Statement of Jonathan G. Katz Before
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The Subcommittee on Government Organization, Efficiency and Financial Management,
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Good afternoon, Chairman McHenry, Chairman Platts, Ranking Member Quigley, Ranking Member towns, and members of the Subcommittees. It is an honor to be invited to testify today on the operations of the Securities and Exchange Commission. This is a subject that is of great importance to me personally. For 23 years I was an employee of the SEC. For 20 of those years I served as the Commission's Secretary. This was a position that afforded me a rare opportunity to participate first hand in virtually every aspect of the Commission's responsibilities. I considered it an honor and a privilege.

I retired from the SEC in January 2006. In the five years since my retirement I have been equally fortunate. I have had the opportunity to use the knowledge I gained at the SEC to advise government regulators in a wide array of countries. This experience has taught me a great deal about financial regulation, what it means and what it can accomplish. During these trips I have learned that while markets may be similar, and the regulatory problems may be similar, the appropriate responses may be very different. As I explain to foreign regulators, no matter how thoroughly and how well you study a problem, you should not expect to identify the perfect solution. A regulator must instead focus on identifying several viable actions and rationally choose from among the reasonable, if imperfect, alternatives. If a financial market is truly a free market, it changes quickly. Any regulatory action taken must be regularly reconsidered. When the market inevitably changes, a regulator must accept that the action chosen may have to change as well.

In addition to my international work, I have also had the opportunity to speak and write about financial regulation in the U.S. In 2008, the Center for Capital Market Competitiveness at the U.S. Chamber of Commerce invited me to conduct a study and write a report on how to improve the efficiency and effectiveness of the SEC. That study focused on three core responsibilities of the Commission: The no-action letter process, primarily in the Division of Corporation Finance; the process for reviewing self-regulatory organization rule filings in the Division of Trading and Markets; and the process in the Division of Investment Management through which registered investment companies apply for and obtain exemptions from specific requirements under the Investment Company Act of 1940. In addition to these activities I also wrote a separate chapter on how the management structure of the SEC could be improved.

While I wrote the report for the Chamber, I cannot take sole credit for its recommendations. The 23 recommendations in the report represent the collective ideas of

more than fifty current and former SEC staff and Commissioners who agreed to be interviewed and who freely offered their ideas, insights and criticisms. It is gratifying that, in the two years since the report was published, the SEC has implemented or begun to implement several of the recommendations.

This statement and my testimony today also are based on an article I wrote in 2009, published in the University of Pittsburgh Law Review. The article focuses primarily on the Enforcement program at the SEC, a subject that I did not discuss in the Chamber Report. While the Chamber Report is based upon a series of interviews, the enforcement article is based solely on my personal views and research. I have previously provided the Committee's staff with electronic copies of both articles. Both documents are freely available on the websites of the Chamber of Commerce and the University of Pittsburgh Law Review.[1]

Rather than repeat everything that is contained in these documents, today I will focus on five recommendations that I believe to be most germane to this hearing. They are:

1. Improving SEC management and organization
2. Improving the efficiency and effectiveness of core SEC functions
3. Improving the quality of the SEC policy development process
4. Improving SEC enforcement
5. The need for a second Special Study of the Securities Market

Improving SEC management and organization

The size, structure and complexity of the U.S. capital markets and financial companies have grown substantially in the past thirty years. While the size of the SEC has increased significantly over that time, its organizational and management structure has not changed to reflect these developments. Reorganization of key divisions and a better system for managing operations are needed. The ability of the five-member Commission to interpret policy and oversee staff implementation of policy must also be strengthened.

A partial reorganization proposal

Throughout its history, the SEC has followed an organizational model that roughly paralleled the functions, organization and structure of the financial services industry it regulated. Unfortunately, it is based upon the functions, organization and

[1] The Chamber of Commerce report is available at:
http://www.centerforcapitalmarkets.com/wp-content/uploads/2010/04/ExaminingtheSECrdcfinal.pdf.
The Law review article is available at:
http://lawreview.law.pitt.edu/issues/71/71.3/71_3_Katz_Reviwing_the_sec.pdf

structure of the financial services industry as it existed in the 1970's, when the last major reorganization occurred. While the structure of the financial services industry has changed dramatically in the past forty years, the organization of the SEC has not changed substantially. Today the financial services industry in the United States is highly integrated. A single entity, typically organized as a holding company with separately incorporated and registered subsidiaries, provides a complete suite of investment products and services. The public increasingly works through a single point of contact. A broad reorganization of the SEC is long overdue. The SEC organizational structure should be changed to parallel these changes in the industry, with one division responsible for regulation of retail services to the public and one division with comprehensive responsibility for oversight of securities markets and prudential regulation of the finances and operations of all entities and subsidiaries regulated by the SEC. This is not an original idea. It is analogous to the "twin peaks" model of regulation that originated in Australia and is being adopted in many other countries.[2]

One division would have responsibility for regulation of all retail investment products and services and all professionals. When a retail investor meets with a "financial adviser or consultant", they may believe that the same laws and professional standards apply regardless of the designation or company letterhead. This is not correct. In the past few years a great deal of attention has focused on the different fiduciary standards that apply under the Exchange Act and the Investment Advisers Act. With a clear mandate under Dodd-Frank the SEC is undertaking to address this problem. But it is not the only important difference between the two regulatory regimes. Here are a few other examples. One regulatory regime imposes restrictions on the sale of securities by related parties and the other does not. One system imposes minimum operating capital requirements and the other does not. One system requires individuals to pass qualification exams and the other does not. I am not suggesting as a solution that the SEC adopt a one size fits all approach. I am suggesting that a single division with comprehensive authority would be better able to adopt regulatory policies that are rational and apply in the same way to the same type of service or relationship.

While many of these differences are explicitly embedded in the different laws and can only be harmonized through Congressional action, the current organization of the Commission exacerbates the problem. Efforts to rationalize, reduce or eliminate these differences have traditionally been hampered by "turf wars" between divisions and offices. Under the proposed structure one office would be responsible both for Exchange Act regulation of "registered representatives" and Investment Adviser Act regulation of investment advisers.

The disparity in the regulation of persons under the two acts is mirrored in the regulation of investment products. Consider, for example, the regulation of exchange-traded funds as an alternative investment to mutual funds. The clear distinction of the

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[2] For a detailed discussion and analysis of the Twin Peaks model see GROUP OF THIRTY, THE STRUCTURE OF FINANCIAL SUPERVISION: APPROACHES AND CHALLENGES IN A GLOBAL MARKETPLACE (2008), https://www.deloitte.com/assets/Dcom-UnitedStates/Local%20Assets/Documents/us_fsi_banking_G30%20Final%20Report%2010-3-08.pdf.

past between discrete investments in the secondary market and investments in mutual funds has become blurred. Coherent and consistent SEC regulation should be structured so that a single division is responsible for all retail investment products and services offered.

A separate division should have sole responsibility for prudential regulation, the so-called safety, soundness and stability component of financial regulation. This would include oversight of secondary markets, as well as the responsibility for licensing, oversight of the back-office and capital adequacy of regulated entities. Within this division, there should be a greatly expanded capacity to oversee the debt markets. The SEC has historically focused its resources on the equity markets, reflecting its view that large institutions dominate the debt markets and these "professional" markets can be largely self-policing. Events of the last several years have demonstrated the limitations of the "self-policing" model. Furthermore, as the "baby boom" generation ages and shifts its collective investment portfolio from equity into fixed-income securities, greater regulatory oversight of this market will become more important.

A critical component of this recommendation is the reconsolidation of the examination functions of the Office of Compliance, inspection and Examination ("OCIE") into the new divisions. When OCIE was created, it was envisioned that a separate unit devoted to examinations would provide greater visibility. It was also thought that a merger of the two primary exam programs (investment company/investment adviser and broker-dealer/SRO) would create synergies and improve efficiency. While the first goal, greater visibility has been achieved, the hoped-for synergies is a matter on which there is disagreement.

Unfortunately, the creation of OCIE had several deleterious unintended consequences. The separation of the on-site examinations staff from the regulatory policy divisions has deprived the regulatory policy divisions of critical real-time information. As one former division director commented, "The division has lost its eyes and ears. I used to be able to read an article in the Wall Street Journal in the morning and have an examination team from the New York office on-site in the afternoon. That's no longer possible". Today, it is more likely that information from an examination will be the basis for a formal order of investigation. While this may be appropriate in many instances, it is another reflection of the shift at the SEC from a "regulatory compliance" paradigm to a "regulation by enforcement" paradigm.

A Chief Operating Officer with broad responsibility to monitor and assess core operations is needed at the SEC

The responsibilities of the SEC are substantial and the issues that require its attention are often dictated by the conditions of the capital markets. These are matters of national policy and require careful attention. The Chairman and the Commissioners must focus their time on regulatory policy. There is insufficient time to effectively oversee the core daily functions of the SEC. At the SEC, the primary operating divisions of the Commission, and the comparably sized OCIE, operate semi-autonomously. Each has

virtually complete control over its operations (with the exception of Enforcement, which has only limited delegated authority) and may adopt policies and procedures that differ from the other operating units. While the Chairman will be informed of significant activities and have the opportunity to control any decision, this is often a reactive not a proactive process. The division largely controls what is presented to the Chairman or the Commission. For this reason, the daily operations of the SEC are rarely given much attention. The Commissioners' problem of insufficient time also applies to the division directors. While many division directors are selected from the Commission's staff, frequently they are hired from outside the SEC. While some division directors serve for a decade or more, most serve for the term of the Chairman who appointed them. They arrive with an agenda of policy matters that they hope to address and delegate responsibility for daily operations to others. While efficiency is always a goal, it is seldom a priority.

In providing this critical assessment of the problem, one must acknowledge that it is a generalization based upon the practices of a variety of division directors over the past twenty-five years. While there have been several occasions when a particular Chairman or division director has made operating efficiency a priority, these have been the exception and short-lived. When the catalyst for the attention fades away or the individual who championed the initiative leaves, the commitment disappears. A COO would institutionalize this current commitment to agency efficiency and reduce the pressure on each division director to be the driving force. If a Chairman appointed a COO whose mandate is to improve agency operations it would relieve the division directors of this responsibility and provide them with greater freedom to focus on agency policy. A single COO could also address the inconsistencies in process that exist.

This is not a new concept. Over the years, some SEC Chairmen have assigned COO duties to either the Chairman's Chief of Staff (also referred to as Executive Assistant to the Chairman or Managing Director) or the Executive Director. In fact, when the position of Executive Director was established at the SEC, this was to be a core responsibility.[3] Historically this has not occurred, largely because an executive director must focus on the annual Congressional appropriation cycle, budgeting process and administrative duties. Because of the critical importance of these responsibilities executive directors have been selected who posses expertise in these areas, rather than knowledge of agency operations. The Chief of Staff has similar higher priority duties, including managing the office of the Chairman, working with the division directors on policy issues, and acting as the Chairman's surrogate or representative.

A COO, on the other hand, must understand the federal securities laws and the complex and varied functions that the staff performs. To be effective, a COO would have

[3] The description of responsibilities for the Executive Director includes the following "The Executive Director is responsible for developing and executing the overall management policies of the Commission for all its operating divisions and staff offices." 17 C.F.R. §200.13.

to have the authority to assign responsibilities, impose deadlines, allocate staff resources and have a role in personnel selection, evaluation and bonuses.

The creation of a COO may appear to represent a diminution in the authority of the division directors, the General Counsel and the Chairman's Chief of Staff. In fact it likely would have the opposite effect. Senior officials have substantial responsibilities and limited time. Furthermore, directors appointed from outside the agency may not have sufficient expertise in internal operating procedures to feel comfortable taking personal responsibility. Inevitably every Director of Corporation Finance has a substantial number of regulatory projects that will always take priority over issues such as which regulatory filings to review and how can staff better identify problems in these filings that may reveal enormous financial misconduct at the next Enron or Worldcom. Under this structure, the Division Director would still retain final authority for policy decisions that must be made and implemented by the operating staff.

Prior to making this recommendation, serious consideration was given to a less dramatic alternative, creation of a COO position in each operating division, a strategy adopted by Director Khuzami for the Division of Enforcement. Admittedly this alternative would be less controversial and less unsettling. It would not alter the primacy of the division director. The downside to this approach is that the ability of the COO to improve efficiency or effect change would be completely dependent upon the support provided by each division director. As noted previously, the current system is flawed because short-term division directors typically have limited time horizons and higher priority policy agendas. If a division director is not personally committed to improving efficiency, a subordinate COO will be unlikely to achieve success.

For these reasons, I believe that a broad reorganization of the SEC should include the creation of a Chief Operating Officer (COO) for the SEC, who reports directly to the Chairman and oversees its daily operations.[4] Under this model, the COO would not be a policy official; rather he or she would be the person responsible for implementing the policy decisions made. By empowering this person to oversee operations across divisions, it is hoped that he or she would be able to deal with the silo problem at the SEC and the recurring dilemma faced by registrants who must shuttle back and forth between multiple offices and divisions when questions require action by more than one office or division.[5]

An immediate priority of a COO should be to identify an appropriate set of metrics to monitor agency efficiency and effectiveness and to evaluate the performance of its individual staff. Throughout the SEC, there is a pattern and history of relying upon the simplest and most basic measures of performance. Too often these measures reward the wrong things and contribute to agency inefficiency. For example, when the

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[4] In 2010 Chairman Schapiro created a COO position. However in creating the position, the SEC chose to split in half the existing responsibilities of the SEC Executive Director. With the announcement that the Executive Director is resigning, a decision may be made to reconsolidate the split functions under the COO. This, of course, would only reestablish the prior status quo, albeit with a new title for its head.

[5] For a more detailed discussion of this function see the Chamber of Commerce Report, pages 18-22.

Enforcement Division measures success by the total number of cases brought, it motivates the staff to investigate the easy cases rather than the complex and time-consuming cases. Similarly, when the Division of Corporation Finance measures its staff by the number of filings reviewed or the number of questions included in a comment letter, it too motivates its staff to focus on the routine. By developing meaningful measures of performance, a COO could immediately contribute to improving agency effectiveness and efficiency.

Strengthening the role of the Commissioners in interpreting regulatory policy

For much of its early history, the Commission met almost daily and acted on virtually every decision that had to be made. Several changes in the laws over time caused a significant diminution in the responsibilities of the five Presidential-appointed Commissioners. The Reorganization Plan 10 of 1950 ("Reorg. Plan 10")[6] shifted executive functions, such as administration, budget, personnel and staffing from the Commission to the Chairman, who would serve as a Chief Executive Officer for the agency. In 1962, Congress amended the Exchange Act to permit the Commission to delegate discrete responsibilities, other than rulemaking, to its staff.[7] Over the years the Commission has delegated to the staff the vast majority of daily decisions, with the notable exception of decisions to authorize and resolve enforcement actions.

An often-overlooked but highly significant legal change was the Government in the Sunshine Act ("Sunshine Act"), enacted in 1975[8]. The Sunshine Act is a procedural law that ostensibly does not change the legal responsibilities of the Commission. It merely requires Commission deliberations to be conducted in public meetings, unless the subject of the deliberations is included in one of the ten categories excepted from the public meeting requirement.

Virtually every Commissioner who has served since the Act's passage in 1975 has commented or expressed frustration over the Commission's inability to meet confidentially with the staff to discuss division operations, activities and decisions. The inevitable consequence of this limited role for the Commission has been the transfer of a significant amount of responsibility for setting policy from the Commissioners, acting as a collegial bi-partisan body, to the division directors, who personally report directly to the Chairman. As one Commissioner suggested sarcastically at one Commission meeting, "the securities bar doesn't want to know what I think, they want to know what the Chief Counsel thinks".

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[6] 64 Stat. 1265 (1950).

[7] Reorg Plan 10 and the 1962 authority to delegate responsibility to the staff implemented recommendations to Presidents Truman and Kennedy, respectively, made by the same individual, James Landis, the second Chairman of the SEC and one of the co-authors of the Federal securities laws.

[8] 5 U.S.C. §552b.

Over the years, the SEC has attempted to address this problem to the extent possible without violating the Sunshine Act. These efforts have included the use of advice and information memos to the Commission[9], periodic briefing memos or "term sheets" and occasional non-public Commission briefing meetings, in which the staff make a presentation, but the Commissioners are required to refrain from engaging in a discussion, "joint deliberations" or expressing opinions. None of these "fixes" has been effective.

In making this recommendation, it is critical to emphasize that the goal is not to require the Commission to micromanage the daily responsibilities of the staff or to discourage the staff from doing its job. This would be a disastrous outcome. The staff must retain the ability to act quickly and decisively in its daily activities. Much of this work is highly technical and it is unrealistic to expect that the five Commissioners collectively would have the expertise and the time to act on questions concerning, for example, the Commission's net capital rule or executive compensation disclosure rules. However, the Commission is the final authority on questions of regulatory policy, both in the interpretation of rules and in periodically overseeing and engaging in discussions of the priorities of each division. In order to exercise this authority it must have the freedom to work with the staff informally and confidentially.

The SEC, likely with the support of other Federal regulatory agencies, should request that Congress amend the Sunshine Act for the limited purpose of providing each agency with sufficient flexibility to meet regularly with its own staff in non-public meetings to discuss the interpretation of agency regulations and the application of these regulations to decisions that have been delegated to the staff.

Improving the efficiency and effectiveness of Core SEC Functions

The question of whether the SEC has sufficient resources to do its job is the highest and most immediate priority to be examined. While everyone is focusing on the new responsibilities and burdens included in Dodd-Frank, insufficient consideration is being given to whether existing resources are used optimally. As I discussed initially, in the Chamber Study I focused on three core SEC functions that I believe could be performed more effectively and efficiently. I believe that if these recommendations are implemented it would reduce the level of resources devoted to routine tasks, permit staff to be deployed on these new responsibilities. I believe that available staff must focus on the important emerging issues. They must simplify and improve the methods by which they provide advice to members of the industry to promote industry compliance and best

[9] An advice memo is submitted by the staff to the Commission to solicit the Commission's views on a decision that the staff intends to take by delegated authority, prior to taking action. Typically an advice memo contains a time deadline, "Unless the Commission instructs otherwise in XX days, the staff intend to do the following". An information memo is sued to inform the Commission of a significant action or event after it has occurred.

practices. They must examine regulatory strategies that are not narrowly defined to fit within the current silos.

Rather than repeat what is included in the Chamber Report, I will briefly focus on one core function, exemptive orders under the Investment Company Act. Because of the structure of the Investment Company Act, an important activity of the Division of Investment Management of the SEC is reviewing and granting companies exemptions from specific requirements of the act when the division, acting pursuant to delegated authority, concludes that it is appropriate and in the public interest. This authority to grant exemptions from specific statutory requirements is provided in thirty-three sections of the Investment Company Act.

The exemptive application process is vital to an effective regulatory program. It provides the financial services industry with a vehicle to experiment and innovate in ways unforeseen when the Investment Company Act was passed in 1940. It enables the SEC, as the regulator, to permit such experimentation in a limited and controlled way. It can create and impose unique conditions on the innovator to protect investors and limit adverse consequences to the market. These conditions can be developed through negotiation with the applicant to ensure that the conditions are not so burdensome that the relief is no longer attractive. The statutory notice and comment requirement provides transparency to this negotiated process and enables third parties, including investors and potential investors, to participate in the decision. This is pragmatic and collaborative regulation that has stood the tests of time.

The ability of the Commission's staff to review and responsibly act on the hundreds of applications that it receives each year is critical to the effectiveness and vitality of its regulatory system. The time and resources it takes to review and act on these requests is also an important measurement of regulatory effectiveness. For more than twenty years, reducing the time to obtain an exemptive order has been an SEC goal.

It is a goal that has gone largely unmet. In 1985 the Division announced a goal of responding to applications with comments within 45 days. In 2006, the SEC Inspector General found that only 13 of 83 applications sampled complied with the goal. In 2007 the Division changed the goal from 45 days to 120 days. In 2008, as part of the Chamber study, we looked at the question. Because we did not have access to the dates of the initial comment letter, we calculated the time between the filing of the application and the order of approval. The median time in 2008 was 190 days.

The exemptive application review process is a useful case study of how changes in process can free up staff resources and better serve the public. In the study we made four recommendations:

- An expedited process should be created for routine exemptive applications that mirror prior exemptive orders.
- Incomplete applications should be rejected with "bedbug letters," consistent with published standards explaining the grounds for rejecting deficient filings.

- Internal compliance deadlines should be adopted for staff review and action, and apply to applicant responses or revisions based upon staff comments.
- Expanding the use of exemptive rules could substantially reduce the number of routine applications.

Improving the quality of the SEC policy development process

Rethinking the rule-making process at the SEC

Smart regulation requires a re-thinking of the process for developing and implementing regulations. In 2006, I described my proposal for a new system for developing regulations in a letter published in the *Wall Street Journal*.[10] I will restate it: Instead of assuming, as lawyers do, that rules are self-effectuating, the SEC should adopt a scientific approach: Consider rules working hypotheses. Whether the anticipated reaction occurs, and at what cost, is the empirical question. Under this approach, when the Commission votes to adopt a rule it would also vote to direct its staff to conduct a thorough quantitative examination of the rule's impact:

1) The SEC's Division of Risk, Strategy and Financial Innovation ("Risk Fin") would submit a plan to collect data on compliance with the rule, associated costs, and goals achievement. Merely developing such a plan will require the staff to articulate and the SEC to accept a statement of anticipated consequences.

2) It would also provide a plan for examining the data collected to enable the agency to examine the impact, costs and benefits of the rule. Making the Risk Fin division the focal point of this assessment would provide the agency's economists and industry specialists with substantially greater leverage in shaping rules in the first instance.

3) A timetable for the presentation of the results of these studies, in a published report.

This approach offers several advantages. In addition to compelling the staff to examine the rule's impact, it would fundamentally change how rules are developed. Knowing rules will be empirically examined will force the staff to carefully consider how this will be done and to develop internal discipline in the drafting process. Institutionalizing a meaningful evaluative role for the Chief Economist will strengthen its hand during drafting of the rule. Finally, requiring the examination staff to consider these issues at the outset will cause it to be more pro-active in its inspection program, less inclined to focus on after the fact disasters and provide the Commission with more oversight of its function.

A final regulation is the start of the process, not its completion. Cost-benefit analyses are and will always be fundamentally flawed. They require estimates of the impact of events that have not yet happened. How does one measure the cost of compliance before one knows how the industry will achieve compliance?

[10] Jonathan G. Katz, Letter to the Editor, WALL ST. J., Aug. 8, 2006.

These recommendations will not result in more or less regulation, but instead they will achieve better regulation. Decisions should never be based upon a bias towards more or less regulation. Regulation must be based upon sound, fact-based understanding and intellectual honesty. Most importantly, it must recognize that a free market is always changing in ways that can rarely be anticipated. There will rarely be a single correct answer. Regulators must accept that they will have a choice between reasonable alternatives. And when the markets move, the choice may change. So, regulation must be nimble, and regulators should never believe that they cannot or should not change as well.

Improving the Enforcement Program

The enforcement program of the SEC is seen as the face of the agency and its most prominent responsibility. When the Enforcement Division acts, it makes headlines. When it's successful, the agency is viewed as effective. When it is unsuccessful, the agency is viewed as ineffectual. Needless to say the past decade has not been good for the division or the SEC. But it is not the first time that SEC enforcement has been found wanting. An objective review of the history of the SEC demonstrates that the recent failures are not unique. In fact, for each of these notable scandals and failures there is an important historical parallel in the history of the SEC. These historical parallels are described at length in the Pitt Law Review article. While one might conclude from this recurring pattern of frauds and failures that no set of reforms will ever eliminate periodic financial disasters and frauds, I believe a different lesson can be learned. The recurring pattern may be evidence that there are fundamental characteristics of how the SEC functions which contribute to its historic tendency to wait for events to happen before acting.

Mark Twain once said that history doesn't repeat itself, but it often rhymes. The recent and not-so-recent history of the SEC confirms the wisdom of Twain. In every decade since the fifties there has been major frauds that went undetected until it was too late. In fact, for each of the scandals of the recent past one may find an analogous scandal from an earlier time. Before the NASDAQ market makers and New York Stock Exchange specialists, there was the Re and Re scandal in the late fifties. Before Bernard Madoff there was Bernard Cornfeld. Before Enron and Worldcom there was Equity Funding. Before the SEC failed to listen to Harry Markopoulos, they failed to listen to Ray Dirks.

In the Pitt Law Review article I describe these past failures to demonstrate certain recurring patterns in the way enforcement functions at the SEC. Today I would like to focus on five aspects of the program that require improvement:

- Enforcement must change from being reactive to proactive
- Enforcement must be structured on functional lines
- Enforcement must develop quantitative empirical investigation capacity
- Enforcement's mission must be refocused

- National criminal prosecution of financial fraud requires a fully staffed office in the Criminal Division of the Justice Department

Investigating yesterday's problems, not tomorrow's

The one common thread of NASDAQ, Enron/Worldcom, and Madoff is that each of these cases became public knowledge before the SEC began its investigation. In essence, the SEC investigated and put out the fire after it was clearly visible on the horizon, and by then, the damage was done. This is a systemic problem that is rooted in the SEC. It reflects the traditional perspective of a lawyer; a preference to wait for "cases and controversies."

While the Division of Enforcement may begin an investigation as "a matter of official curiosity," in reality it has slowly, over time, adopted the approach of criminal authorities. It begins an investigation only after it has obtained information that is analogous to probable cause. As a result, it investigates discrete instances of wrongdoing, rather than examining broad market events or questions. If someone doesn't provide a credible tip, if information is not disclosed in a public filing, if aberrant trading is not observed and reported, or if a newspaper article is not written about a matter, there is no catalyst for beginning an inquiry.

This reliance upon third parties to provide the impetus for an investigation also reflects the fact that there are always plenty of cases to investigate.[11] The Division of Enforcement invariably has more open investigations than it has manpower to assign. No one needs to develop new techniques for finding matters to investigate. In fact, the opposite is the case. There were so many open cases that important investigations not infrequently languish as a result of staffing shortages or staffing turnover.[12]

Thinking reactively means more than just beginning investigations after the fraud collapses. It also manifests itself in the recurring staff tendency to open new investigations that mirror the hottest case of the moment. Because of the surplus of matters to investigate, the staff has a great deal of flexibility in selection of cases to investigate. Not surprisingly, everyone wants to conduct the hot investigation. During the eighties, every member of the staff wanted to do insider trading or penny stock cases. In the nineties, the staff looked for Internet frauds to investigate, no matter how small. A few years later, it was mutual fund late trading cases. After that it was option-backdating cases.[13] Today, post-Madoff, it is Ponzi schemes. And post financial crisis, it is sub-

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[11] One may speculate that the new whistleblower provisions of Dodd-Frank will further increase the number of possible investigations from which to choose.

[12] One SEC Chairman attempted to solve the problem by instructing the Division to refer all investigations involving a single person at a broker-dealer to the appropriate SRO for action. When that Chairman resigned, the referral program ended.

[13] In 2006, Chairman Cox disclosed that the SEC had more than 100 open investigations of option backdating. *Stock Options Backdating: Hearing Before the Comm. on Banking, Housing, and Urban Affairs*, 109th Cong. 12 (2006) (testimony concerning options backdating by U.S. Securities and Exchange Commission Chairman Christopher Cox). Other public comments brought the number of open investigations up to 170.

prime securities. In effect, every branch and every attorney is in competition with each other to bring the "fraud du jour."

The obvious problem with this reactive "hot case" mentality is that it focuses reactively on the past. It diverts attention and resources away from what may be on the horizon. In the military, this is often referred to as "fighting the last war." The consequences to regulatory efficacy are substantial. Open investigations that are not "hot" frequently are ignored or backburnered. Unusual or complex facts or circumstances that may not be understood, or those that do not fit neatly into a known type of fraud, are never opened or, if they are opened, they languish until they are closed.

Both phenomena are highlighted in the SEC Inspector General Report on Madoff. In one instance, an attorney in the Office of Compliance Inspections and Examinations (OCIE) was instructed to drop her interest in Madoff and focus on one of the many mutual fund late trading investigations. Another member of the OCIE staff only considered the possibility of a front-running violation by Madoff, explaining that front-running was *his* unit's area of expertise.

The lack of specialized units has contributed to the failure to identify and pursue complex investigations

Historically, the Division of Enforcement and the regional enforcement programs[14] have operated with minimal or no specialization. Within the home office, each investigating branch has the ability to investigate any matter that it identifies, regardless of the subject area or its complexity. The reason for this structure is based upon two beliefs: (1) that all investigating attorneys are qualified to investigate any type of violation, and (2) that staff turnover, a continuing problem, will increase if attorneys are pigeonholed into one subject area and restricted to only one type of investigation. Because there is no meaningful specialization or assignment of specific areas of responsibility, each investigating branch works in parallel, competing for the best and highest profile cases.[15] This practice directly contributes to several significant and equally important adverse consequences.

One unfortunate consequence is the delay and lack of uniform treatment that results when too many different, and often inexperienced, attorneys independently tackle

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[14] One must be careful in generalizing about the regional office operations. Because they function with minimal direct oversight, there is no one organizational structure. For example, in New York, the largest regional office, there is an enforcement office but the office responsible for broker-dealer examinations also has its own enforcement group. As in the home office, both units operate independently and occasionally overlap. Another interesting operating difference between the home office and the regions is the separation of investigation and litigation responsibility. In the home office, if an investigation results in litigation, the matter is transferred to a trial attorney, who must learn the case from scratch. Conversely in most of the regional offices, the attorney who investigated the case tries the case. Of course, this means that any other open investigations assigned to that attorney are put on hold during litigation.

[15] To illustrate, imagine a national real estate agency in which each local office is a separately owned franchise with each agent in that franchise competing with the other agents in the office to sell or find buyers for the best houses in the community.

difficult and complex cases. Without any meaningful specialization, or the ready availability of in-house experts, new attorneys tackling complex investigations must "reinvent the wheel." One, or occasionally two, attorneys working for a branch chief[16] (who must supervise four to six attorneys), must learn the law, learn the market or the product, and conduct the investigation all at once. Consider difficult corporate accounting frauds, generally the most complex and time-consuming investigations. An attorney assigned to a complex corporate accounting fraud may be required to learn quickly the Talmudic nuances of revenue recognition accounting for "percentage of completion" construction projects; or the circumstances that determine whether the developmental costs for new products must be expensed or capitalized.

When the case deals with complex accounting issues, a staff attorney has the benefit of in-house accountants in the Division who can explain, advise, and guide an investigation. When the case involves highly sophisticated trading in esoteric securities, the result can be a long and arduous investigation followed by litigation that may rely upon untested theories or, worse yet, theories that do not entirely correspond with the underlying facts. Attorneys assigned to these investigations don't have access to internal experts analogous to the Division's accountants. The result is, not infrequently, different investigations of similar or analogous violations that achieve different results. Also not infrequently, these disparities are not obvious until the matter is scheduled for submission to the Commission. When the different treatment becomes obvious, the staff is occasionally instructed to re-negotiate a settlement to achieve some degree of parity.

A second adverse consequence is the tendency, already highlighted, to over-emphasize one area of misconduct and fail to investigate more important but less obvious areas. This is the more serious consequence. Because of the excess of cases available to the staff, decisions must be made quickly on whether to begin or continue an investigation or whether to focus on a completely different investigation that may be more promising, more important, more interesting, or more high profile. If a particular investigation appears highly complex, or difficult to understand, and it may require literally a year or more of investigation and be unlikely to produce a case, it will generally be closed or back-burnered in favor of another available case.

The "fraud du jour" problem, previously described, also contributes to this tendency to apply too many resources to one area. Whenever a case is completed that generates significant publicity or attention, it creates a strong incentive for other staff to actively pursue a matter with the same fact pattern. Because the staff have great latitude on what to investigate, it is easy for many different branch chiefs and assistant directors to simultaneously decide to investigate a certain type of case. As a result other important but difficult open investigations may not be fully investigated. In the Pitt Law Review article I describe three prominent cases at the SEC where this may have occurred – Michael Milken, Charles Keating and Mr. Madoff.

[16] In 2009, the Enforcement Division eliminated the branch chief position. Instead of an Assistant Director supervising two or three branch chiefs, who in turn supervised four to six attorneys, under the new structured each assistant director directly supervises six to eight attorneys.

A third unfortunate consequence is that because everyone chooses to investigate the same types of cases, other less visible potential investigations are never considered. The recurring failure to look out at the horizon is a serious problem. As previously explained, it has its roots in the prosecutor's mentality to act after the crime has become apparent. During the 1990's, while the Commission was suing teenagers who posted ridiculous claims on the Internet, Enron, Worldcom, Sunbeam and other frauds were growing to enormous proportions. Also, at the same time, the hot IPO's of the nineties and the false statements of securities analysts were contributing to the Internet bubble. During the past decade, when a staff attorney in OCIE became interested in the Madoff allegations, she was told to make mutual fund late trading a priority instead. While the staff investigated backdated options, billions of dollars were being invested in complex securities like collateralized debt obligations (CDOs), which in turn were based upon pools of mortgages with little or no disclosure of the questionable assumptions. The extent to which these instruments were sold on the basis of false and misleading statements remains to be determined.[17]

In January 2010, SEC Director of Enforcement Robert Khuzami announced the creation of five specialized units: asset management; market abuse; structured and new products; foreign corrupt practices; and municipal securities and public pensions. At first impression, this appears to be a commendable step in the right direction. However it may be only a partial step that doesn't address the underlying problem. Informally, I have been told that only 25% of the enforcement staff is assigned to these units. The remaining 75% continue to work in the traditional generalist structure. If so, the problem will continue. Furthermore, this partial change may suffer from three other problems. The first is that the focus of these units may not be sufficiently broad to provide responsibility for emerging problems and, thus will focus only on the identified problems of the immediate past. This latter approach has been used, with limited success, repeatedly in the Division. It is a variation on the "flavor of the month" mentality of searching for specific frauds after one such fraud has been exposed. This fraud-specific approach is too narrow and backward, not forward, looking. The second problem arises from the creation of a coordinating rather than centralizing responsibility. While the coordinator may become expert in the area of responsibility, the staff conducting the investigation will continually change and never develop a depth of expertise. When the coordinator leaves the division, the expertise leaves as well. Finally, if 75% of the staff continues to work in the traditional manner, the problem of staff focusing on the hot case and the cases they understand rather than the difficult or emerging cases will continue.

The SEC has Never Developed the Capacity to do Empirical Analysis

The SEC receives tens of millions of pages of documents from corporate filers annually. In addition, it receives regular reports from broker-dealers, investment advisers and institutional investors. The regulated equity and options markets provide electronic reports on trading activity. While the data is available for computer analysis, no office or

[17] In its 2008 Annual Performance and Accountability Report, then-Chairman Cox disclosed that there were 50 open investigations concerning sub-prime securities offerings.

unit at the SEC is assigned responsibility for conducting this sort of research.[18] The SEC has rarely begun an investigation on the basis of its own quantitative analysis of public data. The problem has three components: (1) a bias against this type of non-specific inquiry, (2) a lack of IT capacity, and (3) a lack of professional staff with the correct skills to conduct this type of inquiry.

The first component is another manifestation of the lawyer-centric mindset of the SEC.[19] Attorneys find it difficult to draft a formal order of investigation memo that lacks information pointing to specific misconduct by specific persons. Because the goal of every investigation is to find a violation and bring a case, broad open inquiries that do not initially focus on a specific possible violation are less appealing. The Enforcement Division staff is not interested in conducting an investigation that might shape regulatory policy without the prospect of receiving credit (a "stat") for a case brought. Conversely, while the regulatory divisions might have an interest in developing information to support regulatory action, they do not think in terms of opening an investigation or issuing subpoenas; that is the job of Enforcement.[20] OCIE through its "examination sweep" program attempts to look firsthand at significant issues in the financial industry. But OCIE lacks the subpoena authority to compel testimony.

The second component—the acquisition and development of automated analytical systems—has been an oft-stated goal of the SEC. Since the advent of computers, the SEC has proposed developing automated systems to collect and analyze this volume of data. In the late seventies, the SEC proposed to develop an automated Market Oversight and Surveillance System (MOSS). MOSS was designed but never built, due to a change in administration and a change in priorities. In the eighties, the EDGAR system for electronic filing was developed. It has operated successfully for more than two decades as a system for filing and disseminating these records. People forget that the "A" in the EDGAR acronym originally stood for "analysis." The original pilot EDGAR system included a component for companies to file a preformatted schedule of key items from its financial statement. The formatted data schedule would have enabled the SEC and the public to easily extract the data for automated analysis. That component of EDGAR was abandoned before the system became operational. Since 2005, the SEC has promoted the use of XBRL tagging conventions as a method of conducting automated analysis of

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[18] The Special Study Report identified this failure and recommended that the SEC develop this internal capability: Eight years later, the Institutional Investor Study made the same recommendation "If the Commission is to be fully cognizant of the economic implications of developments in the securities markets under its jurisdiction, including those that result from its own actions, a substantially larger internal economic research capability, fully staffed and supported, is required." H.R. DOC. NO. 92-64, at XI (1971).

[19] The dominance of the lawyer's perspective at the SEC was described by former SEC Chairman Harvey Pitt in an op-ed column in the Wall Street Journal aptly titled "Over-Lawyered at the SEC." Harvey L. Pitt, Editorial, *Over-Lawyered at the SEC*, WALL ST. J., July 26, 2006, at A15.

[20] On rare occasions, regulatory divisions have obtained formal orders from the Commission to conduct investigations for regulatory purposes. A "recent" instance of one such investigation, by the Division of Investment Management resulted in the 2003 publication of its report and recommendations on the regulations of hedge funds. U.S. SEC. AND EXCH. COMM'N, IMPLICATIONS OF THE GROWTH OF HEDGE FUNDS (2003), http://www.sec.gov/news/studies/hedgefunds0903.pdf. This report was primarily a legal analysis rather than a quantitative analysis.

company filings. While the submission of XBRL-tagged documents is progressing, the capacity of the SEC to conduct the analysis is an open question.

Following the 1987 stock market collapse, Congress appropriated special funds so that the SEC could develop an automated, large trader reporting system. That project never progressed beyond the preliminary planning stage, as the appropriated funds were used to build EDGAR.[21] More recently, the SEC received special funding from Congress to develop an Internet surveillance system to find securities frauds on the web. Those funds were expended, but the system as developed produced so few results that it was cancelled.

The inability to conduct, on an ongoing basis, quantitative analysis-based investigations is not solely, or even primarily, due to insufficient IT capacity. The more significant component of the problem is the lack of staff with the necessary skills to do this work. In the past two decades, two of the most significant instances of industry-wide misconduct were uncovered by academics, not the SEC. In one case, William Christie and Paul Schultze, two Vanderbilt University economists, published an academic paper demonstrating that there must be collusion in setting bid-ask spreads by NASDAQ market makers.[22] The study was based not on an informant's tip, but on quantitative analysis of public quotations for an extensive number of companies for an extended number of years. A second and more recent example of an academic study that demonstrated a pervasive pattern of misconduct was the widespread corporate practice of backdating option prices for corporate executives to ensure profitability.[23] These papers were based upon an empirical analysis of data filed with the SEC. The SEC had access to the same information, and it had the IT power to perform the analysis. It lacked the people and the incentive.

The mission and purpose of SEC enforcement must be refocused

While the SEC as a law enforcement agency is a widely accepted opinion today, it has not always been the case. For much of its history, the SEC described itself as a regulatory agency. Until 1971, the SEC did not have a separate enforcement division. Instead, each of the principal operating divisions had its own enforcement unit to investigate and enforce its regulatory responsibilities. Each enforcement program was integrated into regulatory functions and often conducted investigations designed to advance regulatory agendas rather than to take disciplinary action.

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[21] The benefit of systematically tracking the trading patterns of individuals for patterns of misconduct was demonstrated in 2009. A major insider trading case was identified by reviewing trading activity in several companies prior to takeover announcements by the companies. Unlike most insider trading cases, this investigation did not begin with an analysis of trading in a specific company. It began by analyzing trading patterns by the individuals. In its press release, the SEC obliquely stated, "These enforcement actions are the direct result of innovative investigative techniques that the SEC is using to identify patterns of unlawful trading and suspicious relationships among traders who, in this case, live around the world." SEC Press Release 2009-18, available at http://www.sec.gov/news/press/2009/2009-18.htm

[22] William Christie & Paul Schultze, *Why do NASDAQ Market Makers Avoid Odd-Eighth Quotes?*, J. FIN., Dec. 1994, at 1813.

[23] Erik Lie, *On the Timing of CEO Stock Option Awards*, 51 Mgmt. Sci. 802, 803 (2005).

Historically, this subordinated role for enforcement reflected the limited enforcement powers of the agency. Prior to 1990, the SEC lacked broad authority to seek money penalties,[24] to issue cease and desist orders, or to bar officers and directors. Even its authority to directly suspend or bar individuals from the securities industry only dates back to 1975.

Because its range of powers was limited, the SEC did not focus on punishment. It focused on specific remediation and general prospective guidance. Instead of looking backward, it used enforcement to look forward and enunciate what the securities industry must do in the future. Because its resources were also limited, it focused its attention on bringing significant cases rather than bringing the largest number of cases. In 1979 then Chairman Harold Williams explained "Our enforcement resources would be utterly inadequate to the task of policing all securities law violations which may take place. As a result, our enforcement activities are designed not only to correct specific wrongdoing, but also to alert the private sector as to the kinds of activities which we believe to be illegal. We also tend to be programmatic in our enforcement efforts, concentrating on a particular area of concern in order that the parameters of appropriate conduct in that area may be fleshed out. In this way, we hope to stimulate the private sector to self-police inappropriate conduct."[25]

The Commission's enforcement program fundamentally has changed since passage of the Remedies Act in 1990. Prior to then the Commission had only limited power to punish. It could only seek fines in insider trading cases. It could only bar or suspend people who were registered. The ability to obtain disgorgement of illegal profits or to bar an individual from being a corporate director were creative interpretations of general equitable remedies.

During the past twenty years, as its powers to punish have increased and expanded and the size of its staff has multiplied, the Enforcement Division has changed its focus. As Chairman Williams noted, in 1979 the division did not define its responsibility to be policing all securities law violations. Today it appears to believe that it must do just that. The yardstick of success is now the total number of cases brought in a year and the significance of a case is measured by the dollar amount of penalties imposed. Not surprisingly, the increase in the size of the Division has resulted in more cases, but not necessarily better cases. Today it appears that the Division believes its mission is to bring every case where evidence of a violation exists, rather than devoting its staff to investigating a smaller number of matters that may have a greater significance for the fair operation of the capital markets.

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[24] Prior to 1990, the SEC could obtain a money penalty only in insider trading cases, authority that it first obtained in 1983.

[25] THE STATE OF THE SECURITIES AND EXCHANGE COMMISSION - - 1979. An Address by Harold M. Williams, Chairman. Available at http://c0403731.cdn.cloudfiles.rackspacecloud.com/collection/papers/1970/1979_0302_Speech_Williams.pdf

Effective regulation must be forward-looking. The SEC enforcement division should reestablish that its primary mission is effective regulation of the capital markets, and that prospective remediation of broad problems in the market is frequently preferable to a series of discrete actions involving multi-million dollar penalty payments by public companies.

The history of the SEC demonstrates how regulatory actions can provide more effective and more efficient solutions to massive and widespread patterns of misconduct. Compare for example, the SEC response to the options backdating problem with its response in the seventies to the even more widespread problem of illegal corporate payments to politicians, both in the U.S. and overseas.

During the height of the options backdating scandal, it was reported that the SEC had opened investigations of more than 170 companies that had engaged in the practice. Think of the resources that 170 investigations required, in addition to the money spent by corporations conducting internal investigations to ascertain if there was a problem. The illegal corporate payments scandal was even larger, and it occurred during a period when the Division of Enforcement was less than half its current size.

Recognizing that the SEC did not have the resources to investigate literally hundreds of other companies, the Divisions of Enforcement and Corporation Finance created an innovative solution. Nearly four hundred companies avoided enforcement action by participating in a novel voluntary disclosure program. If a company conducted an independent investigation of its questionable payments, supervised by its non-employee directors, and filed a detailed report of the investigation under Form 8-K, it could avoid further SEC action. In preparing its report, a company could meet with SEC staff from Enforcement and Corporation Finance and obtain informal private guidance on the disclosures that had to be made.

Refocusing the enforcement program will require more than a statement of policy. It will require reorganization of the division along functional lines as described. It will also require the development of performance metrics that motivate and reward staff who investigate and bring important forward-looking cases rather than routine cases. In the Pitt Law Review article I describe how the reliance on counting the total number of cases brought each year contributes substantially to the problems I have described. The development of better measures of performance should be the responsibility of the SEC Chief Operating Officer.

The Division of Enforcement must reestablish that timely remediation is as important as punitive sanctions and that its performance should be evaluated by its success in bringing the most important cases, rather than the most cases.

National criminal prosecution of financial fraud requires a fully staffed office in the Criminal Division of the Justice Department

Refocusing the enforcement program on remediation rather than money penalties does not mean that wrongdoing should go unpunished. Rather, it reflects the view that punishment is inherently a matter for criminal prosecution by the Justice Department. Until the early eighties the Enforcement Division worked closely with a specialized office in the Criminal Division of the Justice Department and routinely referred cases to this office, which had national jurisdiction.[26] During the eighties, as insider trading became a priority and these cases could be brought by the U.S. Attorney's Office for the Southern District of New York, a close working relationship with this office developed. Over time, it became the focal point for most criminal referrals. Notwithstanding the many successful criminal actions brought by the Southern District, it has limitations. It does not have national jurisdiction. It has other important priorities, such as organized crime, and international terrorism. These other priorities frequently divert its attention and resources. Some critics even suggest that, because the office is in New York, it may be more sympathetic to large financial institutions headquartered there and so less inclined to bring criminal actions against them.

Whether these criticisms of the Southern District are accurate is subject to disagreement. However its lack of national jurisdiction and the competition for its resources are significant limitations. The solution is simple. A national securities crime office in the Criminal Division would be a sound solution, provided it is adequately funded and staffed.

THE NEED FOR A SECOND SPECIAL STUDY OF THE SECURITIES MARKET

The final recommendation is, in my opinion, the most important. Fifty years ago, the SEC went through a similar period when it was viewed as ineffectual, understaffed and outgunned. At the recommendation of then Chairman William Cary, Congress appropriated funding for a special team of experts to conduct a special study of the U.S. securities markets. At the end of its eighteen-month life, the Special Study team produced a five-volume report that formed the intellectual foundation for the SEC for the next twenty years. This is an appropriate occasion to undertake a second special study. Among the issues that should be addressed are the future of the U.S. and global secondary market structure, the interaction of the equity, debt and derivatives markets both in the U.S. and globally, and the development of a corporate disclosure system that reflects the needs of investors and the information technology of the present and future. An integral component of each of these issues is the regulatory agenda and operations of the SEC.

In conclusion, I would like to thank the subcommittees for providing me with this opportunity to offer my suggestions on reinvigorating the Securities and Exchange Commission. I look forward to answering your questions.

[26] This unit continues to function but lacks sufficient staff.