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Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549
Mail Stop 10-1

**Re: File No. SR-NASD-98-80; Issuance of Temporary Cease and Desist
Orders - Amendment No. 3**

Dear Ms. England:

The National Association of Securities Dealers Regulation, Inc. ("NASD Regulation" or "Association") hereby responds to the comment letters received by the United States Securities and Exchange Commission ("Commission" or "SEC") in response to the publication in the *Federal Register* of Notice of Filing of SR-NASD-98-80¹, regarding temporary cease and desist proceedings and submits Amendment No. 3 to this filing.

Background

NASD Regulation is proposing to add a new rule to the NASD Code of Procedure that authorizes NASD Regulation Department of Enforcement ("Department of Enforcement") staff, after obtaining approval of the President or Chief Operating Officer of NASD Regulation, to initiate temporary cease and desist proceedings with respect to the rule violations that pose the most serious and immediate investor protection concerns. The proceedings would allow the Department of Enforcement, after notice and opportunity for a hearing, to order a member or individual to stop engaging in activity that violates certain securities laws or rules. Orders could remain in place until regular disciplinary proceedings

¹ Exchange Act Release No. 40,826, 1998 SEC LEXIS 2788 (Dec. 22, 1998); 63 Fed. Reg. 71984 (Dec. 30, 1998). The public comment period announced in the Federal Register expired on March 1, 1999.

are completed. It is expected that temporary cease and desist proceedings would only be used in the most serious cases. Further, the rules would permit an accelerated proceeding to impose sanctions for violations of temporary or permanent cease and desist orders.

In June 1998, NASD Regulation issued Notice to Members 98-42 to solicit comment on proposed temporary cease and desist rules that differed in a number of respects from the proposal ultimately filed with the Commission. The comment period closed on July 31, 1998. The Association received thirteen comment letters. The staff modified the proposal in response to the comment letters in many significant respects, including: limiting markup violations for which temporary cease and desist orders can be pursued to those violations involving fraudulent markups; requiring that hearing panels find by a preponderance of the evidence that violations occurred; requiring that the disciplinary action underlying temporary cease and desist orders be conducted on an expedited basis; limiting the duration of temporary cease and desist orders; requiring that members or associated persons being charged with violations of temporary or permanent cease and desists orders be notified of the specific provisions of orders alleged to have been violated and that notifications be accompanied by specific facts supporting the alleged violations; and specifying that temporary cease and desist orders are final and immediately effective decisions of the NASD that can be appealed to the SEC under Section 19 of the Securities Exchange Act of 1934 (the “Act”).

On December 22, 1998, the Commission published in the *Federal Register* NASD Regulation’s modified proposal for public comment. The Commission solicited comment on a number of topics, including: (i) whether the NASD Regulation proposal is consistent with the Act, (ii) whether the NASD has sufficiently justified the need for temporary cease and desist authority, (iii) whether the scope of the possible violations should be narrowed, and (iv) what impact, if any, the NASD proposal would have on other laws.

Comment Letters Submitted to the Commission

The Commission received five comment letters on the proposed rule change.² The North American Securities Administrators Association, Inc. (“NASAA”), an international organization devoted to investor protection, submitted a comment letter supporting the NASD Regulation proposal.³ Four commenters expressed concerns about the proposal: (i) the Federal Regulation Committee, the Self-Regulation and Supervisory Practices Committee, and the Compliance & Legal Division of the Securities Industry Association

² See List of Commenters attached as Exhibit A. Some of these comment letters were submitted after the comment period expired. Nevertheless, NASD Regulation has chosen to respond to each letter.

³ In addition, this same sentiment was expressed in a law review note. See James T. Parkinson, Note, *The National Association of Securities Dealers Should Possess Authority to Issue Temporary-Cease-and-Desist Orders*, 51 ADMIN. L. REV. 301 (1999) (arguing in favor of granting NASD temporary cease and desist authority).

(“SIA”); (ii) an ad hoc task force of the Section of Litigation and the Section of Business Law of the American Bar Association (“ABA”); (iii) Dan Jamieson (“Jamieson”), of Huntington Beach California; and (iv) Orrick, Herrington & Sutcliffe, LLP (“Orrick”), a law firm. In addition to the specific questions for which the Commission solicited input, the commenters expressed their views on a few other issues. Many of the issues raised by the commenters in response to the rule proposal were also raised by commenters in response to Notice to Members 98-42. The comments sent to the Commission are summarized by issue below.

Need for the Rule

As noted above, the Commission solicited comment on whether NASD Regulation sufficiently justified the need for temporary cease and desist authority. NASAA believes that since the securities industry and the number of investors have grown at a faster pace than the regulatory community, regulators need to utilize the available resources as efficiently as possible. NASAA notes that most state securities regulators have cease and desist authority, and have found it to be a valuable tool in fighting fraud. NASAA states that NASD Regulation, as “an integral member of the enforcement community,” should be given the authority to issue temporary cease and desist orders.⁴

SIA, ABA, Jamieson, and Orrick, on the other hand, argue that NASD Regulation can adequately protect investors without the benefit of the proposed temporary cease and desist authority. ABA contends that the proposal fails to explain adequately: the nature, extent, or harm to the public that concerns the NASD; any particular problems that the Association has faced in obtaining adequate relief; and any situations in which NASD Regulation’s ability to proceed was adversely affected because it did not have the authority to issue temporary cease and desist orders. SIA states that the NASD has provided no evidence that the proposal is necessary. SIA further contends that if NASD Regulation becomes aware of a situation where immediate action is necessary to protect the investing public, NASD Regulation should request that either the SEC or a state regulatory authority seek the appropriate emergency relief.

As stated in the rule filing, there is a clear need for NASD Regulation to have temporary cease and desist authority. NASD Regulation would use this tool as a means to prevent members’ or associated persons’ misconduct that causes significant dissipation of or conversion of assets or other significant harm to investors while a disciplinary action is pending. Under the NASD’s current rules, it takes a minimum of four months to complete a disciplinary proceeding. This scenario assumes that the action is not settled and that each aspect of the proceeding occurs without delay. Without temporary cease and desist authority, NASD Regulation has no immediate remedy to order cessation of serious cases of ongoing violative conduct. The NASD’s actions against Stratton Oakmont are an unfortunate example of such a situation. In the Stratton case, the firm continued to violate the federal securities laws and the Association’s rules while it engaged in protracted

⁴ See also *id.* at 302 (reaching a similar conclusion).

litigation with both the NASD and the SEC. While the NASD was litigating its disciplinary actions against Stratton, the firm continued to engage in unlawful conduct. Another example involves the case against D. H. Blair. As noted in the settlement of that action, the firm fraudulently marked-up securities in sixteen different offerings, overcharging its customers by over \$1 million dollars in fraudulent mark-ups. The availability of temporary cease and desist authority would have enabled the staff to stop such on-going illegal conduct at an earlier date, protecting investors from on-going unlawful conduct.

NASD Regulation does not dispute SIA's contention that matters may be referred to the SEC or other regulators. As SIA recognizes in its comment letter, however, the NASD is concerned about "unacceptable delays." Even though NASD Regulation, the SEC and other regulators have made great strides in coordinating their respective enforcement efforts, this is not a substitute for NASD Regulation's having temporary cease and desist authority. There are situations where NASD Regulation is in the best position to take immediate action, based on its preexisting investigation and access to case-specific information. In such situations, having to refer the case to another regulatory authority may result in unacceptable delay and would not be an efficient use of NASD Regulation's or other regulators' resources.

Thus, it is clear that the proposal would substantially aid NASD Regulation's efforts to combat fraud. Nevertheless, as discussed in the following section, the test as to whether the Commission should approve proposed rules of a national securities association under Section 15A of the Act is whether the proposed rules provide a fair procedure for disciplining members and persons associated with members, and are within the scope of the authority granted to national securities associations under the Act. Contrary to what some of the commenters suggest, the statute does *not* require that a national securities association demonstrate a *need* for the rule.

Authority

The Commission solicited comment on whether the proposal is consistent with the Act. NASAA responds that numerous provisions of the Act provide the NASD with the authority to issue cease and desist orders. NASAA cites as examples provisions relating to member enforcement, promotion of fair practices, and the requirement that appropriate disciplinary actions be taken against members of a registered securities association.⁵

SIA, Orrick, and Jamieson question whether there is statutory authority to support Commission approval of the proposal. SIA notes that there was considerable debate concerning the enactment of Section 21C(a) of the Act, which grants the Commission authority to issue cease and desist orders, because some argued that injunction-like powers were the exclusive province of the judiciary. SIA further contends that since there was

⁵ See also *id.* at 319 (arguing that the Act expressly authorizes NASD to take summary action in the form of temporary cease and desist orders).

controversy on whether to grant cease and desist authority to the Commission, it does not make sense that the general disciplinary authority granted to a national securities association under Section 15A of the Act includes the power to issue cease and desist orders. Orrick further states that like the NASD, the Commission has a broad mandate to regulate the securities market, but still, the Commission recognized that it was necessary to get specific statutory authority to issue temporary cease and desist orders.

Orrick also notes that the Association's proposal cites Section 15A(b)(7) as supporting authority for the proposal. Orrick contends that this provision only addresses sanctions, and temporary cease and desist orders are not sanctions. Further, Orrick argues that temporary cease and desist orders are quasi-judicial powers that are primarily intended to preserve the status quo.

The proposed rule change falls squarely within the broad authority granted to the NASD as a national securities association.⁶ As discussed in the rule filing submitted to the Commission, the proposal is consistent with Section 15A(b)(2) of the Act, which requires, among other things, that an association of brokers and dealers have the capacity to be able to carry out the purposes of the Act and to enforce compliance by its members and persons associated with its members with the Act, the rules and regulations thereunder, and the rules of the association. In addition, the proposal is consistent with the provisions of Section 15A(b)(6), which require that the rules of an association be designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, and, in general, to protect investors and the public interest. The proposal is also consistent with Sections 15A(b)(7) and (8). Paragraph (b)(7) permits the sanctioning of members and associated persons by several means, including by imposing fitting sanctions, and paragraph (b)(8) requires that the rules of an association, in general, provide a fair procedure for disciplining members and persons associated with members. NASD Regulation believes the proposed rules are consistent with NASD Regulation's obligations under these provisions because temporary cease and desist orders are fitting sanctions designed to stop violative conduct that is likely to cause significant dissipation or conversion of assets or other significant harm to investors, subject to the specific procedures contained in the rules.

Further, pursuant to Section 15A(g)(3)(A), the NASD can, among other things, condition membership of a registered broker/dealer if the broker/dealer or an associated person had engaged in, and there is a reasonable likelihood he will again engage in, acts or practices inconsistent with just and equitable principles of trade. NASD Regulation believes that this provision supports the proposal because a cease and desist order is analogous to a

⁶ In reviewing sanctions imposed by the NASD, the Commission found that the NASD has broad authority to fashion disciplinary measures. See *In re Application of David Joseph Dambro*, Exchange Act Release No. 32,487, 1993 WL 226038 (SEC) (June 18, 1993) (affirming NASD disciplinary decision that awarded restitution). Further, "[c]ourts have upheld regulatory associations' ad hoc, case-by-case applications of broad statutory language." *In re Application of V.H. Costello Securities, Inc.*, Exchange Act Release No. 29,560, 1991 SEC LEXIS 1589 (August 15, 1991).

“condition of membership.” In 1990, the Commission, in part relying on Section 15A(g), approved an NASD rule change that is similar to the current proposal. The Commission approved a procedure by which the NASD could take remedial action against an NASD member or an associated person if the member or person had been engaging in, and there was a reasonable likelihood that the member or person would again engage in, securities law violations.⁷ The NASD proposed this rule change because it had been confronted on several occasions with instances of members and persons that had violated various Commission and NASD rules and regulations and, when advised by the NASD to cease such activities, had evidenced an intent to continue and had continued violative conduct. The Commission found that the proposal was consistent with the requirements of the Act and Section 15A.⁸ The fact that the Commission approved these expedited remedial proceedings demonstrates that the Commission believes the NASD’s authority under Section 15A of the Act is broad enough to cover the current proposal. In 1997, NASD, on its own volition, decided to eliminate “expedited remedial proceedings” and replace them with a new form of summary action. NASD Regulation is now proposing the alternative enforcement tool.⁹

NASD Regulation disagrees with Orrick’s contention that the proposal is not supported by Section 15A(b)(7). Section 15A(b)(7) authorizes a national securities association to impose a number of disciplinary measures to enforce compliance with securities laws, including limitation of activities, functions and operations, and other fitting sanctions. Because temporary cease and desist orders would instruct a party not to engage in certain unlawful activities, they can properly be characterized as “limitation[s] of activities, functions, and operations.” Further, temporary cease and desist orders are also sanctions. The Commission recognized this in drafting its Rules of Procedure, which classify temporary cease and desist orders as sanctions.¹⁰

⁷ See Order Approving Proposed Rule Change Relating to Expedited Remedial Proceedings Under the Code of Procedure, Exch. Act Rel. No. 28,065 (May 29, 1990). There rules were codified in the NASD Manual under Article XI, Section 3 of NASD’s Code of Procedure.

⁸ *Id.*

⁹ See Notice of Filing of a Proposed Rule Change by the National Association of Securities Dealers, Inc. to Proposed Changes in the By-Laws of the NASD, NASD Regulation, Inc., The Nasdaq Stock Market, Inc., Exch. Act Rel. No. 38,545, 64 SEC Docket (CCH) 862, 912 (Apr. 24, 1997).

¹⁰ See Securities and Exchange Commission Rules of Practice, 17 C.F.R. ' 201.101(a)(11) (1998); see also BLACK’S LAW DICTIONARY 1341 (6th ed. 1990) (defining a sanction as a “[p]enalty or other mechanism of enforcement used to provide incentives for obedience with the law or with rules and regulations”).

Predicate Violations

Another question raised by the Commission is whether the forms of misconduct that can be used to support temporary cease and desist orders should be more limited than those outlined in the proposal. Under the proposal, NASD Regulation can seek temporary cease and desist orders with respect to alleged violations of Section 10(b) of the Act, Rules 10b-5 and 15g-1 through 15g-9 (the penny stock rules) under the Act, and in certain circumstances NASD Rules 2110, 2120 or 2330.¹¹

NASAA believes that additional limitations should *not* be placed on NASD Regulation's ability to seek temporary cease and desist orders.¹² ABA, SIA, and Orrick, on the other hand, contend that the scope of predicate violations outlined in the proposal are too broad. Specifically, SIA and Orrick are concerned because the proposal lists Rule 10b-5 as a predicate violation. SIA states, by including Rule 10b-5, "the NASD has staked out the entire field of securities law enforcement as a basis on which it can invoke this new authority." ABA argues that since the purpose of the proposal is to protect investor funds, especially in the microcap area, then the proposal should be limited to cases involving microcap securities.¹³ ABA further believes that unauthorized trading should not be included as a predicate violation because these cases rarely require immediate action. Finally, ABA argues that markup cases (whether characterized as "excessive" or "fraudulent") should not be included as predicate violations because there is uncertainty as to the standard to be applied in determining the appropriateness of markups.

Contrary to the contentions of SIA and Orrick, by including Rule 10b-5 as a predicate violation, the proposal does not permit NASD Regulation to seek a temporary cease and desist order for any securities law violation, as Rule 10b-5 requires a showing of

¹¹ For NASD Rule 2110, which governs standards of commercial honor and principles of trade, the predicate violations are limited to circumstances involving alleged violations of Section 17(a) of the Securities Act of 1933, or circumstances involving unauthorized trading or misuse or conversion of customer assets. For Rule 2330, which governs members' use of customers' securities or funds, the alleged violations for which a temporary cease and desist proceeding can be initiated are limited to circumstances involving misuse or conversion of customer assets.

¹² Rather, NASAA argues that the goal of investor protection would be better served if NASD Regulation staff were given more flexibility than contemplated in the proposal so as to permit it to seek temporary cease and desist orders based on state law fraud or conversion violations. NASD Regulation, however, does not believe that it needs such authority at this time. Nevertheless, NASD Regulation will take NASAA's recommendation under advisement and consider modifying the proposed rule at a later date.

¹³ ABA notes that if NASD Regulation determines from experience that the authority to issue temporary cease and desist orders should be expanded to include violations that do not involve microcap securities, then NASD Regulation could file a proposal to do so in the future.

fraud. Further, as noted above, the proposed rule only addresses the forms of misconduct most likely to result in quick dissipation of investor funds.

While ABA is correct in suggesting that the temporary cease and desist authority could play an important role in reducing the damages caused by microcap fraud, the value of this enforcement tool is not so limited. Investors need protection, regardless of the market in which they invest. NASD Regulation further believes that unauthorized trading and fraudulent excessive markup cases should be included as predicate acts.¹⁴ Both of these categories of cases pose serious threat to investors, and can result in the rapid dissipation of investor funds.

Collateral Consequences

The Commission further requested comment on what impact, if any, the NASD proposal would have outside of the federal securities laws. ABA responds by noting that it is unclear whether: (a) the issuance of a temporary cease and desist order could trigger a state registration revocation proceeding or an enforcement proceeding concerning the same underlying conduct at issue in the NASDR case; or (b) a respondent would be collaterally estopped from contesting issues raised in customer disputes, allegedly relating to the circumstances that are the subject of the temporary cease and desist order or underlying proceeding. ABA also is concerned about regulatory “piling on.” ABA believes that NASD is in the best position to determine whether the proposal “will have an effect on other laws.”

ABA suggests that NASD Regulation discuss the issue with state securities regulators, including members of NASAA.¹⁵ SIA believes that “the issue is so broad as to require further analysis on the part of the NASD and those who are potentially impacted.”

NASD Regulation believes that it should not be denied a tool designed to protect investors because of a perceived reaction that state regulators may have the use of such tool. For the following reasons, NASD Regulation believes that its temporary cease and desist authority will have limited collateral impacts.¹⁶

¹⁴ In the Notice to Members, NASD Regulation proposed pursuing temporary cease and desist orders in cases in which the Department of Enforcement alleged that the markups were *excessive* and in violation of Rule 2110. Two commenters believed it would be inappropriate to pursue a temporary cease and desist order for excessive markups because of the degree of uncertainty involved in determining appropriate markups. In response to the comments, NASD Regulation has modified the proposal to permit temporary cease and desist orders only in cases in which it is alleged that the markups are *fraudulent* under Section 10(b) of the Exchange Act, SEC Rule 10b-5 thereunder, or NASD Rule 2120.

¹⁵ Based upon NAASA’s comment letter, it does not appear that NAASA is concerned about the collateral consequences of the proposal.

¹⁶ The foregoing is based on a preliminary survey of the blue sky laws of fifty-two jurisdictions, including forty-nine states, the District of Columbia, Puerto Rico, and Guam. New York does not have a traditional blue sky law.

Blue sky laws are state statutes which deal with securities regulation, including the registration of broker/dealers. These laws permit state securities administrators to deny, suspend, or revoke broker/dealers' registrations based on one or more enumerated grounds, including regulatory actions taken by other securities regulators¹⁷, or the failure to disclose such actions.¹⁸ Our research only uncovered seven blue sky laws that have statutory provisions that specifically authorize the denial, suspension, or revocation of broker/dealers' state registrations based on an order issued by a national securities association.¹⁹ Most states' blue sky statutes, however, contain provisions that enable state securities administrators to deny, suspend, or revoke registration statements based upon findings that firms have engaged in dishonest or unethical practices in the securities business.²⁰ Arguably, state securities regulators could find that the existence of an NASD Regulation temporary cease and desist order is evidence of fraudulent or dishonest practices. NASD Regulation, however, is not aware of any state statute that would mandate the denial, suspension, or revocation of broker/dealers' registrations based on NASD Regulation cease and desist orders.

NASD Regulation does not believe that ABA's concern that respondents will be collaterally estopped from contesting issues in customer disputes based on NASD Regulation temporary cease and desist orders is well founded. Arbitrators are generally more reluctant to apply strict legal standards than courts. Further, NASD Regulation does not believe that permitting NASD Regulation to issue temporary cease and desist orders

¹⁷ These other securities regulators include, depending on the particular state statute, the Securities and Exchange Commission, state securities administrators, self-regulatory organizations, and national securities associations.

¹⁸ Most, if not all states, have statutes that arguably could require broker/dealers to disclose the existence of temporary cease and desist orders. *See, e.g.* Del. Code Ann. tit. 6, ' 7314 (1998); D.C. Code Ann. ' 2-2604 (1998); Utah Code Ann. ' 61-1-4 (1998); Mass. Gen. Laws Ann. ch. 110A, ' 202 (West 1998); Mich. Stat. Ann. ' 19.776(202) (Callaghan 1999); N.J. Rev. Stat. ' 49:3-57 (1999); 70 Pa. Cons. Stat. ' 1-303 (1998); Wash. Rev. Code ' 21.20.060 (1999); Fla. Stat. ch. 517.12 (1998); Tex. Rev. Civ. Stat. art. 581-13 (1999); and N.Y. Gen. Bus. Law ' 359-e (Consol. 1998); Va. Code Ann. ' 13.1-505 (Michie 1998); Cal Corp. Code ' 25211 (Deering 1999); Conn. Gen. Stat. ' 36b-7 (1997); Md. Code Ann., Corps. and Assocs. ' 11-405 (1998); Ga. Code Ann. ' 10-5-3 (1998); 815 Ill. Comp. Stat. 5/8 (1998). Colo. Rev. Stat. ' 11-51-403 (1998); Nev. Rev. Stat. Ann. ' 90.350 (1999); R.I. Gen. Laws ' 7-11-205 (1998).

¹⁹ Ala. Code ' 8-6-3 (1998); Ark. Stat. Ann. ' 23-42-308 (1997); Conn. Gen. Stat. ' 36b-15 (1997); Fla. Stat. ch. 517.161 (1998); 815 Ill. Comp. Stat. 5/8 (1998); Ky. Rev. Stat. Ann. ' 292.330 (Michie/Bobbs-Merrill 1998); and Okla. Stat. tit. 71, ' 204 (1998).

²⁰ *See e.g.*, D.C. Code Ann. ' 2-2609 (1998); Minn. Stat. ' 80A.07 (1998); Ariz. Rev. Stat. Ann. ' 44-1961 (1998); Del. Code Ann. tit. 6, ' 7316 (1998); Ga. Code Ann. ' 10-5-4 (1998); Kan. Stat. Ann. ' 17-1254 (1997); Me. Rev. Stat. Ann. tit. 32, ' 10313 (West 1998); Md. Code Ann., Corps. and Assocs. ' 11-412 (1998); Mass. Gen. Laws Ann. ch. 110A, ' 204 (West 1998); Mich. Stat. Ann. ' 19.776(204) (Callaghan 1999); N.J. Rev. Stat. ' 49:3-58 (1999); Tex. Rev. Civ. Stat. art. 581-14 (1999); Wash. Rev. Code ' 21.20.110 (1999); Ind. Code ' 23-2-1-11 (1998); Neb. Rev. Stat. ' 8-1103 (1998).

will result in regulators “piling on” respondents. Under the securities laws, regardless of whether NASD Regulation is given temporary cease and desist authority, there are situations in which more than one regulator can take action against a party. NASD Regulation has worked with other regulators in coordinating efforts, and if given temporary cease and desist authority, will also coordinate the use of this enforcement tool as well. Further, commenters complained of the “piling on” effect when the Commission requested cease and desist authority.²¹ As the concern about the Commission “piling on” proved unwarranted, the concern about NASD Regulation doing the same will also prove unwarranted. Finally, NASD Regulation disagrees with SIA’s belief that the proposal will have such broad implications that further analysis is required. As noted above, NASD Regulation plans to use the temporary cease and desist authority in only the most serious cases. By such judicious use of the temporary cease and desist authority, NASD Regulation believes that the collateral effects of this tool will be limited.²²

Procedural Safeguards

As noted above, commenters raise a few issues that the Commission did not specifically address in the “Solicitation of Comments” section of the rule filing published in the *Federal Register*. One of these issues is whether the proposal provides adequate procedural safeguards. NASAA believes that the proposal contains sufficient procedural safeguards to ensure that the NASD Regulation could only issue temporary cease and desist orders in egregious cases.²³ NASAA notes that the President or Chief Operating Officer of NASD Regulation must issue written authorization before the initiation of a hearing to institute cease and desist proceedings or suspend or cancel NASD memberships for violations of cease and desist orders.

Orrick complains that under the proposal, temporary cease and desist orders can be issued based on findings by the preponderance of the evidence, and that this standard is too low. SIA states that “standards such as ‘preponderance of the evidence’ and ‘likely to result in the . . . dissipation of assets’ do not so much raise the bar for the use of cease and desist orders as invite arbitrary imposition of orders based on subjective interpretation of the standard.” ABA and Orrick believe that Hearing Panels should be required to find that

²¹ See Dennis Block & Jonathan Hoff, *New Proposals to Expand S.E.C. Enforcement Authority*, N.Y.L.J. (May 17, 1990).

²² See testimony of Former SEC Chairman Richard Breeden before the Senate Subcommittee on Securities of the Committee on Banking on February 1, 1990, where he notes that cease and desist orders would not involve the same collateral consequences as injunctions. Testimony of Richard C. Breeden, Chairman, Securities and Exchange Commission, Before the Subcomm. on Securities of the Comm. on Banking, Housing, and Urban Affairs, Concerning S. 647, The “Securities Law Enforcement Remedies Act of 1989,” 101st Cong., 2d Sess. 2, 56-57 (1990).

²³ See also Parkinson, *supra* note 3, at 318 (stating that NASD Regulation’s procedural safeguards for issuing temporary cease and desist orders exceed the requirements of the Act).

investors will be irreversibly harmed or that their chances of subsequent recovery will be damaged by the standard disciplinary process before temporary cease and desist orders could be entered. In other words, if respondents have sufficient capital to cover the alleged damages, there is no need for expedited action. ABA also believes that in cases that do not involve potential investor losses, Hearing Panels should be required to find that there is a substantial likelihood that respondents will engage in future violations. ABA notes that courts have required the Commission to establish such a finding before issuing injunctive relief. ABA further notes that a Commission administrative law judge (“ALJ”) has held that the Commission cannot issue permanent cease and desist orders without evidence of a likelihood of recurrence.²⁴ The ABA letter acknowledges that the Chief Commission ALJ concluded that such a finding is not required for Commission cease and desist orders.²⁵

ABA and SIA believe that Hearing Panels should be required to consider the impact temporary cease and desist orders would have on respondents. SIA states that temporary cease and desist orders could result in the “destruction of legitimate business enterprises, based solely on staff allegations, as seconded by the President (or COO) of [NASD Regulation].” SIA complains that no other private body has such economic authority, and that in giving cease and desist authority to the Commission, Congress provided a mechanism for immediate review. SIA further contends that even though NASD Regulation modified its proposal so as to permit immediate appeals of temporary cease and desist orders, the respondent would still have to await completion of the Commission review process before proceeding to the Court of Appeals.

Orrick complains that the proposed rule could provide for hearings as soon as four days after respondents are served with notices, and that this period is too short to prepare adequate defenses. Orrick points out that the Commission’s temporary cease and desist rules provide for hearings not earlier than thirty days after service of the notice. Orrick further notes that the Commission’s rules provide for judicial review within ten days of the issuance of orders, and the NASD Regulation proposal does not provide for expedited reviews.

NASD Regulation recognizes that temporary cease and desist orders are powerful measures that should be used very cautiously. Consequently, the rules have been designed to ensure that the proceedings are used to address only the most serious types of misconduct, and that the interests of respondents are protected. As NASAA notes, to ensure that temporary cease and desist proceedings are used appropriately and that

²⁴ See *In the Matter of WHX Corporation*, Initial Decisions Rel. No. 579, 1999 SEC LEXIS 619 (March 9, 1999) (Carol Fox Foelak, ALJ); *In the Matter of Warren G. Trepp*, Initial Decisions Rel. No. 115, 1997 SEC LEXIS 1682 (August 18, 1997) (Carol Fox Foelak, ALJ); *In the Matter of Valicenti Advisory Services, Inc.*, Initial Decisions Rel. No.111, 1997 SEC LEXIS 1395 (July 2, 1997) (Carol Fox Foelak, ALJ).

²⁵ See *In the Matter of Joel Zbar*, Administrative Proceedings Rulings Rel. No. 425, 1994 SEC LEXIS 1289 (April 28, 1994) (Brenda P. Murray, Chief ALJ).

decisions to initiate proceedings are made only at the highest staff levels, the proposed rules require the President or Chief Operating Officer of NASD Regulation to issue written authorization before the Department of Enforcement can institute such proceedings. Further, the proposal is based upon the rules that govern NASD disciplinary proceedings, with certain modifications made to reflect that temporary cease and desist proceedings are expedited proceedings. The proposal therefore provides respondents with many procedural protections.

The proposed rules set a specific standard that must be met before Hearing Panels can issue such orders. Hearing Panels must find by the preponderance of the evidence that the alleged violations have occurred, which is the same evidentiary standard used in the underlying disciplinary proceedings. Hearing Panels also must find that the violative conduct or the continuation thereof is likely to result in the significant dissipation or conversion of assets or other significant harm to investors prior to completion of disciplinary proceedings under the Rule 9200 and 9300 Series. This standard is designed to ensure that temporary cease and desist orders cannot be issued for technical violations of rules.

NASD Regulation believes that an irreparable harm standard would frustrate its attempt to stop ongoing fraudulent activity. Under such a standard, as long as members could show that they are solvent and *at the time* could pay any potential arbitration or mediation awards while disciplinary actions are proceeding, NASD Regulation could be unable to stop the ongoing fraudulent activity until the completion of the regular disciplinary proceedings. Too often, a member's financial condition significantly changes after the conclusion of the disciplinary proceeding. Indeed, in a number of recent cases, member firms filed for bankruptcy or went into Securities Investor Protection Corporation liquidation during or immediately after the completion of an NASD Regulation disciplinary action. Finally, NASD Regulation believes that once it has been shown that the violative conduct or the continuation thereof is likely to result in significant dissipation or conversion of assets or other significant harm to investors, the potential harm to respondents if orders are issued is overshadowed by the harm that is likely to occur if orders are not issued.

Further, NASD Regulation believes that Hearing Panels should *not* be required to find that there is a substantial likelihood that respondents will engage in future violations of the same securities laws or rules before issuing cease and desist orders. As noted above, Chief Commission ALJ Murray found that the likelihood of recurrence is not a prerequisite to the issuance of Commission cease and desist orders. In support of this position, Chief ALJ Murray notes that: "The Commission must have a broad range of remedies at its disposal. It needs a remedial structure that is strong enough to deter serious fraudulent conduct, while remaining flexible enough to permit an appropriate response in each case."²⁶

²⁶ *Id.* at *6. Judge Murray further found that the statute that authorizes the Commission to initiate cease and desist proceedings does not impose a requirement that there be a finding that respondents will likely commit future violations. *Id.* This decision also notes cases cited by both parties as to whether other agencies require the

On the other hand, another Commission ALJ, Judge Foelak has found that cease and desist orders are comparable to injunctions, and thus, as in the case of injunctions, should only be granted when there is evidence that respondents will likely engage in future violative conduct.²⁷ ALJ Foelak acknowledges that neither the Commission nor any courts of appeals have ruled on whether the Commission must find a likelihood of future violations to issue cease and desist orders.²⁸ She, however, states that other agencies must show a reasonable likelihood of future violations in exercising cease and desist powers.²⁹ Judge Foelak also cites language from the House Report to the Remedies Act of 1990 for the proposition that cease and desist orders are comparable to court ordered injunctions.³⁰

The staff of the Division of Enforcement at the Commission (the “Division staff”) recently appealed the decision issued by ALJ Foelak to the Commission.³¹ The Division staff took the position that Commission ALJs do not have to find a likelihood of future recurrence before issuing cease and desist orders.³² The Division staff contends that “[s]tandards requiring reasonable likelihood appear to apply only, in some agencies, to situations where broad or affirmative orders are imposed that will dramatically intrude in

finding of likely future violations before issuing cease and desist orders. *Id.* at *1-2, n.1 & 2. For a listing of other agencies’ cases, see *infra* notes 29 & 33.

²⁷ See e.g., *In the Matter of Warren G. Trepp*, 1997 SEC LEXIS.

²⁸ *Id.*

²⁹ *Id.* at *14-15 (citing *Precious Metals Assocs. v. CFTC*, 620 F.2d 900, 912 (1st Cir. 1980); *Borg-Warner Corp. v. FTC*, 746 F.2d 108, 110-11 (2nd Cir. 1984); *NLRB v. Savin Business Machines Corp.*, 649 F.2d 89, 93 (1st Cir. 1981); *Citizens State Bank of Marshfield, Mo. v. FDIC*, 751 F.2d 209, 214-15 & n.9 (8th Cir. 1984)).

³⁰ See *id.* at *15 (citing H.R. Rep. No. 101-616, at 23-24 (1990)).

³¹ Oral argument was heard before the Commission on this matter on April 21, 1999.

³² Division’s Brief in Support of Petition for Review, *In the Matter of Warren G. Trepp*, Administrative Proceeding (Oct. 20, 1997) (No. 3-8833); see also *Cease-And-Desist Authority May Have Limited Use*, SEC Staff Officials Say, 23 Sec. Reg. & L. Rep. (BNA), Mar. 8, 1991, at 369 (noting comments of former SEC Associate Enforcement Director Harry Weiss); *SEC May Bring More Enforcement Cases Against Middle, Lower Level Executives*, 24 Sec. Reg. & L. Rep. (BNA), Jan. 10, 1992, at 39 (noting comments of former SEC Enforcement Director Gary Lynch); 10 LOUIS LOSS & JOEL SELIGMAN, SECURITIES REGULATION 4989 (3d rev. ed. 1996) (reaching same conclusion). But see Robert Romano, *The SEC’s New Cease and Desist Powers*, N. Y. L. J., Oct. 29, 1991, at 1 (arguing that the Commission should demonstrate the likelihood of recurrence in cease and desist proceedings).

the day-to-day activities of a respondent.”³³ The Division staff further reasons that imposing the requirement used in injunctive proceedings – establishing a likelihood of future recurrence before issuing temporary cease and desist orders – would defeat the legislative intent of granting the Commission the authority to issue these orders.³⁴ The Division staff notes that Congressional Reports clarify that the cease and desist authority given to the Commission was meant to “‘enhance the SEC’s ability to flexibly tailor remedies to the facts and circumstance of a particular case.’”³⁵

NASD Regulation supports the position taken by the Division staff in the *Trepp* appeal, and accordingly does not propose modifying the proposal to include the “likelihood of future violations” standard. NASD Regulation appreciates that this is an open issue, and that arguments may be put forth on either side of the issue.³⁶ Of course, NASD Regulation will re-evaluate this position if the Commission determines to include the likelihood of a future violations requirement in Commission cease and desist proceedings.

Finally, NASD Regulation believes that a four day notice requirement should provide respondents with sufficient notice of hearings. These proceedings are designed to occur on an expedited basis so as to stop ongoing violative conduct that is likely to cause significant dissipation or conversion of assets or other significant harm to investors before the underlying disciplinary action is concluded. Further, unlike the Commission proceedings, there is no mechanism in the NASD proposal for ex parte proceedings.

³³ Division’s Brief in Support of Petition for Review at 10,12-23, *In the Matter of Warren G. Trepp*, Administrative Proceeding (Oct. 20, 1997) (No. 3-8833) (discussing numerous cases, including: *In the Matter of Interamericas Investments Ltd. and Peter Ulrich*, 94-064-b-HC, 82 Federal Reserve Bulletin No. 6, 618, 1996 WL 193671 (F.R.B.) (April 9, 1996), *aff’d*, *Interamericas Investments v. Board of Governor’s of the Federal Reserve System*, 111 F.3d 376 (5th Cir. 1997); *Saratoga Savings and Loan Association v. Federal Home Loan Bank Board*, 879 F.2d 689 (9th Cir. 1989); *Oberstar v. FDIC*, 987 F.2d 494, 502 (8th Cir. 1993); *Greene County Bank v. FDIC*, 92 F.3d 633, 636 (8th Cir. 1996), *cert. denied*, 117 S.Ct. 944 (1997); *UAW v. N.L.R.B.*, 427 F.2d 1330 (6th Cir. 1970); *Jacob Siegel Co. v. FTC*, 327 U.S. 608 (1946)).

³⁴ *See id.* at 10.

³⁵ *Id.* at 8 (citing S. Rep. No. 101-337, at 17 (1990) (emphasis added)).

³⁶ *See* Steven W. Hansen, *The Securities and Exchange Commission’s Use of Cease and Desist Authority: A Preliminary Appraisal*, 20 Sec. Reg. L.J. 339, 347-348 (1993) (recognizing that this is an open-ended issue, but concluding that the Commission is unlikely to place such a requirement on its temporary cease and desist authority).

Permanent Cease and Desist Orders

ABA is troubled by language in the proposal that discusses NASD Regulation's authority to seek permanent cease and desist orders. ABA complains that the discussion of permanent cease and desist authority is not highlighted by NASD Regulation in either the Notice to Members or the rule proposal. ABA further states that the issue was not highlighted by the Commission in the "Solicitation of Comment" section of the release published in the *Federal Register*. ABA believes that having the authority to issue permanent cease and desist orders would radically change the sanctions available to Hearing Panels. ABA is further concerned that NASD Regulation will routinely seek permanent cease and desist orders.

As ABA acknowledges, both the Notice to Members and the rule filing mention NASD Regulation's authority to issue permanent cease and desist orders. NASD Regulation did not highlight the issue of permanent cease and desist orders because the Association already has the authority to issue them. As discussed above, NASD Rule 8310 authorizes Hearing Panels to "impose any other fitting sanction," and permanent cease and desist orders fit under the category of "other fitting sanctions." The fact that the Association has never issued such an order in the past should give comfort that such authority will not be routinely invoked. As with the case of temporary cease and desist orders, the Association only plans to seek such orders in the most serious cases. In order to provide additional comfort, NASD Regulation is amending the rule filing with the following language. The following language should be inserted after item (ix) on page 32 of the rule filing, as amended by Amendment No. 1, dated December 15, 1998.

* * *

(x) Context in Which Permanent Cease and Desist Orders will be Sought

The Association staff does not anticipate seeking permanent cease and desist orders on a routine basis. Factors that the Association staff will consider in determining whether a permanent cease and desist order is appropriate include whether the party's violation was isolated or part of a pattern, whether the violation was flagrant and deliberate or merely technical in nature, and whether the party's business will present opportunities to engage in future violative conduct.³⁷

* * *

³⁷ Although courts have considered these factors in evaluating the likelihood of future violations, *see SEC v. Steadman*, 967 F.2d 636, 647-48 (D.C. Cir. 1992). NASD Regulation does not propose requiring Hearing Officers to find a substantial likelihood of future violations before issuing cease and desist orders. NASD Regulation is only stating that these are factors that the staff of NASD Regulation will consider in determining whether to seek a permanent cease and desist order.

In conclusion, NASD Regulation believes that the proposed rule on temporary cease and desist orders fairly balances two public interests: protecting investors and ensuring that excessive regulatory burdens are not placed on member firms. Accordingly, NASD Regulation continues to believe that the proposal is an appropriate and reasonable resolution of the issues.

Very truly yours,

Alden S. Adkins
Sr. Vice President
and General Counsel

Exhibit A - List of Commenters

**LIST OF COMMENTERS ON PROPOSED
TEMPORARY CEASE AND DESIST ORDERS RULE**

1. Dan Jamieson, Huntington Beach, Ca. (Dec. 29, 1998)
2. Sam Scott Miller, Orrick, Herrington & Sutcliffe LLP (Feb. 9, 1999)
3. Peter C. Hildreth, North American Securities Administrators Association, Inc. (March 1, 1999)
4. James Tricarico, Lee B. Spencer and R. Gerald Baker, Securities Industry Association (March 5, 1999)
5. Barbara M. G. Lynn and James H. Cheek II, American Bar Association-Section of Litigation (March 8, 1999)