prosecution and full responsibility for its conduct and outcome. The SEC reputedly has one of the lowest declination rates of all federal agencies (Rabin, 1972). Among SEC criminal references in my sample, federal prosecutors declined prosecution for 26 percent of the offenders (16 percent of the cases referred).¹² And they subsequently dropped charges against another 18 percent, often because of ill-health, death, or other pending charges.

¹¹ The imposition of remedies ancillary to civil injunctions has become increasingly popular in recent years (U.S. Securities and Exchange Commission, 1976: 108; Levine and Herlihy, 1977; Treadway, 1975; Farrand, 1976). The percentage of ancillary remedies in the current SEC civil caseload is undoubtedly higher than the 17% rate found with these older cases.

¹² Included among the reasons prosecutors offered for declination were evidentiary issues; the fact that witnesses were uncooperative, not credible, or self-serving; that offenders derived no benefit from their conduct; that proving intent was difficult; that the offense taken was small or injury minor; that conduct was marginal or ambiguous, questionable, but not improper; that the offender was a subordinate who played only a marginal role in the offense; that federal jurisdiction was inappropriate; or that other legal proceedings were sufficient.

Therefore, only a little more than half of the suspects designated by SEC commissioners for criminal treatment were actually prosecuted. Almost half of these defendants pleaded innocent, and 19 percent were acquitted. Rates of contested litigation are therefore higher in criminal than in civil or administrative proceedings and, from the SEC's standpoint, less successful: only 46 percent of the parties referred by the SEC for criminal prosecution were convicted, compared to 92 percent of those found in violation by civil or administrative tribunals.

Criminal sanctions for the violation of the securities laws include (for each count) imprisonment for up to five years, fines of up to \$10,000 (\$500,000 for stock exchanges), and probation. Among cases in my sample, prison sentences were most common—imposed on half of all convicted defendants (55 percent of convicted persons); 36 percent were sentenced to probation, 37 percent were fined, and 7 percent were given a suspended sentence with no additional penalties.¹³ Prison sentences ranged from less than three months (6 percent) to more than three years (28 percent); the median sentence was about two years in length. Fines ranged from \$1 to \$36,000, with a median of \$2,700 (in contrast, the median take of securities violations subject to criminal prosecution was roughly \$300,000). Judges sometimes ordered defendants to make restitution or barred them from the securities business or from holding a position in a publicly owned corporation.

III. ACCOUNTING FOR PROSECUTORIAL RESPONSE

Table 1 presents the distribution of legal actions taken in the sample of SEC investigations. The table excludes those investigations that failed to find any violations as well as those uncovering offenses that do not carry criminal penalties (together, about one-quarter of the cases).¹⁴ Since I seek to account for the sample selection process within the SEC, “criminal action” in this table and others that follow denotes cases referred by agency commissioners to the Justice Department for criminal prosecution, not the actual

¹³ The sum of these percentages exceeds 100 because some defendants received more than one sanction.

¹⁴ As noted earlier, because of over-sampling to insure a sufficient number of criminal cases for analysis, numbers of non-criminal investigations and their related suspects are weighted to represent true population parameters.

indictments or convictions that follow subsequent selection processes.

Table 1. Types of Legal Proceedings*

	<u>Offense</u>	
	(N)	%
No Legal Action	(402)	51%
Civil Only	(140)	18%
Administrative Only	(96)	12%
Criminal Only	(69)	9%
Civil and Administrative	(36)	5%
Civil and Criminal	(25)	3%
Administrative and Criminal	(9)	1%
Civil, Administrative, and Criminal	(10)	1%
TOTAL CASES	(787)	100%
Any Civil	(211)	27%
Any Administrative	(151)	19%
Any Criminal	(113)	14%
	<u>Suspect</u>	
	(N)	%
No Legal Action	(1617)	49%
Civil Only	(699)	21%
Administrative Only	(438)	13%
Criminal Only	(301)	9%
Civil and Administrative	(113)	4%
Civil and Criminal	(66)	2%
Administrative and Criminal	(20)	1%
Civil, Administrative, and Criminal	(19)	1%
TOTAL CASES	(3273)	100%
Any Civil	(897)	27%
Any Administrative	(590)	18%
Any Criminal	(406)	12%

*Percentages are computed down the columns.

The top portion of Table 1 presents the actions taken in each *offense*; the bottom portion presents data for each *suspect*. For about half of all suspects found in violation by SEC investigators, no legal action was taken. Among the legal actions initiated, civil proceedings were most common, including 27 percent of the suspects, and referrals for criminal prosecution least common, involving 12 percent of the suspects. Administrative proceedings, an intermediate prosecutorial response, occurred in about a fifth of the cases. But, since administrative action is only appropriate for offenders with some ongoing relationship to the SEC, the percentage reported in Table 1 is misleadingly small. Considering only those

potentially subject to administrative action—stockbrokers, investment advisers, investment companies, and attorneys and accountants who practice before the Commission—administrative proceedings are the most common prosecutorial alternative exercised, imposed on 43 percent of the vulnerable suspects.¹⁵ The offense data are similarly distributed. One conclusion from Table 1 requires no special interpretation: criminal prosecution is the road not taken by the SEC. Enforcers are four times more likely to take no legal action than to make a criminal reference, more than three times as likely to institute administrative proceedings, and more than twice as likely to take civil action.¹⁶

Table 1 also demonstrates that staff decisions to refrain from instituting formal proceedings represent by far the leakiest part of the criminal process sieve. Memoranda included in SEC investigative records report the rationale for closing investigations without legal action. These reasons are collected in Table 2. Because enforcers usually provide more than one explanation for prosecutorial leniency, the sum of the percentages reported exceeds 100. Most often, enforcement officials chose not to prosecute because they lacked legal jurisdiction (10 percent of the cases, most of which were referred to the relevant agency), because legal action was being pursued by other government agencies or private investors (41 percent of the cases), or because informal agreements like undertaking corrective behavior or making restitution had been secured (14 percent). Enforcers also declined prosecution frequently (40 percent of the cases) because of timing or equity considerations—the offense was very stale, the illicit activities had ceased, and the like. Characteristics of the offenders or

¹⁵ Some trends are visible in the distribution of SEC dispositions over the 25 years covered by the research. The prosecution rate consistently increased from 32% of all investigations initiated between 1948 and 1952 to 57% of those initiated between 1968 and 1972. The rate of civil action increased consistently, from 11% in 1948-52 to 34% in 1968-72. Rates of criminal prosecution increased by about 1% every five years, but then dropped off considerably (from 17% to 9%) between the periods 1963-67 and 1968-72. Rates of administrative proceedings fluctuated sporadically over this period. Some modest longitudinal trends in characteristics of the offenses investigated are apparent as well—though the distribution of substantive violations is remarkably stable. The 25 years have witnessed a gradual increase in the scope and prominence of the targets of SEC enforcement and the impact of their misdeeds, as well as a shift in the kinds of industries most likely to be investigated (with fewer mining and agricultural firms and more manufacturing and service companies). The concluding section of this article considers the generalizability of these historical data.

¹⁶ Indeed, when the number of SEC criminal references actually pursued by federal prosecutors is taken into account, the odds of non-criminal dispositions are even higher (by a multiple of almost 2).

victims (26 percent of the cases), problems of evidence (23 percent), and the limited impact or seriousness of the violations (23 percent) also served to justify decisions to close investigations without official action.

Table 2. SEC Justifications for No Legal Action

Other Legal Action	41%
Informal Settlements	14%
No Jurisdiction	10%
Temporal Issues	40%
Offender Characteristics	21%
Victim Characteristics	5%
Evidence	23%
Seriousness	23%
Insufficient Resources to Pursue	11%
Offense Not Willful	10%
Offender Did Not Benefit	3%
Technical, Novel Issues	6%
No Jury, U.S. Attorney Appeal	3%
Justification Not Stated	4%
TOTAL CASES	(201)

Of course, rationalizations do not always bear any objective relationship to the facts of the case. One offense, cited as too stale, for example, may in truth be of more recent vintage than the average violation ultimately prosecuted. In fact, only some of the enforcers' justifications are supported by the data on offense and offender characteristics and the likelihood of formal legal action.

A. *Seriousness*

The seriousness rationale, though less popular than many others in the SEC enforcers' vocabulary of motives, receives the most empirical support. It accounts for decisions both to take any legal action against securities violators and to refer offenders for criminal prosecution. For most of the indicators of the complexity, seriousness, scope, or impact of securities violations, the likelihood that some legal action will be taken and that criminal prosecution will be recommended increases significantly with greater offense seriousness. Although cases prosecuted civilly or administratively tend to be more serious than those spared legal action entirely, this aspect of securities violations does not help explain the choice of civil or

administrative proceedings. Among the cases ultimately pursued, the suspects committing the most significant offenses are systematically directed to criminal prosecution.

Table 3 presents the relationship of the type of violation committed to case disposition. In this table and the others that follow, the sum of percentages across the rows exceeds 100 because 10 percent of the cases received some combination of civil, administrative, or criminal prosecution. As offenses become increasingly serious, subtle, complicated, and clearly intentional, the likelihood that some legal action will be taken and that a criminal reference will be made increases substantially. Non-registration and misrepresentation alone are relatively trivial offenses, which may involve inadvertent acts or mere “puffing” or exaggeration rather than contrived lies; 29 percent of the former and 42 percent of the latter offenses were formally pursued, while only 1 percent and 6 percent, respectively, received criminal treatment. Defenses regarding inadvertence or the triviality of misdeeds become less credible when an offender couples non-registration with misrepresentation and, especially, misappropriation. Vulnerability to legal action and to criminal prosecution therefore increases. Vulnerability is also substantial for crimes of self-dealing and stock manipulation—usually subtle, well-concealed, intentional acts. These violations were pursued 48 percent and 54 percent of the time, respectively, and referred for criminal prosecution 19 percent and 25 percent of the time. Stealing assets through misappropriating funds is also regarded as serious. Of those who commit this crime, 59 percent are subject to legal action and 23 percent are referred for criminal prosecution. These rates, like the relatively high rates for self-dealing, may reflect the fact that those who commit these crimes benefit directly and often substantially from their misdeeds.

The complexity of securities violations accounts for case disposition even more than their substantive content, subtlety, motivation, or benefits. Offenders who commit a single kind of violation are prosecuted 26 percent of the time and risk a 1 percent chance of criminal prosecution. As offenses incorporate greater numbers of additional violations, components, and cover-up strategies, prosecution percentages increase in a linear fashion: cases with 11 or more separate violations received legal treatment 78 percent of the time and were referred for criminal prosecution 29 percent of the time.

Table 3. Type of Offense and Legal Consequences*

Type Violation	Legal Action				Total Cases
	None	Criminal	Civil	Administrative	
Non-registration alone	71%	1%	23%	9%	(107)
Misrepresentation alone	58%	6%	16%	25%	(79)
Misrepresentation with Non-registration	56%	9%	31%	12%	(187)
Misappropriation alone	40%	17%	23%	35%	(99)
Non-registration, Misrepresentation, and Misappropriation	41%	27%	29%	19%	(121)
Self-dealing	52%	19%	23%	12%	(84)
Stock Manipulation	46%	25%	35%	20%	(91)
TOTAL	(402)	(112)	(205)	(139)	(768)

*Percentages are computed across the rows.

Other attributes of offenses indirectly betray the intent of their perpetrators and thereby the seriousness of their acts. The development of cover-up strategies suggests clear intent to engage in wrongdoing and generally signals more serious offenses than those committed through inadvertence or naiveté. Cases which contain clear evidence that offenders have covered up their activities by doctoring books and records, creating phony documents and equipment, or channeling illicit activities through nominees or foreign banks are more vulnerable to legal action, particularly criminal prosecution. Of the offenses for which blatant cover-up techniques could not be found, 44 percent were pursued, compared to 71 percent of those that did employ these methods. One-tenth of the former group and one-third of the latter were referred for criminal prosecution.

The duration of illegal activities also relates to the potential seriousness as well as the intentionality of the violation. As an offense continues for longer periods of time, an argument for inadvertence becomes increasingly less tenable. Although the likelihood of criminal prosecution does increase as offenses continue (9 percent of the misdeeds that spanned less than nine months ended in a referral for criminal prosecution, compared to 18 percent of those continuing for more than two years), the relationship of offense duration to the likelihood of legal action is weak, but negative (more on this later).

A different indicator of the scope or magnitude of securities violations—the number of co-offenders—is a better predictor of the likelihood of legal action. Table 4 shows that stock swindles enacted by large numbers of co-offenders are

especially vulnerable to formal proceedings. Of those committed by only a single perpetrator, 20 percent give rise to legal action, as compared to 74 percent of those committed by six or more offenders. On the criminal side, offenses with six or more perpetrators are considerably more likely (26 percent) to end in a referral for criminal prosecution than those with fewer co-offenders (11 percent). For fewer than six participants, however, the number of offenders is unrelated to the likelihood of criminal prosecution.

Table 4. Number of Offenders and Legal Consequences*

Number of Offenders	Legal Action				Total Cases
	None	Criminal	Civil	Administrative	
One	80%	14%	3%	7%	(88)
Two	58%	8%	24%	15%	(229)
Three to five	52%	13%	26%	20%	(300)
Six or more	26%	26%	44%	30%	(170)
TOTAL	(402)	(113)	(211)	(151)	(787)

*Percentages are computed across the rows.

Indicators of the impact of the securities violation show a similar relationship. As Table 5 reveals, offenders who take in relatively small amounts of illicit profits are less vulnerable to legal action than those who profit more. One-quarter of those who net less than \$5,000 are pursued, a percentage that increases steadily to 71 percent for those who reap more than one million dollars.¹⁷ The cost of victimization has a significant impact on criminal prosecution as well. None of those offenders accumulating \$5,000 or less were referred for criminal prosecution, while 39 percent of those garnering more than a million dollars experienced this outcome.

Because the cost of victimization generally rises with the extent of victimization, the number of victims touched by stock swindlers is also related to the likelihood that legal action will be taken and criminal prosecution selected. Table 6 reveals that the likelihood of legal action increases steadily from 38 percent to 71 percent and of criminal reference from 1 percent to 31 percent, where the number of victims grows from fewer than 5 to more than 500. This relationship is, however, muted somewhat when the cost of victimization is controlled.

¹⁷ Although the strength of this relationship is truly impressive, one must not forget that almost 3 of every 10 stock swindlers whose illicit dealings involve more than a million dollars escape without even having to defend themselves against legal charges, let alone experiencing formal sanctions.

Table 5. Offense Cost and Legal Consequences*

Cost of Offense	Legal Action				Total Cases
	None	Criminal	Civil	Administrative	
Less than \$5,000	75%	0%	12%	12%	(32)
\$5,001 to \$25,000	64%	9%	25%	14%	(88)
\$25,001 to \$100,000	48%	13%	32%	18%	(159)
\$100,001 to \$1,000,000	42%	21%	32%	19%	(208)
More than \$1,000,000	29%	39%	36%	20%	(69)
TOTAL	(264)	(100)	(169)	(98)	(556)

*Percentages are computed across the rows.

As offenses increase in scale, duration, seriousness, impact, and degree of contrived intent, they more frequently lead to some kind of legal action, and the likelihood of criminal

Table 6. Number of Victims and Legal Consequences*

Number of Victims	Legal Action				Total Cases
	None	Criminal	Civil	Administrative	
Fewer than 5	62%	1%	15%	28%	(123)
6 to 25	59%	16%	19%	15%	(136)
26 to 100	50%	13%	34%	12%	(131)
101 to 500	44%	29%	29%	11%	(73)
More than 500	29%	31%	31%	23%	(35)
TOTAL	(264)	(72)	(121)	(87)	(498)

*Percentages are computed across the rows.

prosecution increases concomitantly. In most cases, each of these discrete relationships between indicators of offense seriousness and the likelihood of any legal action and of criminal prosecution remains or becomes sharper when the others are controlled. Their individual effects can be aggregated in an overall seriousness measure which sums the number of discrete significant attributes found in a given offense.¹⁸ Cases with relatively high scores on this measure usually represent complex violations amassing considerable profit and touching large numbers of victims.

Table 7 presents the relationship of this summated seriousness scale to case disposition. When measured this way, offense seriousness has only a modest relation to civil and

¹⁸ This scale sums 7 attributes of securities violations: (1) misappropriation, self-dealing, and/or stock manipulation involved; (2) 11 or more separate violations committed; (3) cover-up strategies used; (4) offense lasted more than 2 years; (5) 6 or more offenders involved; (6) more than \$1,000,000 involved; and (7) more than 500 people victimized.

administrative action, but it substantially explains the likelihood that legal action will be initiated or a criminal reference made. With increasing seriousness, the rate of legal action grows from 33 percent to 83 percent and the likelihood of criminal prosecution from 4 percent to 65 percent. What is particularly striking is the sharp increase in prosecution that comes with the addition of the fifth indicator of seriousness. The number of such offenses is, however, small and the result may be unstable.

Table 7. Overall Seriousness and Legal Consequences*

Seriousness	Legal Action				Total Cases
	None	Criminal	Civil	Administrative	
No Items	67%	4%	21%	13%	(218)
One Item	55%	8%	25%	17%	(236)
Two Items	52%	16%	27%	19%	(145)
Three Items	26%	28%	41%	33%	(92)
Four Items	30%	29%	27%	29%	(73)
Five or more	17%	65%	43%	22%	(23)
TOTAL	(402)	(113)	(211)	(151)	(787)

*Percentages are computed across the rows.

B. Beyond Seriousness

Seriousness, as we have seen, plays a substantial role in selecting the subsample of securities violations prosecuted criminally. Undoubtedly, seriousness also influences the decision to formally open an investigation in the first place. It figures in the allocation of investigative resources and thereby in the likelihood of amassing evidence adequate to criminal standards of proof. It accounts significantly for the decision to take no legal action and the diversion of prosecuted cases away from criminal treatment. Lack of perceived seriousness is also an important reason why U.S. Attorneys decline criminal cases referred to them. Moreover, other studies indicate that seriousness plays a significant role in the likelihood of incarceration for convicted white-collar criminals (Nagel and Hagan, 1982: 1452, 1463; Wheeler *et al.*, 1982: 647-50). Thus, it appears that this criterion is successively reapplied over a narrowing pool of securities violators, sifting out all but those who have committed the most substantial illicit acts of great scope, complexity, impact, and harm. This conclusion is not completely accurate. Additional complexity is introduced when we consider the unique features in the social organization of

stock fraud as well as the role of other prosecutorial options available in securities enforcement.

The seriousness hypothesis suggests a vast smorgasbord of securities frauds, fully unfolded and documented, from which SEC enforcers pick and choose, selecting the weightiest for criminal prosecution and those of somewhat lesser seriousness for less stringent legal attention. In fact, more than eight of every ten offenses are still ongoing when detected by the agency. Enforcers do not passively sift the serious offenses from the trivial, sorting them into prosecutorial categories. Instead, they are responsible for the making or unmaking of significant securities frauds in the speed with which they discover offenses and the way in which they respond to detected violations. The punitive character of the SEC criminal reference, though a fully appropriate response to serious securities frauds, is overshadowed by the capacity of other legal options to abort incipient violations, contain or reverse the damage, or minimize the likelihood of recurrence. From this perspective, criminal prosecution is associated with regulatory failure. It is a response to offenses that are discovered too late to prevent substantial harm. Less significant ongoing offenses begin to loom larger—as appropriate targets for legal attention with a remedial rather than a punitive agenda.

By reexamining some of the relationships already considered and turning from the nature of the violations to the social context in which they are committed, one begins to see that criminal prosecution is often invoked as a residual response when other options cannot be pursued. Moreover, one finds an unexpected pattern. Selected attributes of securities offenses or offenders that are associated with the failure to take any legal action are simultaneously associated with the decision to pursue criminal prosecution when legal actions are taken. This contradictory relationship is seemingly inconsistent with the seriousness hypothesis.

Consider, for example, the role of temporal issues in prosecutorial choice. As noted earlier, SEC enforcers cite problems of timing or equity—the fact that violations have ceased or are very stale—in 40 percent of the cases they choose not to prosecute. This rationale receives empirical support from the data, presented in Table 8. Offenses that have ended are less likely to be prosecuted (31 percent) than those still ongoing when detected (51 percent), just as offenses continuing for more than two years are less likely to result in some legal action (46 percent) than those lasting less than nine months (53

percent). Yet, as we have seen, the shorter violations are typically less serious. Because longer offenses are allowed to continue uninterrupted for greater periods of time, they have more opportunity to grow, collect new conspirators, victimize larger numbers of investors, accumulate greater profit, and result in additional misdeeds or ancillary ones to cover up the violations already underway. Whereas a quarter of the offenses lasting less than nine months score at least "2" on the summated seriousness scale (dropping the duration component), this is true of 40 percent of those of more than two years' duration.

Table 8. Offense Timing and Legal Consequences*

	Legal Action				Total Cases
	None	Criminal	Civil	Administrative	
Continuing	49%	14%	31%	19%	(535)
Completed	69%	13%	7%	15%	(122)
TOTAL	(346)	(89)	(174)	(120)	(657)
DURATION					
Less than 9 Months	47%	9%	37%	22%	(207)
9 Months to 2 Years	49%	13%	25%	23%	(262)
More than 2 Years	54%	18%	23%	15%	(257)
TOTAL	(364)	(100)	(201)	(146)	(726)

*Percentages are computed across the rows.

The fresher violations, still ongoing when discovered by SEC enforcers, can be aborted by civil injunctions, illicit proceeds can be disgorged, funds returned, new procedures instituted, and perpetrators dismissed. The fact that they are often not yet serious is not especially relevant to the decision to take legal action; their potential for significant consequences is. As offenses persist for longer periods of time or perhaps even end, the remedial potency of the injunction begins to fade. Among offenses of less than nine months' duration, 37 percent are treated civilly; the proportion drops to 23 percent for those of more than two years' duration. Even more dramatically, almost a third of the ongoing offenses are proceeded against civilly, compared to 7 percent of those completed. The relationship, though weaker, holds for administrative proceedings as well.

Where the disabilities of time eliminate the remedial opportunities afforded by legal—particularly civil—action, enforcers are more likely to close their investigations without prosecuting the violations they have discovered. Older, stale

offenses are commonly spared legal action because little can be done to contain the damage—it has largely been accomplished. But if the seriousness of the misdeeds requires some legal response, criminal reference is often the only option available. Of completed violations subject to legal action, 42 percent receive criminal treatment, compared to 27 percent of those still ongoing; 39 percent of the prosecuted offenses of more than two years' duration end in criminal referral, compared to 17 percent of those ongoing for less than nine months.¹⁹ These relationships persist with relatively equal strength when offense completion or duration is controlled.

This propensity to take legal—but not criminal—action against less serious violations is mirrored in the disposition of offenses committed by SEC registrants. Table 9 presents the distribution of prosecutorial actions for registered stockbrokers (who comprise 86 percent of all offenders in the sample with special ties to the SEC) and other suspects. The table reveals that broker-dealers registered with the SEC are being held to a much higher standard: 68 percent of them are pursued legally, compared to 42 percent of the others.²⁰ Yet the possibility that stockbrokers are pursued more frequently than other offenders because of the greater seriousness or significance of their misdeeds is readily dismissed by the data. Their considerably greater vulnerability to legal action over other kinds of securities offenders remains when offense seriousness is controlled.

Indeed, the broker's greater vulnerability to legal action is associated with the commission of relatively insignificant offenses that employ improper and unsavory—but less than fraudulent—practices: technical violations (like delinquent

¹⁹ In this light, the correlation between criminal prosecution and offense seriousness takes on a possibly spurious cast. Perhaps criminal references name more serious offenders because they attract regulatory failures—about which little else can be done—that were not caught and aborted quickly enough and therefore lasted long enough to become serious. However, the relationship between offense seriousness and criminal prosecution remains after offense duration is controlled. Of the least serious offenses, completed in less than 15 months and subject to legal action, 10% ended in criminal prosecution, compared to 32% of the most serious offenses. This was true of 16% of the least serious offenses ongoing for more than 15 months and 47% of the most serious ones. But, though not spurious, this correlation is at least partly explained by the relationships between offense duration, the corresponding loss of legal options, and criminal prosecution.

²⁰ Ironically, failure to register with the SEC is the least prosecuted of all violations. While about half of all other offenses are spared legal action, this is true of 71% of the non-registration cases. This lenient treatment accorded those who fail to register, coupled with the high standard of responsibility (and associated legal risks) to which registrants are held, might persuade errant stockbrokers to rethink their decision to seek SEC registration.

Table 9. Legal Proceedings Against Broker-Dealers*

	Brokers			Others		
	Less Serious	More Serious	Total	Less Serious	More Serious	Total
No Legal Action	41%	27%	32%	66%	52%	58%
Civil Only	7%	12%	10%	26%	27%	27%
Administrative Only	36%	33%	34%	3%	4%	3%
Criminal Only	4%	11%	9%	4%	13%	9%
Civil and Administrative	10%	10%	10%	0%	0%	0%
Civil and Criminal	1%	2%	2%	1%	3%	2%
Administrative and Criminal	1%	2%	2%	0%	0%	0%
Civil, Administrative, and Criminal	0%	2%	2%	0%	0%	0%
TOTAL CASES	(323)	(746)	(1069)	(981)	(1223)	(2204)
Any Civil	18%	27%	24%	26%	31%	29%
Any Administrative	46%	47%	47%	3%	4%	4%
Any Criminal	6%	18%	14%	5%	17%	12%

*Percentages are computed down the columns.

filings, bookkeeping violations, inadequate firm capitalization, improper extension of credit), boiler-room tactics (high pressure solicitations), improper sales techniques (like failure to consider the suitability of a stock for the client, sell and switch tactics, improper employee supervision), and the violation of previous restrictions on business practices.

Stockbrokers who commit only these misdeeds, without accompanying fraud or misappropriation, have been excluded from the analysis because these lesser offenses typically do not carry criminal penalties. The data show, however, that when registered brokers add these unsavory practices to their otherwise criminally liable actions, their misdeeds receive legal notice. Three-quarters of the brokers in this sample who commit these "technical violations" are prosecuted, compared to 39 percent of those who do not (a proportion even lower than that of non-brokers). The greater vulnerability of "technical violators" to legal action reflects a high rate of administrative action: 60 percent of these brokers, compared to 29 percent of those who have not committed technical violations, are named in administrative proceedings. When brokers add technically illicit business practices to relatively trivial offenses for which non-brokers are rarely prosecuted, the likelihood of nonprosecution gives way to a high probability of administrative proceedings alone. When these misdeeds

facilitate more serious violations, SEC enforcers add administrative proceedings to the civil and/or criminal actions they institute.

Table 9 shows that, although brokers are quite a bit more likely than non-brokers to be pursued legally, their rate of civil or criminal prosecution is roughly the same or slightly lower than that of the other offenders. Administrative proceedings punish offenses that would otherwise not be pursued or supplement the civil or criminal sanctions imposed on otherwise prosecutorially meritorious offenses committed by registered brokers. An examination of the distribution of legal outcomes by type of offense or offender suggests that, in some circumstances, the imposition of administrative dispositions spares registrants from civil or criminal action. But often the administrative proceeding is ancillary, an added burden that registrants alone must bear.

The reader might ask why SEC enforcers mobilize their administrative apparatus to respond to violations so insignificant that they would be ignored were they not committed by agency registrants. One answer builds on the distinction between the preventive or remedial and the punitive purposes of legal action. It echoes the enforcers' rationale for favoring short, recent, less serious misdeeds for prosecutorial attention. As civil proceedings act to nip incipient offenses in the bud, control the damage, and reduce the likelihood of future violations, administrative proceedings seek to minimize the opportunities for more serious offenses. The technical violations to which they respond may facilitate more serious securities fraud, cover up more significant offenses, or increase the likelihood that the extent of victimization will be great. By holding stockbroker business practices to a high standard and responding swiftly when it is not met, the SEC through administrative proceedings seeks to minimize the pool of truly serious violations that might otherwise develop.

A third aspect of the social context of securities violations—the organizational embeddedness of illegal activity—also illustrates the role of non-criminal legal options in dispositional choices. Like short ongoing offenses, organizations provide a setting in which something can be done; like offending registrants, they provide ready targets for legal intervention. Organizations can be ordered to cease or temporarily suspend illegal activities, to repay ill-gotten funds, to restructure their supervision or leadership, and to impose new business practices. Ironically, just as organizations are

strategic weapons in the commission of white-collar crime, facilitating illicit acts and increasing their take (Wheeler and Rothman, 1982), organizational offenders also facilitate and provide greater social control options. As with incipient violations and registered violators, effective alternatives to criminal prosecution tend to be available and are frequently taken. Offenses without organizational involvement therefore have relatively low rates of legal action overall, but high rates of criminal prosecution.

Individuals who engage in securities violations for their own benefit, without conspiring with an organization or inculcating the organizations that employ them, are less likely to be prosecuted (39 percent) than those offending with organizations (54 percent). But they are considerably more vulnerable to criminal prosecution: 35 percent of their offenses are subject to criminal referral, in contrast to 14 percent of those enacted by both individuals and organizations (indeed, 89 percent of the proceedings initiated against these unaffiliated individuals are criminal prosecutions, compared to 27 percent of the actions brought against others). Offenses committed by both individuals and organizations are much more likely than the offenses of individuals acting alone to be disposed of either civilly (31 percent versus 13 percent) or administratively (22 percent versus 0 percent). These legal options account for both the greater vulnerability to legal action and the lesser vulnerability to criminal prosecution of these offenders.²¹

Another dimension of organizational “embeddedness” is provided by individual perpetrators’ ties to the organizations with which they co-offend. With greater organizational position, individuals benefit from the legal options available to organizational offenders with which they are closely associated. Executives are more vulnerable to civil proceedings (32 percent

²¹ In a related finding, lone offenders, while especially unlikely to meet with legal action (only 20% were prosecuted, compared with 74% of the offenses committed by 6 or more), are extremely vulnerable to criminal prosecution. If some legal action is taken, they are dealt with criminally 67% of the time (compared to 20% for two perpetrators, 26% for 3 to 5, and still only 35% for 6 or more). Because solo perpetrators are so marginal—often individuals acting on their own behalf, perhaps under the cover of an illusory professional status or fly-by-night company—they offer an elusive target for civil or administrative proceedings. As Table 4 revealed earlier, only 3% of these offenders met with civil actions and 7% with administrative ones, compared to 44% and 30%, respectively, of the offenses committed by 6 or more perpetrators. The dispositional options available for these marginal perpetrators typically include only criminal prosecution or no legal action at all; both are therefore chosen more frequently than either is in cases where other options are available.

versus 23 percent) than others, but less likely (14 percent versus 25 percent) to be named in criminal referrals.

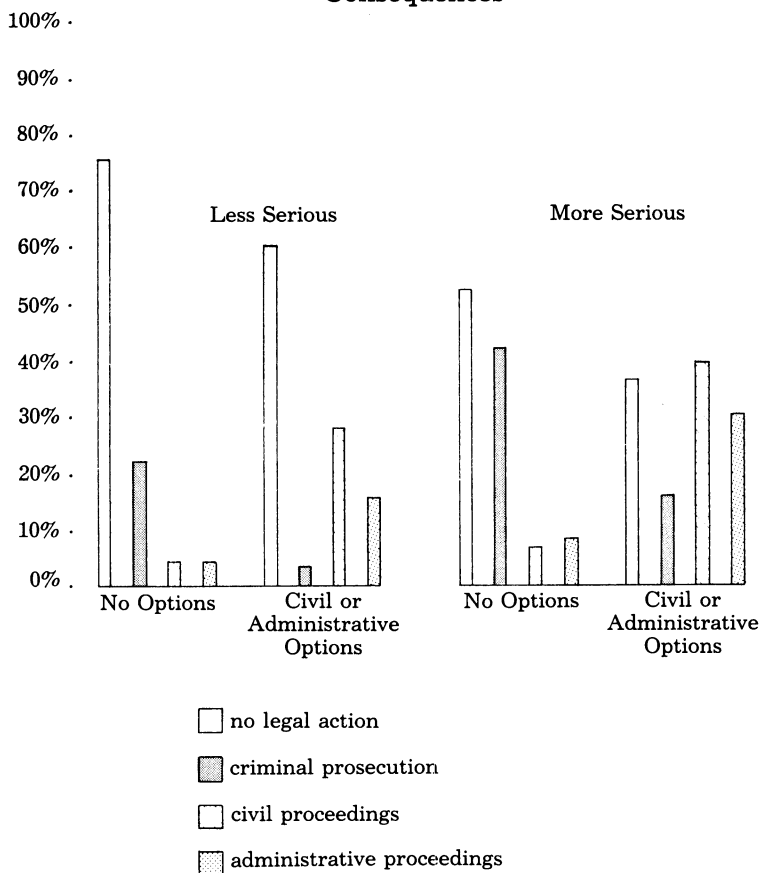
C. The Role of Prosecutorial Options

The diversity of available prosecutorial options clearly affects dispositional choice. Where the social context of a securities violation makes civil or administrative actions appropriate—offenses are committed by registrants; are embedded in viable organizations, with the participation of organizational leaders; are ongoing when detected, and underway a relatively short time, etc.—SEC enforcers usually prefer these options to the more extreme alternatives of legal inaction or criminal reference. Where these non-criminal options exist, enforcers take legal action in 51 percent of all cases, as compared to 37 percent of the offenses where these options are unavailable. And enforcers opt for criminal reference in 7 percent of the former cases, compared to 31 percent of the latter.

The hypothesis of prosecutorial options and dispositional choice complements that of offense seriousness. Figure 1 illustrates their relationship. As offenses increase in significance, all types of prosecution—civil, administrative, and criminal—are more likely to be imposed and, therefore, the rate of prosecution increases overall (the white bars shrink). But even among offenses of relatively equal seriousness, the presence of civil or administrative prosecutorial options has a powerful negative effect on the likelihood that enforcers will select either of the two extreme dispositions—no legal action and criminal prosecution (the black and white bars are both shorter with options). Paradoxically, among both more and less serious offenses, the kinds of cases most vulnerable to criminal prosecution are also most likely to escape legal action entirely. Because criminal prosecution fills a residual role of responding to violations about which little else can be done, offenders are better protected from criminal prosecution by committing serious misdeeds that are easy targets for civil or administrative dispositions (black bar on far right) than more trivial ones that are not (somewhat higher black bar on far left).

Several factors account for the disinclination of SEC enforcers to opt for criminal prosecution, even in the face of serious violations, when other alternatives are available. First, the rules of criminal procedure are more rigorous and the standards of evidence necessary to support guilty verdicts are higher than they are for civil or administrative proceedings.

Figure 1. Offense Seriousness, Legal Options, and Legal Consequences*



*More serious cases scored "2" or more on the seriousness scale; less serious cases scored less than "2."

This means that agency staff must expend a greater proportion of their scarce investigative resources to develop criminal cases than to develop others. The commitment of resources to amassing credible evidence is exacerbated by the fact that contested litigation rates are much higher for criminal prosecutions than for civil or administrative ones and, therefore, the thoroughness of investigation must be even greater. But because of these rigorous standards of criminal evidence, offenses that are well-concealed, with incriminating documents that are hard to find and witnesses who are strangely silent, will often be spared criminal treatment when they apparently deserve it. Indeed, problems of evidence represent one of the most common justifications found in the SEC investigative records for choosing civil or administrative

over criminal prosecution (still it was used in only about 7 percent of these cases).

Second, SEC enforcers are authorized to institute their own civil and administrative actions (in the latter case, before their own judges), but must turn over criminal cases to U.S. Attorneys for prosecution. Although SEC lawyers may assist federal prosecutors in grand jury presentations, indictment drafting, and litigation, agency enforcers lose control over the process and outcome of these cases. In interviews with officials in both the SEC and U.S. Attorney's offices, I found general dissatisfaction with the competence of the other to properly craft a criminal investigation and prosecution. SEC staff complain especially about the reluctance of many prosecutors (especially those outside major white-collar jurisdictions) to take less "sexy" or more subtle or complicated cases and about their lack of experience in litigating these matters. Enforcers are reluctant to relinquish control, especially in the face of their own largely effective legal initiatives.

With a high success rate on its own dispositions (92 percent of civil and administrative actions and comparatively low declination rates on its criminal references), the SEC doesn't appear to take many prosecutorial risks. Given that their criminal references will first be scrutinized by Justice Department lawyers and often subject to vigorous challenge by those criminally charged (many more defendants resist criminal charges to the point of litigation than they do civil or administrative actions), SEC enforcers send only their best cases along the criminal route. The SEC declination rate is low, compared to other federal agencies, because the agency refers relatively few cases for criminal prosecution, something about which some federal prosecutors complain.

Finally, as noted earlier, the remedial properties of criminal action are hardly compelling. Criminal prosecutions are less quickly resolved than other ways of proceeding; they seldom repair the damage done; and it is often difficult to fine tune their sanctions to forestall future harm when substantial penalties would be excessive. Fines are usually regarded as the only criminal sanction appropriate for convicted corporations, and they are often set at about 1 percent of the take of an illicit scheme, hardly a substantial deterrent in the eyes of the SEC. Although sentencing judges have the option to set other conditions on both individual and corporate defendants—from restitution to exclusion from the securities industry—they rarely do so. Since SEC lawyers do not prosecute these

criminal cases, they are poorly positioned to prod judges to impose sentences more consistent with their enforcement priorities. Civil and administrative dispositions therefore offer the SEC's enforcers more timely intervention, flexibility to fashion remedial responses, lower standards of proof, less litigation, higher rates of success, and more control over the outcomes of their enforcement caseload. It is no wonder they use the criminal option selectively.

IV. A RECONSIDERATION OF THE EFFECT OF SOCIAL CLASS

The dual function of criminal prosecution as a fitting response to serious violations, on the one hand, and as a residual response to offenses that present no other legal options, on the other, helps account for the pattern by which securities violations are selected for criminal law enforcement. It also provides an important insight into the puzzling association between social class or status and sentencing for white-collar crimes.

The studies of white-collar sentencing, cited earlier, chose educational attainment (Nagel and Hagan, 1982) and occupational status (Wheeler *et al.*, 1982) as indicators of social standing. For this analysis, I selected yet another indicator, which comes closer to the theoretical issue under consideration and best models the distribution of position and status in the securities world. I group defendants into members of the upper tiers of organizational hierarchies—officers, directors, sole proprietors, partners, control persons—and members of its lower tiers—managers, consultants, employees, salespersons, promoters, and the like. Because upper status offenders figure much more prominently in SEC investigations (65 percent of them) than lower status ones, I made no further status distinctions among members of this latter and somewhat more heterogeneous group.

Table 10 shows the legal proceedings experienced by upper and lower status corporate offenders, controlling for collaboration with members of the other stratum and for offense seriousness. Rows "A" and "D" at the bottom of the table restate the relationship of organizational position to the trade-off between civil and criminal prosecution, noted earlier. Variation in the likelihood of any legal action and of civil or administrative proceedings is actually greater within status groups than between them. By joining those with significant organizational positions in illicit behavior, lower status

Table 10. Corporate Position, Offense Seriousness, and Legal Consequences*

	Legal Action				Total Cases
	None	Civil	Administrative	Criminal	
<u>Least Serious:</u>					
A. LOWER STATUS	88%	6%	3%	3%	(67)
B. Within status	94%	4%	0%	2%	(51)
C. Conspiring with Upper status	69%	12%	12%	6%	(16)
D. UPPER STATUS	57%	30%	14%	4%	(188)
E. Within status	56%	33%	11%	4%	(140)
F. Conspiring with Lower status	62%	21%	21%	4%	(48)
<u>Most Serious:</u>					
A. LOWER STATUS	25%	25%	28%	32%	(378)
B. Within status	40%	17%	0%	57%	(30)
C. Conspiring with Upper status	24%	26%	31%	30%	(348)
D. UPPER STATUS	36%	32%	20%	21%	(568)
E. Within status	53%	25%	9%	21%	(205)
F. Conspiring with Lower status	27%	36%	26%	21%	(363)
<u>All Cases:</u>					
A. LOWER STATUS	40%	23%	20%	25%	(690)
B. Within status	69%	12%	3%	21%	(152)
C. Conspiring with Upper status	31%	26%	25%	26%	(538)
D. UPPER STATUS	45%	32%	17%	14%	(1263)
E. Within status	53%	29%	12%	13%	(618)
F. Conspiring with Lower status	37%	35%	22%	16%	(645)

*Percentages are computed across the rows. Least serious offenses scored "0" on the seriousness scale; most serious offenses scored "3" or more.

offenders shift from being the least pursued (31 percent) to the most pursued (69 percent) of all offenders.

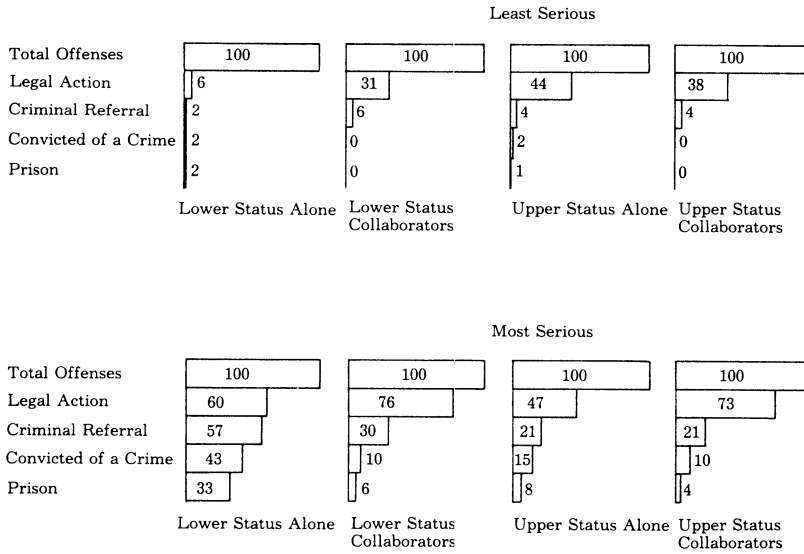
These patterns are partially explained by offense seriousness. Violations fueled by the collaboration of perpetrators across the corporate status hierarchy usually wreak the most significant impact: 60 percent of these violations have seriousness scores of "3" or more, compared to 33 percent of those committed solely by upper status offenders and 20 percent of those by lower status offenders.²² As a result,

²² This pattern holds for discrete indicators of seriousness or impact as well. For example, 11% of the offenses committed solely by lower status perpetrators victimized more than 100 investors, compared to 21% of those enacted solely by organizational leaders and 35% by members of both strata. These percentages for offenses netting more than \$100,000 are 26, 53, and 56,

members of both classes who cross status barriers in their violations receive more severe legal treatment—more civil, administrative, and criminal prosecution—than those who do not.

But the role of prosecutorial options interacts with offense seriousness. Figure 2 depicts what happens to the violations

Figure 2. Offender Status and the Criminal Justice Process*



*Least serious offenses scored "0" on the seriousness scale; most serious offenses scored "3" or more.

committed by the four constellations of offenders as they move through the enforcement process. The top portions of the figure and of Table 10 show that SEC enforcers rarely respond criminally (4 percent overall) to the least significant offenses, regardless of who committed them. Given the dearth of readily available civil or administrative options for lower status offenders who do not collaborate with the corporate upperclass, enforcers opt to overlook their insignificant violations (only 6 percent receive legal treatment). This is not true of their upper status counterparts, 44 percent of whom are pursued for their trivial misdeeds through administrative (14 percent) and especially civil (30 percent) proceedings. Because of their

respectively. The number of different violations committed follows a similar pattern: 15% of the misdeeds of lower status offenders include more than 8 discrete violations, compared with 25% of those of upper status positions and 47% of those involving offenders of both strata.

association with corporate leaders (and the legal options deriving from this organizational embeddedness), collaborating lower status offenders face harsher treatment—more legal actions overall (31 percent versus 6 percent), and especially more frequent civil (12 percent versus 4 percent) and administrative dispositions (12 percent versus 0 percent)—than their less well-connected colleagues. The least serious misdeeds of the unconnected lower status offenders are therefore filtered out of the criminal justice system without legal action; those of their upper status counterparts meet with civil or administrative proceedings at roughly an equal rate.

For all statuses and combinations of offenders, the likelihood of prosecution overall and of all kinds of legal action generally rises with offense seriousness. From even the most cursory examination of the bottom portion of Figure 2, it is apparent that the shape of the processual funnel for lower status offenders who misbehave without upper status collaboration (far left) is significantly different from that of the others. Patterns by which violators in the other three groups are selected for criminal punishment are quite similar, except that more upper status offenders without collaborators drop out without facing any legal action, while collaborating upper and lower status perpetrators are filtered out with civil or administrative proceedings.

What is remarkable about the fate of the lower status offenders without upper status collaborators is how little filtering occurs after the decision to prosecute is made: 94 percent of those prosecuted are subject to criminal referral; 76 percent of those referred are eventually convicted; and 77 percent of the convicted defendants are incarcerated. These percentages for the other three groups together are 36, 46, and 50, respectively. The availability of non-criminal legal options helps explain the disparity between the 94 percent and 36 percent figures, though not the disparities in rates of conviction and incarceration.

With few available non-criminal options, the insignificant misdeeds of unconnected lower status offenders are prosecutorially ignored; their serious violations disproportionately conclude in criminal prosecution. For upper status offenders and their co-offenders, ready access to civil and administrative proceedings means that even their trivial misdeeds will not be spared. But these prosecutorial options divert a good number of serious violations away from criminal processing as well. With flexible legal options available for the

misdeeds of the well-integrated and powerful, the SEC's enforcers can exercise considerable discretion in selecting potential criminals. With few options for dealing with lower status offenders when doing nothing about a violation is unsatisfactory, there is little choice but to begin criminal proceedings.

Hypotheses concerning class bias therefore explain little about the exercise of prosecutorial discretion at the SEC. Upper status offenders are less vulnerable to criminal prosecution, but at the price of having to defend themselves (or more precisely to acquiesce) frequently in civil and administrative proceedings. And, although lower status offenders who collaborate with their bosses are somewhat more vulnerable to criminal prosecution (despite what is probably lesser responsibility for the misdeeds), they are treated more like the latter than like lower status perpetrators acting alone. The data indicate that any apparent discrimination against lower status offenders is more readily explained by recourse to legal options than by social standing.

In this light reconsider the relationship of social status to incarceration. Table 11 shows that, for the few securities offenders who are ultimately sentenced for their crimes, status seems unrelated to the outcome. With the exception of a larger percentage of lower status criminals receiving suspended sentences, virtually the same proportions of upper and lower status offenders receive every other form of penalty, including incarceration. Prison sentences imposed on organizational leaders are slightly longer, though. Again, assumptions of class bias appear unfounded.

Table 11. Corporate Position and Criminal Sentences*

	Probation	Fine	Suspended Sentence	Prison			Total Cases
				Less than 9 Months	9 Months- 2 Years	More than 2 Years	
Lower Status	36%	35%	39%	12%	20%	23%	(83)
Upper Status	38%	35%	25%	9%	20%	26%	(103)

*Percentages are computed across the rows. Since more than one sentence can be imposed, the sum of the percentages exceeds 100.

But these aggregate data mask some important variation. Untangling them exposes a rather different story. Figure 2 reveals, for example, that, among the most serious offenses, convicted lower status offenders, regardless of whether they co-

offend and with whom, are more likely (62 percent) to be incarcerated than organizational leaders (47 percent). Among the convicted collaborators in serious offenses, lower status participants are more vulnerable to incarceration (57 percent) than their upper status counterparts (42 percent). Among convicted perpetrators without different status collaborators, 53 percent of the upper status and 77 percent of the lower status are incarcerated. With offense seriousness controlled, then, both the status of the perpetrator and the social context of the violation account for variability in rates of incarceration. Those offender constellations characterized by the availability of non-criminal legal options seem better able to avoid incarceration upon conviction as well.

Mindful of the possibly confounding effect of sample selection bias, consider the implications of the filtering process on the selection of those who ultimately await sentencing. As might be expected, where attrition is most extensive and the options for diverting offenders out of the criminal process greatest, the pool of violations that end in conviction is more serious. Of the offenses for which upper status collaborators are convicted, 73 percent have a score of "3" or more on the seriousness scale, compared to 48 percent of the offenses committed solely by lower status offenders. Despite these differences, 46 percent of the former and 74 percent of the latter receive prison sentences.

There are obvious problems with this analysis. The limited size of the sample required that theoretically important categories—of offender status as well as offense seriousness—be collapsed. As a result, the measure of seriousness is relatively crude. And many of the offenses that fall in the most serious category are not all that significant by conventional standards anyway. Furthermore, the measure misses more subtle, but theoretically important distinctions—for example, differences in the degree of responsibility or culpability of organization leaders and employees who contribute to the same serious violation. And sample size dictated a simple dichotomy of organizational position, despite enormous variability in the status of members of both groups. Even so, the number of cases in some of the offender constellations is uncomfortably small.

Nonetheless, these findings convey a clear message, explained at least in part by the process by which the SEC selects offenders for criminal prosecution. The sample of upper status offenders who are ultimately convicted of securities

crimes has been more filtered than that of the lower status offenders, especially where the latter have not collaborated with organizational leaders. At the same time, more violations by upper status offenders, particularly less significant ones, receive civil or administrative sanctions. Only the most trivial offenses of the less integrated lower status violator are spared criminal prosecution, but when they are, administrative and civil proceedings are usually avoided as well. However, when the offenses committed solely by lower status offenders are at all serious, there are few prosecutorial alternatives, and lower status offenders disproportionately end up in the criminal courts. Despite the greater seriousness of their misdeeds, the cohort of convicted upper status offenders is no more vulnerable to incarceration, a finding that should surprise no one. We have found the light at the end of the funnel.

V. CONCLUSION

While I have considerable confidence in the results of this analysis, readers should recognize that it falls short of the ideal in several ways. First, there are other factors I don't discuss that are related to the disposition of SEC investigations. For example, offenders with a prior record of stock fraud or other white-collar crime are more vulnerable to legal action (50 percent versus 45 percent), especially criminal prosecution (16 percent versus 6 percent) than first offenders. Consideration of these ancillary relationships was omitted here in order to simplify a complicated argument while still identifying the most important variability in prosecutorial response. Moreover, despite the enormous richness of these data, something important gets lost in the quantitative presentation of very complex events, particularly a more dynamic sense for the enormous variability *within* each offense and SEC investigation as they unfold over months or perhaps years.

Second, the modest sample of criminal prosecutions presented many problems. Important distinctions were not always made or meaningful controls considered. This is a problem that will unfortunately face other white-collar enforcement studies. My sample selected one of every eight criminal cases over a twenty-five-year period, equivalent to the population of all criminal cases generated by the SEC over three years. Because white-collar enforcement populations are small and because criminal prosecution is the road not taken for many offenders, problems of sample size and the analytic difficulties they create are endemic.

Third, these data are historical, representing events that occurred as much as forty years ago. I don't think this problem is serious, however. Other scholars have been concerned about the temporal biases of their research as well. Both the Wheeler *et al.* (1982) and Nagel/Hagan (1982) articles on social class and white-collar sentencing speculated that their unexpected findings might be explained by the fact that they studied the post-Watergate era, an atypical period of presumably greater toughness against white-collar offenders. The SEC data, which cover the twenty-five years immediately prior to Watergate, show essentially the same sentencing patterns. When one looks across decades of SEC enforcement—with fluctuations in the economy; the stock market; public, Presidential, and Congressional attitudes toward regulation; and the vigor of the agency itself—the remarkable stability of patterns of enforcement and violation is striking.

Finally, these data represent a single case study of a rather idiosyncratic law enforcement agency. The SEC is relatively small, as federal agencies go, and its enforcement program modest. The Internal Revenue Service, for example, conducts roughly thirty times more investigations annually (U.S. Department of the Treasury, 1979: 175). Furthermore, the SEC's ability to bring both administrative and civil actions on its own is not widely shared by other state or federal agencies.

The SEC data are nonetheless instructive. Over much of its history, the agency has had an outstanding reputation among federal law enforcement organizations for a vigorous, aggressive, and innovative commitment to enforcement (Cary, 1964: 661; Ratner, 1978: 2-3; Miller, 1979; Subcommittee, 1976: 11; Bruck, 1980: 16). It has been known for its aggressive use (some say overuse) of prosecution to discharge its regulatory responsibilities (Karmel, 1982). Couple this commitment to enforcement and prosecution with the finding that the SEC has one of the lowest criminal declination rates of all federal agencies at the Department of Justice, and one might surmise that fewer potential prosecutions are filtered out through the SEC enforcement process than in many other white-collar crime enforcement contexts.

Obviously, research in other settings needs to be done. My findings suggest that, in doing so, researchers wander off the tip of the iceberg—which reveals only those white-collar criminals actually convicted—and explore the underlying structure, 95 percent of which hides below the surface. They should inquire not only if and why criminal prosecution is the

road not taken and what effect the filtering process has on what is seen at the tip of the iceberg, but they should also explore the nature and impact of the more frequently exercised alternatives as well. And, despite Robert Frost's advice, they might ask whether taking "the road less traveled by" really does make "all the difference."

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