REMARKS OF

COMMISSIONER MARY L. SCHAPIRO*

BEFORE THE

SECURITIES REGULATION AND BUSINESS LAW CONFERENCE

UNIVERSITY OF TEXAS
AUSTIN, TEXAS

MARCH 7, 1991

*The views expressed herein are those of Commissioner Schapiro and do not represent those of the Commission, other Commissioners or the staff.

U.S. Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549

Remarks of
Commissioner Mary L. Schapiro

Before the
Securities Regulation and Business Law Conference

University of Texas
Austin, Texas

I am delighted to be in Austin, Texas and want to thank you very much for inviting me to participate in the Annual Conference on Securities Regulation and Business Law Problems.

As I reviewed the brochure outlining your program, I noted that you will spend most of the morning tomorrow on enforcement matters. I thought I would take the liberty of giving you some background for that discussion and raising some issues that are a part of the debate on the new remedies authority at the Commission. The Commission - staff and commissioners - will necessarily spend a lot of time this year writing the rules and regulations to implement what have been described as the most significant amendments to the securities laws in nearly twenty years. This legislation will significantly impact the Commission's enforcement program going forward, and will, I believe, be a principal focus of our 1991 agenda.

Before getting into the nitty gritty of the Securities Enforcement Remedies and Penny Stock Reform Act of 1990 - more affectionately known as the Remedies Bill - I think a little background is in order. I have been at the Commission for only a bit more than two years. During that time, there have been shifts, not only in the focus of our enforcement efforts and the way we approach enforcement in general, but particularly in the way we approach sanctions.

Let me begin with the changes in our focus. If John Shad's tenure in the enforcement context will be remembered for coming down on insider trading with hob-nailed boots, then Richard Breeden's Commission will perhaps be known for an equally vigilant response to financial institutions fraud. The SEC is acutely aware of the enormity of the savings and loan disaster, and it has prompted a number of responses from the agency. First, and I'll get to this in more detail in a moment, the S&L debacle has colored the way we view our enforcement role - quite frankly, the magnitude of the scandal has changed our attitudes about fraud and appropriate sanctions. Of course, some of the seeds of this change can also be seen in the Report of the National Commission on Fraudulent Financial Reporting, known as the Treadway Commission, and in the Commission's exposure over the past five years to the worst elements of the penny stock market.

Clearly, the egregiousness of the violations and the high rate of recidivism among penny stock violators has had a direct impact on our thinking with respect to sanctions.

Second, two task forces have been created within the agency to focus solely on financial institutions. The first is in the Division of Corporation Finance and is staffed by ten staff accountants and a supervisor. They are conducting a comprehensive review of the financial statements, management's discussion and analysis, and other related disclosures in the Exchange Act reports of banks and thrifts selected on the basis of their poorer-than-average financial condition. This focussed effort enables the staff to look at a broader cross-section of the industry on a shorter time frame than would normally be possible.

Through February 28, 1991, 364 issuers had been reviewed and 331 comment letters had been issued. In addition to what we believe will be improved disclosure, a by-product of this effort, is referral to the Division of Enforcement for possible enforcement action. Corporation Finance has referred a number of task force matters to Enforcement.

Thus, the second of the two task forces is housed in enforcement and is charged with investigating and prosecuting securities fraud by financial institutions including of course, false financial statements and misleading disclosure but also, fraud in the sale by financial institutions of their own or their affiliates' securities. This task force will also look closely at the conduct of accountants, attorneys, brokers, underwriters and other professionals who may have aided in the wrongdoing. Further, in the case of failed financial institutions, we will be looking at the conduct of prior management, including officers and directors. Finally, the task group will be cooperating with the bank regulatory agencies and other law enforcement agencies.

The emphasis on financial institutions is noteworthy, and I believe, it is appropriate. In those cases where misleading financial statements have been filed with the Commission, we must act to ensure that better disclosure is made to the public, and done in a timely matter. Of course, it is legitimate to ask questions about why the SEC is involving itself in those cases where other federal and state authorities and SROs - sometimes lots of them - are already involved and aren't we all just pursuing the same small pot of money on behalf of defrauded investors or in search of a fine?

I have struggled with that question - as I believe my colleagues do as well. It is necessary to balance our obligation to enforce the securities laws with our obligation - as public servants - not to waste the resources of the taxpayer in duplicative and non-productive enforcement efforts, and it is important not to "pile on" against a respondent for fairness reasons and for the sake of our credibility.

While the decision to institute parallel proceedings is obviously best done on a case by case basis after discussion and debate by the Commission, as a general matter, I look at it this way: Criminal sanctions obviously serve a very important purpose, but once a sentence is served or a fine is paid, there is no continuing prohibitory effect; in other words, an injunction is forever.

Second, convictions are overturned in cases where the civil preponderance of the evidence standard of proof has been met, but the higher criminal standard of beyond a reasonable doubt has not been met. Finally, we often seek ancillary relief - implementation of special procedures, accounting and disgorgement and so forth - that other authorities do not get into. Clearly, it is appropriate for the SEC in the circumstances where other agencies are pursuing the same villains, to take into its consideration, penalties that have been paid to other authorities and to assess our sanctions in light of those. The addition of our sanctions must not make the ultimate, total price paid by the respondent or the defendant disproportionate to the violative conduct. I would also add that from my perspective, disgorgement to customers must always take precedence over the payment of fines.

Despite our current interest in financial institutions, we continue to actively pursue insider trading, penny stock fraud, financial and other fraud, reporting, and books and records cases. It does not appear that there will ever be a shortage of work for the enforcement staff.

The second shift in focus concerns changes in our approach to sanctioning. Again, the S&L crisis is not without its influence. The public's disgust over the S&L debacle and its concern about the federal government's ability to protect it from such disasters in the first instance, and to punish the wrongdoers in the second, is not lost on the Commission. It would be naive to think that the greatest financial fraud and regulatory failure since the modern federal government had not left us more intent than ever to prevent, deter and punish wrongdoing. But let us not blame the S&L crisis solely for strengthening our resolve; the securities markets have their own disgraces that have made an impression on us: Drexel, Milken, Boesky, Levine, to name but a few.

Well then, what have I noticed over the past two years with regard to sanctions - and, indeed, my own thinking about how to approach sanctioning has evolved. First, we are more consistent about seeking disgorgement and we are becoming very skeptical of claims of inability to pay disgorgement orders. Ordering disgorgement is almost always proper as a matter of fairness and in order to promote confidence in the integrity of the law enforcement system. Inability to pay can be a legitimate reason for waiving payment of funds ordered to be disgorged, but there must be a genuine inability to pay.

The staff has been instructed that claims of economic inability should be thoroughly investigated, and that settling defendants or respondents without exception should provide sworn financial statements and tax returns. The staff has also been advised that all settlements which excuse payment of disgorgement amounts based on inability to pay should now explicitly state that the settlement is voidable, and the defendant subject to perjury or other charges, if he has misrepresented his financial condition.

But, even where there are financial statements that demonstrate a negative cash flow when a respondent's monthly expenses are added up, I have to wonder whether the Commission should waive payments so a respondent is left able to pay his mastercard bill before he pays back the people he defrauded. As a result, I am looking more favorably upon installment payment plans as a way to retrieve at least some of the ill-gotten gains, if the alternative is nothing at all paid back.

We are clearly seeking disgorgement from a larger number of participants in fraudulent schemes - salesmen are being asked to disgorge their commissions, insider traders their profits, and persons who have filed false Form 13D reports their wrongful gains from misleading the market.

Finally, with respect to disgorgement we are routinely seeking pre-judgement interest as it makes no sense to leave violators with any benefit from their ill-gotten gains.

In insider trading cases the only significant area where we could seek fines until this year, I believe a review of settlements will show you that generally the Commission has sought full disgorgement and a penalty. With rare exceptions, the Commission has insisted that insider traders who wish to settle before a complaint is filed must consent to an injunction, and pay full disgorgement and a one-time penalty. Again, requests for waiver of the payment of the penalty are carefully scrutinized. The amount of the penalty increases with the stage of the litigation, the egregiousness of the conduct and depends as well, on whether the respondent is a person or an institution.

I believe you will notice a trend toward increasingly longer periods of "time-out" for administrative suspensions and more absolute bars from association. Perhaps because we lacked fining authority until very recently, this "economic equivalent" of fining was by far our most powerful administrative sanction. Egregious conduct will get a registrant thrown out of the industry permanently - which in fact means you can reapply for admission in five years and probably get back in. Lesser offenses usually translate into being banished for shorter periods. But I would hazard the guess that even those shorter periods are longer today than they were five years ago.

Finally, let me mention a word or two about ancillary relief. It has become a standard for settlement of 2(e)'s against accountants to bargain for their membership in the SEC Practice Section of the AICPA. Brokerage firms and investment companies routinely agree now to appoint outside counsel for compliance review and to assist them in establishing new procedures. These sorts of actions are sought by the Commission to remedy weaknesses in the firms' structure and operations and are perhaps the most "remedial" of the types of relief we seek in settlements.

Some of what we accomplish now, such as disgorgement or other ancillary relief in administrative proceedings, is possible only through settlement because we have lacked the authority to order it in APs. We have also lacked the authority to seek civil monetary penalties in either APs or Federal District Court, with the limited exception of insider trading cases. All that has now changed with the passage of the Remedies Bill, and the big question seems to be how will the Commission use its extraordinary new powers. For you as practitioners, this new authority must be viewed through the prism of the recent trend toward stronger sanctions.

On October 15, 1990 President Bush signed into law the "Remedies Act." As you are all probably aware, the Act is intended to bolster the enforcement authority of the Commission by enhancing our authority to bring cases in the administrative forum rather than in federal district court, and by broadening the class of activities for which we can seek to collect civil money penalties. Briefly, the key provisions of the Act are as follows:

(1) The Act amends the securities laws to allow the Commission to seek from a court, or in an administrative proceeding, civil money penalties for violations. How much money the Commission can seek in penalties in an administrative proceeding is keyed off the egregiousness of the conduct at issue, with the largest penalties capped at $100,000 per violation for individuals and $500,000 per violation for entities. If the Commission brings the case in district court

rather than in an administrative proceeding, the court has authority to impose fines in excess of these maximums. The Commission's fining authority in the administrative forum is limited to regulated entities and their associated persons.

(2) The Act authorizes the Commission to enter cease-and-desist orders if, after a hearing, any person is found to have violated any of the securities laws or to have been a "cause" of the violation. This authority is a significant new power for the Commission, which previously had no authority to issue cease-and-desist orders. The Commission's order may put an end to currently ongoing illegal behavior and may also reach into the future by requiring permanent future compliance with respect to any security, any issuer, or any other person. In emergency situations, the Act also authorizes the Commission to issue a temporary cease-and-desist order on an ex parte basis against a regulated entity, if the Commission concludes that notice to the respondent and a prior hearing would be "impracticable or contrary to the public interest."

(3) The Act authorizes the Commission in administrative proceedings to enter orders requiring accounting and disgorgement, including the payment of reasonable interest.

(4) The Act makes clear the authority of a court to bar or suspend persons from serving as corporate officers and directors if, in the words of the statute, the person's conduct demonstrates "substantial unfitness" to serve in those capacities.

I have supported the quest for additional enforcement authority for the Commission and I voted in favor of the Commission's proposed Remedies legislation package in 1989 and in 1990 (although I could have lived happily ever-after without emergency C&D authority). I believe the Commission needed the flexibility of additional remedies and have found it frustrating to be unable in many cases to fashion a remedy that was meaningful in light of the particular violative conduct. For example, in cases involving securities violations by a broker-dealer, if the Commission chose to proceed in the administrative forum, we were often in the unfortunate position of ordering a remedy that was either too heavy-handed or too weak; we lacked a middle ground. Our statutes allowed us to censure a regulated person or entity - a remedy that can be too weak - or revoke an individual's or firm's registration - a remedy that may be too harsh in view of its effects upon the firm's customers, employees, and public shareholders. (The SEC's own too-big-to-fail doctrine.) In such cases, the ability to fine the broker-dealer may provide the Commission with a more appropriate response to the conduct in that it likely will provide greater deterrence without the draconian effects of ordering a revocation or even a suspension of the BD registration.

More remedies necessarily translate into more decisions and more difficult choices that the staff and the Commission will have to make. With the new C&D authority and the ability to seek fines administratively, the reasons for electing to proceed in a court as opposed to using the AP process are far less clear. What factors will help us to determine what types of cases or which individual cases belong in which forum?

Clearly the legal standards that govern C&Ds and injunctions are relevant - perhaps more specifically, the "likelihood of future violations" standard. We know we must meet that standard in court; do we need to meet it as well for a C&D to issue? Even if "likelihood" is not a requirement, should the Commission seek a cease and desist order without any such showing? Putting the law aside, is that even logical? Certainly a number of courts have held that a C&D order may properly be based on past conduct which has been voluntarily abandoned or remedied by the violator so long as the order is reasonably related to the remedied harm. Nonetheless, this is just the sort of issue that we are discussing within the agency as we explore the boundaries of this new authority.

I can't answer the question I have just posed to you - at least not yet - but there are some things that I don't think will change much from the way we currently do business in terms of choice of forum.

I do not expect the number of cases brought administratively to grow substantially. About 45 per cent of our nearly 2700 actions brought since October 1982 were administrative proceedings. In cases involving massive frauds and the threatened dissipation of assets - particularly a potential transfer of assets out of the territory of the United States - I expect the Commission will still seek temporary restraining orders, orders freezing assets, and the appointment of receivers, from federal district courts. It is also likely that insider trading cases will remain in the judicial forum. Having said this, however, I do believe there will be cases where the Commission will be able to respond to a violation, particularly by a regulated entity, more quickly in an administrative proceeding than in a judicial one. Also, there is a strong possibility that the number of cases we bring administratively increases simply because respondents would prefer to settle to a cease-and-desist order rather than to an injunction.

I would guess that it is highly unlikely that you will see published guidelines for the Commission to follow when choosing as to where to bring its enforcement proceedings. But, I believe we will strive to bring some degree of uniformity and cogency to those choices. Similarly, we will not publish for you a price list of law violations - there will be no booklet to tell you that a given type of violation is worth a $500 or $5000 civil penalty. The Remedies Act establishes three tiers of violative conduct, and broadly defines the attributes which will place a violation in a particular tier. There is a maximum fine for each tier. In addition, there are other limitations placed on the fining power of both the Commission and the courts. However, the legislation did not detail which specific violations would fall into which tier, or within the range of fines allowed fore each tier, what particular fine would be appropriat. Only through the resolution of cases - either by settlement or adjudication - are you likely to know what response or mix of responses from the Commission will be triggered by particular conduct.

I <u>can</u> assure you that the Commission is serious about using its new authority in appropriate cases, particularly where an individual or entity demonstrates a willful and deliberate disregard for a regulatory requirement, or causes substantial losses to third parties, or threatens the stability of the financial system. In these cases I expect the Commission will use its new fining authority in a manner that makes the potential pecuniary consequences of illegal conduct unacceptable to most would-be fraudsters, and signals to the rest of the world that the Commission will not tolerate this type of conduct.

As you can imagine, it will not be a simple process for the Commission to determine appropriate remedies. For example, until now, the Commission could seek civil money penalties only in court and only for insider trading violations. These penalties were easily reduced to a liquidated sum based on the amount of profit made by a trader or his tippees. The penalty then sought was a multiple of the ill-gotten gain, up to a maximum three times penalty, for institutions or persons who go to trial. We will now be faced for the first time with the need to make judgments about penalties that are perhaps not so susceptible to easy calculation. For example, we will almost certainly be faced - at some point - with determining the appropriate penalty for a net capital violation that brings no profit to a broker-dealer but exposes the settlement system to some increased level of risk.

There is some reason to believe that perhaps the greatest uncertainty, and therefore the greatest potential for negotiation, will arise in the context of our authority to order ancillary relief in a cease-and-desist proceeding. In cases not involving a deliberate intent to deceive - for example, in a case involving minor recordkeeping violations - the Commission may decide that a non-monetary remedy is the best solution, and accordingly may fashion ancillary relief that requires a firm to hire additional back-office personnel, for example. The Commission's authority in a cease-and-desist order to require future compliance or steps to effect future compliance, either permanently or for limited periods of time, will, I think, prove to be a tool at least as powerful as the authority to fine. The fashioning of creative affirmative relief in C&D proceedings may turn out to be the most beneficial provision of the new law.

CONCLUSION:

Let me conclude by saying that there is no lack of appreciation on the part of the Commission for the power these new remedies confer on us. Our goal is to apply them fairly and consistently. But if we miss the mark, I am confident that you will be ready to tell us so.

Thank you.

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