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News Release

Remarks
of

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

I. INTRODUCTION

I am pleased to be in Newport Beach today to make my first speech as an SEC Commissioner, and to have the opportunity to renew my acquaintances with the members of NASAA's enforcement section. I began my government career immediately after law school, as a member of the Commodity Futures Trading Commission's enforcement division. Later during my tenure at the CFTC, as executive assistant to Chairman Phillips, I had the opportunity to meet from time to time with NASAA representatives on a wide variety of enforcement, regulatory, and consumer education issues.

During the four years I spent at the CFTC, the agency's relationship with NASAA evolved in quite a remarkable way. When the CFTC was undergoing reauthorization in 1982 there existed what can only be described as open hostility between NASAA and the agency, largely arising, in my opinion, out of frustration with the exclusive jurisdiction of the CFTC. Over time, accommodations have been made to the CFTC legislative mandate, which permit a greater partnership in the enforcement context between the CFTC and the states. In the past four years, the CFTC and the states jointly filed 31 injunctive actions. In addition, the CFTC sponsored 50 enforcement seminars in 22 states designed to assist the states in their detection and prosecution of commodity fraud.

II. PRELUDE: COMMENTS ON NASAA - SEC RELATIONSHIP

From all that I have seen and heard in the six weeks since I became a member of the Commission, NASAA and the SEC are poised to improve and strengthen our relationship, and thereby improve the administration of the nation's securities markets. By 1934 when the Securities and Exchange Commission was created, 47 of the 48 states already had enacted securities statutes. The federal securities laws recognized the benefits of dual jurisdiction with the states. But the federal - state relationship is far more complex than issues of legal jurisdiction.

The key to that relationship, I think, is to recognize that our regulatory sphere of influence divides, on a day to day, practical basis, into three zones. The states and the SEC each have areas of unique expertise and experience where we function best acting largely by ourselves. There is also a third area of shared skills and experience where we can accomplish the most by acting together or coordinating our plans. The challenge, at times easy, and at times a source of contention, is deciding into which area a particular issue falls, or, even if we agree that an issue is one calling for ongoing coordination, in agreeing on how best to accomplish it. I would hope, however, that on all issues we are willing to expose our ideas, to discuss them amongst ourselves -- at 19C conferences, and other times -- and to make the compromises that are necessary in any ongoing partnership.

I want to talk briefly about some recent developments -- particularly enforcement related matters -- which illustrate these points.

II. THINGS THE STATES DO BEST: REG D

In March 1988 the Commission published for comment a number of revisions to Regulation D, the regulation that provides exemption from Federal registration requirements for certain limited offerings. 1/ Two proposals provoked considerable comment. The first related to the definition of an accredited investor. The second related to the definition of a substantial and good faith compliance standard, which could, under certain circumstances, be used as a shield to preserve an exemption from registration even if an offering did not comply strictly with all the applicable provisions of Reg D. On December 20 the Commission published for comment 2/ revised definitions of both "accredited investor" and the substantial and good faith compliance standard. The states and NASAA gave substantial assistance in shaping the reformulation of both those concepts, and in utilizing the comment procedure to find a common ground for change.

In its March 1988 release the Commission proposed an addition to the definition of accredited investor to specifically include certain employee benefit plans established and maintained

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1/ Release No. 33-6759 (March 3, 1988), 53 FR 7870.

2/ Releases 33-6811 and 33-6812 (December 20, 1988), [--2/ FR --]

by state governments or their political subdivisions. The proposed definition imposed two conditions. First the plan had to have a bank, S&L, insurance company or registered investment adviser as its plan fiduciary. Second the plan had to impose fiduciary requirements similar to those under ERISA.

Virtually all the comments on the proposal, including those from 15 state representatives objected to one or both of the conditions. In the reformulated definition proposed by the Commission in December both conditions were dropped. Instead, the Commission proposed a provision which accredits state and local plans if the plan has total assets in excess of $5 million.

In the March 1988 proposing release the Commission acknowledged NASAA's cooperation. We understand that if the revised definitions are adopted as proposed that NASAA's Small Business Capital Formation Committee will consider the changes with a view to recommending parallel changes to ULOE, the Uniform Limited Offering Exemption.

Perhaps even more remarkable was the resolution of the sharp conflicts among the commentators with respect to the proposed substantial and good faith compliance standard, sometimes referred to as the "i and i" -- innocent and immaterial -- standard. Among other matters, the March proposals included elimination of a Form D filing as a condition to the Regulation D exemption, and a new Rule 507 which would instead disqualify an issuer from future use of Regulation D if the Form were not filed. Proposed Rule 508 provided that a failure to comply with a condition or requirement of Regulation D that was insignificant

with respect to the offering as a whole and to a particular offer or sale under challenge, would not result in a loss of the exemption from registration.

There was sharp discord between NASAA and 15 state commentators on the one hand, and various bar associations on the other. The bar associations supported, and in some respects sought to broaden the substantial non-compliance standard. The states were vigorously opposed. But significantly, comments from the states did not simply reject the proposals. Suggestions were made as to how to improve them.

The open Commission meeting at which the revised proposals were discussed was my second as a Commissioner. In response to various questions about the proposed revisions to Rule 504, Linda Quinn, Director of the Division of Corporation Finance remarked that the states are the primary enforcers of Rule 504, that they are the ones with the expertise and experience in this area, and that the Commission should accommodate as much as possible their views as to what regulations are needed to police abuses in small offerings by small issuers.

When Regulation D was adopted in 1982, it was contemplated that Rule 504 would be regulated by state "Blue Sky" requirements.3/ Clearly this has happened, and we at the Commission should not fail to recognize the states' interests in this area, particularly with respect to enforcement issues.

3/ Release No. 33-6389 (March 1982). [FR Cite]

III. THINGS THE SEC DOES BEST: ENFORCEMENT PHILOSOPHY: HIGH IMPACT CASES, DREXEL

The vigor of NASAA members' enforcement efforts is reflected in a statistic included in a booklet prepared by NASAA for distribution at the 13th Annual Conference of the International Organization of Securities Commissions. That booklet notes that in the aggregate state securities agencies carry out more enforcement and disciplinary actions each year than the NASD, the stock exchanges and the Commission combined. I believe that this is as it should be, certainly with respect to comparisons with the number of cases done by the Commission. This is not only because there are 65 member organizations represented in NASAA, and only one SEC, but because, the Commission should concentrate on prosecution of large impact cases, and especially schemes that cut across state or international boundaries. Many of the violations in these cases would go undetected or unpunished if viewed on an isolated basis. Yet many of these cases require exceptional resources.

Cases arising from the Commission's financial fraud program are one example of this kind of case. Companies that issue false financial statements effect a nationwide market in the company's shares. Moreover, if each state had separate financial reporting requirements, a comparison of companies' financial statements would be meaningless. The Commission is in a unique position to impose and police financial reporting requirements. These cases typically require staffing by accountants as well as attorneys, and usually involve highly complex facts and weeks of

expert testimony from the company's accounting personnel and outside auditors.

As a Commissioner, I am interested in seeing that the Commission concentrates its resources on cases where our unique impact will be the greatest. Historically, that has always been the philosophy behind the Commission's enforcement program. From commission to commission, however, the definition of "maximum impact" may shift. In my view, the size of a case, in terms of the dollars involved, or the numbers of victims is one measure of a case's impact. Equally important is the impact of a case on the Commission's enforcement program. For example, cases that uncover ongoing or previously undisclosed wrongdoing seem to me to have particularly great significance. Also, cases that impose sanctions that are swift as well as meaningful, are more likely to promote general deterrence of future violations and therefore are cases of substantial impact. This does not mean we duck the hard cases; quite to the contrary. Further, cases that police the activities of professionals, including accountants, lawyers, and members of the brokerage community can also have a substantial impact. These people, paraphrasing Judge Stanley Sporkin, are the gatekeepers who provide others, for good purposes or bad, with access to the financial system.

In addition, the Commission should be willing to commit the resources necessary to conduct large investigations, and within the constraints of our budget, to pick appropriate cases to litigate when we believe a settlement to be inadequate. While not a complete catalogue, these are hallmarks that I look at as I

evaluate enforcement matters. One case of unparalleled significance that meets anyone's test for a case of maximum impact has been the Commission's investigation of Drexel Burnham.

Drexel

On September 7 the Commission filed a 184 page complaint against Drexel, Michael Milken, his brother Lowell Milken, Victor Posner, three other individuals and two other corporate entities. At the heart of the complaint is the allegation that Drexel, Milken and others devised a fraudulent scheme involving insider trading, stock manipulation, fraud on Drexel clients, failure to disclose beneficial ownership of certain securities, and numerous other violations of the securities laws.

On December 22 Drexel agreed to plead guilty to six felony counts and to pay a $650 million fine. Drexel's settlement of criminal charges was made contingent on reaching a settlement of the Commission's complaint. For obvious reasons I cannot comment about the status of any discussions with Drexel.

The possible settlement of the cases against Drexel by the Commission and the U.S. Attorney for the Southern District of New York may not bring an end to investigations of Drexel. As you all know, under the Uniform Securities Act and similar statutory schemes state securities administrators have broad discretion to institute disciplinary proceedings based on the entry of Commission orders, court injunctions, or felony convictions. The New York Times reported in its business section on December 30 that Drexel is expected to undergo further scrutiny by many states. As you know, approximately 21 states initiated some

form of proceeding against E.F. Hutton, which unlike Drexel, however, had a large retail network. I have no view whether state proceedings are appropriate or necessary in this case.

As a regulator, however, having the option of obtaining effective administrative remedies, even if they are not pursued in a particular case, is obviously a very valuable enforcement tool. During the past Congress, the Commission submitted proposed legislation that would make significant changes in the Commission's administrative remedies. In addition, the Commission received a variety of new powers that will make us more effective in pursuing cases with international connections.

IV. ENFORCEMENT RELATED LEGISLATIVE DEVELOPMENTS

On September 28, 1988 the Commission sent to the Senate a legislative proposal entitled the "Securities Law Enforcement Remedies Act of 1988." The proposal was not introduced in the 100th Congress. However a similar proposal will likely be submitted again in the near future.

The legislative proposals in the Enforcement Remedies Act reflected recommendations made by the National Commission on Fraudulent Financial Reporting, better known as the Treadway Commission. From October 1985 to September 1987 the Treadway Commission, under the leadership of former SEC Commissioner Jim Treadway, studied the financial reporting system in the United States, and sought, among other things, to identify steps to reduce fraudulent financial reporting.

In April 1988 the Commission endorsed two of the three Treadway Commission recommendations relating to the Commission's enforcement authority. First, the Commission agreed that, it should have the authority to impose civil money penalties in administrative proceedings and to seek civil money penalties from a court directly, instead of as ancillary relief, in injunctive proceedings. Second, the Commission agreed that it should seek explicit statutory authority to bar or suspend corporate officers and directors involved in fraudulent financial reporting from future service in that capacity in a public company, either in injunctive proceedings, or administrative proceedings.

The proposed Enforcement Remedies Act included both these provisions. In injunctive proceedings the Commission proposed that penalties be set at a maximum of $100,000 per violation for natural persons, $500,000 per violation for entities, or the gross amount of the pecuniary gain to the defendant, which ever is greater.

In administrative proceedings, the Commission proposed equal penalties, but without the alternative, gross pecuniary gain standard. The new sanction would be available in administrative proceedings under Section 15(c)(4) concerning violations by issuers and persons required to file beneficial ownership reports, in proceedings against broker-dealers, associated persons, investment advisers, investment companies, municipal securities dealers, government securities dealers, and transfer agents. The Commission would not be able to impose monetary

penalties simply on the basis of an injunction or criminal proceeding against a person.

The Commission would be able to impose a penalty if it determines that a violation has occurred, and that a penalty would be in the public interest. The legislation sets forth factors that may be considered by the Commission in determining whether a penalty is in the public interest: these include the degree of scienter of the respondent, the harm caused to other persons, the extent of unjust enrichment, the respondent's history of prior conduct, the need to deter the respondent from future violations, and "such other matters as justice may require."

The legislation grants courts imposing civil penalties discretion to determine the penalty in "light of the facts and circumstances." While this standard is less detailed than the standard to be followed when the Commission itself imposes penalties, a court is likely to consider many if not all of the same factors enumerated with respect to Commission determinations of the public interest.

As you know, the CFTC already has authority to impose civil penalties in administrative proceedings under Section 6(b) against persons registered with the CFTC, and under Section 6b against contract markets. Based on my experience at the CFTC I support the concept of administrative and court ordered civil penalties. There are many cases where these additional remedies will allow the Commission to better tailor a remedy to fit the violations found. We must be vigilant however that this in fact

is what happens. Civil penalties should not become a measure by which we judge the success of our enforcement program, seeking ever higher numbers.

On balance, however, the authority to seek or order civil penalties will add significantly to the power of the Commission's enforcement arsenal.

While the Enforcement Remedies Act is not yet law, last session Congress did enact a significant piece of enforcement related legislation. On November 19 President Reagan signed into law the Insider Trading and Securities Fraud Enforcement Act of 1988. The Act adds new requirements that broker-dealers and investment advisers establish, maintain, and enforce written policies and procedures reasonably designed to prevent the misuse of nonpublic information. The Act creates an express private right of action for contemporaneous traders in insider trading cases, increases the maximum criminal fines for violations of the Exchange Act to $1 million for natural persons and $2.5 million for entities, and doubles the maximum prison term from 5 to 10 years.

Three other provisions are of particular interest. First, the Act authorizes the Commission to establish a program to award bounties to persons who provide information leading to the imposition of penalties for insider trading. The staff is in the process of establishing procedures to implement the bounty program. Determinations of whether, or how much to pay as a bounty are solely within the discretion of the Commission, and are not subject to judicial review.

Second, the Act authorizes the Commission to issue formal orders of investigation and conduct investigations on behalf of foreign governments. Investigations may be conducted without regard to whether the facts stated in the request would constitute a violation of U.S. law. In deciding whether to provide assistance, the Commission shall consider whether the requesting government has agreed to provide reciprocal assistance to the United States in cases where we request such assistance.

Third, the Act authorized, but did not appropriate funds for a special study of the Federal securities laws. The study is to include a review of the adequacy of cooperation between the Federal, State, and foreign enforcement authorities concerning securities law enforcement.

V. PENNY STOCK TASK FORCE

At the outset of these remarks I referred to areas of shared skills and interest where we the Commission, and NASAA members can accomplish the most by acting together or coordinating our plans. A prime example of such an area is in the fight against penny stock fraud. I have seen on the program agenda that after this lunch there will be a report by the Florida Penny Stock Task Force. I will not intrude too far into that area.

Fraud and manipulation in the penny stock market is a problem of growing concern. The Commission has recently established a task force on market manipulation chaired by Joe Goldstein, Associate Director of the Division of Enforcement.

That task force has as a primary focus, manipulation and sales practice abuses in the penny stock market.

The term penny stock market sometimes misleads people into thinking that the problem is a small one. It is not. Manipulations of a single penny stock can cost investors millions of dollars. Often victims are small investors, who can least afford the loss of their entire investments. Unscrupulous brokers can make millions of dollars from penny stock manipulations. The potential riches from penny stock manipulations have apparently attracted increasingly sophisticated, and increasing numbers of operators.

Cracking down on abuses in the sales of penny stock may require regulatory as well as an enforcement response. The Market Manipulation Task Force is reviewing a number of possible rule proposals. In addition, the Task Force is taking steps such as developing training programs and stepping up information sharing which should lead to additional enforcement actions.

Combatting penny stock fraud is an effort which fits into what I referred to earlier as the regulatory zone of shared skills and experience where we can accomplish the most by acting together. For example, during the course of an investigation the SEC does not have the resources to inspect every branch office of each broker-dealer being investigated. Nor are there resources to bring proceedings against each registered representative discovered to have participated in hyping a stock or making unsuitable recommendations to customers. Primarily by sharing

information and making appropriate referrals, we can achieve more effective enforcement.

One small example of this process arises out of the Commission's action against Fitzgerald, DeArman & Roberts, Inc. a Tulsa, Oklahoma broker-dealer specializing in underwriting and retailing low-priced, OTC securities. On June 28, 1988, in an action against Fitzgerald, DeArman alleging net capital and other violations, the Commission obtained appointment of a SIPC trustee to oversee the dissolution of the firm. On July 27, 1988 the Commission brought an injunctive action against Goldcor, Inc., Carl Martin and Richard Brown. Fitzgerald, DeArman was a major market maker for Goldcor, a penny stock shell company which claimed to have discovered a "secret" digestive process to extract gold from the sands of Costa Rican beaches rocketed in price from under $1 per share to over $15 per share.

No registered representatives or officers of Fitzgerald, DeArman were named in the Commission's actions. However, in October 1988 the State of Oklahoma initiated administrative proceedings against the Fitzgerald, DeArman firm, Goldcor, Martin, Brown and a number of former Fitzgerald, DeArman registered representatives. Those proceedings are pending. I believe the swift action by the Oklahoma Department of Securities is representative of the way in which our enforcement efforts can complement one another in areas of shared interest. It is possible that absent the Oklahoma proceedings the activities of the Fitzgerald DeArman registered representatives may not have been subject to review in a public proceeding.

Finally, in addition to shared areas of enforcement interest, we all share the burden of insufficient resources to combat no shortage of fraud. The SEC's 1990 budget request, announced earlier this week seeks 184 new positions, 32 of which would be dedicated to the fraud area.

I look forward to working with and learning from the members of NASAA. I appreciate the importance and the difficulty of the enforcement jobs you do.