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**"The SEC's New Powers Under the Securities
Enforcement Remedies and Penny Stock Reform Act of 1990"**

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

The SEC's New Powers Under the Securities Enforcement Remedies and Penny Stock Reform Act of 1990

Thank you, and good morning.

My topic today is the recently enacted Securities Enforcement Remedies and Penny Stock Reform Act of 1990.

The remedies portion of the Act provides the Commission with several new enforcement tools to redress violations under the Securities Act, the Exchange Act, the Investment Company Act, and the Investment Advisers Act, as well as dealing with penny stock fraud. Today, I will focus only on the new enforcement remedies for violations of the Securities Act and the Exchange Act.

Prior to enactment of the Remedies Act, the SEC's principal authority to impose fines was pursuant to the Insider Trading Sanctions Act of 1984 (ITSA). That Act, of

course, gave the Commission authority to seek a court imposed monetary penalty of up to three times the profit gained or loss avoided resulting from insider trading.

These insider trading penalties were enhanced in 1988 when the Insider Trading and Securities Fraud Enforcement Act, otherwise known as ITSFEA, was signed into law. ITSFEA expanded the scope of civil penalties to "controlling persons" who failed to take appropriate measures to prevent insider trading by their employees; and required broker-dealers and investment advisers to establish, maintain and enforce written policies designed to prevent misuse of material, non-public information.

But ITSA and ITSFEA only served as remedies and deterrents for insider trading. In the remainder of our enforcement program, which obviously deals with a wide

variety of securities law violations, the SEC could in most cases only enjoin future violations of the securities laws, and when appropriate, obtain disgorgement or restitution.

Origins of the Remedies Act

The Remedies Act had its origins in the 1987 Treadway Commission Report on fraudulent financial reporting. Among the Treadway Commission recommendations was that the Commission seek additional enforcement remedies to punish fraudulent financial reporting.

Specifically, the Treadway Commission recommended that the Commission ask Congress for three additional enforcement powers:

- (1) the authority to impose civil money penalties in administrative proceedings and to seek civil money penalties from courts in injunctive proceedings;

(2) the right to issue a cease and desist order when the Commission discovered an ongoing securities law violation; and

(3) the power to bar or suspend a securities law violator from serving as a corporate officer or director for a public company.

But the Treadway Commission recommendations only encompassed increased sanctions for violations related to fraudulent financial reporting. Soon after receiving the Treadway report the Commission staff began drafting legislation that went beyond the Treadway recommendations by proposing fines and corporate bars for a wide range of violative conduct.

The Commission's efforts received a boost from the 1988 ITSFEA legislation, which required the Commission to

review its enforcement program and forward to Congress recommendations to enhance its enforcement capabilities.

The Original Remedies Bill

In January 1989, the Commission submitted to Congress its initial proposal for legislation designed to enhance the Commission's enforcement powers.¹

The 1989 bill proposed giving the Commission and the courts the power to impose a civil money penalty, for each violation of the securities laws, of up to \$100,000 for natural persons and \$500,000 for others.

The 1989 proposal also would have given the Commission and the courts the power to bar any person from acting as a corporate officer or director of a public

¹ A similar bill was submitted to Congress in September 1988, but Congress adjourned before the bill could be calendared for consideration.

company upon a showing that such person had violated any provision of the securities laws.

The 1989 bill, was, of course, not enacted and in 1990 the Commission submitted an amended version of the bill to Congress. The 1990 Remedies Act retains most of the proposals from the 1989 bill, while significantly expanding the enforcement powers sought by the Commission.

The 1990 Remedies Act, as passed earlier this week by Congress, differs from the 1989 bill in four notable respects.

First, the 1990 Remedies Act, while retaining the concept of fining powers, creates three tiers of fines for securities law violations. The three tiers are designed to match the fine imposed with the severity of the securities law violation.

The first tier sets maximum fines of \$5,000 for natural

persons or \$50,000 for others, without listing any aggravating circumstances. This tier is designed to catch infractions that are not the result of a knowing or reckless violation of the securities laws.

The second tier imposes maximum fines of \$50,000 for natural persons or \$250,000 for others, for violations involving fraud, deceit, manipulation, or deliberate or reckless disregard of a regulatory requirement.

The third tier imposes maximum fines of \$100,000 for natural persons or \$500,000 for others, for violations involving the same aggravating circumstances as the second tier, with the additional requirement that the violation resulted in substantial losses or created a

significant risk of substantial losses to other persons.

In each of the three tiers, a court, and in certain circumstances the SEC, may impose a fine. Imposition of a fine does not preclude disgorgement. Further, a court may impose a fine exceeding the maximum penalty upon a showing that the gross amount of the pecuniary gain from the violative conduct exceeded the fining limits.

Second, the 1990 Remedies Act deletes the proposal from the 1989 bill that would have given the Commission authority to bar security violators -- temporarily or permanently -- from serving as officers or directors of public companies, and limits such authority to the federal courts. Even in the federal courts the bar can be applied only in cases where a person violated one of the scienter-based fraud provisions (which, it should be noted, include reckless

conduct).² The person's conduct must also demonstrate substantial unfitness to serve as an officer or director.

Third, the 1990 Remedies Act adopts the Treadway recommendation that the Commission be empowered to issue cease and desist orders against any person that is violating, has violated, or is about to violate the securities laws. The bill provides that the Commission may enter a permanent cease and desist order after a hearing, presumably before an ALJ. If a permanent cease and desist order is granted, the respondent may seek review before the Commission. After the Commission issues a final order, the respondent may then file an appeal with the U.S. Court of Appeals.

² Thus, under the Securities Act, officer or director bars will be available for violations of Section 17(a)(1), and, under the Exchange Act, for violations of Section 10(b) or the rules or regulations thereunder.

The Commission may also enter a temporary cease and desist order, but only against regulated entities, such as broker-dealers and investment advisers and their associated persons. Temporary cease and desist orders are available upon a finding that an alleged violation or threatened violation is likely to result in significant dissipation or conversion of assets, significant harm to investors, or substantial harm to the public.

Fourth, and last, the 1990 Remedies Act expressly authorizes the Commission to order disgorgement of illegal profits in administrative cease and desist proceedings as well as in other proceedings against regulated entities.

Benefits of the New Remedies Act

The Commission's new remedial powers will aid the Commission's enforcement program in three critical areas

(1) increased flexibility in fashioning remedies; (2) increased deterrence of recidivists; and (3) increased speed in bringing proceedings to halt ongoing securities violations.

Fashioning Flexible Remedies

The availability of civil money penalties will provide both the courts and the Commission with greater flexibility to tailor a remedy to the seriousness of the violation. This flexibility will be particularly helpful in administrative proceedings against registered broker-dealers and other regulated entities.

Prior to the Remedies Act, when the Commission found that a broker-dealer had willfully violated the securities laws, it could theoretically impose sanctions ranging from a censure to a revocation of the firm's registration. In practice, however, the Commission often had to choose between

remedies that were either too weak or too severe.

For many firms, a censure provided relatively little deterrence against future violations. However, it was often impossible to revoke a firm's registration, or even to suspend its operations temporarily, without causing severe hardship to the firm's customers, to public shareholders, and to innocent employees. The new fining authority will give the Commission the ability to sanction misconduct requiring a penalty more severe than a slap on the wrist, but where suspension or revocation is unwarranted.

Deterring Recidivists

During my tenure with the Commission I have been struck by the number of cases involving respondents who previously have been sanctioned for the same or similar conduct. The extent of recidivism reflects to some extent the

inadequacy of the Commission's remedial authority prior to the Remedies Act.

Before the Remedies Act, if a prior offender engaged in conduct that violated a Commission administrative order, the Commission's only remedy was to seek a mandatory injunction directing compliance with its order. Moreover, although a defendant who violated a court injunction can be prosecuted in a criminal contempt action, the criminal standard of proof is difficult to meet. Nor has there been much enthusiasm for bringing contempt cases by the U.S. Attorney's offices. U.S. Attorneys, understandably, frequently believe that other more serious crimes deserve their attention.

The Commission's new authority to seek or impose money penalties addresses the problem of recidivism by

increasing the costs associated with repeated securities law violations. The Commission will take prior violations into account when imposing civil money penalties, thereby achieving greater deterrence against violators who are not deterred by the civil and administrative remedies currently available.

Expedited Relief

The Congressional grant of cease and desist authority provides an important vehicle for expedited Commission action to halt ongoing securities law violations. Prior to receiving cease and desist authority, the Commission's ability to obtain expedited relief was limited to urging federal district courts to grant emergency relief, in the form of preliminary injunctions, temporary restraining orders, asset freezes, and appointments of receivers. Not all infractions, however,

warrant such extraordinary relief. Moreover, the congested nature of our federal court dockets has been such that many of the Commission's injunctive actions were not tried until a year or more after they were filed.

The availability of cease and desist orders will permit the Commission to address securities violations more quickly in circumstances where emergency judicial relief is not available.

Criticisms of the Remedies Act

There have been numerous criticisms of the Commission's new enforcement powers, particularly from the private bar. I want to mention several concerns that have been raised, and then provide some responses.

One of the most frequently heard complaints has been that the Commission's new authority to impose fines and

issue cease and desist orders will allow the Commission to bypass the federal courts and thereby deny defendants the procedural safeguards available to them in the courts.

There are several responses to this. First, due process does not stop at the Commission's doors. We, like all other federal agencies, are bound by the Administrative Procedure Act which guarantees the right to notice and the opportunity to be heard. More importantly, I believe we intend to be open to any and all comments and criticisms which raise due process concerns, and to be responsive to those concerns. Ultimately, neither the Commission nor the public is well served if there exists either the perception or the reality of a failure by the Commission to be sensitive to due process issues. If we need to change our internal rules of procedure, we shall do so.

Another criticism is that the authorization for federal courts to bar securities violators from serving as officers and directors of public companies constitutes a new and serious infringement upon shareholder rights under state law. The Commission certainly recognizes that corporate governance issues generally are regulated by state law, but the barring of individuals from serving as corporate officers and directors as a remedy for federal securities law violations is not completely new. Courts have entered corporate bar orders both in Commission cases settled by consent and in at least one litigated case. See SEC v. Techni-Culture, Inc., [1973-74] Fed. Sec. L. Rep. ¶ 94,501 (CCH) (D. Ariz. 1974).

Moreover, in many Commission enforcement actions, courts have appointed receivers and special agents, removed or appointed directors, and taken other actions that were

functionally equivalent to a corporate bar because the corporate officers were precluded from performing functions and exercising powers contemplated by state law.

There has also been a concern that as the Commission exercises its new fining authority, and seeks officer and director bars in the courts, its litigation load will become overwhelming. I do not expect this to become a real issue, however. Our experience with ITSA for example has shown that the majority of defendants choose to settle rather than litigate. We expect a similar response to the fining provisions of the Remedies Act. Furthermore, with respect to barring individuals from serving as officers or directors, the Commission intends to ask the courts to act only in those situations that involve egregious conduct. Consequently, the number of corporate bar actions will be likely to be relatively

low.

The Need for Expedited Administrative Procedures

Before closing, I want to address two final issues.

First, I believe the Commission's newly granted cease and desist authority carries with it a burden -- the need to expedite and reconfigure Commission administrative proceedings to provide prompt and fair hearings to respondents who are the subject of cease and desist orders.

In fact, the Commission has little choice in the matter because the Remedies Act mandates that within a year of its enactment the Commission shall establish regulations providing for expeditious conduct of hearings and rendering of decisions in cease and desist proceedings.

Having convinced Congress that the SEC needs cease and desist authority, it is now up to the Commission to

devote the resources to make the administrative procedure work quickly while still protecting the fundamental rights of respondents to a fair hearing and decision on the merits.

Another area of concern is how we will utilize our fining authority. Although the tiering of fines provided for by Congress gives us some guidance, the Commission must develop some articulable guidelines to be used in determining the level of fines. Otherwise, we run the risk of inconsistent treatment of similar securities law violations. Perfect consistency is not obtainable, but without having publicly defensible rules, we run a grave risk of acting unfairly and arbitrarily.

Conclusion

The recently enacted Remedies law undoubtedly marks the most sweeping change in the Commission's enforcement

powers since the agency was formed. These new enforcement tools reflect a commitment on the part of Congress to impose swift and meaningful sanctions against securities law violators. But, at the same time, they must be exercised with care and thought, and without sacrificing basic concepts of fairness and justice.

Thank you.