UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

THE CHAIRMAN

November 28, 2011

The Honorable Jack Reed
Chairman
Subcommittee on Securities, Insurance and Investment
Committee on Banking, Housing and Urban Affairs
United States Senate
534 Dirksen Senate Office Building
Washington, DC 20510-3903

Dear Chairman Reed:

Thank you for the recent opportunity for senior staff of the Securities and Exchange Commission to appear before the Subcommittee on Securities Insurance and Investment to discuss our progress regarding management and structural reforms at the agency. During the hearing, our Director of Enforcement identified statutory limitations on our ability to pursue penalties and factors that influence the structure of our settlements. This letter provides additional information regarding these issues, and some suggested legislative solutions.[1]

As you know, the Commission has worked to streamline and strengthen its enforcement program and in so doing has achieved outstanding results. The agency filed a record 735 enforcement actions in fiscal year 2011, including many cases involving highly complex products, transactions, and market practices. More than $2.8 billion in penalties and disgorgement was ordered in Commission enforcement actions in fiscal year 2011. In the area of financial crisis related actions, the Commission has charged more than 80 individuals and entities, including approximately 40 CEOs, CFOs and senior officers.

Notwithstanding these impressive results, the Commission's statutory authority to obtain civil monetary penalties with appropriate deterrent effect is limited in many circumstances. As described below, certain statutory changes would further enhance the effectiveness of the Commission's enforcement program by expanding the Commission's authority to seek monetary penalties for the most serious securities law violations. The changes would increase the statutory limits on civil monetary penalties, more closely link the size of monetary penalties to the scope of harm to investors and associated investor losses, and substantially raise the financial stakes for securities law recidivists.

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[1] The views expressed in this letter are mine and do not necessarily represent the views of the full Commission.

Imposing Appropriate Monetary Penalties for Serious Violations

The federal securities laws authorize the Commission to obtain monetary penalties in both federal court actions and administrative proceedings. These laws generally set forth two alternative methods for calculating the maximum amount of penalties. The first method, applicable in both civil cases and administrative actions, permits a per "violation" calculation, the amount of which increases by tier based on the seriousness of the misconduct. Currently, the highest tier (tier three) – available for violations with the most substantial consequences to investors – is capped by statute at $150,000 per violation for individuals and $725,000 per violation for entities. The second calculation method provided by statute permits imposition of a penalty equal to "the gross amount of pecuniary gain" to the defendant "as a result of the violation." *See* Securities Act of 1933 § 20(d)(2); Securities Exchange Act of 1934 § 21(d)(3)(B); Investment Company Act of 1940 § 42(e)(2); Investment Advisers Act of 1940 § 209(e)(2). This second calculation method can only be used to determine the maximum penalty amount in a federal court action and is not available in administrative proceedings.

In many cases, these provisions impose substantial constraints on the penalties that a court or the Commission can assess because the gross amount of the pecuniary gain to a defendant may be small relative to the seriousness of the violation and the resulting harm to investors. For example, many frauds involving misrepresentation of a public company's financial condition may result in a relatively small pecuniary gain to the company itself or the corporate managers who committed the fraud. Yet such frauds often result in enormous losses to innocent investors. In those cases, the maximum penalty available to the Commission may not adequately reflect the seriousness of the violation or the impact on victims of the fraud.

Three targeted changes would increase the size of the civil penalties available under both existing calculation methods, provide a new calculation method intended to tie the size of a penalty to the amount of associated investor losses, and make the same calculation methods available in both civil and administrative actions.

1. The first proposed statutory change would increase the per violation cap applicable to the most serious violations (*i.e.*, tier three) to $1 million per violation for individuals and $10 million per violation for entities. That would help to ensure that a third tier penalty has an appropriate deterrent effect on both individual and corporate violators, and is not viewed as just a cost of doing business.

2. The second proposed statutory change would amend the maximum tier three penalty to authorize penalties equal to *three times* the "gross amount of pecuniary gain" to the defendant and make a calculation method based on "gross amount of pecuniary gain" available in administrative proceedings for all violations. That would allow the Commission to address situations where the actual pecuniary gain to the violator is relatively small compared to the nature or magnitude of the wrongdoing, and would eliminate the current disparity between the penalty relief available in district court and administrative proceedings.

3. The third proposed statutory change would authorize a calculation method for tier three penalties based on the amount of "investor losses" incurred as a result of a defendant's violation that would be available in both civil and administrative actions. That would allow the Commission to take into account more directly the harm inflicted on investors in seeking appropriate penalties.[2]

Together, these changes would provide the Commission with greater flexibility with regard to monetary penalties in cases where the misconduct is very serious, repeated, or involves substantial investor losses, but the current statutes do not allow for an appropriately significant penalty.

Authorizing Greater Penalties for Recidivists

As the Committee is aware, the Commission sometimes is confronted with individuals or entities that have violated the securities laws repeatedly. In some instances, such defendants' subsequent misconduct violates the federal securities laws and/or a federal court injunction or a bar previously obtained or imposed by the Commission. Current law does not provide the Commission with adequate tools to deter this category of violators. Two statutory changes would provide new sources of penalty authority that would explicitly increase the cost of repeat offenses.

1. The Commission should be authorized to seek a penalty enhancement in the current action equal to three times the otherwise applicable penalty cap if within the preceding five years a defendant has been criminally convicted for securities fraud or become subject to a judgment or order imposing monetary, equitable, or administrative relief in any SEC action alleging fraud. That would enable the Commission to seek monetary penalties against recidivists that are over-and-above the limitations described previously, regardless of the calculation method used.

2. The Commission should be authorized to seek a civil penalty if an individual or entity has violated an existing federal court injunction or a bar obtained or imposed by the Commission. That would include officer and director bars (imposed under Sections 8A(f) or 20(e) of the Securities Act or Sections 21(d)(2) or 21C(f) of the Exchange Act), penny stock bars (imposed under Section 20(g) of the Securities Act or Sections 15(b)(6) or 21(d)(6) of the Exchange Act), and other equitable disqualifications ordered by a court (under Section 21(d)(5) of the Exchange Act). This approach would be more efficient, effective, and flexible than the limited and cumbersome civil contempt remedy. Such authority also would be comparable to the Commission's existing ability to obtain civil penalties for violations of its administrative Cease and Desist orders. *See* Securities Act of 1933 § 20(d)(1); Securities Exchange Act of 1934 § 21(d)(3)(A); Investment Company Act of 1940 § 42(e)(1); Investment Advisers Act of 1940 § 209(e)(1).

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[2] Implementing the change may require the Commission to expend significant additional resources to determine and prove the amount of investor losses in particular cases – for example, to conduct event studies or to retain expert witnesses to evaluate and opine on such losses.

<u>Conclusion</u>

The statutory changes proposed above would substantially enhance the effectiveness of the Commission's enforcement program by addressing existing limitations that have resulted in criticism regarding the adequacy of Commission actions against those who violate the securities laws. I have asked my staff to prepare draft legislative language for these five proposals that we will provide shortly under separate cover. We would welcome the opportunity to work with the Subcommittee and its staff to address these limitations on penalty authority by further developing the proposals discussed above.

Sincerely,

Mary L. Schapiro

Mary L. Schapiro
Chairman

cc: Ranking Member Mike Crapo