REVIEWING THE SEC, REINVIGORATING THE SEC

Jonathan G. Katz[*]

The Securities and Exchange Commission (SEC) celebrated its 75th anniversary in 2009. Ordinarily this would be a basis for celebrating the triumphs of the agency. However, the financial crisis of 2008 and the celebrated frauds and failures of the immediate past have provoked a wealth of criticism of the SEC and calls for fundamental change in the operations of the Commission. 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. 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, this paper takes a different perspective. The recurring pattern may be evidence that there are fundamental characteristics of how the SEC functions that contribute to its historic tendency to wait for events to happen before acting. This paper identifies and discusses these elements of the Commission's "DNA" and offers recommendations for change.

I. HISTORICAL PARALLELS

Mark Twain once said that history does not 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 1950s there have 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 1950s. Before Bernard Madoff there was

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* Mr. Katz was Secretary of the U.S. Securities and Exchange Commission for twenty years. Mr. Katz's tenure as Secretary spanned seven SEC Chairmen and four Acting Chairmen. In this position, Mr. Katz's responsibilities encompassed all aspects of the Commission's regulatory and enforcement programs. Since his retirement in January 2006, Mr. Katz has served as a consultant on SEC regulatory requirements and as a technical advisor to government regulators in nine countries. In February 2009, the United States Chamber of Commerce published a report, Examining the Efficiency and Effectiveness of the U.S. Securities and Exchange Commission, written by Mr. Katz. Mr. Katz is grateful for the many constructive comments he received on an earlier draft of the article from, among others, Jay Brown, James Coffman, Arthur Laby, Phillip Parker, and Erik Sirri.

Bernard Cornfeld. Before Enron and Worldcom there was Equity Funding. Before the SEC failed to listen to Harry Markopolous, they failed to listen to Ray Dirks.

The parallels between the present and the past are not limited to major frauds. Today, critics of the SEC argue that the agency is outmanned, lacking an adequate budget, lacking talented staff, and failing to perform adequately the routine responsibilities of market surveillance and on-site examination of the industry it is charged with regulating. These same criticisms were made of the SEC during the late 1950s. During the 1950s, while the U.S. stock market and economy were booming, the SEC was in decline. Its budget and staffing were at the lowest point in its history. Its enforcement program was moribund. The responsibility for core functions, such as broker-dealer examinations and stock market oversight, was left largely to the self-regulatory organizations (SROs).

Without an effective enforcement program or active examination and surveillance units, it is not surprising that the SEC missed a series of major frauds on Wall Street. Most notable in magnitude and duration was the case of Jerry and Gerald Re, a father and son specialist team on the American Stock Exchange. In his definitive history of the SEC, Joel Seligman explains:

> Between 1954 and 1960, the Res illegally distributed over $10 million of securities on the American Stock Exchange. They manipulated the prices of several securities. They illegally touted shares. They bribed brokers to tout shares. They took advantage of inside information. They caused to be published false and misleading prospectuses by at least four firms. They systematically failed to keep required records, and routinely ignored Section 11(b) of the 1934 Securities Act. . . . All told the Res may have violated ten separate provisions of the 1933 and 1934 Securities Acts and an equal number of rules of the American Stock Exchange.[1]

While this fraud continued for years, the SEC missed numerous opportunities to uncover it. "Between 1954 and 1959, the SEC underinvestigated the Res in spite of clear signals of serious wrongdoing at least as early as 1957."[2] Seligman quotes this sentence in a memo from then Director of Trading and Exchanges Philip Loomis (later to be an SEC General Counsel and Commissioner) to Chairman William Cary. "In the light of hindsight, it is reasonably apparent that the staff of the Commission should have realized that something was seriously wrong on the American Stock

1. JOEL SELIGMAN, THE TRANSFORMATION OF WALL STREET 285–86 (Houghton Mifflin Company 1982).

2. *Id.* at 286.

Exchange considerably earlier than it did, probably in 1957 or early 1958, if not earlier."[3]

During the 1960s, Chairman Cary and Chairman Manuel Cohen led a massive effort to rebuild and restore the effectiveness of the SEC. Chairman Cary created the Special Study Team, ostensibly to examine the need for greater regulation of the equities markets. In fact, the subtext mission of this group was to critically assess the operations of the SEC and advise Cary on what needed to be done to rebuild the agency. Largely because of this second agenda, the Special Study Team operated in an independent environment. Its budget was funded by a separate Congressional appropriation, and the Commissioner transmitted its final report (all five volumes) to Congress without a formal endorsement.

The efforts of Chairmen Cary and Cohen were enormously successful in restoring the prominence of the SEC and the public perception that it was an effective regulator. A two-part article in *Fortune Magazine* in 1967 began with this description of the change in the SEC:

> Though not yet in the same league as the State Department or the Pentagon, the Securities and Exchange Commission has emerged in the last few years as one of the government's most dependable generators of headlines and controversies . . . . The revolution began in 1961 when William L. Cary became Chairman of the SEC; it is being continued, and in some ways drastically extended, by the current Chairman, Manuel F. Cohen.
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> The present controversies are especially remarkable when they are contrasted with the state of chronic newslessness that enveloped the SEC during most of the 1940's and 1950's. The commission in those years led a quiet, relaxed, at times almost somnolent existence.[4]

The SEC began using enforcement actions not merely to police the markets but, more importantly, to guide and instruct market professionals. Chairman Cary personally wrote the Commission's opinion in the Cady Roberts[5] administrative proceeding that became the intellectual foundation for future insider trading cases, including Texas Gulf Sulphur in 1965.

The Special Study of the Securities Markets[6] and the Institutional Investor Study[7] provided the ideas and the documentation to support the most significant expansion in SEC authority since the Federal securities laws were

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3. *Id.* at 288.
4. Carol J. Loomis, *Where Manny Cohen is Leading the SEC*, FORTUNE MAG., Dec. 1966, at 163.
5. *In re* Cady, Roberts & Co., 40 S.E.C. 907 (1961).
6. H.R. DOC. NO. 88-95, pt. 1–5 (1963).
7. H.R. DOC. NO. 92-64 (1971).

enacted during the Great Depression. Chairmen Cary and Cohen led the drive that resulted in Congressional action expanding the SEC authority over the OTC market in 1964, tender offers and mergers in 1969, mutual funds and investment advisers in 1970, and broker-dealers and SROs in 1975.

While the decades of the '60s and '70s are often viewed as the period of the SEC renaissance, a vibrant SEC could not and did not prevent major frauds from occurring. Reminiscent of recent events, in some of these cases, the SEC failed to act even after it received credible information about these frauds.

The most notable of these cases was the Equity Funding fraud, in which investors' losses were estimated at $300 million (a lot of money in 1973).[8] Equity Funding was a New York Stock Exchange-listed insurance company that also sold mutual funds. Its dramatic growth was fueled by its creation of false insurance policies, which the company then turned around and sold to reinsurers. Incredibly, the fraud was known by a large number of its employees. One of these employees was Ronald Secrist, an in-house accountant who became disgruntled after failing to receive a large bonus, which he thought he deserved.

Fearful that the company would retaliate if he went public, Secrist confidentially disclosed the fraud to Raymond Dirks, a securities analyst who covered insurance companies.[9] Dirks in turn investigated the allegations and, during the course of his investigation, discussed it with several investors who held Equity Funding stock (Dirks himself did not own any Equity Funding stock).[10] When he was satisfied that the story was accurate, Dirks contacted a reporter from the *Wall Street Journal* and investigators at the SEC.[11] Neither the Journal reporter nor the SEC staff took any action.[12] Ironically, several large investors who Dirks spoke with (or tipped) during his investigation sold their positions, causing a sudden and dramatic drop in the price of Equity Funding stock.[13] In short order, the New York Stock Exchange halted trading, causing state insurance commissioners to investigate and discover the fraud.[14]

Only then did the SEC act.[15] Subsequently, it was revealed that Dirks was not the first person to alert the SEC. Two years before, the SEC had received

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8. *See* Dirks v. U.S. Sec. and Exch. Comm'n, 463 U.S. 646 (1983).
9. *Id.* at 649.
10. *Id.*
11. *Id.* at 649–50.
12. *Id.*
13. *Id.*
14. *Id.* at 650.
15. *Id.*

a tip about the accounting fraud at Equity Funding.[16] Shortly before Dirks contacted the SEC, an official from the California Department of Insurance contacted the SEC about Secrist's charges.[17]

While these facts bear a striking similarity to Madoff and Mr. Markopolous, there is one notable difference: to date, the SEC has not charged Mr. Markopolous with aiding and abetting a fraud. Mr. Dirks was so charged. In an administrative proceeding against Mr. Dirks, the SEC found that he aided and abetted violations of rule 10b-5 by tipping persons who sold Equity Funding stock.[18] Fortunately for Mr. Dirks, the United States Supreme Court took a dim view of this theory of insider trading. In a 6-3 decision, the Court reversed the SEC action.[19]

While Equity Funding was an enormous accounting fraud, analogous in some respects to Enron, it was not a Ponzi scheme akin to that of Madoff. Ironically, the massive Ponzi scheme had already happened. Less than one year before the Equity Funding scandal, the SEC brought the Investors Overseas Services (IOS) case, which was a mammoth Ponzi scheme involving losses in the hundreds of millions, and possibly billions, of dollars. IOS was a huge family of mutual funds that was marketed primarily in Europe to expatriate Americans, U.S. soldiers, and others interested in investing in the "go go" stock market of the 1960s. Because its investors were not located in the United States, IOS was not registered with the SEC.[20] According to one account, "[a]fter 10 years, IOS had raised $2.5 billion, at a time when the entire fund industry was under $50 billion in assets, and had 1 million shareholders. The corporate goal was to hit $100 billion in the following decade. . . . [It had] a sales force . . . once estimated at 25,000 . . . ."[21] Created by Bernard Cornfeld, IOC invented and actively sold the first "fund of funds," mutual funds that invested in other IOS mutual funds.

The beauty of a fund of fund (for the originator) was the investing leverage that was created and the fees and charges that were layered on each

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16. *Id.* at 650 n.3.

17. *Id.*

18. *Id.* at 650–52. In recognition of Dirks' role in exposing the Equity Funding scandal, the SEC imposed its least severe sanction: a public censure. The purpose of the SEC action appears primarily to have been to articulate the breadth of its theory of illegal insider trading.

19. *Id.* at 667.

20. In 1967, the SEC had brought an action against IOS for operating as an unregistered investment company. This of course is another ironic parallel to Madoff, who the SEC pressured to register a few years before the fraud was exposed.

21. 1 Brian Trumbore, *The Fund Industry's Black Eye*, *available at* http://www.buyandhold.com/bh/en/education/history/2002/fund.html.

fund. Investors found the funds especially attractive because they paid guaranteed dividends. Because they were not U.S. mutual funds, tax evasion was a material side benefit. When the "go go" '60s gave way to the bear market of the '70s, the leverage operated in reverse. Because they generated insufficient money to pay the guaranteed dividends, these were paid out of new investors' capital. Just as the market crash of 2008 doomed Madoff, the bear market of the '70s caused the collapse of IOS. More than two billion dollars was invested in IOS funds.[22]

When Cornfeld ran out of money, he searched for and found a white knight investor: Robert Vesco. Vesco, who would become one of the legendary fraudsters of the 20th century, and probably the most successful fugitive in U.S. history, proceeded to take control of IOS and personally steal somewhere between two hundred and five hundred million dollars from IOS.[23] While there was no Markopolous or Dirks who tried to alert the SEC, IOS was a Ponzi scheme comparable in size to that of Madoff and one that was far more public. Bernie Madoff shunned publicity while Bernie Cornfeld thrived on it.[24]

These highly publicized frauds and failures were not limited to the late 1960s and early 1970s. During the 1980s, the SEC had a virtually unprecedented number of highly successful and highly visible enforcement actions, including Paul Thayer (at the time serving as Deputy Secretary of Defense), E.F. Hutton (at the time the second largest brokerage firm in the United States), Dennis Levine, Ivan Boesky, Michael Milken and Drexel Burnham Lambert, Robert Brennen and First Jersey Securities, and Meyer Blinder and Blinder Robinson and Co.[25]

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22. Wikipedia, http://en.wikipedia.org/wiki/Investors_Overseas_Service.

23. Vesco fled the U.S. after the indictment in 1972 and was a fugitive until his apparent (but unconfirmed) death in Cuba in 2008. "How much Robert Vesco stole no one knew for certain. America's Securities and Exchange Commission (SEC) was after him for more than $224 million, or more than $1 billion in today's money, which was then the biggest financial fraud in history. But oddly, once the crack teams of lawyers and accountants were on the case, they recovered almost twice as much." *Obituary: Robert Vesco*, ECONOMIST, May 31, 2008, at 91.

24. In its obituary for Mr. Cornfeld, *The New York Times* included this description: "Shuttling around the world from his ancient French castle with a coterie of celebrity jet-setters, Mr. Cornfeld built his company, Investors Overseas Services, into a $2.5 billion financial empire that fascinated the news media, attracted small investors and plagued market regulators around the world." Diana B. Henriques, *Bernard Cornfeld, 67, Dies; Led Flamboyant Mutual Fund*, N.Y. TIMES, Mar. 2, 1995, at B10.

25. *See* Sec. and Exch. Comm'n v. Thayer, 1984 U.S. Dist. LEXIS 18562 (S.D.N.Y. Mar. 16, 1984); Sec. and Exch. Comm'n v. E.F. Hutton Group, 1985 U.S. Dist. LEXIS 14450 (D.D.C. Oct. 29, 1985); Sec. and Exch. Comm'n v. Levine, 1986 U.S. Dist. LEXIS 23353 (S.D.N.Y. July 3, 1986); Sec. and Exch. Comm'n v. Boesky, 1986 U.S. Dist. LEXIS 17703 (S.D.N.Y. Nov. 14, 1986); Sec. and Exch. Comm'n v. Drexel Burnham Lambert, 837 F. Supp. 587 (S.D.N.Y. 1993); Sec. and Exch. Comm'n v. First Jersey Sec.,

Notwithstanding this extraordinary series of successes, there were also notable failures. Despite years of investigation, and the signing of the first memorandum of understanding between the SEC and a foreign country (Switzerland), the SEC never succeeded in cracking the mysterious case of insider trading conducted by unknown persons trading through an obscure Swiss bank, Ellis AG. The investigation involved a five-year pattern of trading in more than forty companies with profits estimated at $13 million.[26]

Even the enormous success of the Milken case was tempered by the knowledge that the staff had investigated Milken and Drexel in three prior investigations without submitting a case to the Commission for action. Similarly, several years before the massive collapse of Lincoln Savings and Loan, the largest savings and loan failure in American history, the SEC investigated and enjoined Charles Keating, the man behind the Lincoln fraud, for an unrelated bank fraud. In fact, at the time of the Lincoln collapse, there was an open SEC investigation of Keating and Lincoln that had been dormant for years.[27]

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.[28] 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 demonstrating a pervasive pattern of misconduct was the widespread corporate practice of backdating option prices for corporate executives to ensure profitability.[29] These papers

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2001 U.S. Dist. LEXIS 6887 (S.D.N.Y. May 25, 2001). At the time that the *Hutton* case was brought in conjunction with a parallel criminal proceeding, John Shad was the Chairman of the SEC. Mr. Shad previously served as Vice Chairman of Hutton. While Shad played no role in the misconduct at Hutton, the fact that the SEC—under Shad—could take action against Hutton demonstrated the independence of the agency. Similarly, the action against Thayer, a prominent member of the Reagan administration, demonstrated that the agency was not subject to political influence.

26. *Ellis Is Ordered to Yield Data*, N.Y. TIMES, Apr. 16, 1987, at D15.

27. That investigation was related to the overall Boesky investigation. Keating had invested more than $100 million of government-insured Lincoln deposits in one of Boesky's unregistered investment vehicles. *See* MARTIN MAYER, THE GREATEST-EVER BANK ROBBERY—THE COLLAPSE OF THE SAVINGS AND LOAN INDUSTRY 165 (Collier Books 1990), for a comprehensive and highly entertaining description of Mr. Keating and the Lincoln S&L fraud.

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

29. Erik Lie, *On the Timing of CEO Stock Option Awards*, 51 MGMT. SCI. 802, 803 (2005).

were based upon an empirical analysis of data filed with the SEC. The SEC does not itself routinely analyze these or other filings in this way.

In another celebrated case, Eliot Spitzer, then Attorney General of New York, exposed the widespread practice by mutual funds of permitting certain large traders to buy or redeem fund shares at that day's price, rather than the following day's price. Interestingly, Spitzer's case began with a secret tip from an industry source, who chose to go to a state Attorney General rather than to the official regulator, the SEC.

II. What Have We Learned

Stuff Happens, and It Will Continue to Happen

Just as the recent scandals have parallel antecedents, so will these frauds inevitably be duplicated or surpassed in the future by new, but analogous schemes. Stuff happens. Persons looking to establish a causal link between the strength of the SEC and the frequency of high-profile frauds will be disappointed. The reality is that when the financial markets are booming, frauds occur. When the markets collapse, the frauds are exposed. Madoff's fraud was exposed because a collapsing stock market resulted in substantial investor withdrawals that could not be covered with new investors' money. Nearly forty years before, IOS collapsed for the same reason.

A regulator and the investing public must accept the fact that all frauds cannot be prevented, and that it is not always possible to detect them before they explode. However, this should never become the convenient rationalization for poor performance. The goal of the regulator remains the same: It must attempt to prevent frauds from occurring. When frauds happen, it must detect them quickly and it must ameliorate the consequences of the misconduct.

As history demonstrates, even during the periods when the SEC was viewed as highly effective, it had notable failures. Nonetheless, there is a strong consensus that the SEC in recent years, probably stretching back to the 1990s, failed to perform its job as ably as might be expected. Examining these recent failures provides insight into why this happened and on what can be done to improve the agency's capacity to act.

If the recent events were isolated and caused by one corrupt or incompetent individual at the SEC, solving the problem would be straightforward. Unfortunately, as these historical examples demonstrate, the problem is not due to corruption or an individual's incompetence. It is more complex and pervasive. And while all of the examples involved an enforcement case, the systemic problems underlying them also exist in varying degrees in the other operating divisions of the SEC. As such, the solution must be broader, and it will be more difficult to implement. It is embedded in the DNA of the agency.

What are these DNA pieces? The full answer to this question, like the human genome, is too complex to describe entirely. However, there are several discrete items that must be considered:

- The SEC functions reactively.
- The SEC invariably takes a legal approach, responding to specific facts and specific events. Quantitative data analysis of broad market-wide patterns or practices is rarely used.
- The SEC operates through quasi-independent divisions and offices within divisions.
- The SEC has never engaged in serious self-examination of its performance or used appropriate measures of performance.

Any recommendations to improve the effectiveness of the SEC must consider each of these factors.

The SEC is a Reactive Regulator

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 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 does not 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. Until the past ten years, the Division of Enforcement invariably had more open investigations than it had manpower to assign. No one needed to develop new techniques for finding matters to investigate. In fact, the opposite was the problem. There were so many open cases that important investigations languished because of staffing shortages or staffing turnover.[30]

Because the five-member Commission must consider and approve all Enforcement actions before they are filed or settled, there is a weekly meeting to consider recommended actions. During my twenty years as the Commission's Secretary, I attended almost every meeting. Meetings routinely included at least one case involving events that were between two and five years old. Invariably, the staff responded to questions about the delay by explaining that the one key person assigned to the investigation had left during the investigation. When a new attorney was assigned to the matter, invariably that person had other pending investigations that had to be completed first before the person could devote the time to studying and completing the investigation. If a settlement was negotiated before the Commission authorized the case, this further extended the delay.

The frequency of this problem eventually culminated in the Chairman directing the Division to review all old cases. While an ongoing review of open investigations might appear to be an obvious—and critical—function of management, it has an episodic history within the Division of Enforcement.[31] As such, when a new Chairman would direct such a review, the result would inevitably be a hurried and massive effort by the staff to close older investigations with no action, rather than expediting completion of the investigation and submitting an old case to the Commission. In some instances, if a potentially important case ultimately could not be proven, an entire investigation might be closed rather than recommending a minor action against a peripheral or secondary party for misconduct that had become too old.[32]

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30. 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.

31. I am personally aware of four different Chairmen who directed the Division to actively review old open cases. The fact that four out of seven successive Chairmen would direct such a review suggests that case management has never been a high priority or a rigorous and disciplined process. It is my understanding that case management is again a priority for the Division.

32. In 2008, the SEC Inspector General concluded that the head of an SEC regional office had improperly closed a case despite having received a signed offer of settlement from a person more than twelve months before the closing. Chairman Cox assigned the Chief Administrative Law Judge of the SEC to conduct an inquiry into the finding and make a recommendation on whether to discipline the individual. In an unpublished opinion, the ALJ concluded that the decision to close the investigation was not based upon malfeasance but rather reflected an appropriate decision to close an investigation that was too old and had been delayed by staff departures and the need to investigate other persons and actions. The findings of the Inspector General are described in his 2008 semiannual report to Congress. OFFICE OF INSPECTOR

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 1980s, every member of the staff wanted to do insider trading or penny stock cases. In the 1990s, the staff looked for Internet frauds to investigate, no matter how small. A few years later, it was mutual fund late trading cases. Most recently, it was option-backdating cases.[33] Today, post-Madoff, it is Ponzi schemes. And post-financial crisis, it is sub-prime securities. In effect, every branch and every attorney is in competition with each of the others to bring the "fraud du jour."

The obvious problem with this "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" tend to be ignored or left on the back burner. 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 reactive regulator problem is not limited to the Enforcement Division. Each of the regulatory divisions—Corporation Finance, Investment Management and Trading and Markets—largely takes the same approach, albeit in a slightly different manner. Historically, each division suffers from a daily workload of routine actions that determines how limited staff resources are allocated. The Division of Corporate Finance must review corporate

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GENERAL, U.S. SECURITIES AND EXCHANGE COMMISSION, SEMIANNUAL REPORT TO CONGRESS 43 (Apr. 1, 2008–Sept. 30, 2008), *available at* http://www.sec-oig.gov/Reports/Semiannual/2008/seminov08.pdf.

33. 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) (statement of SEC Chairman Christopher Cox). Other public comments put the number of open investigations up to 170.

filings and provide interpretive guidance for time-sensitive transactions. Investment Management must process filings, act on exemptive applications, and provide interpretive guidance. Trading and Markets must review and approve SRO rule filings, provide interpretive guidance, and act on requests for no-action or exemptive relief. The demands of addressing this workload require the staff to focus on what is submitted to the SEC.

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 unit at the SEC is assigned responsibility for conducting this sort of research.[34] 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.[35] 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 identify 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.[36]

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34. The Special Study Report and the Institutional Investor Study both identified this failure and recommended that the SEC develop this internal capability: "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).

35. 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.

36. On rare occasions, regulatory divisions have obtained formal orders from the Commission to

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 1970s, the SEC proposed to develop an automated Market Oversight and Surveillance System (MOSS). The MOSS was designed but never built due to a change in administration and a change in priorities. In the 1980s, 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.

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 even began, as the appropriated funds were used to build EDGAR. 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. In recent years, the SEC has championed the extensible business reporting language (XBRL) as the electronic tool that will automate the analysis process. Whether this results in useful analytic data remains an open question.

Even if XBRL achieves that goal, it is unlikely that the automated analysis will be performed by SEC staff. This is the third component of the problem, as well as the component that is the most important and the one most ignored by the SEC. Throughout its history, the SEC has never recruited, hired, and retained skilled people capable of performing quantitative analysis. While the agency has sporadically recruited a small number of economists to work in its Office of Economic Analysis (also referred to by many other names), the office has always been understaffed and underutilized. There has never been a coordinated effort to hire people with quantitative skills to work

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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.

directly in the operating divisions where they could help the existing legal and accounting professionals.[37] The importance of automated analytic capacity cannot be overstated. As discussed previously, Christie and Schultze demonstrated the collusive spreads on NASDAQ quoted stocks by analyzing publicly available data,[38] and several other academics identified the incredible pattern of option pricing that resulted in an avalanche of SEC investigations and cases.[39]

Every quarter Madoff filed with the SEC a document listing the securities holdings (including options) that he controlled for his investors. This list included a dollar value for each holding. They were all imaginary. Annually, Madoff also filed reports identifying the amount of investor funds under management. We may never know if an ongoing systematic comparison of Madoff's filings and trading activity with market-wide trading data on options volumes would have alerted the staff that Madoff's filings were not accurate or not plausible.

Following the market collapse of 2008 and the claims of massive short-selling to manipulate financial stocks, it was disclosed that the SEC was collecting data on all trading in these key stocks to ascertain whether "bear raids" had occurred. One year later, the SEC has not disclosed the results of this analysis, or even whether the data collected was actually analyzed.

The lack of persons able to perform quantitative analysis is only one example of the need for a broader mix of skills throughout the agency. In fact, the agency also needs professional staff who understand complex investment and trading strategies, who have had experience working on the trading desks of institutional investors and brokers, and who have worked in the back offices of financial firms and understand not just the clearance and settlement process, but the mechanics of stock lending and borrowing, of reverse repos and international, cross-market trading. When Mr. Markopolous suggested to

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37. There is no single answer to explain the limited number of economists, industry professionals, mathematicians, or other specialists at the SEC. Certainly the lawyer's bias toward hiring more lawyers is a key factor. Also influencing this pattern is the relative ease with which lawyers may be hired under Federal personnel rules compared to the rigid and time-consuming rules that apply to hiring other professions. Limited Congressional appropriations also played a role. Finally, an often-overlooked problem is the comparative reputational appeal of the SEC. Lawyers and accountants see a job at the SEC as career enhancing. More than one SEC Chief Economist who had difficulty recruiting top-flight economists has explained to me that the SEC is viewed as a professional backwater, and that the SEC is not comparable to other high profile government agencies.

38. *See* Christie & Schultze, *supra* note 28.

39. *See* Lie, *supra* note 29.

Congress that the SEC staff members who read his letter did not understand it, he may well have been correct.

The SEC Operates Through Quasi-Independent Divisions and Offices Within Divisions

The SEC is not, and probably never has been, a well-managed organization. To understand how the SEC operates, think of Germany prior to Bismarck: a series of semi-autonomous feudal states that operate autonomously in most ways and occasionally compete amongst themselves, except when a common enemy appears at the border. Each division has its own organizational structure, culture, and pattern of decision-making. For instance, the Division of Trading and Markets, which has the most diverse set of responsibilities, has a series of self-contained offices that perform all functions associated with the subject area responsibility. For example, the office responsible for broker-dealer net capital compliance reviews periodic filings, conducts examinations, considers and acts on exemptive and no-action relief, and drafts regulations. Conversely, the Division of Corporation Finance has a highly pyramidal, integrated structure centered in its "branches," which review corporate filings from specified industry groups. Separate offices within the Division have responsibility for considering exemptive or no-action requests, drafting regulations, or reviewing special types of filings. Workload is carefully monitored, and all products go through extensive review.

The Division of Enforcement and the regional enforcement programs[40] operate 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

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40. 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.

specialization or assignment of specific areas of responsibility, each investigating branch works in parallel, competing for the best and highest profile cases.[41] This practice directly contributes to two 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 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 (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 quickly learn the Talmudic nuances of revenue recognition for a 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 do not 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 renegotiate a settlement to achieve some degree of parity.

The 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

41. 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.

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. One unfortunate consequence is that important but difficult open investigations are not fully investigated. One may speculate that this pattern occurred in the closed Milken investigations, the open but stagnant Keating investigation, and in the decision not to investigate more carefully the allegations against Madoff.

The second unfortunate consequence is that because everyone chooses to investigate the same types of cases, other less visible potential investigations are never considered. The lost opportunity to look at the horizon is serious. 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 IPOs of the '90s and the false statements of securities analysts were contributing to the Internet bubble. 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 such as 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.[42]

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42. In its 2008 Annual Performance and Accountability Report, Chairman Cox disclosed that there were fifty open investigations concerning sub-prime securities offerings. In addition, there is ongoing private litigation that alleges that the originators, underwriters and credit rating agencies made materially false and misleading statements in the offer and sale of CDOs. *See, e.g.*, Abu Dhabi Commercial Bank and King County, Wash. v. Morgan Stanley & Co. Int'l Ltd. et al., No. 08 Civ. 7508 (S.D.N.Y. 2009).

The SEC Has Never Used Appropriate Measures of Performance or Engaged in Serious Self-Examination of Its Performance

Beginning in 2004, the SEC has annually published a Congressionally mandated Performance and Accountability Review describing the Commission's accomplishments and measuring its success against a series of predetermined measures of effectiveness. It should come as no surprise that in this self-assessment the SEC annually concludes that it has performed well.

The problem has always been the inadequacy or inappropriateness of the metrics used to measure and evaluate the performance of the agency and, in turn, to the individual performance of individual members of the staff. When an agency uses the wrong measures to measure its performance, it fails to identify how its performance can be improved. Because people strive to achieve the results that are measured, the choice of measures strongly determines what people try to do. When an agency uses faulty measures to evaluate its staff, it rewards the wrong people for the wrong actions.

Nowhere is this more obvious than in the Division of Enforcement, where the benchmark for decades has been the total number of actions brought in a year, regardless of the relative importance or timeliness of the action and regardless of the result achieved. Simply put, a staff attorney who brings five separate actions for insider trading in the same stock receives credit for five "stats." Conversely, an attorney who brings one insider trading action involving far more trading is credited with one stat.

The permutations of this disparity are obvious. An attorney who successfully revokes the investment adviser registration of someone who is already in jail for fraud receives the same credit as the attorney who succeeds in prosecuting another investment adviser who is still in the business. The timeliness of an action is also not reflected in the total number of cases. An action that results in a TRO freezing millions of dollars of stolen funds from investors is one case, as is an action that enjoins someone for the same conduct years after it occurred. The focus on the annual total also affects the timing of actions. Everyone wants to file cases on or before the end of the government fiscal year, which is September 30. Over the years, many commentators have pointed out that a huge proportion of SEC actions occur during the month of September.[43]

43. The Secretary of the Commission must sign and issue every administrative proceeding order from the Division of Enforcement. The Secretary also reviews prior to publication all SEC litigation releases announcing the filing of an injunctive action. Because of this responsibility, the author routinely stayed at his desk working late into the night every year on September 30, the last day of the SEC fiscal year. On one

Another symptom of this simplistic system of measurement is the annual total of all money penalties obtained, regardless of whether the money has been collected.[44] Even when a public corporation pays a large penalty, its punitive value is diminished by the knowledge that the penalty is not paid by a culpable individual but by the shareholders of the company, who typically were the victims of the fraud. Moreover, a company may agree to a large penalty because it knows that the funds will be transferred into a settlement fund and the company can use these funds to negotiate a lower settlement in the parallel private class-action litigation.

The reliance upon the most simplistic measure of performance, the number of cases brought, strongly influences the way staff approach potential investigations. Why should a staff attorney who receives the letter from Mr. Markopolous drop other pending investigations that will clearly produce results in order to investigate possible misconduct that the staff member may not understand and may not even realize is illegal? Secondarily, an attorney midway into an investigation may have a choice between completing the case and charging a single violator for an obvious infraction or continuing to investigate because there are numerous unanswered questions that may entail greater misconduct by the same or other persons.

The problem of inadequate measurements is not limited to the Division of Enforcement. It permeates the agency. For example, staff in the Division of Corporation Finance who review corporate disclosure filings are evaluated on the basis of the number of filings reviewed and the speed with which the review is completed. Needless to say, these two factors implicitly encourage the staff to choose simple filings from known companies. It also encourages the staff to review certain filings because they largely "incorporate by reference" another filing, a "twofer."

The consequences of this system are obvious. Why would a staff person choose to review the reports of Enron or carefully examine the obtuse disclosures contained in a subprime asset-backed securities (ABS) registration statement? Equally important, the measures are focused on discrete filings. This is another manifestation of the lawyer's case and controversy mentality. While Corporate Finance occasionally undertakes a cross-cutting review of a selected number of disclosure documents, such as the review in 2008 of

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such occasion a senior officer of the SEC who did not work in the Division of Enforcement once commented to the author, "You know we sue companies that keep their books open after the fiscal year ends."

44. In fact, the routine practice of ordering disgorgement but waiving payment began inadvertently in a single case to explain why the person was not actually paying back the money illegally obtained.

foreign company filings in the International Financial Reporting Standards, these are the exception.

Without sound methods to measure success or failure, it is not surprising that the agency, notwithstanding several notable failures, rarely engages in meaningful self-examination to identify how to improve itself. Following the NASDAQ market-makers case and the New York Stock Exchange specialists case, the SEC did not conduct an inquiry into why its staff failed to identify these problems. Similarly, no one reviewed the examination reports of the major mutual fund families that were found to have permitted late trading. After Enron and WorldCom, Corporate Finance did not reexamine its disclosure review procedures to learn why its staff failed to see the red flags contained in annual reports, even though several professional analysts had identified them and publicly raised questions before the implosions.

III. What Should Be Done

Massive frauds happen periodically, as the events described in this paper demonstrate. They happen during periods when the SEC appears to be strong and they happen during times when the SEC is perceived to be weak. Frauds occur when markets are strong and rising. When markets collapse, the frauds are exposed.[45]

The effectiveness of the SEC should not be evaluated solely by the occurrence of specific events. However, the events described in this paper provide insight into several underlying problems at the SEC and are useful for analyzing what the agency could do to be more effective. While a comprehensive set of recommendations is beyond the scope of this paper,[46] I conclude by offering several thoughts on what should be done to reinvigorate the SEC.

Rethinking the Mission of the SEC and Its Reliance on Enforcement Solutions

Reforming the regulatory system for financial services is a priority of the Obama administration and the Congress. In this debate, when the focus is on

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45. Warren Buffet once wrote, "You only learn who has been swimming naked when the tide goes out." Letter to Berkshire Hathaway Shareholders, Feb. 2008, at 2.

46. The U.S. Chamber of Commerce Report examined three discrete regulatory programs and a series of related agency-wide issues. That report is 85 pages in length and contains 23 recommendations. Several of the recommendations in that Report are included in this paper.

the SEC, primary attention is directed at the SEC enforcement and inspection programs, as though that is everything the SEC does. It's understandable, but it is misleading. In 2006, Chairman Cox stated, "First and foremost, the SEC is a law enforcement agency."[47] Virtually every Chairman of the SEC in the past thirty years has expressed a similar view.

The SEC is not exclusively a law enforcement agency and it should never become or be viewed as the Department of Justice. The SEC is first and foremost a regulatory organization with an enforcement program to support its regulatory program. Going forward, there will be a great deal of discussion about reorganization of the SEC and other financial regulators. If the SEC is stripped of some of its regulatory or prudential responsibilities, its effectiveness will suffer. Similarly, if the SEC receives additional resources, there will be a tendency to apply them all to examinations and enforcement. This has been the pattern in the past, and it too would be a mistake.

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.

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,[48] 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. Effective regulation must be forward-looking. The SEC should reassert that its primary mission is effective regulation of the capital markets and that its enforcement program is just one component of this mission.

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47. U.S. SEC. AND EXCH. COMM'N, PERFORMANCE AND ACCOUNTABILITY REPORT (2006), http://www.sec.gov/about/secpar/secpar2006.pdf, at 2.

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

The history of the SEC is also useful in demonstrating how regulatory solutions 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 '70s to the even more widespread problem of illegal corporate payments to politicians, both in the United States 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. 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.

A few examples:

- Gulf Oil paid $12.6 million over a 15-year period, including payments to campaigns of President Nixon, Senator Hubert Humphrey, Senator Hugh Scott, Senator Scoop Jackson, and House Ways and Means Chairman Wilbur Mills. Gulf's Chairman and two executive Vice Presidents resigned after disclosure of their knowledge of the payments and the use of offshore accounts to launder the money.
- Northrop Aviation disclosed payments to U.S. politicians of more than $500,000 over a nine-year period. But that was only a small portion of a total of $30 million in foreign consulting payments for which it couldn't document a purpose.
- Lockheed Air couldn't document or justify $200 million in foreign consulting payments, of which $25 million went to foreign officials.
- Eventually the SEC would bring 62 illegal payments cases, with the first being an action against the American Shipbuilding Company and its CEO, George Steinbrenner.

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 400 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.

Reorganizing the SEC

The current organizational structure of the SEC is based upon the functions and the structure of the U.S. capital markets. Unfortunately, it is based upon the functions and structure of the U.S. capital markets in the 1970s. This world has changed and so must the SEC. A broad reorganization of the SEC is long overdue.

A modern organization of the SEC would reorganize the current Divisions of Trading and Markets and Investment Management, as well as consolidate the inspection and examination program, Office of Compliance Inspections and Examinations (OCIE), into two divisions that would reflect the financial services industry and the financial markets of today. In the modern, reorganized SEC, there would be one division to regulate retail market operations (business conduct) and a second division to regulate market structure and operations as well as firm safety and soundness (prudential regulation). 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.[49] The existing Divisions of Corporation Finance and Enforcement would not be combined into these new divisions, but the internal organizational structure of each would be updated.

While the Division of Enforcement would continue to be a separate division, it would be reorganized along functional lines that correspond to a new agency structure.[50] The tradition of "everyone does everything" must be abandoned. It is inefficient and prevents the Division from building highly experienced units that understand the intricacies of complex investigations and that assigns clear responsibility for all misconduct in particular areas to specific units. It would also facilitate stronger daily interaction between enforcement staff and regulatory staff, breaking down silos and improving

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49. 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.

50. SEC Director of Enforcement Robert Khuzami has publicly announced an intention to increase specialization within the Division by creating a series of specialized units with clear but broad functions, such as hedge funds, market trading and municipal. This appears to be a promising step, provided that the responsibilities of these units is sufficiently broad to provide responsibility for emerging problems and not merely the problems of the immediate past. This latter approach has been used, with limited success, repeatedly in the Divisions. The problem with it is that it reflects 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.

informal coordination. Most importantly, this would also promote the proactive and forward-looking mission approach in which enforcement again becomes a weapon for effective forward-thinking regulation.

While the Division of Corporation Finance would continue to rely upon a branch system reflecting industry groups, it would create an internal forensic review group that would have the ability to conduct "deep dive" reviews of opaque corporate disclosure or engage in broad sector or industry-wide reviews of new products or practices. Unlike the Division of Enforcement, the objective of this process would not be to bring enforcement actions, but rather to improve the quality of corporate disclosure.

This reorganization and redefinition of mission requires the SEC to address its need for staff possessing the broader mix of the skills that are needed to be a modern regulator. Since her arrival, Chairman Mary Schapiro has publicly expressed her interest in hiring professionals who would bring a broader mix of skill sets to the SEC.[51] However, to be truly effective, these new industry professionals should not be cloistered in a single office; they should be hired to work in each operating division.

A regular stream of knowledgeable people from the industry would also address another problem: staff isolation from the industry it regulates. The U.S. capital markets are fueled by information—both official disclosures and informal "chatter." It is interesting, post-Madoff, to hear how many people in the industry informally questioned Madoff and his performance. Remarkably, this occasional gossip never seemed to filter back to the SEC staff in a meaningful way. The agency must regain its access to the talk heard on the street. Visiting industry fellows who are encouraged to maintain their industry contacts could rectify this problem.

A broad reorganization must also include the creation of a Chief Operating Officer (COO) for the SEC who reports directly to the Chairman and oversees its daily operations. Simply put, the SEC needs an office and a senior official capable of breaking down silos and ensuring that the staff function as a single entity. It needs an internal process to timely resolve the inevitable disagreements between divisions and offices.[52] An immediate

51. Press Release, U.S. Sec. and Exch. Comm'n, SEC Announces New Initiative to Identify and Assess Risks in Financial Markets (Apr. 30, 2009) ("The Securities and Exchange Commission today announced a new effort to identify and assess risks in the financial markets by attracting seasoned industry professionals to the agency's Office of Risk Assessment. The new Industry and Markets Fellows Program will help the agency expand its ability to oversee complex industry practices and products in today's markets.").

52. For a more detailed discussion of this function, *see* Chamber of Commerce Report, *supra* note 46, at 18–22.

priority of a COO would be to identify an appropriate set of metrics to monitor agency efficiency and effectiveness and to evaluate the performance of its individual staff.

Reinvigorating the Regulatory Divisions and Regulatory Program of the SEC

Not surprisingly, the emphasis on its law enforcement function has been reflected in the allocation of resources and the agenda of the SEC. While recent attention on the shortcomings of the SEC has highlighted its need for more staff and greater resources, in reality the SEC has received substantial budget increases frequently in the past two decades, most recently in 1990, in 2002, and in 2009. In each case these additional resources have been allocated principally to the enforcement and examination programs. The Divisions of Trading and Markets, Investment Management, and Corporation Finance have been neglected.[53]

However, additional staff is only one component of the solution. A far more important change must be a revival of regulatory self-confidence throughout the SEC. Simply put, the regulatory perspective of the SEC has been heavily influenced by the popularity of the "self-correcting market" hypothesis. Consistently throughout the past three decades, the SEC has frequently deferred from taking regulatory positions when it was persuaded that the market would be more effective if it was free to self-correct. The recent financial crisis has demonstrated that no market is completely efficient and self-correcting. Regulation must play a role. This is a strong statement that should not be misinterpreted to argue for more regulation. Rather, it is support for smarter regulation. Smarter regulation, however, requires smart regulators. As discussed earlier, the regulatory divisions must attract and retain staff with a wide range of skills. They must also revise the way that regulation is performed currently.

The Operating Division must reduce the level of resources devoted to routine tasks. 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 practices.

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53. There is one notable exception. In 2002, following Enron and WorldCom, Corporation Finance received a substantial increase in its accounting staff.

They must examine regulatory strategies that are not narrowly defined to fit within the current silos.[54]

Smart regulation also 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*:

> 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:
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> 1) The SEC's Compliance Office 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) A plan from the Chief Economist for examining data collected to enable the agency to examine the impact, costs and benefits of the rule. Making the Chief Economist the focal point of this assessment would provide the agency's economists 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 Compliance Office 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.[55]

These recommendations will not result in more or less regulation, but instead 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.

54. This subject is fully discussed in the Chamber of Commerce Report.
55. Jonathan G. Katz, *Letter to the Editor*, WALL ST. J., Aug. 8, 2006.

A reconfigured Division of Enforcement has a role to play in this process, and that role is not merely aggressive enforcement of violations when they occur. Enforcement, with its subpoena power, or a reconfigured examination program, working closely or recombined with the operating divisions, should proactively collect information, including sworn testimony, for regulatory purposes.

This is not a new idea. It is a revival of functions performed in the past at the SEC. When the Special Study of the Securities Markets was conducted in the 1960s, the staff used subpoena power to learn what really was happening in the market. When the Division of Corporation Finance had its own enforcement program, it frequently opened formal orders of investigation to compel corporate testimony to determine what must be disclosed in company filings. The goal was not to bring an injunctive action or institute a stop order proceeding, but instead to provide the market with critical information. As the "illegal payments disclosure program" of the '70s demonstrated, prospective remediation through disclosure can be a more effective and less reactive solution than hundreds of separate enforcement actions.

Disclosure Regulation—Back to the Basics

Over an extended period of time, spanning decades, the concept of disclosure has metamorphosed from the goal of providing investors with documents containing clear and comprehensive information into documents containing highly legalistic and all-encompassing statements designed to protect the issuer from future litigation. The result has been the worst of both worlds. Documents include under the category of "significant risks" descriptions of everything ranging from the impact of the loss of key contracts to the possibility of global pandemics eliminating potential customers. Mutual funds that purport to apply "value based" investing strategies disclose the possibility that they might occasionally invest in unproven new technology companies that have no profits and trade at stratospheric multiples. The recent financial crisis demonstrates how poor or inadequate disclosure in structured finance offerings made it impossible for even the savvy institutional investors to assess the risk-reward potential of offerings.[56] The poor quality and

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56. The need for better initial and periodic disclosure in structured finance offerings is fully described in Chapter 3 of the report of the Committee on Capital Market Regulation. COMM. ON CAPITAL MARKETS REGULATION, THE GLOBAL FINANCIAL CRISIS: A PLAN FOR REGULATORY REFORM (2009), http://www.capmktsreg.org/pdfs/TGFC-CCMR_Report_(5-26-09).pdf. Two years earlier, Allan Sloan

inadequate quantity of disclosure made it inevitable that investors would depend on credit ratings to make investment decisions.

In making this recommendation, it is important to stress that full disclosure is fundamentally different than "plain English" disclosure. The goal should not be to take empty disclosure and rewrite in easy-to-understand language. The goal should be to affirmatively require issuers of securities to provide full and honest information that can be used to make informed investment decisions.

CONCLUSION

Winston Churchill once remarked: "It has been said that democracy is the worst form of government except all the others that have been tried."[57] One might apply that comment to government regulation of free markets. It is flawed, slow and imprecise, but it is far superior to blind faith in a self-correcting unregulated "efficient market." Regulation of free markets rarely involves perfect solutions. Instead, regulators must make intelligent but imperfect choices. The SEC at its best has not been perfect. Frauds have happened, and they will continue to happen. The goal of the SEC must be to constantly self-examine current practices and change or improve functions that are found wanting and change regulatory practices as the markets that are regulated change.

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described the inadequacies of structured finance disclosure in an article in *Fortune Magazine*. Allan Sloan, *Junk Mortgages Under the Microscope*, FORTUNE MAG., Oct. 16, 2007, http://money.cnn.com/2007/10/15/markets/junk_mortgages.fortune/index.htm.

57. House of Commons speech, Nov. 11, 1947.