U.S. SECURITIES AND EXCHANGE COMMISSION: A Roadmap for Transformational Reform

December 2011

CENTER FOR CAPITAL MARKETS COMPETITIVENESS

By Jonathan G. Katz

The U.S. Chamber of Commerce, which represents the interests of more that 3 million businesses and organizations of every size, sector and region, strongly believes that the U.S. capital markets are the lifeblood of our economy.

Since its inception, the U.S. Chamber's Center for Capital Markets Competitiveness has led a bipartisan effort to modernize and strengthen the outmoded regulatory systems that have governed our capital markets. Ensuring an effective and robust capital formation system is essential to every business from the smallest start-up to the largest enterprise.

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Executive Summary

In response to the stock market crash of 1929 and the Great Depression, Congress created the U.S. Securities and Exchange Commission (SEC). Throughout much of its history, the SEC has been the preeminent financial regulator, successfully overseeing the world's leading capital markets. However, for more than a decade, the SEC regulatory and enforcement structures have failed to keep pace with rapidly changing markets. This is attributable to a variety of factors including, but not limited to, structural and managerial inefficiencies at the SEC, rapidly evolving markets, and the rise of intense global competition. The purpose of this report and its recommendations is to restore the SEC as the world's premier financial services regulator.

Businesses and investors alike need a modern, efficient, fair, and tough regulator. America's ability to maintain the world's deepest and most liquid markets hinges in part on having a strong, effective, and even-handed regulator. While outdated and broken regulations and ineffective application of regulatory authority were not the primary cause of the 2008 financial crisis, they should not be overlooked as contributory causes. The financial crisis has laid bare many of the shortcomings of an agency that is grounded in an outdated view of the world's financial markets and is in profound need of transformational reform.

This need for transformational change supplants earlier proposals for reform. In 2009, the U.S. Chamber of Commerce released its first SEC reform report: *Examining the Efficiency and Effectiveness of the U.S. Securities and Exchange Commission* (2009 Report). While the 2009 Report made 23 recommendations for reform, they were proposals for incremental change. We fully recognize that over the past few years, the current leadership of the SEC has begun to address some of the key weaknesses of the agency and positive progress has been made in some areas. However incremental change will no longer do.

This report makes constructive reform proposals that, taken together, would help to achieve the level of change needed to transform the agency. In order to achieve fundamental reform of the agency, we recommend:

1. **Developing a bold and clear plan.** We provide many ideas in this report, including how to make rulemaking, supervisory inspections, and enforcement more effective.

2. **Putting someone in charge of implementing the plan**. We recommend increasing the size of the Commission from five to seven members and designating a Deputy Chairman for Management and Operations among the Commissioners to lead the day-to-day implementation of this turnaround program.

3. **Removing statutory and practical obstacles to transformational reform**. Fixing some of the structural weaknesses of the SEC, including the number of mandated direct reports to the Chairman, will require statutory revisions. And the Commission will need sufficient labor flexibility to make changes to ensure it has the staff with the appropriate skills to carry out its expanded and modernized responsibilities. This report recommends ensuring that the Commission has the ability to hire the right people with the right skills to regulate the 21st century capital markets, and ensure that staff are put in positions to succeed—or are removed. It also recommends changes in procedures to ensure that necessary technology improvements can be effectively developed and successfully incorporated into the agency's core programs.

4. **Tying increased funding and resources to the transformation process.** The transformation of the SEC will need to be adequately resourced. While current resources of the SEC can be used much more effectively, additional resources will also be needed. However, Congress should insist on an honest and thorough examination of core programs, followed by timely and clear progress in implementing necessary changes as a condition for expanded funding.

We believe that readers of this report will acknowledge that the level of change proposed here is overdue and that extraordinary steps are needed to achieve change. At the same time, we recognize that everyone may not agree on the specific solutions proposed in each of these recommendations. The Chamber will remain an active and constructive voice for positive change and will continue to work with all of those who share our goal of maintaining the U.S. position as the world's preeminent, best-regulated capital market. We welcome the debate on all ideas to help achieve transformational reform.

We know this will not be easy. Some will surely criticize us for even suggesting this level of change. But we must also recognize that the status quo is no longer acceptable. A vigorous debate, followed with a rational plan of action, is needed to ensure that America's businesses and job creators have access to capital necessary to compete in a 21st century global economy.

The U.S. Chamber of Commerce's Center for Capital Markets Competitiveness was established to help ensure that our nation's capital markets are the most fair, efficient, and innovative in the world. Unquestionably, reforming the SEC is a critical component of achieving that goal.

David Hirschmann
President and CEO
Center for Capital Markets Competitiveness

SUMMARY OF RECOMMENDATIONS

The 2009 Report was based on an external assessment of three core SEC functions. That report contained recommendations for change at the SEC. Each recommendation was made with the goal of improving SEC efficiency and effectiveness and enabling the agency to increase its capacity to meet its dual responsibilities of investor protection and promoting American capital formation.

In 2011, the Chamber commissioned this second study and report. Chapter One discusses the need for a comprehensive transformation of the SEC. It addresses the Commission's leadership, management, and organization; the related issues of resources, accountability, and performance metrics; and the importance of engaging in a serious and thorough review of the core regulatory programs as part of the transformation process. Chapters Two and Three examine two of the most important functions of the SEC—enforcement and rulemaking. These functions were not discussed in the 2009 Report. These chapters include several recommendations to improve these critical responsibilities. Chapter Four updates the 2009 Report and assesses whether the recommendations have been adopted and, if not, whether they continue to be appropriate two years later. The chapter also discusses the many changes at the Commission since 2009.

This report was prepared in the same manner as the 2009 Report. Its findings are based in part on a review of public actions, reports, and statements of the SEC, as well as third party reports and, in part, on a series of informal, confidential interviews and meetings with highly knowledgeable persons. The individuals interviewed include current and former SEC Commissioners and staff (at both senior and subordinate levels), employees of public companies, employees of financial services firms regulated by the SEC, and lawyers and other professionals specializing in the capital markets sector. To encourage open and frank discussions, all persons were interviewed on a "not for attribution" basis.

CHAPTER ONE: TRANSFORMING THE SEC

For most of its history, the SEC has been viewed as an outstanding government regulator. It has been trusted by the public, respected by the industry it regulates, and viewed positively by Congress. Moreover, it has been a model for other countries on how regulation can provide investor protection and at the same time promote capital formation and economic growth. Sadly, the events of the past decade, and the perception that the SEC failed to identify problems early and failed to respond strongly and quickly, has eroded the trust and confidence of the public, the industry, and policymakers.

This chapter discusses some of the fundamental problems of the Commission that must be honestly and carefully examined. The first section of this chapter examines the Commission's leadership structure—how it is managed and organized, and how responsibilities are divided among the Chairman, the Commissioners as a collegial decision making body, the Division directors and office heads, and the career senior officers. The second section examines the perennial issues of agency resources, agency accountability, and performance metrics. The third section discusses the need for a thorough examination of long-standing regulatory programs that have not changed to keep pace with the changes in the capital markets. Recommendations are provided on how to solve these problems.

RECOMMENDATION 1—Congress should increase the number of Commissioners from five to seven and specify that at least one Commissioner must be an accountant, one an economist, and one an attorney.

RECOMMENDATION 2—One Commissioner should be designated by the President, on the recommendation of the Chairman, as Deputy Chairman for Management and Operations. This Commissioner should be required to have expertise and experience in the management of a large organization. The Chief Operating Officer should report directly to the Deputy Chairman.

RECOMMENDATION 3—The Chairman should appoint the Deputy Chairman for Management and Operations to oversee a comprehensive review and reorganization of the Commission, as the Chief Transformation Officer.

RECOMMENDATION 4—The SEC must develop a comprehensive set of performance measures that are based on the significance, efficiency, and quality of results, rather than simply measuring the quantity of actions and the processing time taken for interim steps in the process.

RECOMMENDATION 5—The metrics adopted by the SEC for its annual Performance Evaluation Report should be developed and selected by the Chief Operating Officer, in conjunction with trained staff in Risk, Strategy, and Financial Innovation (RSFI).

RECOMMENDATION 6—The SEC should adopt and vigorously apply a formal process for evaluating new employees during the initial three-year probationary period. Retention decisions should be made by a committee of second-level supervisors based on a recommendation from the first-level supervisor.

RECOMMENDATION 7—Senior officers should be hired for renewable five-year term appointments. A public personnel recruitment competition for the position should be a mandatory component of the renewal process.

RECOMMENDATION 8—The SEC should develop a comprehensive executive development program for its most promising staff who are interested in staying at the Commission.

RECOMMENDATION 9—A rotational assignment program should be established for junior staff, mid-level supervisors, and senior officers.

RECOMMENDATION 10—The Commission should require the development of a full business process plan before developing a new IT system or adopting a new rule mandating the filing of detailed information for use and analysis by Commission staff. The business process plan should be formally approved by the director of the relevant program division or office and by the Chief Data Officer.

RECOMMENDATION 11—In its current configuration, the resource-constrained examination program is untenable. The Commission must confront the brutal fact that it has insufficient resources and that Congress is unlikely to substantially increase its budget or provide the agency with self-funding authority. If an effective self-regulatory organization cannot be created, the SEC should adopt one of the several alternative approaches structured around a private sector examination program.

RECOMMENDATION 12—The SEC should undertake and complete a comprehensive review of its corporate disclosure regulatory system to align disclosure requirements with the needs of the primary users of the information.

RECOMMENDATION 13—The SEC should thoroughly review its disclosure review program and, based on its findings, align the resources expended with the benefits obtained, in terms of investor protection and efficient capital formation.

RECOMMENDATION 14—The knowledge management program recommended in the Chamber's 2009 Report and in the Boston Consulting Group Report should include an internal autopsy program and an informal "red flag" process that enables staff to quickly highlight important events and ideas for senior SEC staff.

RECOMMENDATION 15—Congress should create and fund a blue ribbon team of experts to undertake a thorough review of the SEC and the American capital markets.

CHAPTER TWO: SEC ENFORCEMENT—EXAMINING THE CHANGES IN THE PROGRAM AND DEFINING ITS MISSION

The Division of Enforcement has made a wide range of organizational, management, and policy changes, changes its Director has described as the most sweeping in the Division since it was created in 1972. While the changes are largely positive and should, over time, improve the effectiveness of SEC enforcement, it is too soon to conclude that they are already successful. More time is needed to assess their impact. In several cases additional changes are needed to achieve the desired results and, in other cases, the Division must demonstrate a commitment to full implementation of reforms.

RECOMMENDATION 16—The Office of the Managing Executive for Enforcement should develop an in-depth training program on investigative techniques.

RECOMMENDATION 17—The Division should establish a goal of reducing its open case inventory each year by identifying one-third of its investigations that are least likely to warrant action, due to age, significance, or weak evidence. Any investigation that is more than 18 months old or based on a possible violation older than three years should be closed routinely unless the Division Director or Deputy affirmatively concludes that it is essential to continue the investigation.

RECOMMENDATION 18—The procedure for assignment of investigations should be revamped. The process should not be based largely on the person or group that first identified the matter or the geographical location of the issuer of securities or headquarters of a registered firm. A disciplined top-down system should assign cases based upon staff expertise and experience in the area and the availability of sufficient resources to complete the investigation in a timely manner.

RECOMMENDATION 19—The investigation management process should consider the mix of cases in the pipeline when assessing investigations. The Division should have an explicit goal of bringing cases that advance the Commission's entire regulatory agenda.

RECOMMENDATION 20—The Division should develop an internal autopsy report to carefully examine problems after the fact and use it for training.

RECOMMENDATION 21—The number of specialty units should be increased and the staffing of the specialty units should grow to 40% of the Division. A specialty unit responsible for complex accounting frauds or misstatements should be created. A corporate debt market unit should also be created. The market abuse unit should have a subunit devoted to alternative trading systems, dark pools, and other nonexchange platforms. The Foreign Corrupt Practices Act (FCPA) group should have expanded responsibility for all investigations of foreign issuers listed in the United States.

RECOMMENDATION 22—Use specialty staff to promote consistency throughout the Division. Eliminate dual reporting for regional staff assigned to specialty groups. Provide group leaders with broad oversight authority over all investigations relevant to their subject authority and responsibility for quarterly reviews. Permit defense counsel to request meetings with specialty teams to discuss relevant investigations conducted by other units.

RECOMMENDATION 23—The SEC should update the Seaboard principles on voluntary cooperation and then commit itself to applying them whenever appropriate.

RECOMMENDATION 24—The Division must use its metrics consistently. It should refrain from issuing press releases that evaluate its performance based on the total number of cases and the amount of money ordered to be paid. Instead it should rely on measures of case importance and timeliness. Enforcement actions that duplicate parallel criminal actions, that are based on previous SEC actions, or that involve companies that are defunct or persons who are no longer registered or active should not be included in measures of performance. Statistics on money judgments should be based on the amounts paid, not the amounts ordered to be paid. Staff who conduct, complete, and close a thorough investigation that does not result in a recommendation for action when that is the appropriate action should also get positive recognition.

CHAPTER THREE: SEC RULEMAKING PROCESS—BUILDING A NEW PROCEDURAL MODEL

During the last decade the SEC has suffered an unprecedented series of judicial reversals of high-profile rules that it adopted. Notwithstanding the well-established principle of judicial deference to regulatory agencies concerning legal questions central to their regulatory expertise, the courts vacated Commission rules dealing with the regulation of hedge fund advisers, the regulation of mutual fund board chairmen, and the regulation of a shareholder's ability to nominate persons to a corporation or mutual fund's board. In vacating these rules, the courts of appeal published harsh opinions questioning the Commission's interpretation of its legal authority and the quality and sufficiency of the record compiled to justify the rule. In the process, they suggested that the Commission, as part of its rulemaking process, has to improve its use of empirical information when examining the regulatory questions; its process for accessing the costs of its rule; and its consideration of alternative approaches to address problems. This chapter identifies problems in the rulemaking process that have contributed to the adverse judicial decisions vacating Commission rules. It also discusses the problem of *de facto* rulemaking through the inspection program.

Smart regulation requires a re-thinking of the process for developing and implementing regulations. A final regulation is the start of the process, not its completion. Because it is difficult if not impossible for any regulator to know what will happen when a regulation is adopted, the Commission should combine a pre-adoption cost-benefit analysis with a post-adoption look-back requirement. Under this approach, the Commission would collect data and re-evaluate a rule after a defined period to determine the effectiveness of a rule and the need to keep it on the books or modify it. This look-back process would fundamentally change how rules are developed. Knowing that 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.

The chapter contains other specific recommendations to improve the rulemaking process of the SEC.

RECOMMENDATION 25—The cost-benefit analysis should be an integral component at the earliest stage of the rule development process. The analysis should guide the regulatory process leading to a rule, rather than serve as an after the fact justification of the approach taken.

RECOMMENDATION 26—The Commission should adopt a regulatory look-back requirement whenever it adopts a "major rule" as defined in the Small Business Regulatory Enforcement Fairness Act (SBREFA).

RECOMMENDATION 27—Whenever the Office of Compliance Inspections and Examinations (OCIE) requests the same information from nine or more persons or entities through an exam or series of related exams, it should comply with the Paperwork Reduction Act.

RECOMMENDATION 28—While industry best practices may be effective techniques to promote regulatory compliance, the failure to adopt these practices should not be viewed as regulatory deficiencies. The Commission should mandate adoption of a best practice only through the rulemaking process.

CHAPTER FOUR: PROGRESS TOWARD IMPROVING THE EFFICIENCY AND EFFECTIVENESS OF THE SEC

The final chapter of this report examines the progress made in adopting the recommendations contained in the Chamber's 2009 Report. The chapter updates findings on the size and significance of problems in the earlier report. It also highlights unadopted recommendations that are still valid today.

The 2009 Report contained 23 recommendations grouped into four areas:

- Review of self-regulatory organization (SRO) rule changes by the Division of Trading and Markets;
- Review of exemptive applications from investment companies by the Division of Investment Management (IM);
- Review of no-action letter requests and other forms of staff interpretive guidance by the Division of Corporation Finance (Corp Fin) as well as the other regulatory divisions;
- Improving SEC management, structure and oversight.

The greatest improvement has been in the review of SRO filings. This progress is largely the result of congressional mandates for change included in the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010. There has been limited progress in the three other primary areas of concern in the 2009 Report. IM and Corp Fin have not embraced the recommendations made, even though the available evidence examined indicates that the problems identified in the 2009 Report are more substantial in 2011. The Commission should recognize that these critical functions are not performing well and direct its attention to the 2009 Report recommendations to improve the efficiency and effectiveness of these core functions.

The Commission should also address the seven recommendations in the 2009 Report on improving SEC management, structure, and oversight. The following three recommendations in the 2009 Report are of greatest importance:

RECOMMENDATION—The Division of Trading and Markets and the Division of Investment Management should be realigned into a Division of Investor Protection and Retail Financial Services Regulation and a Division of Market Oversight and Operations. The Examination Programs of the Office of Compliance Inspections and Examinations (OCIE) should be assigned to these new divisions.

RECOMMENDATION—The SEC should create an accelerated conditional approval process for new investment products or services.

RECOMMENDATION—The five-member Commission should play a greater ongoing role in the interpretation and application of regulatory policy. This may require congressional action to amend the Government in the Sunshine Act (Sunshine Act) that was passed in 1976 that, among other requirements, mandates that every portion of every meeting of an agency shall be open to public observation. Although the Act was developed to create greater openness in government, it has had the unintended consequence of restricting valuable communications between Commissioners and SEC staff.

An updated discussion of all 23 recommendations in the 2009 Report is contained in Appendix A of *U.S. Securities and Exchange Commission: A Roadmap for Transformational Reform.*

INTRODUCTION

The first decade of the 21st century was arguably the most difficult period in the long history of the U.S. Securities and Exchange Commission (SEC). The decade began with a substantial decline in the stock markets, the crash of the so-called tech bubble in 2000. Shortly thereafter, enormous frauds at a series of major public corporations—including Enron, WorldCom, and Sunbeam—caused further damage to the American capital markets. They also raised substantial doubt as to the effectiveness of the auditors for these companies, and the effectiveness of the disclosure program at the SEC, which failed to identify problems in corporate reports. Subsequently, the mutual fund market timing cases demonstrated that no component of the financial services industry was immune from scandal and that the SEC examination program also was not accomplishing its mission.

These market crises and regulatory failures were eclipsed in magnitude by two later events. The financial crisis of 2008 demonstrated, *inter alia*, that the system of prudential regulation adopted by the SEC only a few years before and based on industry-developed value at risk modeling (consistent with the approach taken internationally by banking regulators) was fundamentally flawed. Finally, the Madoff scandal exposed serious shortcomings in the SEC enforcement program, historically the crown jewel of the Commission.

During the decade of the 90s, when the markets and participants under SEC authority grew exponentially, the SEC budget remained largely static. Following the turbulent events of 2000–2002, and 2008–2009, Congress provided the Commission with substantial budget increases. Congress also acted to expand the Commission's legal authority, twice enacting laws that greatly expanded the regulatory powers of the SEC—Sarbanes-OxleyAct of 2002 and the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank).

The Purpose of this Report

Congressional action to provide the SEC with additional legal authority and a larger budget has diverted attention from an underlying question: How effectively is the SEC using its powers and resources? Notwithstanding the unprecedented expansion in regulatory authority and historic growth in budget and size, the efficiency and effectiveness of the SEC remains an open question. In part this may be because the SEC has not completed its implementation of Dodd-Frank. In part this may be because, as the SEC asserts, it is still underfunded and lacks the IT infrastructure needed to do its job. However, throughout the decade, one critical exercise has not been undertaken. The SEC has not undertaken a serious, objective self-examination of the way it does its job. While the agency has many more staff and much more authority, it still operates the same way that it has for decades.

In 2009 the Chamber published *Examining the Efficiency and Effectiveness of the U.S. Securities and Exchange Commission* (2009 Report) based on an external assessment of three core SEC functions. The 2009 Report contained 23 recommendations for change at the SEC. Each recommendation was made with the goal of improving SEC efficiency and effectiveness and enabling the agency to increase its capacity to meet its dual responsibilities of investor protection and promoting American capital formation.

In 2011, the CCMC commissioned this second study and report. Chapter One discusses the need for a comprehensive transformation of the SEC. It addresses the Commission's leadership, management, and organization; the related issues of resources, accountability, and performance metrics; and the importance of engaging in a serious and thorough review of the core regulatory programs as part of the transformation process. Chapters Two and Three examine two of the most important functions of the SEC—enforcement and rulemaking. These functions were not discussed in the 2009 Report. These chapters include several recommendations to improve these critical responsibilities. Chapter Four updates the 2009 Report and assesses whether the recommendations have been adopted and, if not, whether they continue to be appropriate two years later. The chapter also discusses the many changes at the Commission since 2009.

This report was prepared in the same manner as the 2009 Report. Its findings are based in part on a review of public actions, reports, and statements of the SEC, as well as third party reports and, in part, on a series of informal, confidential interviews and meetings with highly knowledgeable persons. The individuals interviewed include current and former SEC Commissioners and staff (at both senior and subordinate levels), employees of public companies, employees of financial services firms regulated by the SEC, and lawyers and other professionals specializing in the capital markets sector. To encourage open and frank discussions, all persons were interviewed on a "not for attribution" basis.

Chapter One: TRANSFORMING THE SEC

"I had just arrived at an agency that was in disarray, quite honestly, and deeply demoralized. We were coming out of a financial crisis. There were a thousand things to do. There were virtually no senior staff on board."[1]

– Chairman Mary Schapiro

For most of its history, the SEC has been viewed as an outstanding government regulator. It has been trusted by the public, respected by the industry it regulates, and viewed positively by Congress. Moreover, it has been a model for other countries on how regulation can provide investor protection and at the same time promote capital formation and economic growth. Sadly, the events of the past decade, and the perception that the SEC failed to identify problems early and failed to respond strongly and quickly, has eroded the trust and confidence of the public, industry, and policy makers. Globally, other countries are questioning whether the American capital markets should be the model to emulate and whether the SEC regulatory program should be the benchmark for effectiveness.[2]

Chairman Schapiro provided her snapshot description of the moment when she arrived, at a point when the financial crisis of 2008 was still dominating the country. At the same time, her remark, made in 2011, captured some of the underlying problems that the Commission has been confronting for a much longer time.

After a decade of embarrassing failures, it is difficult to find anyone who would claim that the SEC is a "great agency." In fact, it is likely that most people would be hard pressed to conclude that it is currently a good agency. A few notable commentators have gone so far as to suggest that the SEC is a failure and should be abolished.[3] For an agency charged with protecting investors, maintaining fair, orderly, and efficient markets, and facilitating capital formation, this lack of public confidence is a serious matter. Can the SEC be returned to the ranks of good

1 Chairman Mary Schapiro, Oral Testimony before house Financial Services Committee. September 22, 2011. Available at: http://mfile3.akamai.com/65722/wmv/sos1467-1.streamos.download.akamai.com/65726/hearing0922112pm.asx.

2 In 2010, the International Monetary Fund and the World Bank published their assessment of the U.S. system for capital markets regulation, as part of the ongoing Financial Sector Assessment Program (FSAP). The sharply critical report provides insight into how the U.S. regulatory system is viewed internationally. Available at: http://www.imf.org/external/pubs/ft/scr/2010/cr10125.pdf

3 William D. Cohan, "Big Reason to Shut SEC, Start Over," Bloomberg.com, August 29, 2011. Available at: http://www.bloomberg.com/news/2011-08-30/one-more-reason-to-shut-sec-and-start-over-commentary-by-william-d-cohan.html.

government agencies? Can it achieve the status of a great government agency, a status that, correctly or incorrectly, it could claim in past decades?

Perceptions are inherently backward looking, reflecting what has happened. In the case of the SEC, the current leadership has initiated and publicized a number of changes, described in Chapter Four that are intended to address the Commission's perceived failures or inadequacies. While officials of the Commission have frequently described some of these improvements as "game changers," in reality, they are not. As discussed in Chapter Four, the changes are incremental in nature. None of them represent a fundamental change in what the Commission does or how the Commission does it. There is little hard data to support or refute the claims of improvement.

The 2009 Report took a similar, incremental approach. It focused on three agency functions and proposed specific changes to improve the efficiency and effectiveness of each program. In 2011, a different approach is needed. Rather than incrementally refining or retuning the agency and the various regulatory activities, a broader "macro" examination is necessary. This chapter discusses some of the Commission's fundamental problems that must be honestly and carefully examined. Recommendations are provided on how to solve these problems.

The first section of this chapter examines the Commission's leadership structure—how it is managed and organized, and how responsibilities are divided among the Chairman, the five Commissioners as a collegial decision maker, the division directors and office heads, and the career senior officers. The second section looks at the perennial issue of agency resources and its relationship with agency accountability and performance metrics. The third section discusses the need for a thorough examination of long-standing regulatory programs that have not changed to keep pace with the changes in the capital markets. Recommendations for action are provided at the end of each section.

Countless management books examine why some organizations succeed and others fail. Many focus on "turnarounds," companies that went from the top to the bottom or from the bottom to the top. Principles applicable to corporations in the private sector should have relevance to a government agency also looking to "turn around." In an effort to provide a fresh perspective on improving the performance of the SEC, the discussion in this chapter will occasionally refer to lessons and principles contained in one well-regarded corporate management book, *Good to Great*, by Jim Collins.[4] By applying the traits of great companies to the SEC, can the agency be restored to the ranks of the great?

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4 James Collins, *Good to Great* (New York: Harper Collins Publishers, 2001).

LEADERSHIP AND MANAGEMENT OF THE SEC

STRUCTURAL PROBLEMS IN LEADERSHIP AND MANAGEMENT

Unlike a corporate CEO, the SEC Chair is not the final authority on agency regulatory policy.

The leadership structure of the SEC is complex. The general public may assume that the Chairman of the SEC is the equivalent of a corporate CEO or a cabinet-level Secretary, but this is not the case. Unlike a corporate CEO, the SEC Chair is not the final authority on agency regulatory policy. Although the Chairman controls the agenda and determines what matters will be considered, the five Commissioners make the final agency decisions, and the Chairman has only one of the five votes. Moreover, the Chairman does not control the composition of the Commission. Each Commissioner is selected by the President and subject to Senate confirmation. Because no more than three Commissioners may be from the same political party, selection of the minority party Commissioners frequently is heavily influenced and often controlled by senators from the party that does not control the White House. Furthermore, because each Commissioner is appointed for a fixed five-year term on a staggered basis, a new Chairman often comes to office surrounded by four incumbent Commissioners appointed by a previous administration.

The relationship between the Chairman and the Commissioners

The Chairman functions as a CEO on matters of management and administration. This exclusive authority extends over personnel (subject to input from the Commission on the selection of certain positions), the budget submitted to Congress and the allocation of funds and staff within the Commission, and the priorities and workload of each office and division.

The Chairman's control over selection of staff is a critical aspect of the Commission's leadership. While the Chairman typically has limited control over the selection of the other Commissioners, the Chair has substantial and almost exclusive control over the selection of the General Counsel, Chief Accountant, Chief Economist, and division directors. In most respects a division director or the General Counsel has more real power than a Commissioner. Typically, these individuals provide continuity to the agency. While the Chairman receives the same five-year term as the other Commissioners,[5] in recent history very few Chairmen have served for that long. Since 1970, only 2 of 13 Chairmen (excluding the current SEC Chair) have served for four or more years. The brevity of a Chairman's term is another reason why the General Counsel and division director positions devolve into the *de facto* leaders of the SEC. While most directors also tend to have short tenures tied to the Chairman who appointed them, a significant number stay for more than one Chairman, providing critical continuity of leadership (albeit still for a short period). There have even been some occasions when a division director continued in the position for the full term of the successor Chairman.

5 Five years represents a full term. If a Commissioner resigns before a term is completed, the successor Commissioner is appointed for the remainder of that term. Occasionally, a Commissioner may be appointed simultaneously for the remainder of a term and the full five-year term that follows. Any Commissioner may be reappointed to a new term at the expiration of a term.

Virtually anyone who has worked at the SEC has learned quickly that these individuals are, as a group, the leaders of the Commission. When this "College of Cardinals" works well together, the agency works well. When the individuals do not function collaboratively because of personalities, management styles, or differing regulatory philosophies or agendas, the agency suffers.

This distribution of leadership responsibility between the Chairman, the other Commissioners as a collegial body, and the leaders of the major offices and divisions of the Commissioner has a substantial impact on agency operations. This is not unique. In a monograph that applied his principles to the social sector, Collins explained that one of the significant differences between public and private sector leaders is the fundamental difference in authority and structure. He referred to the arrangement as "legislative leadership":

> In executive leadership, the individual leader has enough concentrated power to simply make the right decisions. In legislative leadership, on the other hand, no individual leader—not even the nominal chief executive—has enough structural power to make the most important decisions by himself or herself. Legislative leadership relies more upon persuasion, political currency, and shared interests to create the conditions for the right decisions to happen.[6]

The legislative executive model implies that the agency leader lacks complete authority and must work through others who have authority. This aptly describes the SEC.

The ability of a Chairman to work in a "legislative" and not an "executive" environment is an important skill that is frequently overlooked. It is one facet of a significant component of the problems of the SEC: the lack of any requirements or necessary qualifications to serve as SEC Chairman or SEC Commissioner. Simply put, the only requirements in the Exchange Act are that no more than three Commissioners may be from the same political party, and that no Commissioner may have another job or business. There is no requirement that a Chairman have executive-level experience or that a Commissioner have professional qualifications or experience that provides expertise relevant to the Commission's responsibilities. There is also no requirement for diversity of professional qualifications or expertise among the five Commissioners.

There is no requirement that a Chairman have executive-level experience or that a Commissioner have professional qualifications or experience that provides expertise relevant to the Commission's responsibilities.

6 Collins monograph, p. 11.

The declining role of the Commissioners at the SEC

The 2009 Report described the decline in the role and responsibilities of the Commissioners in the operations of the SEC. The management section of the 2009 Report described the need for congressional action to amend the Government in the Sunshine Act so that the Commissioners could hold closed meetings with the SEC staff on operations and interpretive questions.[7] The section on SEC staff no-action letters proposed a new process of periodic Commission review of staff interpretive positions that would reinvigorate the Commissioner's primacy over the interpretation of regulatory policy and at the same time ensure that the Commission complies with the spirit, as well as the letter, of the Administrative Procedure Act (APA) requirements for notice and comment and judicial review of final agency rulemaking.[8]

Since the publication the 2009 Report, the Commission has not acted on these recommendations. Instead, it has taken further steps to diminish the role of the Commissioners. As part of the reforms to improve the enforcement program, the SEC has delegated additional authority to the staff to issue formal orders of authority and to request immunity from the Justice Department. It has also rescinded the requirement that enforcement staff consult with the Commission prior to settling actions involving substantial penalties.

This continuing trend of diminished responsibility for the Commissioners inescapably leads to the question of the appropriate role of the SEC Commission. Should it be limited to the review of proposed and final rules, the approval of proposed enforcement actions and settlements (often on a *fait accompli* basis), and the occasional judicial review of litigated administrative proceedings and appeals from the Financial Industry Regulatory Authority (FINRA) disciplinary actions? Or should it play a greater role in some portion of all Commission regulatory programs? Answering this question requires consideration of three rationales frequently provided for the transfer of responsibility from the Commission to the staff:

1. The staff is better qualified to deal with technical issues;

2. The Commission is too slow to act and the Commission's workload is already too great; and

3. The Sunshine Act makes confidential Commission deliberations impossible.

The first is the most frequently given rationale for the increased delegation to the staff. In effect, this assumes that the staff has greater technical expertise and sophistication than the Commissioners. On a superficial level, this may appear to be a sound argument; as previously discussed, the Exchange Act does not require Commissioners to have demonstrated competencies or credentials. Anyone with the right party affiliation and the right political ties can become a Commissioner. However, Commissioners are required to deal with complex and technical matters in the rulemaking process. Why should questions arising from the application and interpretation of these same rules be beyond their technical expertise? More important, while the staff are capable of processing routine matters quickly, they have not demonstrated that they can be

7 2009 Report, p. 17.
8 2009 Report, p. 78.

expected to consider thorny problems with alacrity. The 2009 Report discussed this problem and proposed a two-fold solution: internal processing guidelines to ensure prompt action on routine matters, combined with additional responsibility for the Commissioners on the complex matters.

The second rationale, the slow pace of Commission action and the heavy workload of the Commission, is less persuasive. The Commission typically meets weekly, with Commission action memos circulated 10 days before the meeting. Items that require faster action can be approved by the Commission's duty officer or can be considered through the seriatim process.[9] The Commission has suffered from slow action on seriatim items for many years. The cure is simple and has been used effectively when a Chairman decides that action is necessary. Any seriatim that has not been completed within a given period (typically one or two weeks) is automatically placed on the agenda for the next Commission meeting. This is not a structural problem: strong internal discipline and sound management can solve it.

The suggestion that the workload is too great is puzzling. While Dodd-Frank has imposed a heavy rulemaking burden on the Commission, this is a temporary problem. The available statistics do not suggest that there has been a significant increase in other items submitted to the Commission. At the same time, if the workload has grown substantially, and if the issues have grown in complexity, then would it not be a better solution to change how the Commission performs its duties rather than eliminate it from the process?

If the workload has grown substantially, and if the issues have grown in complexity, then would it not be a better solution to change how the Commission performs its duties rather than eliminate it from the process?

The third rationale is the problem of the Sunshine Act. As described in the 2009 Report, this is a fundamental issue that requires congressional action. It is not unique to the SEC. Other federal regulatory agencies suffer from the same problem and it is hoped that Congress will address the matter.

The arguments that support extensive delegations to the staff do not appear compelling. However, are there sound arguments that support the need for a greater role for the Commission?

There are several reasons to reinvigorate the role of the Commission. The first is compliance with the law. The Exchange Act clearly establishes that the Commission must be responsible for all final agency actions. Even when the Commission delegates authority to the staff, the Exchange Act provides that any person adversely affected by a staff decision may appeal the staff's decision to the Commission. Also, any one Commissioner can decide to require Commission review of a delegated action.[10] As described in the 2009 Report, the problem is that

9 Each week, one Commissioner other than the Chairman is designated the duty officer and authorized to act for the full Commission when the matter requires action before the full Commission can consider it. The seriatim process is a sequential written review and voting process in which each Commissioner votes to act by initialing a written sheet attached to the original of the memo. Both procedures are memorialized as SEC rules, 17 C.F.R. 200.40 and 41.

10 15 U.S.C. 78d-1.

many staff interpretive actions are technically not pursuant to delegated authority. By issuing a no-action letter or any of the other nine vehicles used by the staff to publish its views,[11] the staff can avoid creating an agency action that is appealable to the Commission or, following Commission review, to the judiciary. Staff also avoid the APA notice and comment requirements.

The second argument is very different and goes to the nature of capital market regulation. There are benefits to including differing perspectives and philosophies when considering a complex problem. This is the bedrock of a federal regulatory commission. It reflects the long-standing congressional intent that highly technical regulatory matters are best considered by a collegial body of people with different expertise and backgrounds. This is particularly important in the regulation of capital markets. Capital markets function through the interaction of large numbers of people and companies with different interests and goals. The purpose of regulation is to promote a fair and orderly market. When problems arise, there is rarely an obvious single correct answer. Regulators, instead, must consider a variety of different approaches, including the option of doing nothing. In most cases, each option is imperfect. Even when a regulator makes a decision, it is likely that the market will respond in an unanticipated way. It may be better or it may be worse, but in all likelihood it will be unexpected. For these reasons, there is a genuine benefit to having a group of people rather than one person making the decision.

Another factor is the benefit of promoting decisive and timely decision-making. While one of the criticisms of increased Commission involvement is that it slows down the staff on routine actions, paradoxically it may speed up the process on difficult or novel problems. Submitting the tough questions to the Commission may result in faster, not slower, decisions. As described in the 2009 Report, SEC staff has a reputation for being slow to respond to interesting, unusual, or novel questions. The section of that report on exemptive orders under the Investment Company Act of 1940 describes how staff consideration of such successful products as money market funds and exchange-traded funds extended on for years. This reflects the risk-reward equation that applies to any member of the staff. Simply put, the benefits of making a quick decision or agreeing to a new idea correctly are small, while the consequences of making the wrong decision are substantial. "Getting it wrong" is always adverse to career goals. However, when the staff submits the difficult question to the Commission, it reduces the burden on the staff and the consequences for the staff if the results are less than optimal.

SEC TRANSFORMATION REQUIRES CHANGES IN LEADERSHIP AND MANAGEMENT STRUCTURES

Leadership committed to SEC transformation

One would have thought that the repeated failures of the SEC to identify major regulatory failures in virtually every program area would have been a catalyst for one or more Chairmen to undertake a thorough review and overhaul of the agency. However, it has not. Instead, a succession of SEC Chairmen have responded by citing the need for more money and more

11 The nine staff procedures are discussed in the 2009 report (p. 60–62). In 2011, the Division of Corporation Finance created a tenth method, Corporation Finance Staff Disclosure Guidance Topics.

authority, coupled with incremental changes in SEC programs and the adoption of new or revised regulatory policies. What is the explanation for this disinterest in bold changes to the agency?

An important contributing factor is the short-term horizon of Commission Chairmen. As identified earlier, while a Commissioner's term is for five years, this is not the reality. Since 1980 only two of the past eight Chairmen (2 of 13 from 1970) have stayed in office for four or more years. Because a fundamental turnaround typically takes four or more years,[12] it is understandable that an SEC Chairman would not be committed to undertaking a comprehensive review and reorganization of the agency. It will consume his time and resources. It will disrupt operations and limit his or her ability to complete whatever policy initiatives are a priority. Most important, the process is likely to be unfinished when the Chairman departs. Completion and success will require a commitment from an unknown successor. If the successor is uninterested, it will fail. If the successor is committed and sees it through, he or she will receive the credit.

Other factors also contribute. As discussed in the 2009 Report, while the Chairman is the agency CEO, no Chairman in recent memory has had the time or desire to actively manage the agency. The size, workload, and legal authority of the SEC have grown dramatically in the past 10 years and the burden on the Chairman has increased commensurately. Inevitably, the Chairman must devote time to policy matters and to working with Congress, the administration, and other regulatory agencies in Washington and around the world. It is also essential that the Chairman regularly meet with the regulated industry and the public, attending conferences and giving speeches. Daily management of operations must be delegated to staff and relegated to limited free moments.

Since 1980 only two of the past eight Chairmen (2 of 13 from 1970) have stayed in office for four or more years.

The SEC requires a Deputy Chairman for Management and Operations

Simply put, the responsibilities of the Chairman of the SEC have become too great for a single person to perform. One person cannot be responsible for supervising an agency of four thousand with a budget of more than 1 billion dollars and simultaneously vote as one member of a collegial body on every enforcement action, rule proposal and rule adoption, and disciplinary opinion; while also serving as the public face of the agency, giving numerous public speeches, testifying before Congress, and, post Dodd-Frank, participating as a voting member of the Financial Stability Oversight Council.

Appointment of a voting Commissioner with explicit responsibility for management and budget would reduce the burden on the Chairman, who invariably prefers the intellectual stimulation of policy to the humdrum of management. While the Chairman would continue to focus on policy development, and the one to two hundred people working on policy, the Deputy

12 James Collins, *Good to Great*. "To go from good to great requires a deep understanding of three intersecting circles translated into a simple, crystalline concept (the Hedgehog Concept)…It took four years on average for the good-to-great companies to get a Hedgehog Concept". p. 118- 119.

Chairman could focus on what the other four thousand people at the SEC are doing. As with the other specialized seats, this slot would require the appointment of someone with demonstrated expertise in the management of a large organization. To ensure an effective working relationship with the Chair, it might be appropriate to stipulate that this person must be appointed at the same time as the Chairman for co-terminus five-year appointments, with no political party requirement. This person would also become the logical person to assume responsibility for the comprehensive review and reorganization of the SEC—in effect becoming a "Chief Transformation Officer."

Following the 2008 financial crisis, the Federal Reserve Board Chairman was also criticized for not devoting sufficient time to supervision of the Fed's banking supervision program. Congress addressed this problem in Dodd-Frank by establishing two Vice Chairman positions at the Fed, with one designated as Vice Chairman for Supervision. "The Vice Chairman for Supervision shall develop policy recommendations for the Board regarding supervision and regulation of depository holding companies and other financial firms supervised by the Board and shall oversee the supervision and regulation of such firms."[13]

The Deputy Chairman for Management and Operations would not replace the recommendation in the 2009 Report for the creation of a chief operating officer (COO). Instead, it is designed to address some concerns that were identified with that recommendation. More than one person who understands the dynamics of the SEC suggested that, because of the power of the division directors, a COO could never effectively oversee the entire agency. The collective power of the division directors would always outweigh a COO. However, a COO who reports directly to a presidentially appointed Deputy Chairman of the Commission would be in a stronger position to manage the entire agency.

Increasing the number of Commissioners

During the past decade, capital markets and regulatory issues have grown in size and complexity. The Commission's legal authority has expanded substantially. The size of the SEC staff has grown by roughly 33% during the past decade, and the agency strongly believes that it is still understaffed. The agency has also begun to recognize that to be effective it requires a staff that is composed of more than just lawyers. Today, the development of effective regulatory policy requires staff with first-hand knowledge of the markets, expertise in economics, financial risk calculation and management, and accounting.

Contrast these changes in size and expertise of the staff with the Commission itself. The number of Commissioners remains at five, and there is no requirement that the Commission as a composite group have any breadth, depth, or diversity of expertise, other than representation from both political parties. Numerous senior officials interviewed highlighted this as a significant problem. More than one person identified advantages in having seven Commissioners. Several people also suggested that it was time to create specific professional qualifications for appointees, such as a requirement that at least one Commissioner be an accountant and that at least one Commissioner be an economist.

13 § 1108(a) Dodd-Frank.

If the Commission were expanded to seven members, then it would be possible to create committees of three that could be assigned responsibility in a specific area, such as reviewing enforcement recommendations. This would enable Commissioners to devote their energy to particular activities and be more effective in overseeing those programs. The Chairman would control assignments to these groups, and the assignments could be rotated at regular intervals.

With seven Commissioners, the Commission could create two subcommittees, each with three members (the Chairman would be able to participate on both subcommittees as a fourth member). One subcommittee would be responsible for enforcement matters. The second subcommittee would be responsible for regulatory review and oversight of other core programs at the SEC. The 2009 Report made a series of recommendations on how the Commission could play a greater role in overseeing the formulation of regulatory guidance by the staff. After the report was issued, several persons suggested that, while the concept was sound, it was unrealistic for an overburdened Commission to take on additional responsibilities. This recommendation addresses this concern.

Rulemaking would continue to be the responsibility of the full Commission. Committee assignments could be made for six-month periods, with one Commissioner rotating off every two months. In this way, the workload of any one Commissioner would be reduced but the workload of the full Commission would be expanded.

Reestablishing the responsibilities of the Commission might also contribute in other ways. While SEC Chairmen rarely serve for more than four years, Commissioners frequently serve for extended periods of time. Since 1980, 13 of the 23 Commissioners (excluding Chairmen and the current Commissioners) served for more than four years, with seven serving for more than five years. These Commissioners could provide continuity in leadership that is frequently not provided by Chairmen and division directors.

Rationalizing the SEC organization chart

The Commission is long overdue for a careful reorganization. Its current structure is complicated, confusing, and inefficient. Even after the reconsolidation of the Executive Director and COO offices into a single unit that oversees the five administrative support offices, there are still 17 divisions and offices that report directly to the Chairman and an additional 11 regional offices that report to the Chairman for certain purposes and jointly to the directors of Enforcement and OCIE for other purposes. Additionally, Dodd-Frank created five new offices, four of which must report directly to the Chairman when they are created and staffed.[14] No CEO should be burdened with so many direct reports.

The organizational structure of the SEC is not just confusing. It is also antiquated, built on a functional regulation model that was created to mirror the clear separations in the capital markets of the 1970s. These clear separations are now a matter of history.

14 Paradoxically, Dodd-Frank stipulates that one of the new offices, the Investor Advocate, must have control over its budget and report directly to Congress, bypassing the Chairman.

The dual problems of a convoluted reporting structure and a functional regulation model that no longer comports with the regulated industries have directly contributed to the Commission's inability to do its job well. Many of the people interviewed for this study described a personal horror story about trying to persuade Commission staff in separate divisions to work together and reach a decision. The fights between Trading and Markets (T&M) and Investment Management (IM) over the regulation of registered reps of broker-dealers and investment advisors are well known, as are their problems on regulation of exchange-traded funds. Similar problems arise between IM and Corporation Finance (Corp Fin) on the regulation of hedge fund offerings. IM is interested in more public disclosure and Corp Fin is concerned that greater public disclosure may interfere with its long-standing interpretation of the private offering exemption under the Securities Act. Meanwhile, new products and new business models do not easily fit into the old regulatory structures. Because the divisions compete to protect their turf, decisions are not made and innovation is stifled.

As described in more detail in Chapter Four of this report, section 967 of Dodd-Frank directed the Commission to hire an independent consultant to review Commission operations. In its report the independent consultant, the Boston Consulting Group (BCG) discussed the need for reorganization, including the critical need to reduce the number of direct reports to the Chairman. The report stopped short of recommending a specific comprehensive reorganization structure, but it did provide some partial reorganization options such as possible changes to address the highly controversial problem of different regulatory approaches to the regulation of broker-dealer sales personnel and investment advisers.[15] In its first report to Congress on implementation of the BCG Report, the Commission described its reorganization plans. The description dealt exclusively with changes in the SEC support offices that report to the COO. There was no discussion of any plans to begin a broad reorganization of the program offices.

The reorganization of the SEC is decades overdue. While no Chairman has been interested in taking the responsibility, transformation of the agency will not be possible without it. If Congress mandates the creation of a Deputy Chairman for Management, as it did for the Federal Reserve Board, this should be the Deputy Chairman's first priority.

RECOMMENDATION 1—Congress should increase the number of Commissioners from five to seven and specify that at least one Commissioner must be an accountant, one an economist, and one an attorney.

RECOMMENDATION 2—One Commissioner should be designated by the President, on the recommendation of the Chairman, as Deputy Chairman for Management and Operations. This Commissioner should be required to have expertise and experience in the management of a large organization. The Chief Operating Officer should report directly to the Deputy Chairman.

RECOMMENDATION 3—The Chairman should appoint the Deputy Chairman for Management and Operations to oversee a comprehensive review and reorganization of the Commission, as the Chief Transformation Officer.

15 One option, labeled 1c, mirrors the reorganization recommendation in the 2009 Report.

RESOURCES, ACCOUNTABILITY, AND METRICS

THE CONTINUING AND UNSUCCESSFUL PURSUIT OF SELF-FUNDING

In the past several decades, the financial markets have grown in size and complexity. Congress has steadily expanded the authority and responsibilities of the SEC, most recently and dramatically through Dodd-Frank. And throughout this period, the SEC has tried to persuade Congress that it is underfunded. For most of the past two decades, the Commission has been unable to obtain a congressional appropriation to meet its estimated needs. Typically, it has obtained significant budget increases only in years following major market crises or frauds. Following the Enron and WorldCom frauds, the SEC received a substantial budget increase from $438 million in 2002 to $716 million in 2003. Following the 2008 financial crisis, the SEC budget grew from $906 million in 2008 to $1.19 billion in 2010. In other years, the budget held constant or rose only slightly.

There is a great irony in discussing insufficient resources at the SEC. From 1983, when the modern bull market really began, until 1996, when Congress made a change in the funding formula for the SEC, the agency was actually a profit center for the federal government. Under a series of complex formulas, the SEC collects funds from the industry it regulates. Corporations and mutual funds that register securities for sale pay a filing fee based on the dollar amount of the securities to be sold. The stock exchanges pay an annual fee based on their annual trading volume. Persons and entities that are the subject of an SEC enforcement action frequently pay a substantial penalty in addition to a disgorgement amount (the money illegally gained or the losses avoided).[16] In some years, these funds were greater than the SEC annual budget by multiples of two, three, or more.[17] In 1996, Congress amended the securities laws and revised the fee formulas to ensure that the money collected would roughly correspond to the size of the SEC budget. In this way, the fees would not function as an undisclosed tax on capital formation. Since this change, the SEC budget has been revenue neutral. An increase in the budget does not increase the federal budget deficit and a decrease in the SEC budget does not reduce the federal deficit.

One might assume that this steady-state equation, in which an SEC budget increase has no effect on the government's budget deficit, would make it simple for the SEC to obtain congressional support for its funding needs. However this has not been the case, even in years such as 2011 when the financial markets are in turmoil. Because it has been unable consistently to persuade Congress that a larger budget is needed while collecting industry fees that exceed its budget, the SEC has sought to persuade Congress that it should be self-funded.

Self-funding has been a stated goal of the SEC for more than 20 years. As used by the SEC, the concept means more than the ability to generate sufficient funds to meet its budget. It means that the agency should have the authority to determine its budget needs and then to adjust the

16 Penalties ordered and paid in enforcement actions are either deposited with the U.S. Treasury or transferred into a "fair funds" account to be paid to defrauded investors. These funds are never made available for use by the SEC and are not commingled with fees paid to the SEC. The SEC has never sought to have these funds used to offset the SEC budget.

17 In FY 2001, the SEC budget was $423 million. That year, the SEC collected fees totaling $2.06 billion.

fee rates to meet these needs. Historically, the banking regulatory agencies, the Federal Reserve, the Comptroller of the Currency, and the Federal Deposit Insurance Corporation, have operated in a self-funding environment. The SEC and Commodities Futures Trading Commission (CFTC) have not.

Why has the SEC failed to obtain self-funding authority? The answer is largely for one simple reason. Self-funding status requires Congress to voluntarily relinquish its most powerful tool to oversee federal agencies, the power of the purse string. While it would not dramatically alter the authority of the House Financial Services Committee and Senate Banking committee to monitor the SEC, it would effectively eliminate the Senate and House Appropriations Committees' authority over the SEC. Not surprisingly, the SEC has been unable to persuade Congress to give up its most powerful oversight tool.

This difference in funding authority between banking regulators and capital market regulators is not unique. While it is common for banking regulators around the world to have control over their budgets, it is less common for capital markets regulators. A 2007 study by the International Monetary Fund (IMF) found that a substantial number of the securities regulators evaluated as part of its financial sector assessment program lacked a stable and independent source of funding.[18]

Final authority over a government agency's budget is intrinsically related to two other concepts: regulatory accountability and regulatory independence. The International Organization of Securities Commissions' (IOSCO) principles of effective securities regulation define accountability as appropriate scrutiny and review of the regulator's use of its powers and resources.[19] In another IMF study, the authors describe accountability as a "a network of complementary and overlapping oversight mechanisms and control instruments under which no one actually controls the independent agency, yet the agency remains 'under control.'"[20] Accountability is an essential complement to regulatory independence. Elected officials will never provide a regulatory agency with meaningful independence unless there is an effective method of holding the agency accountable for the exercise of its powers. "The greater the degree of independence, the more important accountability arrangements become."[21] Similarly, one must assume that the need for accountability measures must increase as the regulator's powers grow. Congress' most powerful tool in ensuring agency accountability is its control over the budget.

When one considers the concept of self-funding in the context of congressional authority over government agencies and as a critical component of a process to ensure agency accountability, one must consider its impact on regulatory independence. One could speculate that if the SEC were ever to obtain full self-funding authority, Congress would likely impose

18 "Many regulators still lack a stable and adequate level of funding, particularly in countries where funding stems from the state budget. In many countries, the impact of inadequate and uncertain funding on the skill level at the regulator is compounded by a requirement that the regulator pay staff at the public employee pay scale, thereby limiting the regulator's ability to recruit qualified personnel and thus its capacity to discharge its functions properly. Ana Carvajal and Jennifer Elliott, *Strengths and Weaknesses in Securities Market Regulation: A Global Analysis*. IMF Working Paper 07/259. Paragraph 25.

19 IOSCO Methodology, p. 14.

20 Hupkes, Quintyn, and Taylor, *Accountability Arrangements for Financial Service Regulators*. Economic Issues Report 39, p. 2

21 Guintyn and Taylor. *Should Financial Regulators Be Independent?* IMF Economic Issues Paper 32. 2004, p. 12.

other requirements designed to retain its authority and control over the agency. If the price of self-funding is a reduction in agency independence in setting policy and implementing that policy, would this be an attractive trade-off?

SEC performance measures and the SEC budget

It is highly unlikely that the SEC will succeed in its quest for full self-funding authority. After 20 years of trying, the SEC must acknowledge that this solution to its funding problems is unlikely to be achieved. Accordingly the SEC must take a hard look at why it has been unable to persuade Congress that it needs a larger budget, particularly when additional funds will not exacerbate the national budget deficit, and when the financial services industry that must pay the fees has frequently supported the need for more SEC resources.

Why has the SEC been unable to persuade Congress? Three factors may, in part, contribute to the problem. The first contributing factor, described in the 2009 Report, is the simplistic metrics that the Commission uses to measure and describe performance. Typically, the Commission relies on basic quantity information: the total number of actions taken without reference to significance, complexity, or other qualitative measures. For example, Enforcement has relied on the total number of cases brought without distinguishing between major and minor actions, and the total amount of disgorgements and penalties ordered regardless of whether they have been or ever will be paid. As part of its reform efforts, the Division of Enforcement has announced that it will use a more sophisticated set of performance measures, but it continues to use the old measures in its public statements.[22] Other divisions and offices rely on similar measurements. Corp Fin counts the number of filings it reviews, and OCIE counts the number of registrants that it must examine and the number of examinations it performs. IM counts the number of mutual fund filings, the number of exemptive orders, and the total amount of investor funds under management. Counting the number of filings received or the total amount of investor funds under management by the mutual fund industry are actually measures of input not output.

Even when the Commission attempts to capture its productivity or efficiency, it frequently uses measure of throughput for interim processes. For example, Corp Fin measures the average number of days to comment on a registration statement or a request for a no-action letter, or IM measures the time to prepare initial comments on an exemptive application. While throughput measures can be useful in examining efficiency, it is critical to measure throughput to final action rather than an initial or interim point. One is a measure of output; the other is a measure that encourages endless process rather than a timely result.

The lack of meaningful performance may have an impact on SEC's negotiations with Congress on self-funding. If the SEC cannot provide meaningful information to Congress to justify its critical needs, how can it possibly persuade Congress that it can be trusted to

22 The SEC New York Associate Director said, "I predict that when the statistics are released you're going to see that last year was probably the most productive year ever in the history of the enforcement division…. In fiscal 2010, the SEC initiated 681 enforcement cases, a record yearly number so far. The agency obtained orders of disgorgement and civil penalties totaling $2.85 billion that year." Stephen Joyce, "Enforcement SEC Official Says Enforcement Unit Change Is 'Game Changer' for Division's Effectiveness," *BNA Reporter* (November 3, 2011).

responsibly determine the size of its budget and the amount of fees that it will charge the industry it regulates?

A second problem is the Commission's practice of using its budget requests to trumpet its success. The problem, of course, is that this paints a picture of an agency that is doing its job with the resources it has. Rarely does the Commission use its budget documents to honestly explain how and why its budget limitations are preventing it from fulfilling its responsibilities. Furthermore, when the Commission describes what it could accomplish with more money, it tends to describe how it would just do more of the same, without an explanation of how the funds could make the agency more efficient or more effective.

Finally, and most telling, when the Commission does receive a significant increase in its budget, it is often difficult to see a meaningful improvement in agency effectiveness. In some cases, it is difficult to conclude that the additional funds have been well spent. For example, when the SEC received a substantial increase in its appropriation for FY 2003, nearly $30 million was earmarked for critical information technology (IT) improvements. While the money was spent, it was not spent well. Years later, the SEC continues to describe its urgent need for a better IT infrastructure.

Similarly, when the Commission has not obtained additional funding, it typically has tried to "do more with less." In most years, the Commission accepted its budget and did what it could. It tinkered with its staffing and the allocation of funds by making marginal changes in its core programs. While this represents what a responsible regulator must do under the circumstances, by minimizing the consequences of its actions it obscured its true needs.

In its report, BCG recommended a new approach. It suggested that Congress should either relax SEC funding constraints (i.e., self-funding) or make changes in the SEC role to fit available funding.[23] Having raised the subject of changing what the SEC does or should do, BCG refrained from offering ideas on what those changes could or should be.

SEC performance measures and internal management

The need for better performance metrics is not limited to the task of persuading Congress of the Commission's need for resources. This is only one of several reasons why the agency must develop the right measures of its performance. Internal management of its programs and its staff is equally important. It is a well-known truism that employees do the tasks on which they are measured. If the wrong measures are used, the consequences can be disastrous. The obvious example, discussed in more detail in Chapter Two, is measuring performance on the total number of enforcement actions rather than the significance or timeliness of the cases brought. This metric appears to clearly encourage some staff and some regional offices to focus on small, easy cases and avoid taking on large and complex cases. The Stanford case represents an egregious example of the problem. Examination staff in the Ft. Worth office recognized the possibility of a major fraud in

23 BCG Report, p. 5.

1997, but were unable to persuade the office's enforcement staff to pursue the matter. A member of the Ft. Worth office described the problem in testimony to Congress:

> Much has been made of the former SEC-wide institutional influence that created an institutional bias against matters that were resource intensive and whose outcome was less than certain. Stanford was such a matter. There is no question that during the early Stanford timeframe, the Fort Worth office's management firmly believed that the office's success was measured strictly by the number of cases filed each year. Additionally, in Fort Worth, "beating" other offices by filing a greater number of cases was the highest goal.[24]

The Enforcement Division has announced that it has changed its performance metrics to address this problem. As discussed in Chapter Two, it is premature to assess whether the new metrics will be the catalyst to change this long-standing preoccupation on total number of cases. The recent SEC press release trumpeting the record number of enforcement actions brought in FY 2011 suggests that the old measures and the old culture have not yet changed.[25]

A fundamental problem with every evaluation metric created at the Commission is that it was developed and selected by the office or division that would be measured by it. It is intuitively obvious that the office or person to be graded will invariably choose a metric that is most likely to be favorable and the easiest to achieve. A secondary problem is that the development of metrics is a specialized skill and requires people trained in evaluation methodology and statistics, skill sets that are not present in the Commission's operating divisions.

RECOMMENDATION 4—The SEC must develop a comprehensive set of performance measures that are based on the significance, efficiency, and quality of results, rather than simply measuring the quantity of actions and the processing time taken for interim steps in the process.

RECOMMENDATION 5—The metrics adopted by the SEC for its annual Performance Evaluation Report should be developed and selected by the Chief Operating Officer, in conjunction with trained staff in Risk, Strategy, and Financial Innovation (RSFI).

AGENCY STAFFING—RECRUITING, TRAINING, RETAINING, AND ROTATING THE RIGHT MIX OF STAFF

The 2009 Report discussed the importance of expanding the types of professional staff at the SEC; in particular, the critical need to recruit more economists, people with sophisticated quantitative analysis skills, and people with extensive experience working in the financial services industry. As described in Chapter Four of this report, Chairman Schapiro has embraced

24 Julie Preuitt, "The Stanford Ponzi Scheme: Lessons for Protecting Investors from the Next Securities Fraud," before the Subcommittee on Oversight and Investigations, Committee on Financial Services, U.S. House of Representatives, May 13, 2011. Available at: http://www.sec.gov/news/testimony/2011/ts051311jp.htm.

25 *SEC Enforcement Division Produces Record Results in Safeguarding Investors and Markets*. SEC Press Release 2011-234. Available at: http://www.sec.gov/news/press/2011/2011-234.htm.

this recommendation and made it an agency priority, although the lack of additional funding has limited the capacity of the Commission to broaden the technical diversity of its staff. However a careful examination of SEC resource needs should not be limited to expanding the collective skill set and experience of the SEC staff. Any discussion of SEC resources must also address staff recruitment, deployment, training, development, and retention.

Historically, high turnover and attrition were the greatest staffing problems at the SEC. The reason was simple: inadequate compensation.[26] The experience gained at the SEC traditionally made its staff highly sought by those that the SEC regulates. The substantial salaries paid by regulated firms and by their law firms, accountants, and other professional advisors made the government-rate salaries noncompetitive. In 2002, the SEC completed a staff attrition study and found the rate at the SEC was substantially higher than the government-wide rate, with attrition rates for attorneys, accountants, and examination staff frequently 50–100% higher than the government-wide rates. From 1998 to 2001, more than 1,300 SEC employees (more than 40% of the staff) left, including 600 attorneys. The attrition rate in some job categories had a devastating effect on some offices. For example, in 2002, 65% of the attorneys in the SEC New York office had been at the SEC fewer than three years. Similarly, the average tenure of examination staff leaving the SEC in 1992 was 2.9 years; in 1999, it had dropped to 1.9 years. In 2002, 12 of the 28 branch chiefs (42%) in the SEC Enforcement Division had been in their positions fewer than 10 months.[27]

In 2002, Congress provided the SEC with relief from the limitations of the government-wide salary scale. For the first time, the SEC could pay salaries comparable to the self-funded financial regulatory agencies. The impact on attrition rates was significant. Not surprisingly, in 2011 the BCG Report described a very different agency. Between 2005 and 2009, the attrition rate at the SEC averaged 3.6%, significantly less than the 7.1% rate for the federal government overall.[28] It found that 40% of the staff of the agency had been there for 10 years or more.[29] Pay parity—the ability to pay salaries higher than the rest of the government—has succeeded in addressing the problem of the talent drain at the SEC.

Today, the SEC must consider how to address the problem of too little turnover, not too much turnover. The SEC must no longer assume that its staff will turn over so frequently that it is more important to hire quickly than to hire well. The solution offered here is bifurcated: addressing new employees as one group and the senior-most SEC staff, the so-called senior officer positions, as a second group.

26 See U.S. General Accounting Office, *Securities and Exchange Commission: Human Capital Challenges Require Management Attention* (GAO-01-947), Sept. 17, 2001, p. 6 ("By an overwhelming majority, current and former SEC attorneys, accountants, and examiners we surveyed cited compensation as their primary reason for leaving the SEC."). Cited in *Pay Parity Implementation Plan and Report.* U.S. Securities and Exchange Commission, March 6, 2002.

27 All statistics in this paragraph are from the *Pay Parity Implementation Plan and Report.* Available at: http://www.sec.gov/news/studies/payparity.htm#exec.

28 BCG Report, p. 52.

29 *Ibid.*

Effective evaluation procedures for entry-level staff

> [E]arly assessment mechanisms turn out to be more important than hiring mechanisms. There is no perfect interviewing technique, no ideal hiring method; even the best executives make hiring mistakes. You can only know for certain about a person by working with that person.[30]

It is commonly assumed that federal civil service laws provide employees with substantial protections that make it difficult for agencies to fire poor performers. This is a gross oversimplification of the law that ignores an important limitation. Under federal personnel law, it is easier to fire an employee during the first three years, the "probationary period," than subsequently. The key is a rigorous and consistently applied evaluation process for new hires during the first three years. Implementation of a rigorous employee performance system that carefully considers the retention question for new employees would be a dramatic change at the SEC. The BCG Report disclosed that the government-wide involuntary attrition rate is 4 to 8% per year, but at the SEC the rate is less than 1% per year. According to BCG:

> ...a number of concerns—including unclear processes and cultural norms—can discourage managers from addressing poor performance, with the expected outcome clearly evident in the SEC's attrition data. For example, managers are not equipped with a performance management system that enables them to document performance history. The related complexities increase risk-aversion among managers to consider dismissal as a real option for poor performance. Frequently, managers resolve this by either enduring poor performance or moving poor performers to new roles.[31]

A preference for enduring poor performance rather than addressing it is frequently common among SEC officials who come to the agency for a short period. Without a full understanding of the process, and based on a belief that the law always favors the employee, they frequently conclude that the risks from taking action far outweigh any benefits.

> In addition to reforming the process, the SEC must also make a change in its culture.

With pay parity, and its fundamental change in employee career paths, the era of high turnover has come to an end. Today, the SEC must adopt a disciplined approach to staff retention. New employees should be carefully and fairly rated in each of the first three years, with clear feedback on performance—both strengths and weaknesses. To promote consistency between supervisors, three-year retention decisions could be assigned to a panel of second-level supervisors who would review and act on the recommendations of first-level supervisors. If the annual evaluation is objective and fair, then the SEC would be in a position to ensure that it is keeping the right people.

30 Collins monograph, p. 15.
31 BCG Report, p. 207.

In addition to reforming the process, the SEC must also make a change in its culture. The assumption and expectation that anyone employed for three years will be retained must be reconsidered. Just as a university carefully considers tenure-track decisions and a law firm is judicious in deciding whether an experienced associate should be offered a partnership, the SEC must establish and implement a human resources (HR) process in which only the highly productive employees are retained after three years. This, of course, is a radically different policy and philosophy. It can be successful only if it is developed by skilled HR professionals, implemented by supervisors who have been carefully trained, and the consequences are understood by everyone.

Effective evaluation procedures for SEC senior staff

In virtually any organization, the process of recruiting, selecting, evaluating, and retaining mid-level and upper level staff is critical. This is especially true at the SEC. While the Commission is the final authority on policy at the SEC, it is the senior staff in each of the key divisions and offices who largely guide the Commission's actions in setting policy and are responsible for interpreting and implementing policy. At the SEC, mid- and upper-level staff make the vast majority of decisions pursuant to delegated authority.

If the same people are in the same positions for a decade or more, it can stymie fresh thinking and innovation.

Because division directors and other heads of offices, such as the General Counsel, Chief Accountant, or Chief Economist, are typically recruited from the private sector, they tend to lack an understanding of how the office or division they supervise functions. Therefore, they must rely on the Senior Officers directly under them to "make the trains run on time." Prior to the substantial increase in salaries of SEC senior officers (the SEC equivalent of the Senior Executive Service or SES at other federal agencies), it was common for a division to turn over most if not all members of the "front office" every three to five years. Regardless of whether the person selected was the right person or the wrong person, they tended to leave at regular intervals.

Pay parity has had a profound effect on turnover at the higher ranks of the SEC. With senior officer annual salaries reaching more than $225,000, private sector jobs are not as attractive for many SEC officials. This is particularly the case during periods of time when the financial services industry is downsizing due to bad markets and industry consolidation. A healthy federal salary, coupled with attractive alternative work schedules that include telework options[32] and challenging work and job security, has become an attractive package. Not surprisingly, some divisions and offices of the SEC have very low turnover among the senior staff. Some offices or divisions of the SEC have had the same group of senior officers for nearly a decade, serving under and surviving more than one division director.

32 More than 40% of SEC staff use the telework option. BCG Report, p. 52.

The low attrition rate at the senior officer level is an important issue for the SEC and it must be approached with great care and sensitivity. Typically senior officers have worked their way up the ladder by demonstrating both ability and hard work. They are often role models for the rest of the staff. However, while low turnover among the senior staff may be beneficial in most organizations, at the SEC it may create problems. Since the Chairman and division directors typically serve for short periods, they typically inherit their key subordinates. If the leaders want to effect changes in policy, they must work through the people who may have been responsible for creating and implementing the policies and may be reluctant to change a policy just because a "short-termer" does not like it. Low turnover at the senior levels can also have other adverse effects. Upward mobility may become limited, lowering morale or causing talented people to leave. If the same people are in the same positions for a decade or more, it can stymie fresh thinking and innovation.

Conversely, it would be irresponsible to suggest that all senior officers should serve at the pleasure of the Chairman or the division directors. Job protection in the federal civil service is an important protection against excessive politicization. It has stood the test of time and should be respected. An agency such as the SEC has an enormous capacity to influence and affect major decisions in the private sector, with price tags in the tens of millions up to literally billions of dollars. The integrity of the federal regulatory system over the financial markets would be jeopardized if a senior officer at the SEC could be fired at will.

These competing interests must be carefully balanced. The solution proposed here is in some ways similar in approach to the three-year probationary period for new employees. Whenever a senior officer position is created or becomes vacant, there must be an open public competition. The announcements describe the position, the necessary qualifications, and the salary and terms of the appointment. It is proposed that a new term of appointment should be included. Any person selected for a senior officer position would be hired for a five-year term. At the end of four years, the person would be notified that the position will be posted for a new five-year term. The incumbent would be eligible to apply for the new appointment, but would be competing against all other applicants. During the fourth year, the incumbent would have the ability to assess the chances of reappointment and decide whether to find a new job or reapply. Because the five-year expiration would be publicly known, the senior officer could look for other jobs before the period ends, avoiding the stigma of not being reappointed. Conversely, if the incumbent wanted to continue and had the support of their superior, the process would accommodate this.

By adopting these strategies, one for the entry level and one for the senior level, the SEC could ensure that it finds and hires the right people, that senior officers' skill sets mesh with evolving regulatory responsibilities, and that the SEC is not constrained by poor decisions made by previous leaders.

The importance of streamlined hiring authority for market specialists, accountants, economists, and other professionals with specialized expertise

The 2009 Report discussed the critical importance to the Commission of having on its staff people with advanced degrees in economics, IT skills, and extensive experience working in the financial services industry. Historically, the lack of staff with this expertise was reflected in several problems. First the SEC was considered an "attorney-centric" agency in which economists and other professionals were second-class citizens. Second, the pay problem that caused high rates of staff turnover also made it difficult to recruit seasoned professionals with industry experience. Finally, while the SEC had special authority to hire attorneys directly without adhering to cumbersome civil service rules, this authority did not extend to other categories of professional staff.

It must create an executive development program to identify and select younger employees who have the potential to become senior staff.

The first two problems have been partially solved. Chairman Schapiro has publicly endorsed the importance of expanding the breadth of staff skills, and the Commission has hired a number of people with diverse skill sets. While the consolidation of the Chief Economist's office into RFSI has been viewed negatively in the profession, the recent selection of a prominent economist as director of RFSI has partially offset this. The second problem of inadequate salaries has been mitigated by pay parity combined with various "quality of life" benefits. Also, the poor economy and industry consolidation have expanded the pool of skilled professionals interested in government jobs.

Last year, it appeared that the third factor had also been successfully addressed. Section 929(g) of Dodd-Frank explicitly provided the SEC with "streamlined hiring authority for market professionals." The SEC immediately began to use this streamlined process to recruit and hire new staff to the extent that available funding permitted. Unfortunately, the U.S. Office of Personnel Management (OPM) formally challenged the procedures adopted by the Commission to implement this authority. As a result, current SEC staff interviewed for this study described how they have been prevented from offering positions to exceptionally qualified professionals. Knowledgeable staff at the Commission have confirmed the problem. If the problem is not resolved favorably, it will seriously impair the ability of the Commission to recruit and hire critically needed professionals. It will also inevitably result in the reinstitution of a two-track process in which attorneys can be hired quickly and without cumbersome procedures while economists and market experts can be hired only through a time-consuming and confusing process. Once again, managers will choose the fast and easy process to hire attorneys over the slow and cumbersome process required to hire other professionals. It will also validate the perception that non-attorneys are second-class citizens at the SEC.

Additional features of a robust human resources program

Because the SEC now has a staff of long-serving employees, it must make other changes in its HR program. It must create an executive development program to identify and select younger employees who have the potential to become senior staff.[33] Those selected for the program would be given special managerial training, as well as the opportunity to work in more than one division or office, in the same way that large corporations move the best talent around the company to broaden their knowledge and skills in preparation for senior positions. The expertise gained would improve SEC management and would address the chronic silo problem. For divisions with low turnover among senior staff, it would provide expanded opportunities for talented staff to move up the ladder.

Rotational opportunities would not be limited to those selected for the executive development program. The SEC must also develop rotational programs so that talented junior staff in one division can rotate into another division to expand their skills and increase their likelihood of finding the program most suited to their skills. This is not a new concept. The concept of permitting or encouraging junior staff to do rotational assignments in more than one division or office has been discussed at the SEC in the past. When the idea was proposed in the past, inevitably division directors strongly opposed the idea. Because it was assumed that most new staff required six months to a year of on-the-job training to be productive, a six-month rotational assignment to another division would mean that staff would be fully productive for only two years before they left the agency for the private sector after completing a three-year commitment. Whether this concern was valid in the past is arguable, but in today's environment it should not be a serious problem.

Another program should rotate mid-level and senior managerial staff so that these individuals do not become entrenched and unmotivated. It is common in any organization to find mid-level supervisors who have been in the same position, at the same pay level, for so long that they are no longer as effective as they once were. An opportunity to reassign them to another function could be an important personal motivator and at the same time enable a talented junior employee to be promoted. It would also address the silo mentality that has been a chronic problem at the Commission.

Fresh ideas are critical to a successful transformation of the SEC. They are also critical because Congress has directed the Commission to make fundamental improvements in its personnel practices. Section 962 of Dodd-Frank directs the Government Accountability Office (GAO) to prepare a triennial report on SEC personnel management. The section further requires the SEC to submit to Congress a report on actions taken in response to the GAO report 90 days later.

RECOMMENDATION 6—The SEC should adopt and vigorously apply a formal process for evaluating new employees during the initial three-year probationary period. Retention decisions should be made by a committee of second-level supervisors based on a recommendation from the first-level supervisor.

33 When OPM created the SES in the late 1970s, agencies were required to create an SES development program for promising staff. The SEC program faded away after only a few years, a victim of budget cuts and indifference.

RECOMMENDATION 7—Senior officers should be hired for renewable five-year term appointments. A public personnel recruitment competition for the position should be a mandatory component of the renewal process.

RECOMMENDATION 8—The SEC should develop a comprehensive executive development program for its most promising staff who are interested in staying at the Commission.

RECOMMENDATION 9—A rotational assignment program should be established for junior staff, mid-level supervisors, and senior officers.

IMPROVING TECHNOLOGY AT THE SEC

A critical component of a transformation, but not a panacea

The list of IT systems that failed to deliver is a long one.

The development and integration of automated information technology (IT) into operations has been an Achilles heel at the SEC for decades. Over the past four decades, the Commission has recognized a critical need to develop automated systems to collect and analyze reported information and to increase its capacity to monitor markets, examine entities, and investigate violations. Virtually every Chairman in the past decade has stressed the need to increase IT spending and use it to improve operations. Unfortunately, recognition of the need has rarely been successfully translated into IT systems that deliver what is needed. Between 2002 and 2004, the SEC budget for IT grew from $46.6 million to $120.5 million, much of which was spent on a comprehensive system to scan and digitize every document obtained in an SEC enforcement investigation. This even included cases in which the document production was small and best reviewed by the staff in paper format.

This trend continues. The Commission has announced plans to develop a comprehensive real-time market surveillance system at an estimated cost of $4 billion in the first year and more than $2 billion thereafter.[34] This is not the first time that an ambitious new system has been proposed. During the 1970s, the Commission developed a plan for a real-time market surveillance system (MOSS) and spent millions to create an in-house capacity to convert paper filings to microfiche. MOSS was never developed. The microfiche project was funded, but after spending millions for development it was scrapped in favor of a private contractor service.

Similar IT development projects also were proposed but never developed, or developed and later scrapped. For example, a current IT priority is a large trader reporting system. Following the 1987 market correction, Congress appropriated funds to develop a large trader reporting system. As with the MOSS project, a system requirements project was initiated but the system was not developed. In past decades, the Commission also developed at least two automated complaint-tracking systems, but neither system was ever effective. In 2009, following

34 See Nina Mehta and Whitney Kisling, "SEC $4 Billion Data Tracking System Is Too Costly, Virtu's Concannon Says," Bloomberg News, June 4, 2010. Available at: http://www.bloomberg.com/news/2010- 06-04/sec-s-4-billion-tracking-system-for-trades-is-too-costly-concannon-says.htm

the Madoff scandal, the Commission began to develop yet another system.

The list of IT systems that failed to deliver is a long one. At one time, the SEC spent millions on a system to conduct automated Internet searches looking for securities frauds. The system was cancelled after several years of operation because it failed to identify more than a handful of candidates for investigation. Less than a decade ago, the Division of Enforcement spent tens of millions on a system to scan paper documents received in investigations. Rather than use the system selectively for cases where it was needed, the Division decided to use it in every investigation, even those with small documents files. While the system is still in operation, the Division has again identified automated document storage and analysis as a priority need.

A common problem in the projects that did not succeed is the lack of effective collaboration between the program office users of the systems and the IT staff charged with development or procurement.

Under Chairman Christopher Cox, the primary IT initiative was the XBRL project to require EDGAR filers to use special tags for critical information in a filing. This would enable SEC staff and the investing public to conduct automated searches and analyses of company disclosure documents. While XBRL is a reality and corporations are now tagging data in filings, the analysis function is still in its infancy. SEC staff report that they use XBRL on a limited basis. Persons interviewed in the private sector report only very limited use of the technology. One person described it as "a solution whose time has not arrived."

Avoiding past mistakes

A common problem in the projects that did not succeed is the lack of effective collaboration between the program office users of the systems and the IT staff charged with development or procurement.[35] Frequently, systems have been designed and funded before the Commission has done a careful analysis of its business processes to ensure that the system can be integrated into operations. Too little thought is given to what information will be collected and how it will be analyzed. People in the industry complain that the IT development process does not fully consider the relative cost for filers of different approaches.

The latest manifestation of the problem is the multiple initiatives at the SEC to collect data to improve operations and the creation of a new position: Chief Data Officer. In the past year, the SEC has announced plans to collect data on large trader reporting and mandate that the securities markets develop a consolidated audit trail for secondary market trading. However, T&M has not hired the staff responsible for analyzing this data and the division has not finalized a business process plan on how the people hired to use the system will be integrated into existing SEC operations. Because the proposed form requires "large traders"

35 BCG Report, p. 62.

The agency's fascination with large amounts of data in machine-readable format is likely to create more problems than it solves.

to submit significant amounts of trade-specific data, it is essential that filers be able to develop their own software to compile the information from existing data bases and electronically input it into the form. However persons interviewed for this study explained that the staff has decided on a software application that is not "open" and will not be shared with people and companies that must make filings. Therefore filers will be required to enter this data manually—a laborious, time-consuming, and costly procedure.[36]

The same problems are apparent in IM, where newly registered hedge fund advisors will be required to regularly report detailed information on hedge fund positions. However, the division does not have enough staff to analyze the filings and does not have a business plan on how it will review the information.

The agency's fascination with large amounts of data in machine-readable format is likely to create more problems than it solves. In addition to these regulatory initiatives, the Division of Enforcement has stated that it is receiving three to four terabytes of data electronically every month in its investigations. It is dangerous for any organization to collect more data than it can reasonably review and use intelligently. It is also a challenge to develop new approaches to successfully use the data in its investigations without carefully developing a plan on integrating new expertise or new forms of analysis. When one considers the enormous amount of data coming in to Enforcement, and adds the enormous quantities of data that will be collected through mandatory reports and filings, it is difficult to envision the SEC staff analyzing and using these data in a meaningful way.

An effective business development plan must consider more than just what information will be collected and how it will be analyzed. Of equal importance is the question of who will be hired to do the work and how people with different skill sets and different analytical approaches will be integrated into existing organizations with well-established ideas on how problems are identified, analyzed, and solved. It is dangerous to assume that an organization can just hire people with the necessary quantitative skills and embed them effectively in an organization. Consider the introduction of "quants" into the Division of Enforcement. On Wall Street, the term quants generally is used to describe people with advanced degrees in mathematics or information technology who have developed methods of analyzing large quantities of market data to guide investment strategies. Quants provide exactly the type of diverse expertise that the Division Enforcement requires to effectively police the modern world of market finance and innovations such as high- frequency trading. But bringing new people with different training and expertise into an existing program with an established way of doing business is hard work. Enforcement must focus on "facts and circumstances" that suggest the likelihood of misconduct. A "quant" looks for anomalous patterns or trading inefficiencies, which may represent illegal behavior but may also be perfectly legal strategies designed to profit from market inefficiencies. Before quants can add value to Enforcement, they must be trained to understand what

36 This decision and its impact do not appear to have been considered in the cost-benefit section of the SEC rule release.

information is required to differentiate legal trading from illegal trading. Professionals with different skill sets must understand each other and develop a common strategy.

Technology must be viewed as a component of a solution, rather than the solution. This is not original. According to Collins, "When used right, technology becomes an accelerator of momentum, not the creator of it."[37] "Indeed, thoughtless reliance on technology is a liability, not an asset. When technology is linked to a simple, clear, and coherent concept rooted in deep understanding, it is an essential driver in accelerating forward momentum. But when it is used wrong—when grasped as an easy solution, without deep understanding of how it links to a clear and coherent concept—it simply accelerates its self-created demise.[38]

Collins provides a surprising and illuminating insight. "We were quite surprised to find that fully 80% of the good-to-great executives we interviewed didn't even mention technology as one of the top five factors in the transition; furthermore, in the cases where they did mention technology, it had a median ranking of fourth, with only two executives of eighty-four interviewed ranking it number one."[39]

The history of IT development at the SEC validates Collins' finding that poorly planned applications of technology can be a liability, not an asset. Before the SEC spends millions in IT procurement projects, it should complete comprehensive business process engineering plans.

RECOMMENDATION 10—The Commission should require the development of a full business process plan before developing a new IT system or adopting a new rule mandating the filing of detailed information for use and analysis by Commission staff. The business process plan should be formally approved by the director of the relevant program division or office and by the Chief Data Officer.

TRANSFORMING THE SEC REQUIRES CONFRONTING THE BRUTAL FACTS

In *Good to Great*, Jim Collins described the critical path to a successful corporate turnaround. "All good-to-great companies began the process of finding a path to greatness by confronting the brutal facts of their current reality. When you start with an honest and diligent effort to determine the truth of your situation, the right decisions often become self-evident. It is impossible to make good decisions without infusing the entire process with an honest confrontation of the brutal facts."[40]

Technology must be viewed as a component of a solution, rather than the solution.

The theme of this chapter is the transformation of the SEC to the exemplary regulatory agency that it was once considered. The first section of this chapter focused on making necessary structural changes in the Commission's leadership, management, and organization. The second section considered the need for more

37 Collins, p. 152.
38 *Ibid.*, p. 159.
39 *Ibid.*, p. 155.
40 *Ibid.*, p. 88.

SEC staff focus almost exclusively on the regulation of equity securities and the secondary equity market.

resources and the best approach to obtaining additional resources now and on an ongoing basis in the future. This chapter focuses on the regulatory mission of the agency itself. Any successful transformation of the SEC must examine whether the regulatory programs that have been central to the SEC should continue to be the core of its program. While a comprehensive review of all core programs is beyond the scope of this report, two sample programs are examined to demonstrate what questions should be asked. The final section of this chapter highlights how this type of honest examination can be incorporated into the agency as an ongoing part of its operation.

CLARIFY THE SEC'S MISSION

The SEC has been in existence since 1934. It has withstood dramatic changes in its responsibilities and in the markets and companies that it regulates. After 77 years, one would think that its mission is well established. In fact it is. The problem is that the Commission's application of that mission is in many ways outmoded.

The SEC has been and continues to be an "equity-centric" regulator. SEC staff focus almost exclusively on the regulation of equity securities and the secondary equity market. T&M devotes its resources almost exclusively to the equity markets. It does not have a single unit responsible for oversight of the secondary market in debt securities. This is surprising when one considers how much larger and more complex the debt market is. The financial crisis of 2008 was primarily a debt market crisis. The complex securities at the heart of the problem were debt securities. Even after 2008, T&M has not changed its approach.

Nearly 20 years ago, the Commission created a small office to oversee municipal securities. Then-Chairman Arthur Levitt created the office, largely as a response to the efforts of one Commissioner at the time (Richard Roberts), who focused public and Commission attention on an area that is virtually entirely composed of retail investors. Even when the SEC announced a focus on the municipal securities market and adopted bold disclosure requirements, the office was severely understaffed. Eventually it was merged into T&M, where it shrank to two attorneys. One year after Dodd-Frank mandated the creation of an independent office of municipal securities, the SEC continues to function with only two or three professional staff overseeing the entire market, as it has for the past decade. One former senior SEC official interviewed for this study suggested that the largely retail "muni market" should be one of the highest priorities for the Commission. Instead it continues to be understaffed and overlooked.

The equity-centric focus is not limited to T&M. Corp Fin traditionally focuses its attention on equities, consistent with its view that the debt market is not a retail market. One of the fundamental problems in the asset-backed securities market was that SEC regulations governing asset-backed securities (ABS) disclosure were structured as though the nominal issuer of the ABS (a legal fiction) was an organic entity with a past, present, and future, the functional equivalent of a corporation issuing equities or debt.

In the past, Enforcement rarely brought a case involving debt securities or trading in the debt markets. While one of the new specialty groups in Enforcement is responsible for complex financial instruments, largely debt securities, it does not have broad responsibility for the general debt market.

The equity-centric philosophy of the SEC continues to manifest itself in other ways. Several people interviewed for this study commented that the SEC is trying to implement its new authority over derivative securities by applying equity-based regulatory principles that fail to reflect the fundamental difference between equities issued by a corporation and derivatives issued by the market on which they are traded.

Another mission-clarification problem is the Commission's definition of itself as a law enforcement agency rather than a regulatory agency that has a law enforcement program. This problem is discussed more fully in Chapter Two of this report.

Another mission-clarification problem is the Commission's definition of itself as a law enforcement agency rather than a regulatory agency that has a law enforcement program.

Post Dodd-Frank a new aspect of the problem is emerging. Under Dodd-Frank the SEC has new powers intended to enable the agency to consider market safety and soundness issues. While as a matter of public policy this may be an admirable goal, it is a fundamental change in the Commission's role. Unlike banking regulators, which are explicitly charged with responsibility to promote bank solvency through safety and soundness regulation, the SEC has always had a disclosure-based philosophy. While the Commission had the authority to adopt prudential requirements for market participants so as to protect the overall market, historically it did not view its responsibility as encompassing prevention of financial failure by a registered firm. Firms could and did fail. The SEC was concerned with preventing one firm's failure from spreading to other firms. When the large broker-dealer Drexel Burnham Lambert failed, the Commission's agenda was protection of client funds and orderly clearance and settlement of open positions. As this report is being written, commentators are questioning whether the SEC and CFTC properly regulated the MF Global firm, as though it was the duty of the agencies to prevent any firm from making foolish investment decisions that would cause the firm to fail. This has never been the function of the SEC or the CFTC. Once again, the mission of the SEC must be clarified.

THOROUGHLY EXAMINE KEY REGULATORY PROGRAMS

The three largest programs at the SEC in terms of number of professional staff, are Enforcement, inspections and examination in OCIE, and disclosure review in Corporation Finance. While the enforcement program is the most visible program at the Commission, inspections and examinations and disclosure review are rarely in the public eye until something goes wrong. The examination and inspections program received public scrutiny for its failures to find the NASDAQ and NYSE market makers scandals in the mid 90s, the mutual fund market timing problems a decade earlier, and, most recently, the Madoff and Stanford frauds. The effectiveness of Corp Fin's disclosure review program was questioned after the division failed to see the massive financial failures at Enron, WorldCom, Sunbeam, and others a decade ago, even though some savvy professional investors foresaw these problems based on their analysis of the same corporate reports. During the financial crisis of 2008, some critics suggested that the SEC disclosure requirements for ABS offerings were inadequate and exacerbated the magnitude of the financial collapse. Whether these claims are valid or unfairly harsh is a matter of debate and not the purpose of this discussion. Rather, these concerns support the view that both programs should be thoroughly examined to determine whether fundamental change is needed.

The SEC inspection and examination program

The inspection and examination of regulated entities is the second largest program at the SEC. However, unlike enforcement, the program has never been seen as part of the SEC brand. Even during the best of times, it has been viewed as a weak link. In part this is because the agency has never had enough funding to build a program large enough to do the job. In part it may also be due to a failure to clearly define the purpose and goals of the program. One can argue that the program has been required to inspect too many different types of registrants with vastly different business models, to perform too many different inspection functions, and to achieve too many different program goals.

The inspection and examination of regulated entities is the second largest program at the SEC.

The universe of entities subject to SEC inspection authority includes broker-dealers, investment advisers, investment companies, stock transfer agents, stock exchanges, alternative trading systems/platforms, industry self-regulatory organizations (such as FINRA, the Municipal Securities Rulemaking Board, and Securities Investor Protection Corporation), and organizations responsible for the markets infrastructure such as the Deposit Trust and Clearing Corporation (DTCC), SIAC, and others. Post Dodd-Frank it also includes advisers to hedge funds and a wide array of entities engaged in the derivatives markets. The functions that these entities perform and the technique that must be applied to an examination of them are extraordinarily broad.

Within each type of entity, there is a wide range of very different functions that may be the focus of an examination. For example, a broker-dealer examination may look at the financial solvency of the firm by examining the firm's books, and the accuracy of its mandatory net capital calculations. It may focus on the segregation of firm and client accounts and assets. Alternatively an exam may look at the firm's sales practices. This may require a review of a sample of customer account files to assess whether the firm has complied with customer investment suitability standards, to see if customer complaints have been addressed, to see if commissions and other fees are lawful, to review sales materials, and finally to review customer account statements and the existence of customer assets. Finally, the exam may focus on regulatory compliance by the firm with record keeping rules, internal compliance obligations, and the qualifications and licenses of firm employees. An examination of an investment company may have an entirely different focus, for example fund net asset value calculations or front running trading by fund portfolio managers or the processing of customer investments and redemptions.

As one can imagine, an examination of a stock exchange or an SRO or an organization like the DTCC will be completely different. Contrast this multiplicity of functions and businesses with a bank regulator's examination program, which is concerned primarily with the bank's solvency.

Also remember that the SEC uses its examination staff for related purposes. OCIE routinely conducts sweep exams, in which it looks at a specific function or activity of a broad sample of registrants to examine industry-wide practices of interest to the regulatory divisions. OCIE also conducts a substantial number of "cause" exams, in response to tips or complaints of individual or firm misconduct. These are a preliminary step before turning a matter over to the enforcement staff for a formal investigation.

Now consider the huge number of registered firms included in the largest categories of registrants. The size, breadth, and complexity of the inspection program are enormous. Not surprisingly, whenever the SEC attempts to justify its need for increased resources, it begins with the inspection program.

The problem of insufficient inspection resources has existed for virtually the whole history of the SEC, and the agency has developed a wide range of partial solutions. Foremost among these is its reliance upon SROs to inspect the broker-dealer community. At one time, virtually every stock exchange had an inspection program, with the NASD and NYSE having the largest. As a result of exchange consolidation and the conversion of the NYSE and NASDAQ to for-profit competitors, FINRA has become the exclusive inspection SRO for the brokerage community.

FINRA authority has never been extended to the investment company and investment adviser segments of the industry. For more than 20 years, FINRA and its predecessor, NASDR, have sought to take on this responsibility. However the mutual fund industry and the investment adviser sector have successfully opposed this expansion. While several investment advisor trade or professional associations have proposed becoming an SRO, competition within the industry has prevented any of the groups from succeeding.

This has been a serious problem for the SEC. Without an SRO to delegate the function to, it has never been able to solve the problem of examining this industry. No matter how talented or effective the SEC staff may be, if investment advisers are subjected to on-site exams once every 10 (even 30) years, the program will not be credible.

Because the Commission lacks the necessary resources and without an SRO to delegate the function to, the SEC twice obtained congressional action to reassign examination authority for smaller investment advisors to state agencies. The Commission has also relied heavily on internalizing the regulatory compliance function within regulated entities. Mutual fund chief compliance officers are an example of this approach. In 2002 the Commission openly discussed whether the inspection program for mutual funds and investment advisers should be privatized, with licensed professional companies performing annual regulatory compliance reviews, akin to an audit of a public company by an accounting firm.[41]

Virtually since its creation in 1995, OCIE has attempted to maximize the impact of its resources by using various risk-metrics to select which entities to examine. The development, refinement, and application of these risk-based metrics has been repeatedly trumpeted as a major innovation by a succession of SEC Chairmen. Notwithstanding all of these efforts, the problem has continued to grow and questions of regulatory effectiveness have never been adequately answered.

In Dodd-Frank Congress directed the Commission to conduct a study to "review and analyze the need for enhanced examination and enforcement resources for investment advisers."[42] In January 2011 the Commission issued its staff study.[43] Not surprisingly, the report finds that the SEC continues to lack sufficient resources to fulfill its responsibilities. The report then outlines three options "that Congress should consider in order to strengthen the Commission's investment adviser examination program. Specifically, it discusses:

1. Imposing user fees on SEC-registered investment advisers to fund their examinations by OCIE;

2. Authorizing one or more SROs to examine, subject to SEC oversight, all SEC- registered investment advisers; and

3. Authorizing the Financial Industry Regulatory Authority (FINRA) to examine dual registrants for compliance with the Advisers Act."[44] The report did not discuss fully the challenges of examining broker-dealers, the exchanges and SROs, and the ever-expanding list of other types of entities supervised by the SEC.

RECOMMENDATION 11—In its current configuration, the resource-constrained examination program is untenable. The Commission must confront the brutal fact that it has insufficient resources and that Congress is unlikely to substantially increase its budget or provide the agency with self-funding authority. If an effective self-regulatory organization cannot be created, the SEC should adopt one of the several alternative approaches structured around a private sector examination program.

41 While the Commission never adopted this idea, it continues to be actively discussed within the industry. Former SEC Chairman Harvey Pitt is a strong public proponent of the concept.

42 Section 914 Dodd-Frank Act.

43 Study on Enhancing Investment Adviser Examinations, SEC Division of Investment Management. (SEC IA Report). Available at: http://www.sec.gov/news/studies/2011/914studyfinal.pdf. Commissioner Elise Walter issued a separate statement containing her different analysis of the options presented. Available at: http://www.sec.gov/news/speech/2011/spch011911ebw.pdf.

44 SEC IA Report, p. 4.

Public company full disclosure program

> In its current configuration, the resource-constrained examination program is untenable.

The corporate disclosure program in the Division of Corporation Finance is the third largest program at the SEC, with nearly 500 professional staff (primarily attorneys and accountants). It is also the oldest regulatory program, predating the creation of the SEC. One year before the SEC was created in 1934, Congress enacted the Securities Act of 1933 and assigned responsibility to the Federal Trade Commission. The program today is remarkably faithful to its roots, at least in philosophy if not practice. Before a security is publicly sold for the first time, a securities registration statement must be filed with the Commission and may be subject to some level of staff review. Only after the completion of this process (which in the case of large well-known public companies may be automatic) will the offering be declared "effective" so that it may be sold to the public. In addition to securities offering documents the Commission requires public companies to prepare and file a wide variety of disclosure documents, including periodic reports, special material events reports, and proxy statements to solicit shareholder proxies on matters requiring shareholder action. Other forms must be filed for extraordinary events such as tender offers, and mergers and acquisitions.

The two intertwined aspects of this program—Commission disclosure regulations and the staff disclosure review process—are discussed separately.

Disclosure regulation

At the most basic level, SEC disclosure regulations require public companies to disclose all information that would be material to an investor considering whether to purchase or sell the company's securities. Critics of the system believe that in recent years the Commission's disclosure requirements have extended "materiality" far beyond its usual meaning. For example, does the SEC really believe that an informed investor reviews a company's diversity policy for its board of directors before making a decision to buy or sell stock in the company? Does the SEC really believe that a discussion of risk factors should include risks that are remote to the point of irrelevancy? At one time materiality was viewed as a calculus of the magnitude of an event and the probability of it happening. Today, companies treat as material anything that meets one of the factors, regardless of the others. Small companies believe that too many disclosure requirements are pertinent only to large cap companies and large cap companies complain of disclosure requirements that are relevant only to small companies.

Another category of criticism concerns the Commission's failure to embrace the Internet and electronic disclosure options. For example, rather than require proxy statements to include detailed charts of executive compensation, some argue that the Commission should permit a so-called cascading disclosure system, whereby electronic readers could link to the detailed information on a company website. Similarly routine attachments could be stored and quickly accessed on a company or SEC website. Some suggest that even the concept of discrete form-based reports is outmoded and should be replaced by an online company disclosure document.[45]

Finally, a large group of critics point to the recent decision vacating the controversial SEC proxy access rule. Rather than adopt a controversial rule that has been hotly debated for decades, they point out that the SEC should be focusing on the antiquated rules on the shareholder voting process ("proxy plumbing"), an area clearly within the Commission's jurisdiction but one where the Commission has not taken final action on its proposals.

SEC staff have been aware for years of the flaws in the regulatory framework for corporate disclosure. In the 1980s, EDGAR was intended as the catalyst for a new disclosure regime. Ten years ago, Corp Fin began work on "project alpha" to redesign its corporate disclosure program. This morphed into the "21st century" disclosure project, and EDGAR morphed (if only in name) into IDEA, which reverted back to EDGAR. The names were catchy and the aspirations were real. Only the results were missing, the victim of competing short-term priorities and insufficient resources.

There is another reason why the disclosure regulatory structure must be reexamined. SEC disclosure requirements are designed to ensure that company reports are written for an audience of individual retail investors who directly own individual company shares. However, this is no longer the case. In 2007, then-General Counsel Brian Cartwright explained:

> In the United States, retail investors own a much smaller percentage of publicly traded stock than they used to. Estimates vary, but widely cited sources put retail stock ownership in 1950 at more than 90%, while I've seen some estimates that put current retail ownership as low as a little over 30%. Other estimates aren't quite as low. But for our purposes, the exact numbers don't matter. The point is simply that over the last half century direct stock ownership by U.S. retail investors has been in an on-going decline relative to ownership by institutions. Institutional ownership used to be almost irrelevant. Now, retail ownership seems to be headed in that direction. This is a long-term trend, and it shows no sign of abating. If it continues, sooner or later the very roughly 90-10 relative importance of retail investors and institutions in the stock market of 1950 could even be reversed. But even if that doesn't happen—and I'm not here today to predict it will—deretailization of our stock market nonetheless will have, and already is having, profound consequences. Retail investors of course remain *indirect* owners of stock. It's just that their ownership now is increasingly intermediated by mutual funds and other collective vehicles.[46]

45 Joseph A. Grundfest and Alan L. Beller, "Reinventing the Securities Disclosure Regime: Online Questionnaires as Substitutes for Form-Based Filings." Stanford Law and Economics Olin Working Paper No. 361; Rock Center for Corporate Governance at Stanford University Working Paper No. 2. August 4, 2008. Available at SSRN: http://ssrn.com/abstract=1235082

46 *The Future of Securities Regulation*, Brian G. Cartwright, General Counsel. U.S. Securities and Exchange Commission. University of Pennsylvania Law School Institute for Law and Economics. Philadelphia, Pennsylvania. October 24, 2007. Available at: http://www.sec.gov/news/speech/2007/spch102407bgc.htm.

To be sure, some retail investors are direct investors who read annual reports. But these direct investors are a rapidly shrinking segment. Retail investors today are largely indirect investors who invest through and rely on professional intermediaries to make the specific investment decisions—mutual funds, hedge funds for the affluent, investment advisors or brokers who operate on a wrap fee/assets under management basis. An updated disclosure regime should be designed to meet the needs of these readers.

In 2011, the director of the Division of Corporation Finance, Meredith Cross, testified before Congress and described the latest plan to reform corporate disclosure:

> The Division intends to review and recommend amendments to modify core disclosure requirements, many of which have not been significantly updated in close to 30 years, to ensure that they reflect contemporary business practices and address the needs of modern day investors. The goal is to make sure that the rules elicit useful information, not necessarily more information. In determining what information is useful to today's investors, the Division expects to conduct roundtables and other direct contact with professional and non-professional investors. CF expects this project will be accomplished in phases over several years. As part of this project, CF will work with the Commission's Office of Information Technology to consider how disclosure documents are electronically prepared and submitted to the agency, and how they appear on EDGAR.[47]

RECOMMENDATION 12—The SEC should undertake and complete a comprehensive review of its corporate disclosure regulatory system to align disclosure requirements with the needs of the primary users of the information.

The Corporation Finance disclosure review process

The second piece of the disclosure program is the staff disclosure review process in Corp Fin. Nearly 500 professional staff work in Corp Fin and most are assigned to disclosure review.

The SEC review process is disclosure-based. The staff does not assess the merits of the securities as an investment. At the SEC, disclosure review is designed to ensure that the Commission's full disclosure rules are followed and to improve the amount and clarity of material information disclosed to the investing public and market professionals. Because it is a passive process, reviewing what is filed and what is otherwise publicly available, the disclosure review staff are not expected to uncover fraud, except in unusual circumstances.

For decades, more documents have been filed with the SEC than the staff can review. Prior to 2002, the division utilized a program of selective review. Based on selected data extracted from company financial statements and several risk criteria, staff reviewed certain types of filings and transactions and certain companies. For example, staff reviewed virtually all new issuer filings

47 Meredith Cross. Testimony on Budget and Management of the U.S. Securities and Exchange Commission Before the United States House of Representatives Committee on Financial Services Subcommittee on Capital Markets, Insurance and Government-Sponsored Enterprises. March 10, 2011. Available at: http://www.sec.gov/news/testimony/2011/ts031011directors.htm.

(including initial public offerings), third-party tender offers, contested solicitations, and going-private transactions. Historically, a significant number of small business filings also were given a full review. For example, if a company's financial statement indicated a high debt burden to cash flow ratio, this could trigger closer scrutiny.

Depending on the filing and the various red flag triggers, the staff could conduct one of three levels of a review. A full review involves a complete examination by both an attorney and an accountant. A financial review involves an analysis of the financial statement by an accountant. A monitor involves a review of only a specific portion of a filing or a specific issue related to the filing.

The parameters of selective review changed after passage of the Sarbanes-Oxley law. The law mandated that the Commission review on a three-year cycle all public companies that file reports with the Commission. The financial failures of WorldCom, Enron, and others were the catalyst for the change. Nearly 10 years later, it would be interesting to compare the results of the current policy of reviewing all companies on a regular basis with the prior policy of selectively reviewing some companies believed to have higher risk profiles. Such a review should also consider more fundamental questions, such as the utility of devoting hundreds of professional staff to a process that is not designed to detect fraudulent conduct.

RECOMMENDATION 13—The SEC should thoroughly review its disclosure review program and, based on its findings, align the resources expended with the benefits obtained, in terms of investor protection and efficient capital formation.

Autopsies and red flags: Regular examination of the brutal facts must be an integral component of SEC operations

This section began with a quotation from *Good to Great* explaining the critical importance of confronting the brutal facts to a successful corporate turnaround. This process should not be viewed as a discrete first step in the process. It must be integrated into the fabric of an organization as an ongoing process. This integration requires a culture that encourages people to speak and to disagree. It requires a capacity to perform autopsies when things go right or go wrong. It also requires a red flag system so that information cannot be ignored. Collins' view that all good-to-great companies began the process by confronting the brutal facts is not unique. His belief that this must be an ongoing process that is integral to the organization also is not radical. Neither are his views that an organization must encourage employees to speak freely; that it must engage in autopsies to learn from successes and mistakes; and that it must have a red flag system so that signs of problems are not ignored. Nonetheless these processes are inherently difficult for any organization.[48]

48 Many years ago, Jonathan Katz had a conversation with a well-respected and long-serving senior member of the SEC staff. He described how, when he was a young attorney, "everyone argued about everything. They even argued about which deli had the best corned beef sandwich." He explained that this fostered a culture of critical thinking in which everyone and everything was challenged and everything had to be defended internally. Sadly, this process of intellectual challenge has faded away.

The recommended reviews of the inspection program and Corp Fin disclosure programs are examples of what is needed to transform the SEC, but they are not meant to be viewed as one-time events. Any large organization must continually review and learn from its successes and its failures. This is sometimes a painful process and for that reason it may be difficult to establish on an ongoing basis. But it is necessary. For this reason creation of an autopsy program should be a priority at the SEC. Too many major failures during the last decade have cried out for a careful autopsy to find out what went wrong and why.[49] Clearly Enforcement can and has learned from Madoff and Stanford. One hopes, and assumes, that Trading and Markets has learned from Bear Stearns, Lehman Brothers, and the CSE program; Corp Fin from Enron, WorldCom, and Sunbeam; and IM from the market-timing problems and the money market component of the 2008 crisis. However, the autopsy process should not be episodic and limited to the major disasters. It should be ongoing and closely coordinated with internal training programs.

> Transforming the SEC will require the selection of a Chairman who is committed to initiating an agency transformation immediately, while recognizing that it is unlikely to be completed during his or her tenure.

Similarly, creation of a functioning "red flag" program is needed. In this respect, the program should not be confused with "whistleblowing" or with centralized collection and processing of complaints, tips, and referrals. Staff must be encouraged to speak up when they see something and divisions must provide procedures that make it easy for staff to highlight and transfer information internally. Both the 2009 Report and the BCG Report recommended creation of a knowledge management program at the SEC. An effective knowledge management program is not just a readily accessible repository of memos and other internal documents. It requires a method for passing along and sharing information among the staff. Information must flow up the chain of command as well as down the chain.

RECOMMENDATION 14—The knowledge management program recommended in the Chamber's 2009 Report and in the Boston Consulting Group Report should include an internal autopsy program and an informal "red flag" process that enables staff to quickly highlight important events and ideas for senior SEC staff.

A TRANSFORMATION STRATEGY, A REALISTIC TIME FRAME, AND THE TENURE OF SEC CHAIRMEN

SEC Chairmen who assume the role must confront the difficult reality that their tenure in office will probably be short. Moving the SEC forward will probably take years, longer than they are likely to be the Chairman. If the benefits are achieved, it will be under a successor who will get the credit. But they will have to accept the controversy, the internal opposition, and the

49 The SEC Inspector General has reviewed each of the major failures and published detailed reports. However, the IG reports should not be viewed as forward-looking autopsies. To be effective, the responsible office must engage in honest self-examination and learn from it.

disruptions of starting the process. For Chairmen that come on the job with a personal "to do" list of policy changes, beginning the process may interfere with and prevent them from completing that list of objectives.

This is a fundamental problem of a government that functions on four-year presidential election cycles, and with agency heads whose tenures at the agency typically are less than four years. Transforming the SEC will require the selection of a Chairman who is committed to initiating an agency transformation immediately, while recognizing that it is unlikely to be completed during his or her tenure. It will require the selection of a Deputy Chairman for Management and Operations who embraces the role of Chief Transformation Officer and is committed to the concept. Finally, it requires senior staff who are committed to the transformation and dedicated to making changes in internal process and operations that can survive their departure from the agency.

Congress must create an independent, nonpartisan team of experts to undertake the transformation of the SEC.

Sadly, this is unlikely to happen. For this reason, the final recommendation in this report is probably the most important. Congress must create an independent, nonpartisan team of experts to undertake the transformation of the SEC. 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 team of experts to conduct a study of the U.S. securities markets. At the end of its 18-month life, the Special Study team produced a five-volume report that formed the intellectual foundation for the SEC's next 20 years. This is an appropriate occasion to undertake a second special study.[50] The team should be empowered to consider the broader issues of American regulatory policy, such as the future of the U.S. and global secondary market structure; the interaction of the equity, debt, and derivatives markets both in the United States 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, including the problems described in this report. The structure and role of the self-regulatory organizations should also be carefully examined.

RECOMMENDATION 15—Congress should create and fund a blue ribbon team of experts to undertake a thorough review of the SEC and the American capital markets.

50 When Congress enacted the Insider Trading and Securities Fraud Enforcement Act of 1988, it authorized the Commission to undertake a second Special Study. Unfortunately, funding for the study was never appropriated. For a detailed contemporaneous discussion of this provision see Stuart Kaswell, "An Insider's View of the Insider Trading and Securities Fraud Enforcement Act of 1988," *Business Law* 45:145 (1989).

Chapter Two: SEC ENFORCEMENT—EXAMINING THE CHANGES IN THE PROGRAM AND DEFINING ITS MISSION

Virtually since its creation in 1972, the Division of Enforcement has been the most visible program of the SEC. Its achievements are the measures that the public uses to judge the effectiveness of the SEC. While the professionals in the financial services industry may be aware of a new rule to improve the efficiency of the securities markets or required changes in an initial public offering prospectus, the public is largely unaware. When the SEC sues an Ivan Boesky, or fines a large public company, the public reads about it or hears about it. If the action is timely, if the sanctions are appropriate, the investing public has confidence that the markets are fair.

Conversely, when the public learns that a monumental fraud has occurred and that the SEC didn't learn of it or take action until it was too late, the effectiveness of the entire SEC is questioned. Of course this may not be a fair standard. The reality is that when the financial markets are booming, frauds occur. When the markets collapse, the frauds are exposed. Madoff's fraud was eventually exposed because a collapsing stock market resulted in substantial investor withdrawals that could not be covered with new investors' money.

CHANGES IN THE DIVISION OF ENFORCEMENT—GAME CHANGERS OR INCREMENTAL IMPROVEMENTS?

IT'S TOO SOON TO TELL—A WORK IN PROGRESS

Enforcement Director Robert Khuzami has made a wide range of organizational, management, and policy changes during his first two years. He has described them as the most sweeping changes in the Division since it was created in 1972. Khuzami gave a clear rationale for the changes:

> The restructuring, while composed of many initiatives, had some common goals – to make us smarter about the products, markets, transactions and practices that we police; to make us quicker to stop fraud and misconduct before it's on the front page and all the investor money is squandered; to make us more efficient in how we use our resources, thus allowing us to do more within existing budgets; and to maximize our deterrent impact by moving quickly to

> address newly-emerging threats before they take hold across entire business lines or even industries.[1]

The eight changes, discussed in Chapter Four of this report, are as follows: Specialization, Management restructuring, Office of the Managing Executive, Office of Market Intelligence, Elimination of unnecessary process, Whistleblower Office, Cooperation Program and Evaluation metrics.

The first section of this chapter describes the implementation of these reforms to date. For simplicity, management restructuring and the Office of the Managing Executive will be combined. Also combined will be the discussion of the new Market Intelligence and Whistleblower offices. The second section of this chapter discusses the impact of these changes on the Division's performance. The final section considers what further changes should be made to the Division and the overarching question of the mission of the Enforcement Division and its role as part of a regulatory agency. The final section offers recommendations for the Division.

ENFORCEMENT REFORMS

SPECIALTY UNITS

The creation of five national specialty groups in the Division has been the most publicized of the eight changes. Each group includes staff from Washington and from some or all of the regional offices. The groups are dedicated to high-priority areas of enforcement: asset management (hedge funds and investment advisers), market abuse (large-scale insider trading and market manipulation), structured and new products (various derivative products), Foreign Corrupt Practices Act violations, and municipal securities and public pensions. The rationale for creating these units is simple and persuasive.

> These specialized units will provide the structure and resources for staff to "get smart" about certain products, markets, regulatory regimes, practices and transactions. This will permit us to be better investigators, because we will be more efficient and less likely to be misled by those who use complexity to conceal their misconduct. Specialization will also permit us to be more proactive in deciding on an informed basis where to focus our investigations, as opposed to being more reactive to public information or the vast number of undifferentiated tips we receive. It will also enable us to attack problems systemically, swiftly and thoroughly and on an industry-wide basis where appropriate.[2]

Interviewees for this report expressed positive opinions about the creation of the units. Those who have dealt firsthand with the units believe that the staff selected already have or are rapidly acquiring the level of expertise needed. In fact, a number of people suggested that the

1 Remarks at SIFMA's Compliance and Legal Society Annual Seminar. Robert Khuzami, Director, Division of Enforcement, U.S. Securities and Exchange Commission, Phoenix, Arizona (Video Presentation) March 23, 2011. Available at: http://www.sec.gov/news/speech/2011/spch032311rk.htm ("SIFMA speech").

2 Remarks Before the New York City Bar: My First 100 Days as Director of Enforcement, Robert Khuzami, Director, Division of Enforcement, U.S. Securities and Exchange Commission. August 5, 2009. Available at: http://www.sec.gov/news/speech/2009/spch080509rk.htm.

Division should expand the size and responsibilities of the existing specialization groups. For example, one person suggested that the Foreign Corrupt Practices Act (FCPA) group should be expanded to include foreign issuer investigations. Several people also recommended the creation of new groups, for example, one dedicated to investigating large corporate financial frauds.

Supporters of the specialty groups also suggested that these units should have additional responsibilities. Some suggested that the heads of each specialty group should have more supervisory control over investigations within their area of expertise that are conducted by regional offices and other units in the Division. Others suggested that defense counsel should be able to request meetings with these groups to discuss legal questions related to their area of interest in investigations conducted by other units, as a way of promoting greater consistency throughout the Division.

Since their creation, the specialty units have brought (independently or in conjunction with other enforcement units) several notable cases that, in all likelihood, would not have been brought in the past. For example, the market abuse group brought a complex insider trading case in 2011 that they developed by analyzing trading data collected in prior investigations. The analysis enabled the group to identify common trading patterns in apparently unrelated accounts in unrelated investigations.[3] In October 2011, the same unit was responsible for an investigation that led to the entry of a cease and desist order against a registered securities exchange for improperly assuming member trades that were executed erroneously because of a glitch in new computer software.[4]

The Municipal Securities group has also brought several noteworthy cases. In July 2011, it settled a case involving a multiyear bid rigging scheme.[5] An Enforcement action against a "dark pool" trading platform that used undisclosed affiliates to complete trades was investigated jointly by the market abuse group and the New York Regional Office.[6] The New York office also worked jointly with the asset management (hedge fund) group on an action against UBS Securities involving its failure to properly locate securities for short sale trading, as required by SEC Reg. SHO.[7]

Notwithstanding these examples, more than one person pointed out that it was too soon to conclude that the change is a success. The new groups have not brought enough cases to assess whether the goals articulated by Director Khuzami have been achieved.

Several Enforcement alumni expressed concerns about the long-term prospect for the groups given that the Division has tried similar approaches in the past. During the 80s one group specialized in tender offer cases, and later a penny stock task force was created. In the 90s an

3 Litigation Release No. 21917 / April 6, 2011, Securities and Exchange Commission v. Matthew H. Kluger and Garrett D. Bauer, Case No. 11-cv-1936 (D. N.J. April 6, 2011).

4 Release No. 34-65556 / October 13, 2011, File No. 3-14586, In the Matter of EDGX EXCHANGE, INC., EDGA EXCHANGE, INC., and DIRECT EDGE ECN LLC. Available at: http://www.sec.gov/litigation/admin/2011/34-65556.pdf.

5 Litigation Release No. 22031 / July 7, 2011, *Securities and Exchange Commission v. J.P. Morgan Securities LLC*, Civil Action No. 11-cv-03877-WJM-FM (D.N.J. July 7, 2011). Available at: http://www.sec.gov/litigation/litreleases/2011/lr22031.htm.

6 Release No. 34-65609 / October 24, 2011, File No. 3-14600. In the Matter of Pipeline Trading Systems LLC, Fred J. Federspiel, and Alfred R. Berkeley III. Available at: http://www.sec.gov/litigation/admin/2011/33-9271.pdf.

7 Release No. 34-65733 / November 10, 2011, File No. 3-14620. In the Matter of UBS Securities LLC. Available at: http://www.sec.gov/litigation/admin/2011/34-65733.pdf.

Internet fraud group was created. At one point the Division created a "real-time" enforcement unit in which additional staff was assigned to selected investigations with the goal of bringing complex financial fraud cases in less time. Each of these units faded away over time. Typically they were charged with short-term problems that were too narrowly defined. Over time, they brought repetitive cases in areas that became yesterday's priority (the "fraud du jour" problem). Staff grew bored bringing the same cases and moved on to other branches in the Division or left the Division. The groups dissolved through attrition. Similarly, efforts by past Division directors to improve consistency by creating coordination specialists and assigning them responsibility to monitor all investigations on a specific subject also failed, because the investigating staff feared that updating the coordinators would diminish their control over the investigation.

The long-term prospects for these groups will largely depend on two factors. The first is the units' success in staying abreast of developments in their areas of expertise so that they can bring timely, high-quality cutting edge cases that halt new forms of illegal activity. For most of its history the Division has been a reactive regulator that responds to problems after they have become public, rather than identifying problems at an early stage.[8] If these units are successful in spotting problems before they explode, it will be a significant accomplishment. It will require these groups to evolve over time, by identifying, investigating and bringing new types of cases as the markets and the misconduct change.

The second factor in the long-term success of these groups reflects the problems that inevitably arise when an organization attempts to mesh vertical and horizontal operating groups. The long-term viability of the specialization units may be threatened by the inevitable conflicts between the specialization groups and the heads of the regional offices and the other headquarter units. The Enforcement Division currently has a bifurcated organization structure. Roughly 75% to 80% of the staff is assigned to nonspecialized units in the regional offices and in Washington. Their goal is to find and bring the full range of cases. To the extent that the specialization groups are able to control the "best" cases in the high-profile areas, it will create intra-divisional rivalry and friction. Traditionally, regional office heads have controlled their staff and the investigations in their geographical area. Several view the specialization groups as infringing on that authority, particularly if staff in their office are assigned to one of the groups.

This friction could have adverse consequences, for example, the staff in regional offices assigned to work in the specialty groups might be passed over for promotions because they have not worked on that office's cases. These are classic large organization problems that arise when a division simultaneously uses horizontal and vertical lines of authority. A future director, if confronted by ongoing friction and disputes over assignment of investigations, may decide to solve the problem by disbanding the specialization groups. If budget problems limit hiring in the divisions, a director may decide that the groups are not the most efficient use of limited resources and require too great a commitment of skilled staff, making them luxuries that can't be afforded. Finally, over time staff attrition in the groups, coupled with staff unwillingness to be restricted to one type of investigation, may cause the groups to fade away through attrition.

8 The problem of a reactive enforcement program was discussed by Jonathan Katz in another article. See Katz, *Reviewing the SEC, Reinvigorating the SEC.* 71 Pitt L R 3.

Because the program is still a work in progress, it has not yet met all of its goals. For example, some people in the defense bar thought this change would partially solve the long-standing problem of achieving consistency among many different investigating groups. This does not appear to have happened as yet. Anecdotal evidence suggests that many of the regional staff are guarded about discussing or coordinating ongoing investigations with the head of the relevant specialty group. The unit heads apparently have limited authority to insist that another office head coordinate investigations or highlight key issues of fact or law while the investigation is open. The tradition of permitting the investigating attorney to control the scope and direction of an investigation appears not to have changed significantly.

Moreover, the process for assigning cases between regions, between the regions and the home office, and between the specialization groups and the rest of the Division is still a work in progress. The geographic location of the corporate issuer continues to be the single most important factor in determining which office or group will have control over the case. The location of the corporate issuer even influences the assignments of investigations focused on questionable trading by unrelated third parties located in other areas.

CHANGES IN ORGANIZATION: A COMMITMENT TO IMPROVING DIVISION MANAGEMENT

Director Khuzami has publicly expressed his interest in improving the overall management of the Division and, in particular, direct oversight of ongoing investigations and staff supervision. As part of this process, he created an Office of the Managing Executive to consolidate information technology, workflow, management processes, data collection and analysis, human resources, and other administrative responsibilities. He also adopted a flatter organizational structure by eliminating branch chief positions, and has proposed tripling the number of fulltime paralegals and support personnel to reduce the administrative burden on investigative staff. Internal processes were streamlined to make action memoranda shorter and reduce the time required to calendar matters for Commission consideration.

This increased commitment to top-down management is an expansion of a trend that began a decade ago. The Division has created a series of internal review mechanisms to improve oversight of the investigation inventory. First-level and second-level supervisors are required to conduct quarterly reviews of all open investigations to assess progress and decide whether the matter warrants continued investigation. The Division Director and Deputy Director, in turn, conduct their own quarterly reviews. Rather than review every case (as many as 4,000 investigations may be open at any one time), these reviews focus on "the status of National Priority Matters and other significant cases, any major issues presented, coordination with other law enforcement agencies, estimated completion time of investigations, and the need for any assistance or resources to advance investigations to completion."[9]

Virtually everyone interviewed who has worked in the Division believed that the management changes, such as eliminating one layer of supervision and creating and staffing an

9 *Enforcement Manual*, Office of Chief Counsel, Division of Enforcement, August 2, 2011, p. 7. Available at: http://www.sec.gov/divisions/enforce/enforcementmanual.pdf.

Most important, people believe that a chronic problem, the failure to promptly close stale investigations that have been put on the "back burner" or weak investigations that are unlikely to result in an enforcement action, has not been fixed.

office to consolidate support functions and to collect data on internal operations, were long overdue. They also supported the commitment to stronger top-down review of the investigation inventory. Unfortunately, few people believed that the increased oversight has significantly improved the speed of investigations or reduced the number of weak investigations opened. Most important, people believe that a chronic problem, the failure to promptly close stale investigations that have been put on the "back burner" or weak investigations that are unlikely to result in an enforcement action, has not been fixed. The problem of slow investigations is discussed further in section two of this chapter.

COOPERATION AGREEMENTS

Continuing an initiative begun in 2001, the Commission formally established incentives for individuals and companies to cooperate and assist with SEC investigations and enforcement actions. When Director Khuzami announced the cooperation agreement program in 2010, he predicted that it would have a substantial impact. "Our new cooperation program has the potential to be a game-changer for the Enforcement Division. For the first time, we will have a formal framework of incentives—incentives to secure the cooperation of persons who saw, heard, and witnessed securities fraud first-hand—and who can walk into a courtroom, raise their right hand, and tell their story to the world."[10]

The cooperation agreement program creates three incentive levels. At the first level, the Division considers the level of cooperation and assistance when making its recommendation to the Commission on what, if any, action to take, and presumably the terms of the settlement that it would recommend to the Commission. The second level provides for a deferred prosecution agreement. While the Commission defers taking formal enforcement action, the person or firm would have to comply with certain reforms, controls, and other undertakings. The third level involves a non-prosecution agreement under which the Commission formally agrees not to pursue an enforcement action, although the party may have to agree to an undertaking negotiated with the staff. All three levels of cooperation are expressly contingent on the individual or company agreeing to cooperate fully and truthfully in an investigation or enforcement action.

While Director Khuzami described the program as a first, in fact it is not. Virtually from its beginning the Division of Enforcement has rewarded people and companies with substantially the same incentives to cooperate. The most notable—and the most successful—

10 Remarks at News Conference Announcing Enforcement Cooperation Initiative and New Senior Leaders, Robert S. Khuzami, Director, Division of Enforcement, U.S. Securities and Exchange Commission. January 13, 2010. Available at: http://www.sec.gov/news/speech/2010/spch011310rsk.htm.

example was the voluntary disclosure program created in the 70s to deal with the illegal corporate payments scandal.

During the course of the Watergate investigation, it was discovered that many of the largest corporations in the United States had been routinely making undisclosed payments to politicians within the country and around the world. The very prominent persons receiving the payments, the amounts paid, and the extent of the payments was front-page news. Over the course of several years the Commission brought 62 injunctive actions. However 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 nonemployee 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.

Over the years, the Commission has regularly rewarded people and firms who provided critical information or cooperated in an investigation. Sometimes the Commission would still bring an enforcement action, but agree to lesser violations or less severe sanctions. Typically the Commission's litigation release on the matter would include a statement that the person or firm had provided assistance or cooperation. Instead of a formal non-prosecution agreement, the staff would informally agree to not recommend an action to the Commission. In limited circumstances, when a person's cooperation or testimony was critical to the investigation, the commission would request a criminal immunity order from the Justice Department.

In 2001 the Commission issued its Seaboard statement and articulated the types of cooperation that would be considered when deciding whether to refrain from taking enforcement action.[11] The press release announcing the policy had language similar to the announcement of the cooperation agreement program nine years later. "Credit for cooperative behavior may range from the extraordinary step of taking no enforcement action at all to bringing reduced charges, seeking lighter sanctions, or including mitigating language in documents the Commission uses to announce and resolve enforcement actions."[12] While the Seaboard statement provided 13 examples of the type of cooperation that the Commission would reward, the 2010 cooperation program is silent on what constitutes "substantial cooperation."

Director Khuzami has described the cooperation agreement program as a game changer. This might be an overly optimistic prediction. As of February 2011, the Division had agreed to 20 cooperation agreements including one deferred prosecution agreement[13] and one non-prosecution agreement.[14] The deferred prosecution agreement contained a full explanation of the conduct and the violations that the SEC would have charged. The company also agreed to pay more than $5 million in disgorgement and prejudgment interest. The non-prosecution agreement did not

11 Release No. 34-44969 / October 23, 2001, *Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934 and Commission Statement on the Relationship of Cooperation to Agency Enforcement Decisions.* Available at: http://www.sec.gov/litigation/investreport/34-44969.htm.

12 SEC Press Release 2001-117, October 23, 2001. Available at: http://www.sec.gov/news/press/2001-117.txt.

13 S.A. Tenaris, May 2011. Available at: http://www.sec.gov/news/press/2011/2011-112-dpa.pdf.

14 Carter's Inc., December 2010. Available at: http://www.sec.gov/litigation/cooperation/2010/carters1210.pdf.

contain a recitation of the violative conduct or the violations that would have been charged. Also, the company was not required to make disgorgement.

The cooperation agreement program was discussed at length with several interviewees. Most were not surprised that only two agreements had been announced under the program. One person explained that such agreements are better suited to a criminal investigation, where the possibility of incarceration for individuals and severe collateral consequences for public companies can make such an agreement very attractive.

The benefits in a civil action are inherently less substantial. What is the practical difference between settling to an injunctive agreement on a "neither admit nor deny" basis and paying disgorgement and possibly a money penalty; or agreeing to a deferred prosecution agreement that contains the same detailed statement of misconduct and the payment of a substantial sum of money, albeit described only as disgorgement? Both are likely to receive similar publicity. It is unclear whether the market for a company's stock would be affected differently.

Notwithstanding the detailed public statement of standards for when the Commission would reward cooperation, the application of those standards appears to be opaque and inconsistent.

One material difference between the two would be the collateral consequences under the securities laws and SEC regulations of consenting to an injunction or a cease and desist order. For example, any enforcement action results in a statutory disqualification under the Investment Company Act, and persons subject to an enforcement action typically are no longer eligible for certain SEC exemptive provisions. However, the theoretical impact is rarely felt if the action is a negotiated settlement. It has become commonplace for persons or entities who would be subject to these collateral consequences to negotiate, as part of an enforcement settlement, for a Commission waiver of any relevant automatic disqualification.[15]

The most significant comment from members of the defense bar was the complaint that, notwithstanding the detailed public statement of standards for when the Commission would reward cooperation, the application of those standards appears to be opaque and inconsistent. For example, just days before the announcement of the program the SEC issued a settled cease and desist order finding that Natco Group had violated the FCPA.[16] The order explained that the company had discovered the violations during an internal audit, had taken extensive remedial actions throughout the company, had self-reported the violation to the SEC, and had provided SEC staff with its internal audit report and other relevant documents. In other words

15 See, for example, In the Matter of UBS Securities, supra note 7. As a result of the cease and desist order in that case, UBS would have been disqualified from having an exemption under SEC Regulation E for the registration of securities under the Securities Act of 1933 for the securities of business development securities of small business investment company issuers or business development company issuers. As part of the enforcement settlement, the Commission issued an order waiving the disqualification. See SEC Release No. 3-9276 / November 10, 2011. File No.3-14620 In the Matter of UBS Securities LLC. Available at: http://www.sec.gov/rules/other/2011/33-9276.pdf.

16 SEC Release No. 34-61325 / January 11, 2010. File No. 3-13742 In the Matter of NATCO GROUP INC. Available at: http://www.sec.gov/litigation/admin/2010/34-61325.pdf.

the company appeared to have met the standards contained in the 2001 Seaboard statement and to have qualified for the cooperation agreement program, which would be announced just days later. Notwithstanding this exemplary conduct, the Commission apparently did not offer either the deferred prosecution or non-prosecution options.[17]

While the cooperation agreement program is a sound initiative in principle, the very limited and seemingly inconsistent application of the principles raises serious questions about its impact. To date it is definitely not a "game changer."

This apparent inconsistency between SEC policy and the application of SEC policy is not an isolated example. In October 2011 the SEC announced the settlement of another FCPA violation case, Watts Water Technologies, with virtually the same facts.[18] The company discovered the violation through an internal investigation, took immediate action to remedy the violations, publicly disclosed the matter, self-reported to the SEC, and adopted new procedures to prevent future misconduct. The principal difference with NATCO was that this company also agreed to pay millions in disgorgement and a penalty. One commenter, an alumnus of the Division of Enforcement, titled his analysis "FCPA Compliance: Does the SEC Get It?".[19]

While the cooperation agreement program is a sound initiative in principle, the very limited and seemingly inconsistent application of the principles raises serious questions about its impact. To date it is definitely not a "game changer."

BETTER PERFORMANCE METRICS ARE AN ESSENTIAL COMPONENT OF A SOUND ENFORCEMENT PROGRAM

The Division has revised the metrics it uses to manage and evaluate staff and office performance. Rather than relying on the total number of actions filed, the Division is using a combination of metrics that measures the significance of an enforcement action. The new metrics are designed to focus on the programmatic priority of the case, rather than the number of cases filed. Ten programmatic priorities are included, including deterrent value, the extent of the misconduct, and extent of harm to investors.[20] The approach is interesting but not really new. The programmatic priorities are substantially the same as the criteria for opening an investigation that were published in the first *SEC Enforcement Manual* in October 2008.

17 However, in addition to describing the company's conduct, the Commission did not impose a money penalty. More important, the SEC brought the action in the name of NATCO even though the company had been acquired by another public company more than a year before the order was issued. In effect the Commission ordered a nonexistent company to agree not to violate the law in the future.

18 SEC Release No. 34-65555 / October 13, 2011. File No. 3-14585 In the Matter of Watts Water Technologies, Inc. and Leesen Chang. Available at: http://www.sec.gov/litigation/admin/2011/34-65555.pdf.

19 Thomas Gorman, SEC Action.com blog. October 16, 2011. Available at: http://www.secactions.com/.

20 The Stanford Ponzi Scheme: Lessons for Protecting Investors from the Next Securities Fraud. Robert Khuzami, Director, Division of Enforcement and Carlo di Florio, Director, Office of Compliance Inspections and Examinations. U.S. Securities and Exchange Commission Before the Subcommittee on Oversight and Investigations, Committee on Financial Services, U.S. House of Representatives. May 13, 2011. Available at: http://www.sec.gov/news/testimony/2011/ts051311rk-cvd.htm.

The decision to create a new set of performance metrics to judge the overall effectiveness of the enforcement program, as well as the performance of specific regional offices, groups, and staff, has not received as much attention as other changes. However, if developed properly, it could have a significant long-term impact. For most of its history, the Division has relied on two basic measures of performance—the total number of cases brought and the total amount of money ordered to be disgorged or ordered as a penalty (this is invariably far more than the total actually paid). The simplicity of these measures made them easy to calculate and useful to promote the success of the program. Each year the Director or the Chairman could proudly announce that the Division brought more cases than the previous year and that violators were ordered to pay more money.[21]

Unfortunately, the simplicity of these measures created the wrong incentives for the staff. According to the performance metrics, staff and offices would be successful if they brought many cases, no matter how small. This encouraged staff to look for "quick hits," cases that were quickly investigated and easily proven. Large-scale cases involving complex transactions that would require extensive investigations were not as attractive. Staff who had never investigated a particular type of case, or who were not familiar with that area of the securities laws, or who weren't initially confident that an enforcement action would result were often disinclined to open these investigations.

The Allen Stanford case was an embarrassing example of this problem. An SEC staff person explained the problem in testimony before Congress:

> Much has been made of the former SEC-wide institutional influence that created an institutional bias against matters that were resource intensive and whose outcome was less than certain. Stanford was such a matter. There is no question that during the early Stanford timeframe, the Fort Worth office's management firmly believed that the office's success was measured strictly by the number of cases filed each year. Additionally, in Fort Worth, "beating other offices by filing a greater number of cases was the highest goal."[22]

While this may be the most egregious example of the problem, it is not unique. Under the "stats" system of counting every case the same, an attorney who successfully revoked the investment adviser registration of someone who was already in jail for fraud received the same credit as the attorney who succeeded in prosecuting another investment adviser who was still in the business and engaged in defrauding clients. In the same vein, a speedy action resulting in a temporary restraining order (TRO), freezing millions of dollars of stolen funds from investors, would be counted as one case, just like an injunction based on conduct that was years old and where the money was long gone.

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21 This tradition continues. On November 9, 2011, the SEC issued a press release announcing once again that the Division set a new record for the total number of enforcement cases brought in a fiscal year. *SEC Enforcement Division Produces Record Results in Safeguarding Investors and Markets.* SEC Press Release 2011-234. Available at: http://www.sec.gov/news/press/2011/2011-234.htm.

22 The Stanford Ponzi Scheme: Lessons for Protecting Investors from the Next Securities Fraud. Julie Preuitt, Fort Worth Regional Office U.S. Securities and Exchange Commission. Before the Subcommittee on Oversight and Investigations, Committee on Financial Services, U.S. House of Representatives May 13, 2011. Available at: http://www.sec.gov/news/testimony/2011/ts051311jp.htm.

The focus on the annual total also affected the timing of actions. Offices and some staff rushed to file cases on or before September 30, the end of the government's fiscal year. Over the years, many commentators have pointed out that a large number of SEC actions occur during September, the last month in the fiscal year when annual statistics are calculated.[23]

The second traditional measure of success, disgorgement and penalties ordered, also often failed to reward the right action. Because the statistic failed to differentiate between money that was ordered but not paid and money that was actually collected, staff were not credited with moving swiftly to act before the money disappeared. Even when a public corporation pays a large penalty, its punitive value may be diminished if a company knows that the funds will be transferred into a settlement fund and the company can use these funds to negotiate a lower settlement in a parallel private class-action litigation.

To date the new metrics do not appear to have had much impact. As noted, the Commission and Division continue to issue press releases that define success using the old measures, rather than the new "programmatic metrics". Not surprisingly, the staff have followed this lead.[24]

Until several years of data are available, it will not be possible to measure the extent to which these new metrics motivate staff to find, investigate, and bring more important or more complex cases. In fact, one has to wonder whether the next Director of Enforcement will adopt a new and different set of metrics as part of a new set of reforms.

ELIMINATION OF UNNECESSARY PROCESS

In one of the first changes in the enforcement process,[25] the Commission delegated the authority to issue formal orders of investigation (needed to issue a subpoena) to senior Enforcement staff. Some considered this delegation a sensible approach to speeding up the process. Others questioned the wisdom of the change and believed that it reflected a lack of understanding of the purpose of Commission review. While it is true that the Commission rarely voted to deny a request for a formal order, requiring the staff to submit a written memo to the Commission served other purposes. It required the staff at an early stage to marshal the known facts and explain the possible violations that would be investigated.[26] In addition to being reviewed by each Commissioner, the memo would be reviewed by the Office of General Counsel

23 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 of this report 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 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."

24 "I predict that when the statistics are released you're going to see that last year was probably the most productive year ever in the history of the enforcement division…. In fiscal 2010, the SEC initiated 681 enforcement cases, a record yearly number so far, [SEC New York Associate Director Andrew] Calamari said. The agency obtained orders of disgorgement and civil penalties totaling $2.85 billion that year." Stephen Joyce, *Enforcement SEC Official Says Enforcement Unit Change Is 'Game Changer' for Division's Effectiveness*, BNA Reporter, November 3, 2011.

25 Release No. 34-60448, August 5, 2009, Delegation of Authority to Director of Division of Enforcement. Available at: http://www.sec.gov/rules/final/2009/34-60448.pdf.

26 Current staff members report that they are required to draft an investigation plan at the beginning of every investigation, regardless of the type of investigation or its complexity.

and the Enforcement liaison in the three regulatory divisions. This scrutiny would provide valuable early feedback to the investigating staff from experienced and knowledgeable staff throughout the agency. Critics of the change expressed concern that the change eliminated an important internal control process and that it would likely result in the initiation of more investigations of questionable significance or investigations that lacked a well-thought-out investigative theory and plan.

The Division has announced that the time from the beginning of an investigation to the date when an action is brought has declined on average by 11%, but one must be cautious in concluding that the delegation of formal order authority is the reason. This issue is discussed in section two of this chapter.

OFFICE OF MARKET INTELLIGENCE AND WHISTLEBLOWER OFFICE

Few persons commented positively or negatively about the Office of Market Intelligence, other than to express uncertainty as to how it would process and review the tens of thousands of complaints in order to find the "next Madoff." Several persons commented that the problem in "Madoff" was not in processing. In fact the letter from Mr. Markopolous, the principal whistleblower, was received and reviewed by the appropriate Enforcement staff. Moreover Mr. Markopolous met personally with SEC enforcement attorneys. The problem was that the staff failed to do anything meaningful after the meeting. The dangers of relying too heavily on an automated system to process and analyze large numbers of complaints, of differing significance and reliability, is discussed in section three of this chapter.

The Whistleblower Office was mandated by the Dodd-Frank Act. Its mission is to act as the point of contact for people who want to provide the Commission with information pursuant to the bounty program created by Dodd-Frank. The office was created and staffed in 2011, so it is too soon to offer any perspective.

IMPACT OF THE REFORMS ON THE SEC ENFORCEMENT PROGRAM

IT'S TOO SOON TO TELL

The previous section described each of the enforcement reform initiatives and provided largely anecdotal evidence of the impact of each change. A true measure of the impact of the reforms, however, requires an assessment of the overall improvements in SEC enforcement. Any assessment must consider whether the SEC is bringing more cases, the traditional and flawed measure. It must also consider whether evidence shows that the SEC is bringing better quality cases and more timely cases; whether it is bringing a mixture of cases covering the wide array of regulatory responsibilities; whether the settlements negotiated and sanctions imposed are strong and commensurate to the misconduct; and finally and most important, whether the cases are consistent with and in furtherance of the mission of the SEC to protect investors, promote fair and orderly markets, and foster capital formation.

Director Khuzami has embraced this broad view of how the program should be viewed. He has publicly stated that each of the changes made in the last two years is designed to improve the quality of cases brought, the speed of the investigations, and the significance of the sanctions imposed. In a speech marking his first 100 days on the job, Director Khuzami explained "For my part, on my first day on the job, I asked the staff to embrace four principles — the four "S's" as they have come to be known:

- First, to be as *strategic* as possible. This means a focus on cases involving the greatest and most immediate harm and on cases that send an outsized message of deterrence.
- Second, to be as *swift* as possible. A sense of urgency is critical. Long gaps between conduct and atonement undermine the deterrent impact of our cases, and result in missed opportunities to achieve a permanent change in behavior and culture.
- Third, to be as *smart* as possible. Our resources are finite and critically limited. We must better determine on an informed basis whether to continue an investigation, who to continue it against, how to shape it, and how to charge it.
- And last, to be as *successful* as possible. This means building strong cases so that defendants settle quickly on the Commission's terms or face a trial unit armed with compelling evidence."[27]

CHANGES IN THE SPEED AND EFFICIENCY OF THE INVESTIGATION PROCESS

There continue to be problems with the length of time required for an investigation and with undisciplined and voluminous document and data requests.

Table 2.1

SEC Enforcement Investigations (Days)

	1980	1988	1993	2003	2008	2009	2010
Open Investigations (Start of Year)	1171	805	1270	2302	4545	4088	4317
Investigations Opened (incl. F.O.)	322	366	377	910	890	944	952
Formal Orders Opened	186	68	184	254	233	496	531
Investigations Closed	405	227	232	283	1355	716	975
Open Investigations (end of year)	1089	944	1415	2929	4080	4316	4294
Administrative Proceedings	74	109	229	365	386	352	429
Injunctive & Contempt Actions	103	142	172	313	285	312	252
(Parties Named in Civil Actions)	387	438	571	908	808	1065	824
Total Civil and AP Actions	177	251	401	678	671	664	681
Criminal Indictments/Info.	26	50	67	246[28]	108	154	139
Access Requests Granted	74	136	205				
Total SEC Budget (Millions)	72.7	114.5	253	716	906	960	1,190

27 Remarks Before the New York City Bar: My First 100 Days as Director of Enforcement, Robert Khuzami, Director, Division of Enforcement, U.S. Securities and Exchange Commission. August 5, 2009. Available at: http://www.sec.gov/news/speech/2009/spch080509rk.htm.
28 In the 2003 annual report the Commission used the number of individuals who were criminally prosecuted, rather than the number of criminal cases. Therefore this number is a different measure than the statistics for other years.

During the past 30 years the overall SEC budget has increased roughly 1500%. As the largest program at the SEC, the enforcement program has actually increased even more. To say that the enforcement program today is larger and more complex than it was one, two, or three decades ago would be an understatement.

Investigations are the core of the enforcement program. Because the program has historically placed a priority on negotiated settlements of its actions, it must place its highest priority on conducting complete and thorough investigations. Virtually every one of Director Khuzami's changes has been directed at improving the conduct and management of investigation. Therefore, any assessment of the program and these reforms must necessarily focus on the investigative process.

The statistics provided above demonstrate how the investigation program has grown. Roughly three times more investigations are opened annually than there were in 1980. This is not surprising given the huge increase in the investigative staff and the tradition of a bottom-up investigation process in which staff attorneys look for matters to open and typically control the investigations they open.

While the figures vary from year to year, generally slightly more cases are opened every year than are closed. As a result the number of open investigations has grown steadily over time. In the oldest years sampled, the number of open investigations at the end of the year ranged from 944 to 1,415. For the three most recent years, the figure at the end of the year has exceeded 4,000. It is not surprising that improved management of the process is a priority.

A CLOSER LOOK AT THE NUMBERS

Gross numbers, of course, do not reveal how well the process is functioning. In this regard, one must look to available information on the speed of the process and its effectiveness in finding the right cases.

Statistics on the speed of the investigative process are not publicly available. For his part, Mr. Khuzami believes that there has been improvement already:

> We are both filing and closing cases more quickly— an 11 percent decrease in the last two years in the average amount of time it takes to file an action; a nearly 10 percent increase in the percentage of actions first filed within two years of the opening of an investigation, and a 33 percent increase in cases closed in fiscal year 2010 and 2009 as compared to previous years. This trend translates into more timely cases with greater deterrent impact, and a decrease in the uncertainty for the subjects of our investigations about their status.[29]

29 Khuzami, SIFMA speech, supra note 1.

The Commission's budget request to Congress for FY 2012 contained somewhat different statistical information. It indicated that 67% of all "first enforcement" cases were filed within two years of the date that the MUI was opened. In 2009 the figure was 70% and in 2008 it was 62%.[30]

Without disagreeing with these facts or dwelling on the slight inconsistency, one should understand that they do not present a full picture. For example, statistics that measure the amount of time from the beginning of the investigation to filing a case do not include ongoing investigations in which cases haven't been filed. In effect, it omits the slowest cases. Moreover, it doesn't include investigations that are closed without an action filed. Historically it is the "dog investigations," which are going nowhere and will not result in an action, that tend to drag on the longest. So an 11% decrease in time in a sample that by definition excludes the slowest investigations in the Division should be viewed with considerable skepticism.

Another factor that may distort the results is the types of cases that have been filed. Table 2.2 on page 69 shows the percentage of cases filed by the subject matter of the case. In FY 2010, 37% of all enforcement cases concerned securities offerings violations and delinquent filing violations. Virtually all securities offering cases involve the offer and sale of unregistered securities. Typically these are Ponzi scheme violations. Delinquent filing cases are actions against a public company that has failed to file timely mandatory periodic reports with the Commission. As any experienced enforcement attorney knows, both categories of cases, once discovered, require very limited investigations. They are historically the easiest and the fastest cases to bring. While the increase in these cases from FY 2009 was only 2%, the large number in these categories has probably contributed to the overall speed of process.

The changes in formal order authority are designed to increase the speed of the investigative process at the beginning. The changes in management review, particularly the quarterly review process, are designed to improve internal discipline and speed up the process at the end. To date, neither effort appears to be making a significant difference in speed. While the statistics demonstrate that eliminating the requirement to obtain a Commission vote on a formal order has dramatically increased the proportion of new investigations conducted with a formal order, so far it doesn't appear to have achieved the goal of increasing the speed of the investigation. Similarly, the large number of open investigations suggests that the quarterly review process is not resulting in faster closure of unproductive investigations.

CONTINUING PROBLEMS WITH THE INVESTIGATIVE PROCESS

Interestingly, interviewees who currently represent persons or companies in ongoing investigations did not believe that the changes in the program have had a significant impact on the investigation process. They consistently identified three problems:

1. Investigations that initially are overly broad in scope and begin with expansive subpoenas;

30 FY 2012 SEC Congressional Justification. p. 26. Available at: http://www.sec.gov/about/secfy12congbudgjust.pdf.

2. Enormous data and document requests that are time-consuming and expensive to provide and difficult and laborious for the staff to review and analyze; and

3. Investigations that are not productive but remain open for too long.

The first problem—that the staff initially frames the investigation too broadly—is disappointing. For several years, the Division has required the staff to prepare an initial investigation plan that is designed to avoid this problem. To date, the approach does not appear to have worked well. People interviewed anecdotally described a common pattern of receiving extremely broad subpoenas that seem to be designed to encompass all possible scenarios.[31] Numerous interviewees explained that the beginning of any investigation is focused on negotiating with staff to narrow the scope of the subpoenas, the document and data demands, and the testimony requested.

Problem two—enormous data and document demands—is a subset of problem one. Document production requests increasingly call for massive amounts of email correspondence from any and every possible related person at an organization. Staff also may subpoena the entire hard drive from the computers of the persons under investigation. One person described walking past rooms at his law firm full of short-term contract attorneys hired just to review documents and emails under subpoena. The process is so laborious and time-consuming that firms often can't afford to use their own associate lawyers.

As burdensome and expensive as the production process is for the recipient of the subpoena, the burden on the SEC attorney who issued the subpoena and must review the production is also considerable. Even though document production is now largely in electronic format, the review and analysis process continues to depend on one or more trained pairs of eyes. One member of the defense bar suggested that the staff's focus on finding the "smoking gun" emails and other correspondence, has diverted attention from reviewing company documents, which frequently are the critical evidence in proving misconduct. Similarly, another person described a case in which staff focused on emails in an unsuccessful attempt to prove a big sexy case, and in the process, failed to see the clear, technical violation in a company filing with the Commission.

The quantity of data or records obtained under subpoena should not be considered a measure of investigative effectiveness.

Post-Madoff and Stanford, the problem seems to be growing. In a speech earlier this year, Director Khuzami disclosed that "the Division receives each month approximately 3 to 4 terabytes of electronic data. As a comparison, 20 terabytes is often noted as the equivalent to the printed book collection of the U.S. Library of Congress."[32] Mr. Khuzami mentioned this to demonstrate the Division's need for larger and better IT support. Unfortunately, more robust IT capacity is the

31 The problem of overly broad subpoenas may be an unintended consequence of the elimination of branch chiefs. In the past, branch chiefs were expected to review all subpoenas before issuance. In addition to avoiding the problem of broad subpoenas, when done well, the exercise was also considered an effective form of on-the-job training.

32 Khuzami, SIFMA speech, supra note 1.

easiest component of the problem to address. The far more difficult piece is the human analytic capacity to review and properly analyze what is not a mountain of data, but a mountain range of data.

The quantity of data or records obtained under subpoena should not be considered a measure of investigative effectiveness. It should be viewed as an indication of too many unfocused and undisciplined investigations. Several current SEC staff acknowledged a tendency by some staff and some offices to draft subpoenas broadly; to ask for too much data and documents; and to keep investigations open on the chance that something was missed.

Problem three is, in some ways, the most pernicious to an effective investigation program. Old investigations rarely improve with age. As the underlying facts become old, it becomes increasingly difficult to find persons who can testify accurately to events and to argue that a case should be brought. Also, given staff turnover in the Division, when an investigation languishes, the staff originally assigned to the case may leave the Division, be promoted or move to another unit. Most frequently, they are assigned to a new, fresher case and lose interest in the old one.

The adverse consequences arising from a slow investigation are not limited to delays in bringing an enforcement case. The far greater harm is suffered by the persons and companies that are the subjects of an investigation and ultimately are not charged with a violation.

The adverse consequences arising from a slow investigation are not limited to delays in bringing an enforcement case. The far greater harm is suffered by the persons and companies that are the subjects of an investigation and ultimately are not charged with a violation. When an investigation remains open for years without action, the subjects of the investigation are affected. Companies may have made the investigation public, and their stock price may suffer. An open investigation may make it impossible for a company to raise capital. Firms may not be able to grow their businesses because of wary potential clients or contractors. A person may be suspended from work, or may be unable to find work due to the cloud of suspicion. Ongoing legal defense costs can also be substantial.

It must also be remembered that most SEC investigations do not result in an action. The investigation statistics reveal that at any time of the year, there are typically more than 4,000 open investigations at the SEC. Yet, even in a record-breaking year, the Commission brings only 650 to 700 actions. Because several actions often come from a single investigation, the percentage of investigations that do not lead to a case is substantial.

For all of these reasons, the changes Director Khuzami has made to improve the focus of an investigation at the beginning stages and to apply a disciplined investigation review process to close old or weak investigations are critical.

One additional factor that appears to be playing a role in the speed of investigations and the staff's reluctance to promptly close investigations must be mentioned. When current staff were interviewed and asked to respond to the complaint that stale or weak investigations are not closed promptly, the response was surprising. They explained that, post-Madoff, they are reluctant to close any investigation out of a fear that they will be subjected to an investigation by the SEC Inspector General (SEC IG). The SEC IG can confidentially access the email and phone records of the entire staff of the Commission. As everyone in the Division knows first-hand, emails can be a valuable source of evidence. But emails out of context can also be very misleading. The concern is that even if a closing decision is sound, a future event may cause the SEC IG to conclude otherwise. If the SEC IG concludes that an investigation was closed too soon, or an investigation was too narrow in scope, or if he believes that the staff missed a critical piece of evidence among the millions of pages received, the staff may be the subject of an SEC IG report that concludes with a referral to the Justice Department for criminal investigation. As George Canellos, Director of the New York Regional Office, recently explained, "Right now if you close an investigation and, god forbid, you've missed something, you could be subject to significant criticism".[33] A public report and public or leaked "referral to the Justice Department" can have a disastrous impact on a person's reputation, no matter how unwarranted it may be.

While it is difficult for someone outside the SEC to assess the merits of this explanation, it appears to have some basis. A recent public report noted that since October 2007, the SEC IG has made 28 referrals for criminal investigation to the Justice Department.[34] To date, the Justice Department has declined to act in all but one of the 28 referrals.[35] In another instance, where the IG concluded that an Enforcement official had improperly closed an action that had been approved by the Commission, then-Chairman Cox assigned the matter to an SEC Administrative Law Judge for a disciplinary hearing. After a full hearing, the judge concluded that the Enforcement official had not engaged in improper conduct, and the matter was dismissed with no action.[36] Of course the adverse publicity surrounding the IG report could not be undone.

CONSISTENCY AMONG THE REGIONAL OFFICES AND BETWEEN THE REGIONS AND THE HOME OFFICE CONTINUES TO BE A PROBLEM

One other chronic problem in the Division's investigative process that does not appear to have improved is the lack of consistency among the various regional offices and the home office staff. Historically, the enforcement program in each regional office operated largely independently of the headquarters staff. Not surprisingly, this led to a great deal of variation in how staff conducted investigations and which types of investigations they preferred to open. The emphasis on greater investigation management is designed to reduce this variation among offices. However, to date the improvement in top-down oversight appears to have had limited

33 Robert Schmidt and Joshua Gallu, "SEC Enforcers Frozen as Watchdog Unleashes 'Chilling Probes'". *Bloomberg Law Reports*, November 7, 2011. Vol. 5, No. 45, p. 23.

34 Liz Skinner, "Mary Schapiro Lands in Hot Seat Again". *Investment News*, October 30, 2011. Available at: http://www.investmentnews.com/article/20111030/REG/.

35 "[Kotz] said in a statement yesterday that only about 10 were formal referrals and one resulted in a conviction." Schmidt and Gallu, supra note 10 at p. 22.

36 Because the matter resulted in a dismissal, the written opinion of the ALJ was not made public. The author of this report obtained a copy of the opinion. The incident was discussed in Schmidt and Gallu, supra note 33 at p. 25.

impact. As one person said during an interview, "If you tell me which region opened the investigation, I can tell you what they will look for and how long it will take them."

The Stanford case demonstrates how the head of one office can make a strategic decision to focus on bringing the most cases, rather than focusing on the most significant cases with devastating consequences. Because of the largely autonomous structure of each office, such a "rogue" strategy may go unnoticed or it may be well-known and not addressed.[37]

CHANGES IN THE MIX OF CASES AND THE QUALITY OF CASES

Table 2.2

Summary of Enforcement Actions by Category Type

CATEGORY	1989	2000	2005	2006	2007	2008	2009	2010
Securities Offering	28%	25%	9%	11%	10%	18%	21%	21%
Issuer Reporting and Disclosure	14%	20%	29%	24%	33%	23%	22%	18%
Broker-Dealers	16%	14%	15%	13%	14%	9%	16%	10%
Other Regulated Entities	15%	9%	17.5%	17%	13%	14%	12.4%	16%
Delinquent Filers	1%	2%	9%	16%	8%	16%	14%	16%
Insider Trading	13%	8%	8%	8%	7%	9%	6%	8%
Market Manipulation	5%	10%	7%	5%	5%	8%	6%	5%
Contempt Actions	5%	7%	4%	4%	2%	1%	2%	3%
Municipal Securities			1%	1%	1%	1%	0.03%	1%
MISC Cases	3%	5%	0.5%	1%	7%	1%	0.3%	2%

The mix of cases brought is an important indicator of the overall effectiveness of the SEC. Because its responsibilities cover a wide array of people, companies, and businesses, it must attempt to apportion its resources to effectively address all of its responsibilities. Furthermore, as a national regulatory program, each case must not be viewed solely as disposing of one violation or series of violations. Instead each case must be viewed in the context of the guidance it provides to other persons or entities engaged in the same area of conduct regulated by the SEC. One former Director of Enforcement frequently reminded his staff that every Enforcement action represented a regulatory pronouncement. The message and guidance that is given to other persons or entities in the industry on what is illegal, in the long run, may be more important than the particular punishment of a single person or company.

Annual statistics published by the Commission show that the mix of cases brought is roughly the same from year to year. Contrary to the public's perception, insider trading cases account for a small number of Enforcement actions, typically less than 10%. Market manipulations and other forms of secondary market misconduct are an even smaller slice of the enforcement pie.

37 Sadly, the Ft. Worth office focus on bringing the most cases, regardless of significance, was well known by many at the SEC; including the author of this report. What was not known was that this strategic plan meant that the office would consciously decline opening investigations if the matter appeared to be too complex or time-consuming.

Delinquent filings cases account for a large percentage of the actions brought every year. These cases are brought when a corporation fails to file its periodic reports (e.g., Forms 10K, 10Q) or when an individual fails to file ownership trading reports (Forms 3, 4, 5). While these cases must be brought to maintain the integrity of the mandatory reporting process, they are atypical actions. Delinquent filings cases are almost always brought by one group in the home office (a specialty group that predates the creation of specialty groups). This unit is extremely efficient in identifying and quickly completing these matters. Generally they require limited investigation, and the facts are immediately ascertainable. Frequently the only question that must be answered is whether the company is defunct and whether there is any person to serve with papers, other than the Corporation Department of the state of incorporation.

Securities offering cases are another category that generates consistently large numbers of actions. These cases typically involve an unregistered offering of securities that does not qualify under any of the exemptions from registration. Most of these cases are complete frauds. Many of the frauds are Ponzi schemes and/or affinity frauds. The conduct is clearly illegal and usually criminal—a scheme to defraud unsuspecting investors. The defendants are not members of the securities industry. They are criminals. As a result, an SEC injunctive action or administrative proceeding is largely irrelevant, except when the staff move quickly to identify and freeze assets before they disappear. Criminal prosecution is the only effective response.

The fact that these two categories have been and continue to be substantial slices of the total mix of cases suggests that the strategic plan to focus on important cases hasn't been fully accepted by the staff. Bringing "quick hit" cases that don't require much time but boost the total number of cases appears to continue to influence the choice of investigations and cases.

These statistics confirm anecdotal comments in interviews. When members of the defense bar were asked if they saw any changes in the case mix of investigations, there was a consistent answer. The Enforcement staff is looking for "quick hits," especially Ponzi schemes. There do not seem to be many complex, and time-consuming, accounting fraud investigations. Instead the staff seem to be opening more FCPA violation cases, which typically begin when a company self-reports a violation.

Managing the overall mix of cases in the Division is a difficult task. In large measure the problem has its roots in the bottom-up method of deciding which investigations to open, which largely controls which cases are brought. Everyone in the investigation groups is looking for cases to investigate. The staff member that first finds something usually gets to investigate it. They take ownership. In effect everyone in the Division is competing with everyone else to find the next big case. It's analogous to a real estate broker's office in which agents compete with each other to find a listing or a buyer. This encourages a program where available resources are self-assigned to cases. It's a tough pattern to disrupt. The specialization groups should break this pattern, but the change will likely be on the margin because 75% of the staff continue to be assigned to the traditional generalist groups.

One former senior Enforcement attorney recently wrote an article highlighting the importance of improving the mix of cases brought by the Division: "The simple reality though is that not every violation of the law can be pursued and what the SEC needs to decide is which violations are the most imperative to pursue."[38] The author, Joan McKown, highlighted delinquent filing cases and Ponzi schemes as examples of cases that should be lower priorities for the SEC. As she noted, Ponzi schemes are straightforward criminal activities. An SEC civil injunction accomplishes little. A criminal prosecution is required.

More important than the mix of cases is the overall quality of cases brought.

More important than the mix of cases is the overall quality of cases brought. A significant Enforcement action against a major firm or company invariably will have a greater impact than multiple cases against small companies or firms for minor violations. One former Enforcement Director would frequently remind the staff that obtaining money penalties for minor violations would make an enforcement action look like a traffic citation.

Of course, large complex cases are difficult to investigate and frequently require a large commitment of staff. Inevitably, when the SEC requests more money in its budget for enforcement, it explains that the additional funds will better equip it to investigate these large complex cases. However, there is little indication that the Division has used any increased funding to do complex investigations. Once again, the bottom-up investigation selection and staffing process, previously described, contributes to the more staff/more investigations pattern. New staff are encouraged to look for cases in the same manner as other staff. Rather than working on larger, complex cases, they frequently just find more cases to investigate. The substantial increases in the number of investigations opened and overall number of open investigations seems to roughly track the episodic increases in the Commission's budget.

It is of course difficult to measure whether the Commission is bringing "better" cases. A judgment of this sort is inherently based on subjective opinions as to what is significant. For this, it is often necessary to look to the Commission's own press releases and public statements for indications of quality.

To date, however, it is difficult to see any fundamental changes in the Division's output. According to SEC 2012 Budget Submission to Congress, only 3.26% of all open investigations were deemed "high impact".[39] A careful examination of the November 2011 press release on Enforcement actions describes a number of noteworthy and high-profile cases, including actions against major financial firms for misconduct relating to the 2008 financial crisis. The release identifies only one major accounting fraud case (substantiating the comments in interviews), and announces an 8% increase in insider trading cases. An 8% increase, however, amounts to only about five more actions than the previous year.

38 Joan McKown, "Limited Resources Mean Difficult Choices for the SEC," *Bloomberg Law Reports*, September 6, 2011. Vol. 5, No. 96.
39 FY 2012 SEC Congressional Justification, p. 26. Available at: http://www.sec.gov/about/secfy12congbudgjust.pdf.

While the general public typically measures the severity of a sanction by the size of the money judgment, the subjects of the investigation may have a very different perspective.

IS THE COMMISSION OBTAINING STRONG SANCTIONS IN ITS CASE?

This is possibly the most serious, and controversial, question to raise in an assessment of the enforcement program. Again, it is a difficult one to answer, other than through subjective and anecdotal evidence. It is serious because it goes to the heart of a regulatory enforcement program. When the SEC finds a violation, on what terms is it prepared to settle the matter? If the terms of the settlement are not commensurate with the misconduct, the Commission sends a message to other similarly situated persons and entities that the rewards of misconduct may outweigh the risks.

Traditionally, an SEC sanction has three components—the violations charged, the remedial actions or prospective changes required in the process, and the punishment imposed. Punishment includes both money penalties, limitations on future activities, and, for persons or firms registered with the SEC, the possibility of suspensions or bars from the securities industry. In the context of a negotiated settlement, another aspect may be whether the SEC insists on charging individual employees of a company or firm, or agrees to refrain from charging individuals as part of a settlement with the company.

While the general public typically measures the severity of a sanction by the size of the money judgment, the subjects of the investigation may have a very different perspective. The most critical piece of the negotiation may be the issue of charging individuals. Secondarily, some companies and individuals may be concerned about what violations are charged. It may be important that the SEC confine the matter to what is considered a "technical" violation, such as a failure to include information in a filing, rather than a finding that the failure to include the information constituted a fraud. There are even distinctions between frauds. Is it based on "knowing misconduct" (scienter) or was the act grounded in negligence?

Once again, it is difficult to empirically assess the quality of SEC sanctions. The strength of the evidence supporting the case is typically not known. Moreover, SEC settlement negotiations are confidential and normally occur before an action is even filed. Therefore, it is not possible to know what the SEC would have charged if the party did not agree to a negotiated settlement.

However, in the past two years there have been some apparent trends in key cases. For example when one examines the series of cases arising out of the financial crisis of 2008, it appears that in a settlement the Commission will agree to charge fraud based on negligence rather than knowing or scienter-based conduct. The November 2011 press release highlighted six cases related to the 2008 crisis. Three cases were settled on the basis of negligence-based fraud, while the other three cases are in litigation. In the litigated cases the Commission is alleging scienter-based fraud. Similarly, while only one of the settled cases included an individual (who is litigating), all three of the litigated cases involved individuals (two of the companies are defunct and not charged).[40]

The use of negligence-based charges in settled actions and the reluctance to name culpable individuals in settlements has not gone unnoticed. Recently, more than one judge who was assigned to accept a settlement involving, among other issues, nonscienter fraud, questioned the terms of the settlement. One judge asked the SEC and the defendant to submit briefs explaining the reasons for the settlement.[41]

WHAT NEXT FOR THE ENFORCEMENT PROGRAM?

This final section of the chapter discusses the current direction of the enforcement program of the SEC, in particular the shift in program scope and focus that has occurred in the past two decades. Also discussed will be recommendations on how the Division can continue to build on the reforms initiated in recent years to improve the effectiveness of the program.

CLARIFY THE MISSION OF ENFORCEMENT AND DIFFERENTIATE CIVIL AND CRIMINAL RESPONSIBILITIES

What is the mission of the Division of Enforcement? Surprisingly, this comment was made repeatedly, in a variety of different ways. "Is Enforcement part of the SEC or part of Justice?" "Enforcement has to focus on big, market-impact cases, and not bring so many Ponzi scheme cases". "What is the vision of Enforcement?" These comments are all variations on a single theme. The people who made these comments frequently explained that SEC Enforcement went through a dramatic change in size and authority during the past 20 years without considering the implications of these changes.

It is important to remember that the Division of Enforcement was created in 1972, 38 years after the creation of the agency. Until that time each operating division had its own enforcement staff. They were viewed as one component of a comprehensive regulatory program that included licensing, disclosure review, and onsite examinations. The enforcement staff in a division brought enforcement actions, but they sometimes conducted investigations for other purposes. A former head of the enforcement unit in Corporation Finance once explained that his staff would sometimes conduct an investigation because the operations staff were uncomfortable with the information in a securities registration offering or an annual report, and the comment process wasn't providing sufficient clarification. While the investigation might result in a stop order proceeding to halt the sale of securities, sometimes it would have a different purpose, persuading the issuer to make significant changes in its public disclosures and thus eliminating the need for an enforcement action.

40 "SEC Enforcement Division Produces Record Results in Safeguarding Investors and Markets." SEC Press Release 2011-234. Available at: http://www.sec.gov/news/press/2011/2011-234.htm.

41 Peter Lattman, "Judge in Citigroup Mortgage Settlement Criticizes S.E.C.'s Enforcement," *New York Times Dealbook*, November 9, 2011. Available at: http://dealbook.nytimes.com/2011/11/09/judge-in-citigroup-mortgage-settlement-criticizes-s-e-c-s-enforcement/.

It is important to remember that the Division of Enforcement was created in 1972, 38 years after the creation of the agency.

The SEC enforcement program has changed dramatically since its creation 40 years ago. It has increased dramatically in size. In 1972 when Enforcement was created, the entire SEC had a staff of 1,650. Today the SEC enforcement and examination programs have more than 2,000 employees. The authority and powers of the enforcement program have grown even more dramatically. In 1972, the Commission had very limited sanctioning power. It couldn't directly discipline individuals who worked for broker-dealers, investment companies, and other registered entities. It couldn't impose any money penalties and its authority to ask courts to order defendants to disgorge ill-gotten gains was a novel legal theory that was based on common law principles, not statutory authority. It wasn't until enactment of the Remedies Act in 1990[42], that the Commission acquired most of the broad sanctioning powers that it uses routinely today.

Given its limited resources and limited authority, the Commission historically focused on bringing the most substantial cases it found and on cases that could be used to clarify regulatory policy and inform the securities industry of SEC regulatory positions. The program had two essential elements—bringing a wide range of significant cases, optimally encompassing each of the programs and laws of the SEC, and using the cases to clearly articulate legal principles that would put other persons and entities on notice. Of course this implied that any negotiated settlement had to be crafted to send the correct message. While the staff negotiated the wording of its orders with legal counsel for a specific defendant, it did so with an eye toward the entire industry. An important component of these cases was often the defendant's agreement to develop and implement remedial procedures designed to prevent future misconduct. Often the remedial procedures adopted would become models for industry-wide "best practices."

Even after the separate enforcement units were consolidated into the present Division of Enforcement, the mission of the Division was still closely linked to the Commission's regulatory functions. The voluntary disclosure program discussed previously is a notable example of how the enforcement program supported the corporate disclosure regulatory program. On a number of occasions the Division issued a "21(a)" report of investigation in lieu of an enforcement action. The report would describe the results of an investigation that involved an unusual factual situation or a new legal interpretation and explain the Commission's legal analysis of the conduct. Even though no one would be disciplined, the report would provide guidance to the industry and notice that the Commission would sanction this misconduct in the future.

The enforcement program has evolved dramatically since its beginning. Of course the most obvious change is in size. It is far larger, conducts far more investigations, and brings more enforcement actions. For example, in 1980 the Commission opened 322 investigations and brought 177 total enforcement cases. In 2010, 952 investigations were opened and 681 cases were

42 Securities Enforcement Remedies and Penny Stock Reform Act of 1990. Pub. L. No. 101-429, 104 Stat 931.

brought. These numbers do not tell the full story. Another even more significant change has been in the sanctions that the Commission can and does obtain in these cases.

In 1990 the Commission gained the power to assess substantial financial penalties, issue cease and desist orders, and bar persons from working as officers or directors of public companies. As a result, the program changed fundamentally. In the last two decades the primary goals have changed dramatically from regulatory guidance and remediation to an emphasis on imposing substantial money penalties. In 2002, 12 years after enactment of the Remedies Act, the Xerox Corporation paid a $10 million penalty to settle an SEC enforcement action. It was the largest money penalty paid by a public company, other than a registered entity (e.g. broker-dealer or investment company). In 2003 the SEC obtained 20 penalties of $10 million or more, and in 2004 the number grew to 40.[43] Since that time, penalties have continued to be a substantial component of the enforcement program. The total amount of penalties is now a standard yardstick to measure annual accomplishments. At the end of each fiscal year, the SEC publishes a report titled *Select SEC and Market Data* on its website. The first table each year begins with the total amounts of money ordered for disgorgement and penalties. In FY 2010, the penalty total was $1.03 billion.[44] This change in focus is a major reason why some believe that the SEC Enforcement Division is more closely aligned with the Justice Department than it is with the regulatory programs of the SEC. It also explains why former Chairman Christopher Cox explained, "first and foremost, the SEC is a law enforcement agency."[45]

As a result of the changes in the Division's size and powers, it has become less committed to the concept of a national program of selective prosecution. In this respect it is beginning to resemble and act like a local prosecutor's office rather than a national regulator and standard setter. Prosecutors typically prosecute all cases they receive, if the evidence is sufficient. Historically the SEC enforcement program had a different focus. It brought cases selectively. After it brought several cases for the same misconduct, it would consciously look for other types of cases to ensure it was maximizing its impact and not ignoring an area of responsibility. Today it appears willing, and in fact committed, to bringing every enforcement action it is aware of. This willingness to bring every case, regardless of significance or repetition of a regulatory message, can be seen in the mix of cases. As discussed previously, 37% of the Commission's cases in 2010 involved offering frauds, typically Ponzi schemes or actions against companies that were delinquent in complying with their periodic report filing duties, usually because the company was defunct. Once again, bringing a large number of the same type of cases may not enhance a regulatory program.

The SEC enforcement program has changed dramatically since its creation 40 years ago.

43 Statistics published in *Report on the Current Enforcement Program of the Securities and Exchange Commission.* U.S. Chamber of Commerce. March 2006. The primary author of this report was Bruce Hiler, a partner at the law firm of Cadwallader, Wickersham and Taft and formerly an associate director in the Enforcement Division. ("Hiler Report").

44 *Select SEC and Market Data for FY 2010.* U.S. Securities and Exchange Commission. Available at: http://www.sec.gov/about/secstats2010.pdf.

45 SEC 2006 Performance and Accountability Report, p. 2. Available at: http://www.sec.gov/about/secpar2006.shtml.

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The Division's increasing emulation of criminal processes may have other consequences. Generally a federal prosecutor views a case primarily in terms of obtaining the best possible result. In some cases this means dropping some charges in exchange for a plea agreement that will result in incarceration. Prosecutors rarely make decisions on the basis of how the result will affect other cases in other jurisdictions.

In the past, Enforcement staff evaluated settlements not only on the facts of the case in question but also in terms of the regulatory message that it would send to others in the industry. There is a perception today that many of the staff negotiate settlements based on obtaining the best deal for that individual case, with only limited attention to what, if any, national message the case sends. One example of this may be the willingness to agree to settlements based on negligence-based fraud, rather than insisting on scienter-fraud, even if the facts support it. Some believe that the prosecutorial mindset also partly explains why the Commission frequently agrees to settlements with large companies without charging any individuals at these companies. As a matter of regulatory policy, one could argue that punishing specific culpable persons would be a more important message than extracting a large money penalty from the company, which will be paid by the shareholders.

Ironically, today the possibility of an Enforcement action may be resulting in less regulatory guidance. Some people believe that the regulatory divisions may be reluctant to provide interpretive guidance to the securities industry because of concerns from the Enforcement Division that this guidance might limit Enforcement's legal theories in future investigations.[46] The goal of improving the U.S. capital markets by ensuring compliance and providing regulatory guidance appears to be secondary to the goal of bringing cases that result in eye-catching sanctions.

Another notable trend in the enforcement program has been the perceived emphasis on investigations that will lead to criminal prosecutions. At one time, criminal actions based on securities law violations were rare. While Enforcement staff would refer many cases to federal prosecutors, there was limited interest outside of the offices of the U.S. Attorney for the Southern District of New York. Prosecutors viewed securities cases as too complex to prove to a jury. Moreover, they were a lower priority than high-profile organized crime or drug cases. Over the past 10 years this disinterest has changed. Federal prosecutors are looking for high-profile corporate crime cases. And the SEC is emphasizing its responsibility to support criminal prosecutions. In FY 2010, 139 criminal cases were based on SEC investigations. In FY 2009 there were 154 such criminal actions. Compare these figures with the 50 criminal indictments in 1988 and the 67 criminal indictments in 1993 that were based on SEC investigations. While it is not

46 For a full discussion of this problem see Hiler Report, supra note 43 at p.18.

possible to document this trend, a consistent comment from interviewees is a perception that the staff is focusing on cases that have "criminal potential." As one scholar, formerly a litigator in Enforcement, explained: "The apparent push to turn the Enforcement Division into a quasi-prosecutorial office is interesting because the premium focus seems to be on pursuing enforcement cases that involve dishonest practices broadly affecting the markets, and not as much on the more mundane, although important, aspects of securities law enforcement."[47]

One might ask what is wrong with having a more aggressive enforcement division that is focused on imposing the toughest sanctions and encouraging criminal prosecution whenever possible. The response to this argument lies in the unique responsibilities of the SEC. While it may be thought of as a law enforcement agency today, under the securities laws, it remains first and foremost the national regulator of the American capital markets. If the Division is focused on bringing cases that are most likely to result in a criminal prosecution, this suggests that the office will have less interest in bringing difficult and complex cases that are unlikely to ever interest a criminal prosecutor. "While insider trading and Ponzi scheme cases may garner the greatest media attention, it is the day-to-day administration of the federal securities laws that ensures the capital markets are operating properly."[48]

Clarifying the mission of the SEC civil enforcement program also requires recognition that there are certain types of cases where an SEC civil action is not the appropriate response and is likely to be an inadequate response. "There are times that the SEC, a civil law enforcement agency, needs the help of criminal law enforcement. Largely this occurs when a matter involves (1) a recidivist defendant who has repeatedly violated the law; (2) egregious misconduct, for example, when a broker misappropriates investors' money; and (3) perjury or obstruction of justice in an SEC investigation."[49] Ponzi scheme cases are a common example of a nominal securities law violation that should be treated as though it were a criminal theft of money. Effective criminal prosecution of violations undoubtedly has a greater impact than an SEC civil action.

Some people believe that the regulatory divisions may be reluctant to provide interpretive guidance to the securities industry because of concerns from the Enforcement Division that this guidance might limit Enforcement's legal theories in future investigations.

In these cases, when the staff find a clearly criminal activity and refer it to the appropriate criminal authorities, there is limited benefit in filing a companion SEC civil action. However, this is typically not what happens. The SEC usually files a parallel civil proceeding at the same time that the criminal case is announced. While this ensures that the SEC receives public credit and

47 Peter J. Henning, "Should the SEC Spin Off the Enforcement Division?," 11 *Tenn. J. Bus. L.* 121 (2009), page 126. http://trace.tennessee.edu/transactions/vol11/iss1/10.

48 Henning, supra note 42.

49 McKown, supra note 38.

that the staff attorney who conducted the investigation gets credit for bringing a case, it does little if anything to benefit the capital markets or protect investors.[50]

CONTINUING TO IMPROVE THE INVESTIGATIVE PROCESS—BUILDING ON THE RECENT CHANGES

Training—In every interview concerning the enforcement program, people were asked what they would recommend to improve the enforcement program. While a wide range of suggestions were made, one recommendation was made more than all others—the need for extensive training in investigative techniques. People commented frequently that staff lacked experience in deposition questioning. "They read the list of questions and don't listen to the answers," was one comment. "The staff frequently don't understand how to question people regarding specific documents." Many lack the knowledge of internal practices in the industry that are necessary to understand what might have happened and what must be investigated. The lack of quantitative analysis skills needed for reviewing massive amounts of trading data was often mentioned. One person suggested that knowledgeable persons in Risk Strategy and Financial Innovation should be recruited to provide training in the use of standard data analysis software and analytic techniques. While these suggestions are broad generalizations that do not apply to all Enforcement staff, the common theme is important and applicable to many.

Several people also recommended that the specialty units could be important in the training process. They suggested that each group should be responsible for providing in-depth training to staff throughout the Division on the operation of the capital markets in their area, on the proper investigative techniques to use, and on the critical legal issues to investigate. Several people stressed how important this function would be to minimize the friction that may exist between the specialty groups and the rest of the Division. In a similar vein, several people encouraged the trial unit to periodically work with investigating staff on understanding what evidence is critical to successfully litigate cases.

RECOMMENDATION 16—The Office of the Managing Executive for Enforcement should develop an in-depth training program on investigative techniques.

Top-down management of investigations—This is one of the reform areas that requires further effort. In particular, careful supervisory attention must be given to the investigation plan. The scope of the investigation must be carefully defined, and a data and document collection plan should be specified. The staff should be required to explain the data and information demands, what they anticipate receiving, and how they intend to analyze it. Supervisors should ensure that the persons assigned to the investigation have enough understanding of the issues and that a sufficient number of staff are assigned, based on importance and complexity.

Equally critical is ongoing management and oversight as the investigation develops. Priorities should be placed on refining and narrowing the scope of investigations as evidence is reviewed and on closing investigations that are unlikely to warrant action, that have weaknesses

50 The only material benefit in filing a companion SEC action would be if it is needed to freeze stolen assets for eventual distribution to defrauded investors.

in legal theory or supporting evidence, or where the age of the case makes it less significant. A formal process is needed to encourage disciplined review of ongoing investigations.

Chapter One of this report recommends the creation of an autopsy program at the SEC. It is inevitable that the SEC will miss something critical. It is also inevitable that the staff will close an investigation and subsequent events will reveal that they missed something. When this occurs, it is critical to learn what happened and why. An IG report that is looking for misconduct is rarely a useful diagnostic tool. The Division must develop a capacity for honest self-examination and use it positively.

RECOMMENDATION 17—The Division should establish a goal of reducing its open case inventory each year by identifying one-third of its investigations that are least likely to warrant action, due to age, significance, or weak evidence. Any investigation that is more than 18 months old or based on a possible violation older than three years should be closed routinely unless the Division Director or Deputy affirmatively concludes that it is essential to continue the investigation.

RECOMMENDATION 18—The procedure for assignment of investigations should be revamped. The process should not be based largely on the person or group that first identified the matter or the geographical location of the issuer of securities or headquarters of a registered firm. A disciplined top-down system should assign cases based upon staff expertise and experience in the area and the availability of sufficient resources to complete the investigation in a timely manner.

RECOMMENDATION 19—The investigation management process should consider the mix of cases in the pipeline when assessing investigations. The Division should have an explicit goal of bringing cases that advance the Commission's entire regulatory agenda.

RECOMMENDATION 20—The Division should develop an internal autopsy report to carefully examine problems after the fact and use it for training.

Continuing the development of the specialty groups—The creation of the specialty groups was consistently endorsed by those interviewed, particularly by members of the defense bar who formerly worked in the Division. There is a widespread belief that the specialty groups are essential to ensuring that the Division develops and retains the type of expertise and knowledge of changing markets necessary to deal with the major market problems of the future. The problem is how to ensure that these units stay current, continue to attract good staff, and don't become locked into yesterday's matters. The second problem is bureaucratic. How do units with less than 25% of the staff survive against the remaining 75%?

If Director Khuzami and his successors are truly committed to changing the culture of the Division—bringing higher impact cases—the percentage of staff assigned to generalist groups must be reduced. This would be a dramatic change. An interim transitional step would be to secund staff from the regional offices and the generalist groups to the specialized groups to work on specific investigations. In addition to gradually realigning staff, it would also be a training opportunity for new staff. This approach would not be unique at the SEC. For years the Division of Corporation Finance has detailed staff from its operations branches (the units that review corporate filings) to the rulemaking groups or to task force groups created for temporary high-profile projects. In Corporate Finance, operations staff compete for these details, as they are usually intellectually challenging and offer opportunities for recognition that can lead to promotion.

The responsibilities of the specialty groups should be expanded. Each group should have its own market intelligence team. In addition to looking for new investigations, this team should be the group responsible for identifying and understanding new developments so that it can train others in the Division. Heads of specialty groups should play an active role in managing the entire Division's inventory of matters within their area of expertise.

RECOMMENDATION 21—The number of specialty units should be increased and the staffing of the specialty units should grow to 40% of the Division. A specialty unit responsible for complex accounting frauds or misstatements should be created. A corporate debt market unit should also be created. The market abuse unit should have a subunit devoted to alternative trading systems, dark pools, and other nonexchange platforms. The Foreign Corrupt Practices Act (FCPA) group should have expanded responsibility for all investigations of foreign issuers listed in the United States.

RECOMMENDATION 22—Use specialty staff to promote consistency throughout the Division. Eliminate dual reporting for regional staff assigned to specialty groups. Provide group leaders with broad oversight authority over all investigations relevant to their subject authority and responsibility for quarterly reviews. Permit defense counsel to request meetings with specialty teams to discuss relevant investigations conducted by other units.

SEC cooperation program—The SEC cooperation program is sound in principle, but it has failed to achieve the hoped-for results. Its use has been too limited and inconsistent. The effectiveness of the program will depend on companies understanding what is expected and having confidence that their cooperation will be recognized.

RECOMMENDATION 23—The SEC should update the Seaboard principles on voluntary cooperation and then commit itself to applying them whenever appropriate.

Continuing work on performance and management metrics is essential—The measurements principles articulated by Director Khuzami are a sound basis. However, the Division continues to rely on its old, and imperfect measures. Employees do what they are measured on. If the Division is committed to a program that places its highest priority on bringing important cases on a timely basis, then it must build its metrics to reflect this.

RECOMMENDATION 24—The Division must use its metrics consistently. It should refrain from issuing press releases that evaluate its performance based on the total number of cases and the amount of money ordered to be paid. Instead it should rely on measures of case importance and timeliness. Enforcement actions that duplicate parallel criminal actions, that are based on previous SEC actions, or that involve companies that are defunct or persons who are no longer registered or active should not be included in measures of performance. Statistics on money judgments should be based on the amounts paid, not the amounts ordered to be paid. Staff who conduct, complete, and close a thorough investigation that does not result in a recommendation for action when that is the appropriate action should also get positive recognition.

CONCLUSION

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 a convenient rationalization for poor performance. The goal of the regulator must remain the same—prevent frauds from occurring. When frauds happen, the regulator must detect them quickly and ameliorate the consequences of the misconduct.

Following the unprecedented series of apparent failures in detecting and promptly responding to misconduct, the Division of Enforcement has been the most ambitious unit of the Commission in attempting fundamental changes to fix its shortcomings. After slightly more than two years, Director Khuzami's changes appear promising, though it would be premature to conclude that they have been successful. The statistics are not definitive indicators and the persons interviewed uniformly believe that more time is needed. Most important, the changes made must continue into the future, beyond the tenure of the current leadership.

Even if the near future demonstrates the effectiveness of the organizational changes that have been made, further improvements can be made in the investigative process and the selection of cases. Most important, the Commission should reestablish that the primary purpose of its enforcement program is to regulate the capital markets and to support the regulatory agenda of the Commission.

Chapter Three: SEC RULEMAKING PROCESS—BUILDING A NEW PROCEDURAL MODEL

The 2009 Report focused on management of the SEC and three often-overlooked core regulatory functions. The report did not discuss the two areas of the SEC that traditionally have had the highest profile: the Enforcement program and the rulemaking function. Since 2009, these programs have received intense scrutiny from the media, the public, the courts, and Congress. Much of this scrutiny has been unfavorable and adverse, resulting in an unprecedented diminution in public confidence and respect for the SEC. Chapter Two of this report discussed the changes that have been made in the enforcement program at the SEC and included a series of recommendations for further changes. This chapter focuses on the rulemaking function.

To say that the capital markets of the United States are highly complex would be an understatement. The same would be true of the regulatory system for these markets and the participants in them. Since Congress created the Interstate Commerce Commission in the late 19th century, Congress has acknowledged that statutes cannot, and probably should not, be the sole legal authority governing the complex modern economy. Accordingly, Congress has preferred to set broad public policy by statute and delegate the technical implementation of this authority to regulatory agencies.

To say that the capital markets of the United States are highly complex would be an understatement. The same would be true of the regulatory system.

During the past decade, the SEC suffered an unprecedented series of judicial reversals of high-profile rules that it adopted. Notwithstanding the well-established principle of judicial deference to regulatory agencies concerning legal questions central to their regulatory expertise, the courts vacated Commission rules dealing with the regulation of hedge fund advisers, the regulation of mutual fund board chairmen, and the regulation of a shareholder's ability to nominate persons to corporation or mutual fund Boards. In vacating these rules, the courts of appeal published harsh opinions questioning the Commission's interpretation of its legal authority and the quality and sufficiency of the record compiled to justify the rule. In the process, they suggested that the Commission as part of its rulemaking process has to improve its use of empirical information when examining the regulatory questions; its process for assessing the costs of its rules; and its consideration of alternative approaches to address problems.

Industry criticism of Commission rules is not a new phenomenon. Virtually every Commission rule will generate some level of criticism over the need for the rule, the approach taken, or the costs of complying. In recent years, much of the criticism has focused on whether the Commission has focused too much attention and resources on short-term controversies and drafted rules that are too prescriptive. Congress has contributed to the problem. In the case of Dodd-Frank, it mandated that the Commission must adopt new rules covering a vast range of new responsibilities, some significant and some of questionable value, and do so in an unrealistically short time frame.

The purpose of this chapter is not to opine on whether the courts reached the right result on the challenged rules. Instead, this chapter attempts to identify problems in the rulemaking process that have contributed to the adverse judicial decisions. It contains specific recommendations to address the problems identified and improve the efficiency and effectiveness of the SEC.

SPECIFIC REQUIREMENTS OF THE RULEMAKING PROCESS

Over the years, Congress has imposed a variety of procedural limitations on the rulemaking process. These requirements or limitations are intended to ensure the procedural fairness, integrity, and transparency of the process. Increasingly, Congress has emphasized the importance of considering the costs and burdens that will be imposed in comparison with the anticipated benefits.

In 1946, the Administrative Procedure Act (APA) was enacted.[1] The APA requires agencies to publish in the *Federal Register* a notice of proposed rulemaking to provide the public an opportunity to comment.[2] Final rules are published in the *Federal Register* for at least 30 days prior to becoming effective, although shorter periods or immediate effectiveness is permitted under emergency circumstances.[3]

The Paperwork Reduction Act[4] imposes limitations on the ability of a Federal agency to require the submission of information. Before an agency adopts a rule requiring 10 or more persons to submit information, it must prepare a "paperwork burden" estimate and submit it for approval to the Office of Management and Budget (OMB). If an agency seeks to collect information by order or other method, it must also obtain OMB approval following a 60-day comment period. This limitation has been identified as a constraint on the capacity of the SEC to collect information needed to assess costs and benefits of proposed rules.[5]

The Regulatory Flexibility Act (Reg Flex)[6] requires agencies to consider the impact on small businesses of proposed regulations. Agencies must prepare and publish for comment an

1 5 U.S.C. §551.
2 5 U.S.C. §553(c). An agency may adopt certain types of rules without notice and comment.
3 5 U.S.C. §553(d)
4 44 U.S.C. §3501, et seq.
5 See *Report of Review of Economic Analysis Performed by the Securities and Exchange Commission in Connection with Dodd-Frank Act Rulemakings*, Office of Inspector General, U.S. Securities and Exchange Commission, June 13, 2011, p. 16. Available at: http://www.sec-oig.gov/Reports/AuditsInspections/2011/Report_6_13_11.pdf. (SEC IG Report)
6 5 U.S.C. §601 et seq.

initial regulatory flexibility analysis (IRFA) that describes the impact of the proposed rule on small entities. The IRFA must explain any significant alternatives to accomplish the same purpose that the agency has considered that would reduce the impact on small entities. A final regulatory flexibility analysis (FRFA) must be published when a rule is adopted that responds to any public comments concerning the IRFA.[7] Small entities that are adversely affected by the rule may seek judicial review of the FRFA for compliance with the Act.

Reg Flex imposes other duties on an agency. Twice annually, an agency must publish an agenda of all rulemaking activity. The agency is also required to review, within 10 years of adoption, any rule that is likely to have a significant economic impact on a substantial number of small entities to determine whether the rule should be amended.[8]

In 1996, Congress enacted the Small Business Regulatory Enforcement Fairness Act (SBREFA).[9] The Act requires the agency to submit a report to Congress and the Government Accountability Office (GAO) before the rule becomes effective. If the rule is determined to be a major rule, it may not be effective for a minimum of 60 days to enable congressional review. Congress may overrule the rule by a joint resolution.

In 1996, Congress made one other significant change that affected SEC rulemaking. The National Securities Markets Improvement Act (NSMIA) amended Section 2(b) of the Exchange Act by adding to the statutory mission of the SEC a responsibility to consider efficiency, competition and capital formation as part of the public interest finding in rulemaking.[10]

It is commonly believed that Congress has also imposed on the SEC an obligation to conduct a cost-benefit analysis as part of all rulemakings. In fact, there is no explicit statutory requirement. Instead, the Commission's responsibility to consider the costs and benefits of proposed rules is derived from a combination of partial responsibilities under the Reg Flex, the Paperwork Reduction Act, and SBREFA processes, and its statutory obligations to consider questions of efficiency, competition and capital formation as part of the public interest. While there is no express statutory obligation to conduct a cost-benefit analysis, the Commission agreed to adopt the process in a letter to Congress many years ago and the SEC Inspector General (IG) found that "the Commission's current rulemaking procedures are closely aligned with the requirements of the executive orders."[11] In fact, the Commission's internal procedures manual provides detailed guidance on what must be considered in the cost-benefit analysis.[12] Significantly, the internal procedures manual states that "there is no requirement that the SEC weigh the costs against the benefits, or conclude that the benefits outweigh the costs. An adopting release may state that the SEC's view is that the likely benefits justify the costs."[13]

7 An IRFA and FRFA are not required if the Chairman signs a certification that the rule will not have a significant economic impact on a substantial number of small entities. 5 U.S.C. §(b).

8 5 U.S.C. §610.

9 Pub. L. No. 104-121, Title II, 110 Stat. 847 (1996).

10 15 U.S.C. § 77b(b).

11 SEC IG Report, p. 41.

12 *Ibid.*, p. 8.

13 *Ibid.*, p. 9.

JUDICIAL SKEPTICISM OF THE SEC RULEMAKING PROCESS

The SEC has utilized its broad delegation of authority to adopt two volumes of regulations. While it has suffered reversals throughout its history, rarely has there been a time when it has suffered a series of judicial rebukes comparable to the recent past. It began with the D.C. Circuit's *Chamber of Commerce* decision in 2005 that vacated a Commission rule requiring mutual fund boards of directors to have an independent chair,[14] and continued in 2010 with the *NetCoalition* decision that vacated an SEC-approved New York Stock Exchange rule setting fees for specialized data services,[15] the *American Equity Life* decision that vacated a new Commission rule on fixed indexed annuity products,[16] and most recently in 2011 with the *U.S. Chamber of Commerce and Business Roundtable* decision that vacated its proxy access rule.[17] Significantly, in each decision the court did not conclude that the SEC had exceeded its authority. Rather, each decision found important flaws in the record and analysis supporting the rule.

Throughout its history, the SEC has rarely relied on quantitative analysis of data to guide its rulemaking process. Instead, it has focused on a legal analysis of the requirements of the law and its broad authority to proscribe or prescribe conduct. To the extent that it has sought empirical support for a rule, it has tended to rely on voluntary analysis submitted through the comment process following publication of a proposed rule. Typically, the Commission's proposing releases will identify empirical data and solicit responsive comments. This is especially true for rules that require forms to be filed with the SEC. In these cases, the proposing release will explicitly seek comment on its estimates of the "man hours" required to complete the proposed form and the cost of completion.

In the *Chamber of Commerce* decision, the court found that the Commission failed to meet its "statutory obligation to determine as best it can the economic implications of the rule."[18] In the *NetCoalition* decision, the court opined "For the reasons set forth below, we conclude that the SEC did not adequately explain the basis of its approval nor, on this record, support its conclusion with substantial evidence and, accordingly, we remand to the SEC."[19]

The 2011 *U.S. Chamber of Commerce and Business Roundtable* decision contained a particularly harsh review of the inadequacies in the rulemaking record: "Indeed, the Commission has a unique obligation to consider the effect of a new rule upon "efficiency, competition, and capital formation," 15 U.S.C. Section 78c(f), 78w(a)(2), 80a-2(c), and its failure to "apprise itself—and hence the public and the Congress—of the economic consequences of a proposed regulation" makes promulgation of the rule arbitrary and capricious and not in accordance with law."[20] The Court continued: "Here the Commission inconsistently and opportunistically framed the costs and benefits of the rule; failed adequately to quantify the certain costs or to explain why those costs could not be quantified; neglected to support its

14 *Chamber of Commerce v. SEC*, 412 F.3d 133, 143 (D.C. Cir. 2005).
15 *NetCoalition v. SEC*, 615 F. 3d 525 - Court of Appeals, Dist. of Columbia Circuit 2010
16 *American Equity Investment Life Insurance Company v. SEC*, 613 F.3d 166, 167–68 (D.C. Cir. 2010)
17 *Business Roundtable and Chamber of Commerce of the United States of America v. SEC*, No. 10-1305 (D.C. Cir. July 22, 2011).
18 *Chamber of Commerce v. SEC*, 412 F.3d 133, 143 (D.C. Cir. 2005).
19 *NetCoalition*, page 525.
20 *Business Roundtable and Chamber of Commerce*, p. 6.

predictive judgments; contradicted itself; and failed to respond to substantial problems raised by commenters."[21]

IS THE PROBLEM MERELY INADEQUATE ATTENTION TO THE COST-BENEFIT ANALYSIS?

In recent years, the Commission has attempted on occasion to conduct empirically based analysis. For example, in 2004 when the Commission proposed abolishing the "uptick rule" or price test for short selling, it adopted a temporary rule that would apply to a sample of 100 stocks.[22] The Commission then examined trading patterns in these 100 stocks and compared them with a cohort sample of stocks to determine whether elimination of the rule had any measurable impact on trading. The Commission also encouraged others to examine the trading patterns and data. In fact, four independent studies were conducted and submitted to the Commission as part of the notice and comment process. In 2010, following the "Flash Crash" of May 6, 2010, the SEC and CFTC jointly issued a detailed analysis of trading on that day.[23] The analysis conducted for the uptick rule and the Flash Crash report demonstrate that the SEC is capable of conducting this type of analysis. While the short sale rule is notable because of its effective use of a pilot project, it is also notable as an exception to standard Commission practice.

There are indications that the Commission has tried to improve the quality of its cost-benefit analyses. As previously described, the Commission's internal procedures manual includes a detailed description of the process and the need to consider quantitative and qualitative analysis of costs and benefits. A recent report by the SEC IG contains additional evidence of the increased attention. The report detailed how the Commission has made cost-benefit analysis an integral part of its rulemaking process. In fact, "The OIG's review concluded that a systematic cost-benefit analysis was conducted for each of the six rules reviewed. Overall we found that the SEC formed teams with sufficient expertise to conduct a comprehensive and thoughtful review of the economic analysis of the six proposed releases that we scrutinized in our review."[24]

Notwithstanding this increased emphasis on conducting a better cost-benefit analysis, these analyses have not withstood judicial scrutiny. The appellate decisions reversing SEC actions demonstrate the significance and the severity of the problem that the Commission faces in future rulemakings. A simplistic response would be to hire more economists so that there are a sufficient number to assign to all rulemakings. In fact, based upon the public statements of Chairman Schapiro and the Commission's FY2012 budget justification, one could conclude that the Commission has adopted this approach. If so, one should be wary of its long-term success. A larger number of economists at the SEC may be necessary, but simply hiring more of them may not be sufficient.

21 *Business Roundtable and Chamber of Commerce*, p. 7.

22 Exchange Act Release No. 50104 (July 28, 2004), 69 FR 48032 (Aug. 6, 2004).

23 Findings Regarding the Market Events of May 6, 2010: Report of the Staffs of the CFTC and SEC to the Joint Advisory Committee on Emerging Regulatory Issues. September 30, 2010. Available at http://www.sec.gov/news/studies/2010/marketevents-report.pdf.

24 SEC IG report, supra note 5, p. 42.

JUDICIAL REVERSALS OF SEC RULES MAY REFLECT A DEEPER PROBLEM: JUDICIAL SKEPTICISM OF A DEMONSTRATED NEED FOR THE RULE

While each of the appellate decisions highlighted previously found flaws in the cost-benefit analysis and record and used them to vacate the Commission's rule, the problem should not be viewed solely in terms of easily repairable problems in the preparation of the cost-benefit analysis. Instead it may reflect a broader problem that must be considered: the Commission's choice of rulemaking projects and whether it demonstrated that there is a substantial need for the rule as adopted. If the Commission had demonstrated a compelling case for the need and value of the rule's benefits, quantitatively and qualitatively, this information might have had an impact on how a court examined the record. In this respect, the Commission failed.

The proxy access rulemaking is one example. Over the past four decades, the Commission has considered on several occasions adopting a rule that would provide shareholders with an opportunity to directly nominate board directors via access to the company proxy. Each time the issue was considered, no final action was taken. On each occasion, controversy surrounded the need for and merits of the specific proposal, as well as concern that the SEC lacked the authority to adopt such a rule. Because of the controversy surrounding this issue, the Commission clearly understood that it would be subject to careful judicial scrutiny. It knew that the rule would likely be appealed to the Court of Appeals for the District of Columbia, where cost-benefit issues are a high priority. A careful reading of the adopting release for rule 14a-11, compared with Commission rulemakings over the past two decades, reveals that the cost-benefit analysis for this rule was more extensive than most. Clearly, the Commission tried to provide a record that would demonstrate that it had collected and analyzed the available data and given it careful consideration in its deliberations. However, it failed to persuade the court.

The Commission's failure to demonstrate the importance of the problem and the need for the rule must be considered in the context of the times. Following the 2008 financial crisis and the enactment of Dodd-Frank, the regulatory agenda of the Commission is undoubtedly larger and more substantial than at any other time in its history. With all of the clearly higher priorities confronting the agency, why was so much time and effort spent on a controversial rule to address a 30-year-old issue that has generated controversy and disagreement on every occasion when the Commission considered it? This point was made in a comment letter submitted to the Commission by a group of former senior SEC officials.[25]

Proxy access is not an isolated example of the problem of questionable regulatory priorities. Many of the people interviewed for this report suggested that the Commission has focused too heavily on responding to short-term pressures from key constituencies. Interviewees identified other examples of rulemaking efforts by the Commission in recent years that lacked urgency or importance, to other than a narrow constituency. These include the disclosure rules on risk-based compensation practices, expanded disclosure about the qualifications of director nominees, and corporate board diversity policies. While the Commission apparently believed

25 Comment letter on proxy access. The author of this report was one of the signatories to this letter. Available at: http://www.sec.gov/comments/s7-10-09/s71009-502.pdf.

that each new rule had merit, a number of people viewed these rules as cosmetic responses to pressure exerted by political or special interests. Moreover, they diverted the Commission from considering action in other related areas where a clear need is more immediate. For example, instead of acting on proxy access, the Commission could have used its time to consider reforming the well-known problems of processing actual shareholder proxy votes (the "proxy plumbing" problems), which were the subject of a 2010 concept release.

Another problem related to the choice of rulemaking priorities is the apparent tendency to prematurely decide upon one regulatory approach from a series of options. This tendency to focus on a specific issue and a specific response frequently can distort the objectivity of any cost-benefit analysis. Because a cost-benefit analysis of a proposed rule deals with a hypothetical impact, it is inherently subjective. As such, it will always be possible to control the results by one's choice of anticipated outcomes and by the assumptions that are made on how compliance will be achieved. Not infrequently, there will be more than one analysis of the same issue that reaches a different conclusion because of the choice of assumptions. If a clear preference exists for one regulatory approach, there will be a natural tendency to look for research that supports that position. By selecting one study and discounting conflicting studies, it is possible to support the result that is desired. In fact, the court in *Business Roundtable* highlighted this problem:

> The Commission acknowledged the numerous studies submitted by commenters that reached the opposite result. *Id.* at 56,762/2 & n.924. One commenter, for example, submitted an empirical study showing that "when dissident directors win board seats, those firms underperform peers by 19 to 40% over the two years following the proxy contests." Elaine Buckberg, NERA Econ. Consulting, & Jonathan Macey, Yale Law School, Report on Effects of Proposed SEC Rule 14a-11 on Efficiency, Competitiveness and Capital Formation 9 (2009), *available at* www.nera.com/upload/Buckberg_Macey_Report_FINAL.pdf. The Commission completely discounted those studies "because of questions raised by subsequent studies, limitations acknowledged by the studies' authors, or [its] own concerns about the studies' methodology or scope." 75 Fed. Reg. at 56,762–63 & n.926–28.
>
> The Commission instead relied exclusively and heavily upon two relatively unpersuasive studies, one concerning the effect of "hybrid boards" (which include some dissident directors) and the other concerning the effect of proxy contests in general, upon shareholder value. *Id.* At 56,762 & n.921 (citing Chris Cernich et al., IRRC Inst. for Corporate Responsibility, Effectiveness of Hybrid Boards (May 2009).[26]

The unfortunate result is that instead of the research guiding the result, the desired result guided the research. This problem cannot be fixed merely by hiring more economists. It requires decision makers who are prepared to make decisions based on the record, rather than preconceived beliefs, political interests, or the interests of vocal groups.

26 *Business Roundtable and Chamber of Commerce*, p. 11.

TRANSFORMING THE RULEMAKING PROCESS

TRANSFERRING THE COST-BENEFIT ANALYSIS FROM THE "BACK-END" OF THE RULEMAKING PROCESS TO THE "FRONT-END" OF THE PROCESS

When the Commission proposes a rule for notice and comment or adopts final rule, it issues a detailed statement known informally as a Commission release. These documents are lengthy, sometimes running to hundreds of pages. All rulemaking releases follow a standard organizational format. They begin with a summary of the rule, a history of the process, and an analysis of issues, including specific questions for public comment in a proposing release or detailed explanations of the issues raised during the comment process in an adopting release. After the substance of the rule has been addressed, the remainder of the release addresses each of the legal requirements, such as Regflex, PRA, SBREFA, and the cost-benefit analysis. Together, this information is known as the "back-end" of the release. Including the cost-benefit analysis in the back-end is emblematic of how the staff views the cost-benefit process. First, the rule-writing staff develops the rule. Then, after it is drafted, they ask the economists to conduct a cost-benefit analysis to support the rule.

The process should be reversed. While the cost-benefit analysis may continue to be placed in the back-end of the release, the research and analysis of costs and benefits should be placed at the front of the rulemaking process. The first step in any rulemaking project should be to collect data on the costs and benefits of different approaches to the regulatory problem. Then, on the basis of the data, the staff should develop the regulatory approach and draft the proposed rule that best addresses the problem at the lowest cost of compliance. This approach would require the economists to participate at the earliest stage of the process. It might require a project to compile quantitative data on the regulatory problem under examination. This might require a public request for comment—not on a proposed rule, but rather requesting information on industry practices and relevant data on costs associated with these processes. Alternatively, it might require a solicitation of data, in compliance with the PRA, from a number of affected persons or entities.

Implementation of this approach will be far more difficult than hiring additional economists for the RSFI division. It will require placing economists and other technical experts in the offices responsible for drafting rules. It will also require the staff and the Commission to exercise regulatory self-discipline and refrain from choosing a specific approach until after the analysis is performed.

RECOMMENDATION 25—The cost-benefit analysis should be an integral component at the earliest stage of the rule development process. The analysis should guide the regulatory process leading to a rule, rather than serve as an after the fact justification of the approach taken.

COMBINING COST-BENEFIT ANALYSIS WITH A "LOOK-BACK" PROCESS

There is one other structural problem that exists with cost-benefit analyses. While a cost-benefit analysis can be a useful component of the rulemaking process, it has limitations that are often overlooked. Cost-benefit analyses are and will always be fundamentally limited. They require estimates of the impact of events that have not yet happened. Even when the Commission undertakes a thorough analysis of the likely impact of a proposed rule, it will always be constrained by the uncertainty of not knowing exactly what will happen as a consequence of a rule. As the SEC IG described in his analysis of the risk retention rule mandated by Dodd-Frank, "The costs and benefits were set out separately for the various menu options. Commission staff stated that although they had extensive knowledge related to credit risk retention and felt very prepared when proposing the rule and performing the related economic analysis, they found it difficult to quantify associated costs and benefits and, as a result, provided primarily qualitative analysis."[27] Further, "Although Corporate Finance and Risk, Strategy and Financial Innovation staff stated that they made their best effort to qualitatively describe the costs and benefits of the proposed rule, neither was able to quantify the costs and benefits."[28]

Smart regulation requires a re-thinking of the process for developing and implementing regulations. A final regulation is the start of the process, not its completion. Simply put, it is difficult if not impossible for any regulator to know what will happen when a regulation is adopted. Capital markets are the reflection of large numbers of individuals making individual decisions. A regulator rarely has the capacity to predict with certainty how individuals or firms will respond to a new rule. If a regulator cannot predict the response, it is difficult to accurately quantify the cost of compliance or quantify the value of benefits before one knows how the industry will achieve compliance. The current means of developing cost-benefit analyses may be manipulated or fail to take into account facts that may not be readily apparent yet are important to the ultimate purpose of a proposed rule. For this reason, the Commission would be well served to consider an approach that combines a pre-adoption cost-benefit analysis with a post-adoption look-back requirement.[29]

Instead of assuming, as lawyers do, that rules are self-effectuating, the Commission should adopt a scientific approach: Consider rules as 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 Commission's Division of Risk, Strategy and Financial Innovation (RSFI) 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 Commission to accept a statement of anticipated consequences.

27 SEC IG Report, p. 21.
28 *Ibid.*, p. 22.
29 This approach was originally described in a letter to the editor of the *Wall Street Journal*. Jonathan G. Katz, "Letter to the Editor," *The Wall Street Journal*, August 8, 2006.

2. The RSFI division 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 RSFI 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 would be available in a published report for public notice and comment. Following the comment period, the Commission would then issue a statement on whether it will propose amendments to the rule, rescind the rule, or take no further action on the rule.

Under this approach, as an example, the Commission would collect data and re-evaluate a rule after a defined period—perhaps two years—to determine the effectiveness of a rule and the need to keep it on the books or modify it. Such a periodic check of all rules would also help to determine whether rules are obsolete.

To be effective, this look-back process must be rigorously conducted according to a clearly defined methodology. GAO has developed such a methodology[30] in the *Government Auditing Standards* (GAS, or the Yellow Book) that it applies when conducting a performance audit: "Performance audits are defined as engagements that provide assurance or conclusions based on an evaluation of sufficient, appropriate evidence against stated criteria, such as specific requirements, measures, or defined business practices."[31] The Yellow Book provides a clear methodology for conducting a study to assess the effectiveness of a program. It identifies four elements for measuring effectiveness:

1. ***Criteria*** – The legal or regulatory standards and other benchmarks of the expected outcome of the program or initiative.
2. ***Condition*** – A description of the situation as it currently exists.
3. ***Cause*** – A description of the reasons for the current state (condition) and the factors that explain why it differs from the desired condition.
4. ***Effect*** – The measurement of the difference between the condition (the situation as it exists) and the criteria (the desired or expected outcome).

This look-back process offers several advantages. In addition to compelling the staff to examine the rule's impact, it would fundamentally change how rules are developed. Knowing that 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 RSFI division and the Commission's chief economist will strengthen the role of economists during the early stages of drafting a rule. Because the staff drafting the rule will be aware that the RSFI division will be

30 This GAO methodology is thoroughly discussed in *Implementing Regulatory Harmonization*, an article by Professor Arthur B. Laby. Laby explains how the SEC could apply this approach to the study of gaps or deficiencies in the regulation of broker-dealers and investment advisers mandated by §913 of Dodd-Frank. I am indebted to Professor Laby for informing me of the GAO Yellow Book and sharing his article. 30 Annual Review of Banking and Financial Law 189(2010).

31 GAO, *Government Auditing Standards* 1 (GAO-07-731G 1), 2007, p. 17.

examining the rule after adoption, staff will ensure that the economists are actively involved in the analysis and proposing process at the earliest stages. This role likely will also influence how a rule is drafted so that it best addresses the concerns identified by the RSFI staff.

These recommendations will not result in more or less regulation; instead, they will achieve better regulation. Decisions should never be based on a bias toward more or less regulation. Regulation must be based on sound, fact-based understanding and intellectual honesty. Most important, it must recognize that a free market is always changing in ways that can rarely be anticipated. There will seldom 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. Regulation must be nimble, and regulators should never believe that they cannot or should not change as well.

RECOMMENDATION 26—The Commission should adopt a regulatory look-back requirement whenever it adopts a "major rule" as defined in the Small Business Regulatory Enforcement Fairness Act (SBREFA).

THE COMMISSION SHOULD INSPECT HOW THE EXAMINATION PROGRAM IMPOSES REGULATORY REQUIREMENTS AND REGULATORY COSTS OUTSIDE THE FORMAL RULEMAKING PROCESS

Through its rulemaking process, the Commission may require firms or companies to create and maintain internal record-keeping systems, to adopt specific prophylactic procedures, or to periodically report information to the SEC. When it does so by rule, the Commission must comply with the various procedural requirements contained in the PRA, SBREFA, and Reg Flex acts. The Commission must also be prepared to demonstrate that it has considered the rule's impact on competition, efficiency, and capital formation. However, the Commission also has the capacity to obtain data through its examination and enforcement programs.

Through its examination program, the Commission has broad authority to require regulated entities to provide any information they are required to maintain by Commission rule.[32] It has been the position of the Office of Compliance Inspections and Examinations (OCIE) that information requested through an examination is not subject to the Paperwork Reduction Act. On occasion, however, principally when conducting a "sweep examination," OCIE staff have made extensive data requests of a large number of entities, sometimes extending to 20 or more pages of questions that each require detailed answers or voluminous responsive data.[33] In some instances, the requests include information and data not required to be maintained by a Commission rule. Firms have indicated that their responses to these nonrule requests can be exceedingly expensive to prepare. However, unlike a rule proposal (which must consider the costs of compliance), there is no limiting cost-benefit analysis applicable to these examination demands.

32 See for example, §204 of the Investment Advisors Act.

33 Matthew Chamber and Kimberly Beattie, "The SEC's Investment Adviser Examination Program: A Proposal for Reform," *Wall Street Lawyer*, Vol. 11, Issue 12. December 2007.

In recent years, the Commission has increasingly relied on internal control type regulations to require firms to self-police. OCIE examinations of firm compliance with these rules have increasingly looked to whether a firm has adopted "industry best practices" for compliance. When a firm has adopted its own approach to compliance, it receives a deficiency letter based on its failure to adopt industry best practices. This results in the so-called best practice becoming a de facto regulatory requirement, without the procedural safeguards applicable to an APA rulemaking. While the development and use of so-called best practices is typically an attractive method of promoting regulatory compliance, care must be taken that adoption of these practices is viewed as voluntary and only one possible compliance technique. When a regulator takes the next step and views a best practice as the exclusive method of compliance, it has taken a step toward rulemaking.

RECOMMENDATION 27—Whenever the Office of Compliance Inspections and Examinations (OCIE) requests the same information from nine or more persons or entities through an exam or series of related exams, it should comply with the Paperwork Reduction Act.

RECOMMENDATION 28—While industry best practices may be effective techniques to promote regulatory compliance, the failure to adopt these practices should not be viewed as regulatory deficiencies. The Commission should mandate adoption of a best practice only through the rulemaking process.

Chapter Four: PROGRESS TOWARD IMPROVING THE EFFICIENCY AND EFFECTIVENESS OF THE SEC

THE SEC IN 2011

CHANGES IN LEADERSHIP

The leadership of the SEC has undergone a comprehensive turnover since the 2009 report. Mary Schapiro, then head of the Financial Industry Regulatory Authority (FINRA) and formerly an SEC Commissioner, became Chairman in 2009. While three of the four Commissioners predated Chairman Schapiro, their appointments were recent, beginning the summer of 2008.

Since her arrival, Chairman Schapiro has orchestrated a complete turnover among the heads of the operating divisions and the critical policy offices of the Commission. She has appointed new Directors of Corporation Finance; Enforcement; Investment Management; Trading and Markets; Office of Compliance Examinations and Inspections; and Division of Risk, Strategy, and Financial Innovation; a new General Counsel; a new Chief Economist; and a new Chief Accountant. She has also appointed new heads of several other offices, including the Office of Investor Education and Advocacy; a Freedom of Information Act and Privacy Act Officer; a new Ethics Counsel; and directors for the New York, Ft. Worth, Miami, and Atlanta regional offices. In addition, she created and hired the agency's first Chief Compliance Officer; named a new Chief Information Officer; and appointed a head of the Whistleblower Office mandated by Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank). Although Dodd-Frank created four other new offices, budget limitations have prevented her from appointing office heads. Finally, Chairman Schapiro filled the newly created position of Chief Operating Officer, effectively replacing the position of Executive Director.

BUDGET AND RESOURCES

The SEC's budget is determined annually by Congress. However, its budget is paid for with funding from two industry transaction fees. One fee is based on the value of securities traded in U.S. markets. In fiscal year (FY) 2011, the fee rate was set at \$19.20 per \$1 million in transactions. The second fee is based on the value of securities registered with the SEC. As of October 1, 2011, the fee will be reduced to \$114.60 per million from their current rate of \$116.10 per million. Both fee rates are adjusted annually to equal the SEC budget.

At an agency such as the SEC, which spends nearly 70% of its budget on salaries, a flat budget often results in a decline in staff size, as cost of living adjustments and other adjusted amounts must be accommodated.

Between 2000 and 2005, the SEC budget increased from $368 million to $888 million. Following three years of static budget, Congress again appropriated increases in 2009 and 2010, with the budget reaching $1.119 billion in 2010. The SEC has experienced this pattern of a large increase in funding, followed by years of flat budget, several times in the recent past. At an agency such as the SEC, which spends nearly 70% of its budget on salaries, a flat budget often results in a decline in staff size, as cost of living adjustments and other adjusted amounts must be accommodated. For example, when the SEC budget was frozen for a three-year period, FY 2005–FY 2007, staff size declined by 10%. As a result, the substantial budget increases in FY 2009–FY 2010 merely returned SEC staffing to FY 2005 levels. Similarly, the agency's investments in new or enhanced information technology (IT) systems declined about 50% from FY 2005 to FY 2009.

In addition to increased funding, in 2002 Congress provided the SEC with "pay parity," the authority to pay salaries comparable to those of the federal banking regulators. This change addressed the long-standing problem of employee pay limits that were grossly disproportionate to the industry regulated (and to the salaries at federal banking regulators). This disparity in employee salaries had contributed substantially to high turnover and a heavy dependence on professional staff that lacked experience and expertise in rapidly changing financial products and markets.

LEGAL AUTHORITY

In response to the scandals in the markets and the perceived failures of the SEC, Congress expanded the agency's authority. In 2002 it enacted the Sarbanes-Oxley Act and granted the SEC greatly expanded powers to regulate public corporations and auditors, and to impose enforcement sanctions. Implementation of the Act required the SEC to adopt an unprecedented number of complex new regulations in a short period. Then-SEC Chairman William Donaldson described this as the most extensive regulatory agenda since creation of the SEC in 1934.[1]

Following the financial crisis of 2008, Congress acted again, enacting the Dodd-Frank Act in 2010. While Sarbanes-Oxley mandated that the SEC engage in 19 rulemakings and conduct six staff studies in a short period,[2] Dodd-Frank mandated that the SEC undertake more than

1 Remarks before Financial Services Leadership Forum, William H. Donaldson, Chairman U.S. Securities and Exchange Commission. New York City, NY, September 27, 2004. Available at: http://www.sec.gov/news/speech/spch092704whd.htm.

2 Total rulemakings and staff reports included on the SEC website page titled Spotlight on Sarbanes-Oxley. Available at: http://www.sec.gov/spotlight/sarbanes-oxley.htm.

100 rulemakings and more than 20 staff studies, with statutory deadlines for virtually all.[3] The law also assigns the SEC additional responsibilities that will have a considerable long-term impact on the agency's resource needs. These new responsibilities include oversight of the over-the-counter derivatives market and hedge fund advisors; registration of municipal advisors and security-based swap participants; enhanced supervision of nationally recognized statistical rating organizations (NRSROs) and clearinghouses; greater disclosure and risk retention regarding asset-backed securities; and creation of a new whistleblower program.

Dodd-Frank also addressed several management issues. It directed the SEC to create five new Offices, four of which were required to report directly to the Chairman. It further directed that the Office of the Investor Advocate should have independent authority over its hiring, its budget, and its reporting to Congress.

The impact of Dodd-Frank on the agency will be substantial and long term. In its FY 2012 budget proposal to Congress, the SEC requested 468 new staff positions (60% of the staff increase it requested) to implement and enforce its new responsibilities under the Act. According to the budget request, "Many of these new positions would be used to hire experts in derivatives, hedge funds, data analytics, credit ratings, and other new or expanded responsibility areas, so that the agency may acquire the deeper expertise and knowledge needed to perform effective oversight."[4] In fact, the Act itself recognized the additional workload that the SEC will face and authorized an increase in the agency's budget from the $1.11 billion appropriated in FY 2010 to $1.3 billion in FY 2011, $1.5 billion in FY 2012, and $2.25 billion by FY 2015. Because these amounts represent an authorization of funding, they do not result in increased funding for the agency, which requires passage of an appropriations bill.

BOSTON CONSULTING GROUP'S INDEPENDENT MANAGEMENT REPORT

Section 967 of Dodd-Frank mandated that the Commission retain an independent management consultant, the Boston Consulting Group (BCG), to review the operations of the agency and recommend changes to improve its performance. Congress specified seven areas for the consultant to address:

1. The possible elimination of unnecessary or redundant units at the SEC;

2. Improving communications between SEC offices and divisions;

3. The need for a clear chain-of-command structure, particularly for enforcement examinations and compliance inspections;

4. The effect of high-frequency trading and other technological advances on the market and what the SEC requires to monitor that effect;

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3 Testimony on the President's FY 2012 Budget Request for the SEC, Chairman Mary Schapiro, U.S. Securities and Exchange Commission, Before the United States Senate Subcommittee on Financial Services and General Government, Committee on Appropriations, May 4, 2011, available at: http://www.sec.gov/news/testimony/2011/ts050411mls.htm ("Chairman's FY2012 budget testimony").

4 *Ibid.*

5. The SEC's hiring authorities, workplace policies, and personnel practices, including—

- whether there is a need to further streamline hiring authorities for those who are not lawyers, accountants, compliance examiners, or economists;
- whether there is a need for further pay reforms;
- the diversity of skill sets of SEC employees and whether the present skill set efficiently and effectively fosters the SEC's mission of investor protection; and
- the application of civil service laws by the SEC;

6. Whether the SEC's oversight and reliance on self-regulatory organizations (SROs) promotes efficient and effective governance for the securities markets; and

7. Whether adjusting the SEC's reliance on SROs is necessary to promote more efficient and effective governance for the securities markets.

Dodd-Frank required the Commission to hire a consultant within 90 days of enactment of the law and required the consultant to complete the report within 150 days of being hired. The Commission is required to provide Congress with reports on its implementation of recommendations every six months after publication of the report for a two-year period.

In response to the mandate, the Commission hired the BCG to perform the study. The consultant issued its report (BCG Report) in March 2011. On September 9, 2011, the Commission submitted to Congress its first report on implementation. The BCG Report contains a significant amount of timely data on current SEC operations, while refraining from providing specific recommendations to the SEC.

CHANGES IN OPERATIONS

The 2009 Report focused on the need for the SEC to carefully examine its internal operations and make fundamental changes to restore agency effectiveness. The report examined core regulatory programs and proposed specific changes in how these duties are performed. More than any other Chairman in recent memory, Chairman Schapiro has advocated for internal operational change and supported the efforts of her new appointees. While the 2009 Report examined and proposed changes to the regulatory divisions of the SEC, Corporation Finance (Corp Fin), Investment Management (IM), and Trading and Markets (T&M), the initial emphasis under Chairman Schapiro has been the examination and investigation functions, the Office of Compliance Inspections and Examinations (OCIE), and the Division of Enforcement.

Office of Compliance Inspections and Examinations

Office of Compliance Inspections and Examinations was created in 1995 by reassigning and consolidating the examination programs of IM and T&M (then known as Market Regulation). At that time, the rationale for the action was straightforward—a separate office would raise the profile of the examination function and improve coordination between the two separate programs. Sixteen years later, while the profile of the examination program is higher, the hoped-for synergies have been less certain. Moreover, the separation of examinations from the regulatory program has likely had an adverse effect on T&M and IM. For those reasons, the 2009 Report recommended reconsolidating the examination program with the regulatory divisions under a recommended reorganization of T&M and IM.

The highly publicized Madoff and Stanford cases provided a catalyst for change by the new Director of OCIE. The SEC has publicly described how it undertook an internal self-examination of OCIE in 2010 and initiated significant changes in every aspect of its examination program. Most important, it has announced the development of new risk assessment procedures and techniques to select firms for on-site inspection. OCIE created a central Risk and Surveillance Unit to analyze emerging risks among the registrant population. It also has begun emphasizing the review and analysis of information that financial firms submit before sending examiners on-site.

In an effort to improve its performance, OCIE has made significant changes in staffing, organization, coordination, and supervision. A category of senior specialized examiners has been created and people have been hired who have specialized experience in areas such as risk management, trading, operations, portfolio management, options, compliance, valuation, new instruments and portfolio strategies, and forensic accounting, and with expertise in financial products and techniques such as derivatives, structured products, and hedge fund activities. Organizationally, OCIE has established five new specialization working groups and created a process for quarterly reviews of the status of specific exams. To avoid a reoccurrence of the Stanford problem, exam staff are now empowered to go directly to senior management to appeal decisions not to pursue questionable contact. Exam teams are now being selected that cross over the traditional lines between the broker-dealer and the investment adviser/company staff.

Division of Enforcement

Enforcement has initiated more changes to its structure and procedures than any other SEC division or office. While some of these changes have been widely reported, others have not. The changes include:

- ***Specialization.*** Five national specialized investigative groups have been created dedicated to high-priority areas of enforcement: asset management (hedge funds and investment advisers), market abuse (large-scale insider trading and market manipulation), structured and new products (various derivative products), Foreign Corrupt Practices Act violations, and municipal securities and public pensions.
- ***Management restructuring.*** Enforcement adopted a flatter organizational structure by eliminating branch chief positions. It also tripled the number of full-time paralegals and support personnel to reduce the administrative burden on investigative staff. Internal processes were streamlined to make action memoranda shorter and less-time consuming to draft, review, approve, and calendar for Commission consideration.
- ***Office of the Managing Executive.*** This office was created to consolidate IT, workflow, management processes, data collection and analysis, human resources, and other administrative responsibilities. The office will be responsible for creating and collecting data needed to manage and supervise the staff.

- ***Office of Market Intelligence.*** This office serves as the central office for the handling of tips, complaints, and referrals; coordinating risk assessment activities; and supporting strategic planning activities. In a first for the SEC, the Federal Bureau of Investigation detailed an agent to work in the office temporarily.
- ***Elimination of unnecessary process.*** The Commission delegated to senior Enforcement staff the authority to issue formal orders of investigation (needed to issue a subpoena), file subpoena enforcement actions, and begin settlement negotiations involving monetary penalties.
- ***Whistleblower Office.*** This office was mandated by Dodd-Frank. It acts as the public point of contact for persons providing the Commission with information pursuant to the bounty program created by Dodd-Frank.
- ***Cooperation Program.*** Continuing an initiative begun in 2001, the Commission formally established incentives for individuals and companies to cooperate and assist with SEC investigations and enforcement actions.
- ***Evaluation metrics.*** The Division has revised the metrics it uses to manage and evaluate staff and office performance. Rather than relying on the total number of actions filed, the Division is using a combination of metrics that measure the significance of an enforcement action.

Division of Risk, Strategy, and Financial Innovation (RiskFin or RSFI)

The newest division of the SEC was created in 2009 by consolidating the Office of Risk, Strategy, and Financial Innovation with the Office of Economic Analysis (OEA). It has been a priority for Chairman Schapiro and has grown in size considerably since its creation. In 2008, RiskFin's last year as an office, it had shrunk to three staff (plus 22 staff in OEA). The FY 2012 budget request includes an increase of 32 positions for a total of 96 positions. The Commission's goals for this division are ambitious. In her congressional testimony, Chairman Schapiro described the purpose of the division as providing "sophisticated analysis that integrates economic, financial, and legal disciplines, and is re-focusing the agency's attention on and response to new products, trading practices, and risks. RiskFin has attracted renowned experts in the financial, economic, and legal implications of the financial innovations being crafted on Wall Street."[5]

Chief Operating Officer and SEC support offices

The Commission has made several administrative changes in its support office structure. In 2010 the Commission created a new position of Chief Operating Officer (COO) and assigned it supervisory responsibility over the Commission's IT office and its Freedom of Information Act office, and shared responsibility over its Office of Financial Management. Previously these functions reported to the Commission's Executive Director. One year later, with the departure of the Executive Director, that position was abolished and its responsibilities were transferred to the COO. In 2010, the Commission created a Chief Data Officer to coordinate the various IT programs and filing requirements so that information collected by the agency can be integrated

5 Chairman Schapiro, FY 2012 budget testimony, supra note 3.

into compatible databases. The agency also created a Chief Compliance Officer position within its Ethics Office to oversee employee compliance with financial transaction reporting.

To date there have been minor changes in the other principal divisions of the Commission.

Division of Corporation Finance

While not as heavily publicized as the changes in OCIE and Enforcement, Corp Fin made some changes to its operations in 2011. It created a new deputy director position for policy and capital markets, and added three new offices—the Office of Structured Finance, the Office of Capital Markets Trends, and a new group in disclosure operations that will focus on the largest financial institutions. The SEC FY 2012 budget request proposes adding 50 positions for a total of 539 positions. Forty staff would be assigned to disclosure review, and 10 would be assigned to rulemaking and interpretation.

Division of Trading and Markets

While T&M did not initiate any significant reorganization, it is the division most affected by the Dodd-Frank Act. The Act greatly expands SEC and T&M responsibility in the areas of oversight of the over-the-counter derivatives market; registration of security-based swap participants; and enhanced supervision of NRSROs and clearinghouses. T&M will also have primary responsibility for coordination with other federal financial regulators on the Financial Stability Oversight Council (FSOC) on topics such as the designation of systemically important nonbank financial entities and financial market utilities, and creation of mechanisms for the orderly liquidation of broker-dealers under the new liquidation authority afforded to FSOC and the Federal Deposit Insurance Corporation. Also, Section 916 of Dodd-Frank made significant changes in the review cycle for SRO rule filings. Not surprisingly, the FY 2012 SEC budget request proposes increasing the staff of T&M to 301 positions, an increase of 80 positions (60 full-time equivalents). Notwithstanding this substantial increase in responsibility and staff, T&M to date has not announced any significant changes in its organization.

Division of Investment Management

This Division also has expanded authority under Dodd-Frank, primarily pertaining to the registration and regulation of hedge fund advisors and the increased regulatory focus on money market funds. The SEC's budget request for FY 2012 proposes an increase of 31 positions for a total of 193 positions. These new positions would be added to the existing organization structure. While the Commission has apparently decided that it will not consolidate the OCIE examination programs into IM and T&M, the SEC congressional budget request notes that IM intends to use some of these new positions to create a program within the Division to conduct compliance inspections and examinations of investment companies and investment advisers, as required under Section 965 of Dodd-Frank. If this occurs, it will be interesting to see how this program is coordinated with OCIE examinations.

A LIMITED RESPONSE TO THE 2009 RECOMMENDATIONS

The financial crisis of 2008, followed closely by the Madoff and Stanford scandals, demonstrated that the SEC was not performing up to its historical standards. A new administration that was committed to reinvigorating the Commission appeared to provide a rare opportunity for a fresh approach and meaningful change. When the U.S. Chamber Center for Capital Markets Competitiveness published the 2009 Report, it appeared to be a well-timed opportunity to implement recommendations that would improve the Commission's efficiency and effectiveness.

Progress has been made since 2009, but the changes have largely been confined to Enforcement and OCIE. Less attention has been focused on the regulatory divisions—Corporation Finance, Investment Management, and Trading and Markets—the primary focus in the 2009 Report. While several recommendations have been adopted and some are under consideration, most of the 23 recommendations have not been implemented. The following is a summary of these recommendations and the progress that has been made since 2009. The complete set of recommendations, accompanied by an updated discussion, is included in Appendix A.

RECOMMENDATIONS ON STRENGTHENING MANAGEMENT, STRUCTURE, AND OVERSIGHT

The 2009 Report contained seven recommendations for strengthening the overall management, structure, and oversight of the SEC. Each of these recommendations was discussed, directly or indirectly, in the BCG Report. In fact, the BCG Report recommended that the SEC create a COO position, expand the breadth and depth of its staff by hiring professionals with expertise in economics and experience in the financial services industry, and create a knowledge management program. The BCG Report also positively discussed, while refraining from making a recommendation, several ideas addressed in other recommendations from the 2009 Report. Such ideas include: comprehensive reorganization of OCIE, IM, and T&M; the need for examination of the Commission's responsibilities vis à vis the SEC staff acting under delegated authority and the impact of the Government in the Sunshine Act; and ways of improving internal coordination between SEC divisions. The only recommendation not discussed fully concerned the importance of an accelerated conditional approval process for new investment products and services.

Since her arrival, Chairman Schapiro has publicly committed to increasing the number of nonattorney professionals on the staff. This is an important long-term change. However, it has been limited to date by the budget uncertainties at the SEC; by the historic difficulties in recruiting high-quality economists to an agency with a reputation for treating nonattorney professionals as second-class citizens; and by recent actions by the U.S. Office of Personnel Management to restrict the Commission's legal authority to recruit and hire people outside the cumbersome civil service recruitment and hiring process.

Unfortunately, there has been limited meaningful progress on the other recommendations. Although the Commission created a COO position, in fact it merely renamed the Executive Director position. Instead of a true COO as envisioned in the 2009 Report, the position actually is a Chief of Operations, responsible for the budget, IT, and support services.

EXEMPTIVE ORDERS UNDER THE INVESTMENT COMPANY ACT OF 1940

The Investment Company Act is a prescriptive and proscriptive law. It contains detailed legal requirements for investment companies offering shares to the public. These requirements concern the legal structure of an investment company, the process of offering shares to the public and redeeming those shares, restrictions on the investment decisions that may be taken, limitations on dealing with related entities, and requirements for disclosure of information to investors.

Because of the structure of the Investment Company Act, an important activity of the SEC's Division of Investment Management 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 numerous sections of the Investment Company Act. An SEC study of the Act identified 33 separate provisions that permit the SEC to grant an exemption.[6]

In addition to the specific grants of authority, Section 6(c) of the Investment Company Act provides the SEC with omnibus authority to grant exemptions from any requirement of the Act to one or more registrants, either by application and order or by the adoption of a rule or regulation. This broad authority is limited by only one requirement, a finding by the Commission that the relief is "necessary or appropriate in the public interest and consistent with the protection of investors and the purposes fairly intended by the policy and provisions of the title." Throughout its history, the Commission has used this authority to grant relief and adopt regulations concerning those statutory provisions that do not contain congressional authority for exemptions.

The 2009 Report described how even routine applications, requesting relief substantially identical to exemptions previously obtained by competitors, required time-consuming filings, lengthy individual staff reviews, and delays that stretched for months. Moreover, requests for novel relief or for exemptions needed to launch a new product or offer a new service could entail years of review and negotiation with the staff.

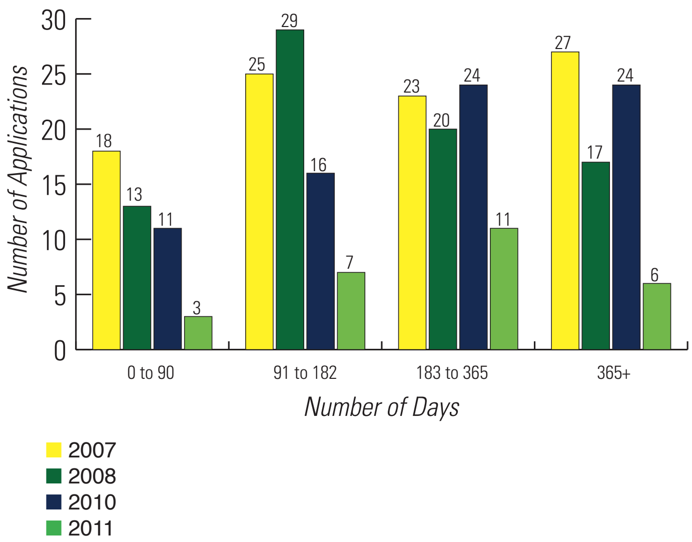
To demonstrate the extent of the problem, data were collected on all applications that were published for notice in the *Federal Register* in 2007 and 2008. The average and median number of days to process these applications were tabulated. The results demonstrated the extent of the problem. However, they also revealed an encouraging trend. Processing times in 2008 were better than in 2007.

6 *Protecting Investors: A Half Century of Investment Company Regulation*. Report of the staff of the Division of Investment Management of the U.S. Securities and Exchange Commission, May 1992, p. 503. ("1992 IM Study").

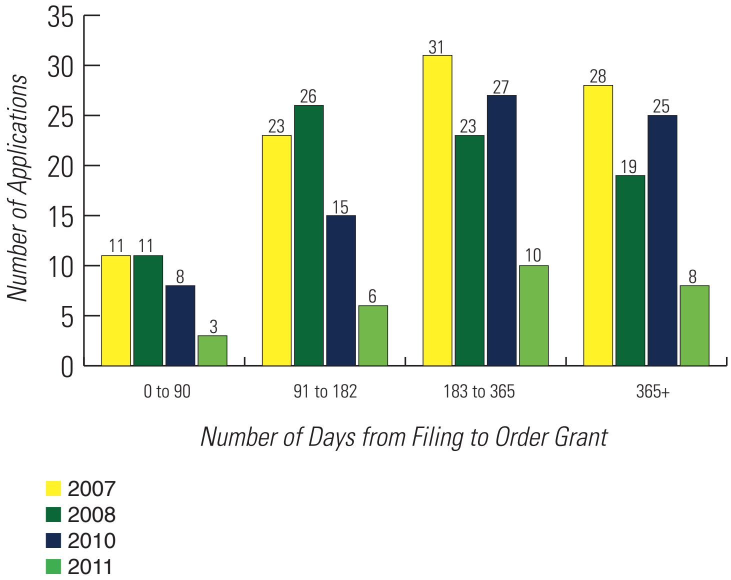
Table 4.1

Processing Time for Exemptive Order Applications

FILING TO NOTICE



FILING TO ORDER



The same analysis has been conducted for filings noticed in 2010 and 2011 (through August 7, 2011). Sadly, the progress made in 2008 has not continued. In fact, processing times in both years are dramatically longer than in 2007 and 2008. Moreover, 2011 is worse than 2010.

Table 4.2

Processing Time for Exemptive Order Applications

	Average time (Days)		Median time (Days)	
Year	**Filing to Notice**	**Filing to Order**	**Filing to Notice**	**Filing to Order**
2007	366.3	399.9	204.0	232.0
2008	286.1	312.3	162.0	190.0
2010	400.1	426.2	218.0	246.0
2011	409.5	436.0	259.0	284.0

While the longer processing times might be explained if the applications in 2010 and 2011 entailed a larger number of complex or novel issues, this is not the case. Every person contacted for this study who has knowledge of the process commented that, since the 2008 financial crisis, the Division has been reluctant to act on applications that involve complex or novel issues. Thus, it is likely that the applications included in the analysis for these years represent a simpler set of requests than those in the 2007 and 2008 sets.

The 2009 Report made four recommendations to improve the efficiency and effectiveness of the exemptive application process. To date the Division of Investment Management has not adopted any of these recommendations. As the statistics on processing time demonstrate, the size of the problem has grown since 2009.

REVIEW AND ACTION ON SRO RULE FILINGS

Section 19(b) of the Exchange Act requires each SRO to file proposed rule changes with the SEC, accompanied by a concise general statement of the basis for, and purpose of, the proposed change. The Exchange Act requires the SEC to examine whether SRO rules and practices are consistent with the Exchange Act and the goals of the national market system, including promotion of fair competition among markets, transparency of prices, best execution of customer orders, fair and orderly markets, and most important, investor protection. SRO rules also must be designed to prevent fraudulent and manipulative acts and practices and promote just and equitable principles of trade. Finally, the public notice and comment procedure ensures that interested persons have an opportunity to provide input into SRO actions that may have a significant impact on market participants and individual investors.

The 2009 Report described the process for SEC review and approval or disapproval of SRO rule filings as a paradox: "The Exchange Act creates an explicit timetable for completion of the process, yet it is rarely followed. Furthermore, both parties to the process, the SRO and the staff of the SEC, routinely express frustration over delays in the process, without making unilateral changes within their control."[7] The report described how numerous SEC staff reports, dating back over nearly 20 years, consistently highlighted the same set of problems with the process.[8] In 2008, an SEC Inspector General report on the SRO rule filing process found that "the Commission did not consistently finalize proposed rule changes within the statutory time frame set forth in the Exchange Act."[9]

Since the publication of the 2009 Report, there has been a significant change in the SEC review process. Section 916(a) of the Dodd-Frank Act made important changes in the statutory review procedures for SRO filings.[10] The Act created new processing deadlines, including a deadline for publication of proposals in the *Federal Register*, and a deadline for Commission approval or disapproval. It gave the Commission the option to disapprove summarily an SRO filing without the requirement for a hearing.[11] Any filing disapproved would become a final agency action that could be appealed to the appropriate U.S. Court of Appeals.

7 2009 Report, p. 50.
8 1994, the staff of the Division of Market Regulation (now Trading and Markets) published *Market 2000*, a comprehensive analysis of the U.S. equity markets and the regulatory issues that must be addressed. In its discussion of the process for SEC review of SRO rule changes, the report stated, "The SROs have complained that the rule filing process is too lengthy and places them at a competitive disadvantage to PTSs [proprietary trading systems] … which are not subject to section 19(b). The SROs claim that the process hampers their efforts to provide prompt, flexible, and innovative order-entry and trading services to their members and the investing public…. The NYSE [New York Stock Exchange] further recommends that only rule filings that present genuine investor protection concerns should be subject to the pre-effective review process" (2009 Report, p. 50). These comments from 15 years ago could have been made today. In fact, they closely reflect the opinions expressed in interviews for this report. The only significant difference is that today the competitors include foreign markets, as well as U.S. alternative trading systems.
9 U.S. Securities and Exchange Commission, Office of the Inspector General, SRO Rule Filing Process, at 7 (March. 31, 2008). http://www.secoig.gov/Reports/AuditsInspections/2008/438final.pdf. [2008 SEC Inspector General Report].
10 Appendix A includes additional information on the processing deadlines contained in §916(a).
11 15 U.S.C. 78s(b)(2)(C)(ii). For an example of a Commission order of disapproval with a hearing, see Release No. 34-63885; File No. SR-FINRA-2010-055, February 10, 2011, Financial Industry Regulatory Authority, Inc.; Order Disapproving Proposed Rule Change to Amend FINRA Rule 6140 (Other Trading Practices).

As many people have noted over the years, the SEC is "over-lawyered." It relies on lawyers to perform tasks that may not be best suited to a lawyer's analysis.

These statutory changes substantially address three of the seven recommendations on SRO filings in the 2009 Report. It is too soon to assess the impact of the Dodd-Frank changes on the speed of Commission review. Anecdotally, however, the changes appear to have improved the process, particularly the change that requires the Commission to publish a filing for notice within 15 days of website posting.

However, several of the problems that were discussed in the 2009 Report and formed the basis for two recommendations persist.

One recommendation proposed the creation of an expedited conditional approval process for SRO applications for new products or services, analogous to the recommendation on exemptive applications. In an era when stock exchanges are for-profit competitors with each other and a wide array of trading platforms are subject to lesser regulatory standards, it is essential that the SEC support innovation and competition. An expedited conditional approval process would enable the Commission to accomplish this, while continuing to meet its statutory obligations.

The other recommendation that persists form the 2009 Report was that T&M implement a dual review process for SRO filings. As many people have noted over the years, the SEC is "over-lawyered." It relies on lawyers to perform tasks that may not be best suited to a lawyer's analysis. Nowhere is this more evident than in the review of SRO filings. While the review of every filing must include, as one component, a legal analysis and determination that the filing is consistent with the principles of the Exchange Act, this should be viewed as merely one component of the review, rather than the full scope of the review. People who understand the inner workings of highly complex automated trading platforms and back-office trade processing must examine filings that deal with important, highly technical issues such as trade routing and processing, or clearance and settlement. Controversial proposals concerning the fees that exchanges charge for services should be examined by lawyers who consider the Commission's statutory obligations to promote open competition. Nevertheless, this legal conclusion must consider and incorporate an economist's analysis and perspective.

While T&M has not publicly indicated the formal adoption of this strategy, persons outside the agency with firsthand knowledge of the current review system indicate that some offices in T&M have begun to utilize a form of the "two sets of eyes" approach. The Office of Trading Practices and Processing within T&M, which reviews filings submitted by the securities clearance and settlement organizations, has constructed a small group composed of people with operational expertise who play an active role in the review filing process. The Office of Market Supervision, the office in T&M with authority over SRO filings from the exchanges and FINRA, has not yet adopted this approach. Anecdotally, those interviewed report that a small number of significant filings are considered by Division staff with nonlegal backgrounds, when deemed appropriate.

SEC STAFF NO-ACTION LETTERS AND INTERPRETIVE GUIDANCE

Since its inception in 1934, the SEC, through its divisions and offices, has routinely provided informal guidance and administrative interpretations of the securities laws and regulations to members of the public, prospective registrants, and others. This informal assistance has been used to provide clarity on the applicability of the securities laws and SEC regulations to particular situations and to assist the public in complying with the law.[12] While the SEC has been criticized occasionally for its frequent use of informal guidance to create a body of "informal regulations," informal guidance has become an important vehicle for advising the public and regulated industries of SEC staff positions and interpretations. The critical challenge is creating and implementing informal processes that provide prompt and useful guidance without overstepping boundaries and creating or altering regulatory policy. For an agency that is often criticized for "regulating through enforcement," regulatory procedures that promote prophylactic compliance are an essential complementary function to effective enforcement.

The 2009 Report identified several important problems in the current process, including excessive delay in processing requests, inconsistencies between SEC divisions on the general applicability of no-action letters, confusion in the use of no-action letters and exemptive orders, and important legal problems when staff no-action letters become *de facto* regulatory policies. This last issue encompasses important questions on the role, relationship, and responsibilities of the staff and the five Commissioners to set and interpret policy. Six recommendations in the 2009 Report were designed to improve access to informal staff guidance and, at the same time, clarify the distinction between informal interpretive guidance and formal agency regulatory action. To date the Commission has not acted on these recommendations. As the relationship between the Commission and the staff is identified as a priority issue in the BCG Report and the SEC Report to Congress on implementation, consideration of these recommendations may yet occur.

CONCLUSION

Since 2009, significant changes have been made in the operations of the Divisions of Enforcement and OCIE. The same cannot be said for the three regulatory divisions, to which most of the recommendations in the 2009 Report are directed. The statistical information on IM processing of exemptive applications and the comments of people interviewed on no-action letters in Corp Fin indicate that the problems identified in the 2009 Report are more substantial in 2011. It is hoped that the three regulatory divisions will give some attention to these recommendations or develop their own ideas on how to improve the efficiency and effectiveness of these core functions.

12 17 C.F.R. § 202.2 (2008).

Appendix A: DETAILED SUMMARY AND UPDATE OF THE 2009 REPORT RECOMMENDATIONS

A great deal has happened at the SEC since the 2009 Report was written. The SEC under Chairman Schapiro has been open to change and fresh thinking. However the changes have largely been confined to the Divisions of Enforcement and the Office of Compliance Inspections and Examinations (OCIE). Less attention has been focused to date on the regulatory divisions—Corporation Finance, Investment Management (IM), and Trading and Markets (T&M)—the areas of primary focus in the 2009 Report. While several recommendations have been adopted and some are under consideration, most of the 23 recommendations have not been implemented.

The 23 recommendations contained in the 2009 Report are restated below. Under each recommendation there is a brief explanation of the reasons for the recommendation as well as updated information on the underlying problem. The current status of each recommendation is provided—implemented, partial or proposed implementation, or not implemented.

RECOMMENDATIONS ON STRENGTHENING MANAGEMENT, STRUCTURE, AND OVERSIGHT

RECOMMENDATION 1—The Division of Trading and Markets and the Division of Investment Management should be realigned into a Division of Investor Protection and Retail Financial Services Regulation and a Division of Market Oversight and Operations. The Examination Programs of the Office of Compliance Inspections and Examinations (OCIE) should be assigned to these new divisions.

Status—Not implemented.

The Boston Consulting Group (BCG) Report, prepared in response to Section 967 of Dodd-Frank, discussed SEC reorganization options at length. BCG discussed three possible options for reorganization, without recommending one to the Commission. They included the realignment proposed in the 2009 Report as one of the options.[1] On September 9, 2011, the Commission submitted to Congress its report on the steps it has taken in response to the BCG Report.[2] In this report the SEC identified agency reorganization as a high priority. However the initial focus of the effort will be on the Office of Administrative Services, Office of Financial Management, and

1 BCG Report, p. 89.
2 Report on the Implementation of SEC Organizational Reform Recommendations, Staff of the Office of the Chief Operating Officer of the U.S. Securities and Exchange Commission. September 9, 2011.

Office of Human Resources. The report makes no mention of reshaping either Investment Management or Trading and Markets.

While BCG declined to voice an opinion on the consolidation of OCIE with the regulatory divisions, Congress provided its own guidance in Dodd-Frank. Section 965 of Dodd-Frank explicitly states that IM and T&M must have a staff of examiners that "perform compliance inspections and examinations of entities under the jurisdiction of that Division and report to the Director of that Division." A person reading this provision would assume that compliance would require the SEC to eliminate OCIE and reassign the staff into T&M and IM. Of course, that hasn't happened. As the BCG Report explains, the SEC has determined to comply with Section 965 through a cosmetic change, rather than a meaningful change. "SEC management believes that the most effective and efficient means of implementing Section 965 would be to have a coordinating committee between OCIE, T&M, and IM and have a limited number of examiners in T&M and IM whose function would include liaising with OCIE and supporting the coordinating mechanisms noted above."[3] The BCG Report also states that the efforts to reshape OCIE have been completed, which suggests that a consolidation of that office with the regulatory divisions is unlikely.[4]

RECOMMENDATION 2—The SEC should create an accelerated conditional approval process for new investment products or services.

Status—Not implemented.

The 2009 Report described at length how the review process for new investment products has historically been lengthy and cautious. The report described how approval of the first exchange-traded fund came after more than four years of review. Recent efforts at next-generation exchange-traded funds based on actively managed funds, containing innovative ideas on pricing, continue to require lengthy and extensive review by both Investment Management and Trading and Markets.[5]

While the goal of promoting capital formation continues to be a priority for the Commission, it does not appear that this recommendation is being given serious consideration. In fact, several persons interviewed for this report commented that after 2008, the Commission's staff have become even more cautious and are unwilling to provide approvals for virtually any new products that require some form of Commission action.

3 BCG Report, page 45, footnote 86.
4 Refer to §965 of Dodd-Frank.
5 See e.g. Eaton Vance Patent Gives Birth to ETF-Fund Hybrid, Ignites, Jackie Noblett August 12, 2011.

RECOMMENDATION 3—The five-member Commission should play a greater ongoing role in the interpretation and application of regulatory policy. This may require Congressional action to amend the Government in the Sunshine Act (Sunshine Act) that was passed in 1976 that, among other requirements, mandates that every portion of every meeting of an agency shall be open to public observation. Although the Sunshine Act was developed to create greater openness in government, it has had the unintended consequence of restricting valuable communications between commissioners and SEC Staff.

Status—Not implemented but under consideration.

The 2009 Report focused on core functions in the three regulatory divisions, Corporation Finance (Corp Fin), Investment Management, and Trading and Markets (T&M). Because the recommendations made in that report were tailored to improve the efficiency of a specific core function, each set of recommendations was different in some material respect. However, embedded in each set of recommendations was a procedure that would provide an increased role for the five-member Commission on issues involving questions of regulatory policy rather than the application of policy. This reflected a view that the five-member Commission had, over time, become too removed from large areas of SEC responsibility. Many factors have contributed to this separation of staff and Commission, including the ever-increasing volume of agency work, its complexity, and the staff's extensive use of authority delegated from the Commission.

However the single most important contributing factor has been the Government in the Sunshine Act (Sunshine Act) enacted in 1975. 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 10 categories excepted from the public meeting requirement. Virtually every Commissioner who has served during the past three decades 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 the Commission's limited role has been the transfer of a significant amount of responsibility for setting policy from the commissioners, acting as a collegial bipartisan body, to the division directors, who personally report directly to the chairman. As one Commissioner suggested sarcastically at a Commission meeting, "The securities bar doesn't want to know what I think; they want to know what the chief counsel thinks."

A common theme in the discussion of no-action letters, exemptive applications, and self-regulatory organization (SRO) filings is the reestablishment of a policy role for the Commission. While it is hoped that each recommendation, if adopted, would be successful in reestablishing the Commission as the final authority on regulatory policy, there is a simpler and more effective solution. The SEC, likely with the support of other federal regulatory agencies, should request that Congress amend the Sunshine Act to provide each agency with sufficient flexibility to meet regularly with its own staff in nonpublic meetings to discuss the interpretation of agency regulations and the application of these regulations to decisions that have been delegated to the staff.

While an amendment to the Sunshine Act requires Congressional action, the recommendations on IM exemptive applications, T&M review of SRO rule filings, and Corp Fin interpretive guidance do not require Congressional action. In this regard, the BCG Report recommended that the Commission undertake a review of the current Commission/staff interaction process and the formal delegations of authority.[6] In its report to Congress on implementation of the BCG Report, the Commission stated that this subject would be one of its "workstreams."[7]

RECOMMENDATION 4—The SEC should create a Chief Operating Officer (COO) position with sufficient authority to oversee daily operations throughout the SEC.

Status—Partial implementation.

The 2009 Report explained that "this recommendation may be the most radical proposal in this report."[8] It would fundamentally change the responsibilities of every division director and senior officer at the SEC. It would also enable the Chairman to perform the CEO responsibilities and provide a degree of consistency and uniformity to SEC operations that has been absent for much of its history.

As discussed, the four primary operating divisions of the SEC, 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 those of the other operating units. While the Chairman is informed of significant activities and has the opportunity to control any decision, this is often a reactive—not proactive—process. The division directors largely control what is presented to the Chairman or the Commission.

The Commission has taken some action on this recommendation. In 2010 a Chief Operating Officer (COO) was appointed. Following the resignation of the Commission's Executive Director in 2011, the various support office functions, such as financial management and human resources, were consolidated under the COO. In effect the Commission's COO is really a chief of support operations, the same role the Executive Director performed. As a result, the COO will be unable to oversee the day-to-day operations that are often overlooked by division directors focused on setting policy. This reduces the potential for the COO to address many of the management problems that historically have adversely affected agency efficiency and effectiveness.

Instead of empowering the COO to oversee all day-to-day functions not involving policy questions, the Commission has adopted a slightly different model. It has created the equivalent of a chief management officer within each division. This is an option that was discussed in the 2009 Report. Because these positions are new and evolving it is difficult to assess whether this approach will be effective. For example, it may be that a division-level manager acting with the

6 BCG Report, p. 102.
7 SEC Report to Congress on BCG Report, p. 18.
8 2009 Report, p. 18.

full support of the division's director and devoted to the specific functions of that division may be in a better position to make changes in operations to improve efficiency. Such a person, having a full understanding of the requirements of the division, may also be better able to develop effective standards and metrics to measure individual and office performance.

A more likely outcome is that a manager responsible solely for a single division will be less likely to promote change and more inclined to defend the status quo. For example, any performance metrics will necessarily become the standards used to measure the division and its director. This of course would lead to the use of those measures that make the division look the best, even if they are not the most appropriate. This problem is demonstrated by the metrics that the SEC has used over several years in its strategic performance plans. In these plans each division has been responsible for choosing its performance standards, collecting the necessary data, and determining whether the numbers demonstrate superior performance. Not surprisingly, this method has resulted in a series of performance plans that are uniformly self-congratulatory, even during periods when the Commission's performance has not been superior.

RECOMMENDATION 5—The SEC should establish a coordinating council, chaired by the COO, to resolve issues or disagreements involving more than one division or office.

Status—Not implemented.

This recommendation, in conjunction with recommendation 4, is designed to deal with the recurring problem of inter-divisional gridlock that causes novel ideas or difficult questions to languish. The BCG Report spoke positively about the efforts of Chairman Schapiro to improve coordination and communication at the SEC through the use of issue-specific coordinating committees and work groups.[9] While the BCG description emphasized the positive benefits of communication and coordination, it was silent on whether these committees were empowered to resolve disputes or provide a vehicle for reaching agreement on regulatory issues that require joint coordinated action by more than one office or division.

Every person in the financial services industry who was interviewed for this study was asked a question about inter-division coordination at the SEC. The responses consistently indicated that access to Commission staff in any one division was typically not a problem (or was at the least improving). However, if a question required a joint answer from more than one division, obtaining a single coordinated answer continues to be a problem. Many reasons were suggested. Frequently the people interviewed explained that the problem was due to conflicting statutory frameworks or inconsistent regulatory policies. Occasionally they suggested that the staff, post the 2008 financial crisis, were "gun shy" on any subject that might appear to be similar to a problem in 2008. Invariably, interviewees described making progress with each division separately, only to be unable to get the two divisions to act together. This is exactly the problem that a formal Coordinating Council could solve. For this reason, it is recommended that the Commission's initiative to promote effective coordinating groups should evolve into a tool that can drive resolution of these issues.

9 BCG Report, page 158.

RECOMMENDATION 6—The SEC should expand the breadth of its staff expertise. Legal and accounting expertise should be complemented with staff experts in capital markets operations and the business operations of regulated entities, as well as financial economics.

Status—Implemented.

In several of her earliest public statements Chairman Schapiro expressed strong support for expanding the breadth of expertise on the Commission's staff by hiring more economists, as well as persons with financial services industry expertise, risk management abilities, and other skills that could improve the quality and sophistication of the Commission. The decision to merge the Office of Risk, Strategy, and Financial Innovation (RSFI) with the Office of Economic Analysis and elevate the combined unit to division status was an important symbolic action, although many believe it had the reverse effect of diminishing the status and role of the Office of Economic Analysis.

It is noteworthy that the SEC used a significant portion of its funding increases in FY 2010 and FY 2011 to hire people with these qualifications. In FY 2008 the RiskFin and Economic Analysis offices had a combined total staff of 25. In FY 2011 the RSFI division has a staff of 64, and the Commission proposes in its FY2012 Congressional budget request to increase the staff to 96.

To maximize the benefits from hiring staff with a broader range of expertise, it is important that they not be confined to a single unit that is isolated from the staff in other divisions. While statistics are not publicly available on the number of non-attorney professionals hired and assigned to work in the operating divisions, anecdotal information suggests that there has been progress, most notably in Trading and Markets and OCIE.

Historically, it was extremely difficult under Office of Personnel Management (OPM) civil service regulations for the SEC to recruit professionals with expertise in financial markets. To remedy this problem the Dodd-Frank Act provided the SEC with excepted service hiring authority (ESHA) to hire experts in these areas.[10] Under ESHA the SEC can hire qualified persons without following the multitude of OPM procedural requirements. Unfortunately this progress may be short-lived. While Chairman Schapiro has publicly supported the initiative, OPM has intervened in a way that severely undermines the initiative. Using its authority to monitor agency personnel practices, it has rescinded ESHA for the SEC.

RECOMMENDATION 7—The SEC should develop a knowledge management program to transfer information and expertise between divisions, preserve the knowledge and experience of departing staff, and provide future staff with ready access to materials explaining and documenting the analysis and reasons for actions taken or not taken.

Status—Implementation proposed.

Knowledge management is a broad concept, encompassing the need to preserve and memorialize information and expertise and make it available to other staff, now and in the

10 §929G, Dodd-Frank.

future, both in substantive knowledge of the securities markets and in the best methods for doing a job. As anyone familiar with the SEC knows, its greatest resource is the individual and collective knowledge and expertise of its staff. Because the SEC historically has had a high turnover rate, it has routinely been faced with the challenge of preserving the expertise of key staff, transferring it to new staff, and exchanging it among staff working in separate offices or performing different functions.

The BCG Report recommended creation of a knowledge management program at the SEC,[11] and the SEC has indicated that it is committed to its implementation as part of a broad training program under the direction of the Commission's new Chief Learning Officer.

Chapter One, "Transforming the SEC" recommends the inclusion in a knowledge management program of two components—an internal "autopsy" program and a "red flag" program.

EXEMPTIVE ORDERS UNDER THE INVESTMENT COMPANY ACT OF 1940

RECOMMENDATION 1—An expedited process should be created for routine exemptive applications that mirror prior exemptive orders. Applications that contain a factual certification from the applicant and a legal counsel certification that the application is consistent in all material ways with applications previously approved would be eligible for expedited action. A single weekly summary Federal Register notice would be published for all eligible filings. The weekly notice would contain a hyperlink to each application included. If no requests for hearing are submitted and the staff has concluded that the certifications in the application are sufficient, approval orders would be issued immediately following the expiration of the notice period.

Status—Not implemented.

RECOMMENDATION 2—Incomplete applications would be rejected with "bedbug letters," consistent with published standards explaining the grounds for rejecting deficient filings.

Status—Not implemented.

RECOMMENDATION 3—Internal compliance deadlines should be adopted for staff review and action, and apply to applicant responses or revisions based upon staff comments.

Status—Not implemented.

The Investment Company Act is a prescriptive and proscriptive law. It contains detailed legal requirements for investment companies offering shares to the public. These requirements concern the legal structure of an investment company, the process of offering shares to the public and redeeming those shares, restrictions on the investment decisions that may be taken,

11 BCG Report, p. 57.

limitations on dealing with related entities, and requirements for disclosure of information to investors.

Because of the structure of the Investment Company Act, an important activity of the IM Division 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 numerous sections of the Investment Company Act. An SEC study of the act identified 33 separate provisions of the act that permits the SEC to grant an exemption.[12]

In addition to the specific grants of authority, Section 6(c) of the Investment Company Act provides the SEC with omnibus authority to grant exemptions from any requirement of the act to one or more registrants, either by application and order or by the adoption of a rule or regulation. This broad authority is limited by only one requirement, a finding by the Commission that the relief is "necessary or appropriate in the public interest and consistent with the protection of investors and the purposes fairly intended by the policy and provisions of the title." Throughout its history, the Commission has used this authority to grant relief and adopt regulations concerning those statutory provisions that do not contain congressional authority for exemptions.

One former senior official in the IM Division, now in private practice, explained the significance of exemptive authority to regulation. "I think it is fair to say that, without that exemptive authority, the Investment Company Act would have become irrelevant or at least the investment company industry would have become irrelevant by 1960 or 1970. Instead, we have a vibrant investment management industry, investors enjoy access to variable annuities, money market funds, multiple classes, funds of funds, ETFs, all of which wouldn't have happened without the existence and use of this exemptive authority, and they have the opportunity to select among classes which allows them to pay fees for services in a variety of ways."[13]

The 2009 Report described how even routine applications, requesting relief substantially identical to that granted to competitors, required time-consuming filings, lengthy individual staff reviews, and delays that stretched on for months. Moreover, requests for novel relief or for exemptions needed to launch a new product or offer a new service could entail years of review and negotiation with the staff.

To demonstrate the extent of the problem, data was collected on all applications that were published for notice in the *Federal Register* in 2007 and in 2008. The average and median number of days to process these applications was tabulated. The results demonstrated the extent of the problem. However, it also revealed an encouraging trend. Processing times in 2008 were better than in 2007.

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12 *Protecting Investors: A Half Century of Investment Company Regulation*. Report of the staff of the Division of Investment Management of the U.S. Securities and Exchange Commission, p. 503, May 1992 ("1992 IM Study").
13 Martin Lybecker. This quotation is contained in an oral history roundtable sponsored by the SEC Historical Society on June 5, 2008. Available at: http://www.sechistorical.org/collection/programs/transcripts/Transcript_2008_0605_AM.pdf.

The same analysis has been conducted for filings noticed in 2010 and 2011 (through August 7, 2011). Sadly, the progress made in 2008 has not continued. In fact processing times in both years are dramatically slower than in 2007 and 2008. Moreover, 2011 is worse than 2010.

Table A.1

Processing Time for Exemptive Order Applications

Year	Average time (Days)		Median time (Days)	
	Filing to Notice	Filing to Order	Filing to Notice	Filing to Order
2007	366.3	399.9	204.0	232.0
2008	286.1	312.3	162.0	190.0
2010	400.1	426.2	218.0	246.0
2011	409.5	436.0	259.0	284.0

While the longer processing times might be explained if the applications in 2010 and 2011 entailed a larger number of complex or novel issues, in fact this is not the case. Every person contacted for this study who has knowledge of the process commented that since the 2008 financial crisis the Division has been reluctant to act on applications that involve complex or novel issues. Therefore, it is likely that the applications included in the analysis for these years represent a simpler set of requests than those included in the 2007 and 2008 sets.

Recommendations 1, 2, and 3 offer an approach that, if implemented, could reduce the time to slightly more than one month for routine applications. It would also reduce the workload and enable the existing staff to focus on the more complex applications.

RECOMMENDATION 4—Expanding the use of exemptive rules could substantially reduce the number of routine applications. Reassigning rule-writing authority for exemptive rules to the same staff that acts on exemptive applications would eliminate the organizational impediment that historically has hampered the rule development process.

Status—Not implemented.

As previously discussed, a substantial proportion of the Investment Management division's workload in this area involved consideration and action on applications that are substantially the same as requests previously made and granted. This is a distortion of a process that Congress intended to be used for individual requests, not the adoption of general policy. When an agency determines to establish rules of general applicability it should engage in rulemaking. As described in the 2009 Report, the Commission has on many occasions drafted and adopted rules to codify a series of exemptive orders, eliminating the need for future applications and providing consistent treatment for all similarly situated entities.

The use of rulemaking to reduce the number of exemptive applications has been proposed on many occasions. In fact it has been identified as a priority initiative in the SEC Strategic Plan. In 2006, the SEC Inspector General (IG) found that as of the end of FY 2005, approximately 24 fund of funds, cash sweep, and multimanager applications were pending (15% of the total exemptive applications pending) that likely would have been unnecessary if proposed rules had been adopted sooner.[14] The IG recommended that this problem could be addressed if the office responsible for exemptive orders was also assigned authority to draft rules that codify the standards set in its exemptive orders.

REVIEW AND ACTION ON SRO RULE FILINGS

Section 19(b) of the Exchange Act requires each self-regulating organization (SRO) to file proposed rule changes with the SEC, accompanied by a concise general statement of the basis for, and purpose of, the proposed change. The SEC must approve a proposed rule change if it finds that the proposal is consistent with the requirements of the Act and the applicable rules and regulations. SEC approval of an SRO rule change confers implied antitrust immunity.

The rule filing process under the Exchange Act requires the SEC to examine whether SRO rules and practices are consistent with the Exchange Act and the goals of the national market system, including promotion of fair competition among markets, transparency of prices, best execution of customer orders, fair and orderly markets, and most important, investor protection. SRO rules also must be designed to prevent fraudulent and manipulative acts and practices and promote just and equitable principles of trade. Finally, the public notice and comment procedure ensures that interested persons have an opportunity to provide input into SRO actions that may have a significant impact on market participants and individual investors.

The 2009 Report devoted an entire chapter to improving the efficiency and effectiveness of the SRO rule review process.[15] This emphasis reflected several factors. First, the function is heavily staff intensive. In terms of workload and staff resources assigned, it is the largest single duty of the Division of Trading and Markets. The Office of the Chief Accountant similarly devotes significant resources to the review of Public Company Accounting Oversight Board rule filings. Second, because the SROs play a pivotal role in the overall system of capital market regulation, it is essential that the SEC monitor the policies embodied in these rules. Because the financial market SROs, such as the NYSE and NASDAQ, are now for-profit entities—operations working in direct competition with other domestic markets and with international markets—SEC review of new products, new services and the fees imposed is critical to fulfilling the Exchange Act goal of "promotion of fair competition among markets, transparency of prices, best execution of customer orders, fair and orderly markets."

Since the publication of the 2009 Report, there has been a significant change in the SEC review process. Section 916(a) of the Dodd-Frank Act made important changes in the statutory review procedures for SRO filings. It provided the Commission with the option to disapprove

14 2006 SEC Inspector General Report, p. 4. Fn 32

15 For a detailed description of the legal authority of the SEC to review SRO rule filings, as well as a summary of the evolution of that authority, see the 2009 Report, pp. 41 et. Seq.

summarily an SRO filing without the requirement for a hearing.[16] Any filing disapproved would become a final agency action that could be appealed to the appropriate U.S. Court of Appeals.

Section 916 also made several fundamental changes in the statutory review cycle contained in Section 19(b)(2) of the Exchange Act. Previously, all time deadlines in the section did not begin running until the Commission published a summary of the filing in the *Federal Register* for notice and comment. As revised by Dodd-Frank, if an SRO publishes a notice of the filing together with the substantive terms on a publicly accessible website, then the SEC shall publish in the *Federal Register* within 15 days of the website publication. If this doesn't occur, then the date of website publication will be deemed the date of *Federal Register* publication.

Dodd-Frank also permits the Commission to return a filing to the SRO as "not received" if the SEC notifies the SRO not later than seven days after receipt that the proposed rule change does not comply with Commission rules on form for a proposed change. This seven-day deadline for returning a filing may be extended to 21 days by the Commission if the SRO is notified not later than 7 days after submission that the proposal is unusually lengthy, is complex, or raises novel regulatory issues.

Other significant changes in the process include a new 45-day deadline for Commission approval or disapproval, with the Commission permitted one 45-day extension, provided it publishes the reason for the extension, or additional extensions if the SRO consents.[17] If the Commission fails to take any action within the deadline, a filing will be deemed approved.

If the Commission orders a hearing on a proposed rule it must complete the process and either approve or disapprove the filing within 180 days of publication, subject to one 60-day extension by the Commission or if the SRO consents to the extension.

A significant change was also made to the process under Section19 (b)(3) of the Exchange Act for automatic effectiveness of certain types of filings. Previously the Commission retained the right to abrogate an immediately effective filing for 60 days. If abrogated, the SRO was required to refile the item. Dodd-Frank substituted a "suspension" right for the abrogation right. In the event of a suspension the Commission must order a hearing on the filing.[18]

It is too soon to assess the impact of the Dodd-Frank changes on the speed of Commission review. Anecdotally the changes appear to have improved the process, particularly the change that requires the Commission to publish a filing for notice within 15 days of website posting. However several of the problems that were discussed in the 2009 Report and that formed the basis for the recommendations in that report persist. These are discussed under each of the following recommendations.

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16 15 U.S.C. 78s(b)(2)(C)(ii). For an example of a Commission order of disapproval with a hearing, see Release No. 34-63885; File No. SR-FINRA-2010-055, February 10, 2011, Financial Industry Regulatory Authority, Inc.; Order Disapproving Proposed Rule Change to Amend FINRA Rule 6140 (Other Trading Practices).

17 For an example of a notice of extension, see SR-FINRA-2011-012, Notice of Designation of a Longer Period for Commission Action on Proposed Rule.

18 15 U.S.C. 78s(b)(3)(C).

RECOMMENDATION 1—In 2006, 127 filings (12.5%) were rejected, and in 2007 (12%) were rejected by the SEC staff as incomplete or incorrect filed. These high rejection levels demonstrate that a problem exists. The division should formulate a standard articulating the grounds for rejecting a filing as improperly filed. The division should also require its staff to send a rejection letter to the SRO identifying which items on Form 19b-4 are deficient.

Status—Partial implementation.

While Section 916 of Dodd-Frank provides a time framework for returning filings, it does require the Commission to explain its reasons for rejecting a filing as improperly filed. While the T&M staff frequently explain the decision in an informal phone call, there is a perception that the reasons are not uniformly applied. For this reason, the lack of clarity on why a filing is being returned should be eliminated by T&M publication of a set of uniform standards that may be the basis for returning a filing.

RECOMMENDATION 2—Waivers of statutory time limits should be the exception, not the norm. All requests for waivers of statutory deadlines should require senior-level approval and should be time limited.

Status—Implemented.

While comprehensive data is not available on the number of time limit waivers sought and obtained, a nonscientific review of self-regulatory organization notices posted on the SEC website indicates that it is not a frequent event. This is another indication that the Dodd-Frank changes appear to be achieving their objectives.

RECOMMENDATION 3—The five-day pre-filing requirement should be eliminated.

Status—Not implemented.

The use of the five-day pre-filing requirement continues to be popular with some staff in Trading and Markets. While at first glance it would appear to be a useful, efficient, and informal method of interaction between the SRO and the review staff, it has flaws. Most important, it provides a method to bypass the clear statutory policy of disciplined and timely review and action. Through this process, staff may engage in multiple rounds of comments, taking the position that each SRO response to comments is a new draft filing with a new five-day window. With the creation of an explicit process that enables the Commission's staff to return a filing and deem it not properly filed, it is not clear what purpose the five-day pre-filing procedure serves. Even if there are occasions when a pre-filing may be useful, it is difficult to foresee occasions requiring more than one pre-filing draft.

RECOMMENDATION 4—The Commission should re-delegate to the staff the authority to abrogate SRO filings that are deemed effective upon filing.

Status—Implemented.

As described above, the Dodd-Frank self-regulatory organization procedure substitutes a suspension of effectiveness process for the abrogation process. In conjunction with the adoption of procedural rules for implementing the Dodd-Frank procedures, the Commission re-delegated to the Trading and Markets staff authority to suspend SRO rules that were effective on filing under Section 19(b)(3).[19]

RECOMMENDATION 5—The SEC should order hearings on SRO filings that raise complex issues that cannot be resolved following the notice and comment period. Division staff should have responsibility for review of all papers submitted in response to the order for hearing and for submitting a recommendation to the Commission. An administrative law judge should be assigned only for exceptionally complex matters.

Status—Partial implementation.

During the past two years the Division of Trading and Markets has begun using the hearing process to a limited extent.[20] This is a significant change from a decades-long reluctance to order hearings on self-regulatory organization rule filings. To date no hearings have been assigned to an administrative law judge.

RECOMMENDATION 6—The SEC should create an optional conditional approval process to encourage SRO innovation.

Status—Not implemented.

As for-profit corporations, the New York Stock Exchange, NASDAQ, and the other national trading platforms are in direct competition. The development of new investment products and services is a vital component of this competition and one that directly contributes to the Commission's statutory responsibility to promote capital formation. However the Commission's traditional approach to new products is to "go slow." This is understandable as it is always difficult for the staff who have a statutory obligation to make a finding that the product or service proposed is consistent with the Exchange Act. Recognizing that this philosophy permeates the Commission, one approach would be to reduce the burden on the staff to reach conclusions about the consequences of anticipated events. A process that would reduce this burden on the staff by providing a form of conditional approval is one possible solution. To date the SEC has not indicated that they are actively considering this recommendation.

ADDITIONAL RECOMMENDATION—The Division should implement a dual review process.[21]

Status—Partial implementation.

19 See Exchange Act Release 34–63049, October 6, 2010. 62466 *Federal Register*, Vol. 75, No. 196 , Tuesday, October 12, 2010 .

20 See, for example, Release No. 34-65330; File No. SR-BX-2011-046, September 13, 2011, NASDAQ OMX BX, Inc.; Suspension of and Order Instituting Proceedings to Determine Whether to Approve or Disapprove a Proposed Rule Change to Amend the BOX Fee Schedule with Respect to Credits and Fees for Transactions in the BOX Price Improvement Period.

21 This recommendation was not explicitly included in the 2009 Report but was discussed within the Review and Action on SRO Rule Filing Section

The section on management and operations of the 2009 Report recommended that the Commission increase the number of staff with extensive industry expertise. As discussed in that section of this report, the Commission has publicly embraced this recommendation and, to the extent possible under its current budget constraints, the Commission has hired new staff who bring this type of expertise. The next challenge will be to maximize their contribution.

As many people have noted over the years, the SEC is "over-lawyered." It relies on lawyers to perform tasks that may not be best suited to a lawyer's analysis. Nowhere is this more evident than in the review of self-regulatory organization filings. While the review of every filing must include, as one component, a legal analysis and determination that the filing is consistent with the principles of the Exchange Act, this should be viewed as merely one component of the review, rather than the full scope of the review. Filings that deal with important highly technical issues, such as trade routing and processing or clearance and settlement, must be examined by persons who understand the inner workings of highly complex automated trading platforms and back office trade processing. Controversial proposals concerning the fees that exchanges charge for services should be examined by lawyers who consider the Commission's statutory obligations to promote open competition. But this legal conclusion must consider and incorporate an economist's analysis and perspective.

For many years the Division of Corporation Finance grappled with an analogous problem in its review of corporate disclosure filings. It developed its "two sets of eyes" approach. Filings were reviewed by an attorney and an accountant. The 2009 Report recommended that T&M adopt a similar strategy for SRO filings. While T&M has not publicly indicated the formal adoption of this strategy, persons outside the agency with first-hand knowledge of the current review system indicate that some offices in T&M have begun to utilize a form of the "two sets of eyes" approach. The Office of Trading Practices and Processing within T&M, which reviews filings submitted by the securities clearance and settlement organizations, has constructed a small group composed of people with operational expertise who play an active role in the review filing process. The Office of Market Supervision, the office in T&M with authority over SRO filings from the exchanges and the Financial Industry Regulatory Authority (FINRA), has not, as yet, adopted this approach. Anecdotally, persons interviewed report that a small number of significant filings are considered by Division staff with nonlegal backgrounds when appropriate.

While these are partial steps toward implementing this recommendation, formal adoption and implementation by T&M has not occurred.

SEC STAFF NO-ACTION LETTERS AND INTERPRETIVE GUIDANCE

Since its inception in 1934, the SEC, through its divisions and offices, has routinely provided informal guidance and administrative interpretations of the securities laws and SEC regulations to members of the public, prospective registrants, and others. This informal assistance has been used to provide clarity on the applicability of the securities laws and SEC regulations to particular situations and to assist the public in complying with the law.[22] While the

22 17 C.F.R. § 202.2 (2008).

SEC has been criticized occasionally for its frequent use of informal guidance to create a body of "informal regulations," informal guidance has become an important vehicle for advising the public and regulated industries of SEC staff positions and interpretations. The challenge is creating and implementing informal processes that provide prompt and useful guidance without overstepping boundaries and creating or altering regulatory policy.

For an agency that is often criticized for "regulating through enforcement," regulatory procedures that promote prophylactic compliance are an essential complementary function to effective enforcement. This chapter focuses on the use of no-action letters, the current processes for requesting and receiving a no-action letter, variations among the SEC's offices and divisions, and concerns about the continued vitality of the process. The recommendations are designed to reinvigorate the no-action letter process by making it faster and less costly to the SEC and the requestors, while retaining its informality. The recommendations also propose changes to ensure that policy remains the responsibility of the five-member Commission. One recommendation is made to address concerns expressed about the number of staff informal guidance processes.

RECOMMENDATION 1—The Commission should rationalize the current system of informal guidance by reducing the number of vehicles it uses to provide guidance. Each operating division should develop a web-based system of Compliance and Disclosure Interpretations (CDI), which should replace Staff Legal Bulletins, FAQs, summaries of staff comment letters, small entity compliance guides, and interpretive letters.

Status—Not Implemented.

The basis for this recommendation is the CDI series created by the Division of Corporation Finance (Corp Fin). Persons interviewed for this study strongly endorsed the use of CDI's by Corp Fin as a single source of staff views and guidance. Unfortunately, while Corp Fin has continued to issue CDIs, it has not as yet used this format to consolidate and codify all relevant staff guidance in a single series. The Division continues to issue occasional Staff Legal Bulletins and Staff Accounting Bulletins (issued jointly with the Commission's Office of the Chief Accountant), among the nine forms of staff guidance discussed in the 2009 Report.[23]

In 2011 the Division's staff issued a document titled CF Disclosure Guidance: Topic No. 1 *Staff Observations in the Review of Forms 8-K Filed to Report Reverse Mergers and Similar Transactions.*[24] As the document is labeled No. 1, one must assume that it is intended to be the first in a new series of staff interpretive guides. As there was no accompanying public staff communication explaining the purpose of the new series, it is not possible to ascertain the reasons for creating it rather than issuing the information as a CDI. The substance of the document and the careful explanation that it represents informal staff views suggests that it could easily have been issued as a CDI. One can only speculate that because the document is based on the views of staff in the Office of Disclosure Operations, rather than the staff in the Office of Chief Counsel or another interpretive office in the division, it may be merely another unfortunate example of internal "turf" problems within the Division contributing to the silo problem at the SEC. So *Staff Observations* becomes a tenth form of staff guidance published by the Commission's staff.

23 For a description of the nine forms of staff guidance see the 2009 Report, pages 60-62.
24 Available at http://www.sec.gov/divisions/corpfin/guidance/cfguidance-topic1.htm.

When the Division of Corporation Finance initiated the Staff Legal Bulletin (SLB) series, the Divisions of Investment Management and Trading and Markets embraced the concept and on occasion issued SLBs. This has not been the case with the CDI series. It is another example of how the good ideas and innovations of one division are rarely transferred and adopted by other divisions. One might argue that the concept is not germane to the other divisions as their regulatory programs are not entirely disclosure-based. This however is purely a superficial argument. The concept of creating a single form of staff guidance that consolidates and codifies in one place all forms of guidance is a concept that is fully applicable to all regulatory programs, whatever name is given to the documents.

Unfortunately, while the recommendation continues to garner widespread support from people and entities regulated by the SEC, it has not been embraced by the Commission's staff. Instead the list of different formats becomes longer.

RECOMMENDATION 2—The Commission should publish guidelines distinguishing the use of no-action letters and exemptive orders.

Status—Not implemented.

RECOMMENDATION 3—The practice of issuing no-action letters of general applicability should be discontinued in favor of exemptive orders or emergency orders, as appropriate.

Status—Not implemented.

These recommendations should be viewed together. They both speak to the importance of and the need for internal controls at the SEC that ensure that an agency that regulates the conduct of others adheres to its own legal duties, obligations, and limitations. When used properly, no-action letters are a valuable tool. They enable a regulated party to seek and obtain the regulator's guidance on how to obey the law in the context of novel or unusual circumstances. They also provide the staff with a method of acting quickly and informally. As a matter of history, the Commission's use of no-action letters reflected the fact that for six decades only the Investment Company Act provided the Commission with broad exemptive authority. Today that is no longer the case. Each of the three regulatory divisions has broad delegated exemptive authority under relevant law. Because exemptive orders may be issued through a notice and comment process and, as final agency action, are subject to appellate judicial review, these orders are inherently a superior tool for the enunciation of regulatory policy.

Adoption of these recommendations would serve another purpose. They would also impose external discipline and outside scrutiny on the process and the responsible staff. This side benefit may explain why there has been little interest among the Commission's staff in adopting the recommendations. Since 2009, the Commission has declined to publish internal or external guidance to distinguish the use of no-action letters and exemptive orders. Also the Commission's staff continues to occasionally issue no-action letters of general applicability.

The line between a general applicability no-action letter and a general applicability exemptive order is becoming even cloudier. The staff has begun issuing statements that are clearly structured to provide exemptive relief to a broad category of entities, but which are written without any indication of whether it is a no-action letter or an exemptive order. The ambiguity is clearly intentional as the statement refrains from any indication that it is an expression of staff views or a statement issued by the staff pursuant to a delegation of authority from the Commission. One example of this new form of "androgynous statement" is a letter sent to the Center for Audit Quality in April 2011 that exempted foreign private issuers from the regulatory requirement to file documents that use XBRL data tagging formats.[25] While the need for the relief was obvious and the result was sound (the necessary data taxonomies for an IFRS financial statement weren't available), the legal basis for the action was not revealed.

RECOMMENDATION 4—Each division should post on the SEC Website a list of the staff members, with e-mail addresses and phone numbers, who are authorized to provide assistance on specified topics. Authorized SEC staff should complete a short summary of each telephone inquiry received and each answer provided on an internal template, retained on an internal shared file, accessible by all designated staff and the senior staff in each division. If the staff person is uncertain or uncomfortable responding to a question, the question should be added to the internal system with a notation that no answer was provided. Each division should have a biweekly meeting of the designated staff (typically the staff of the Office of Chief Counsel) to review and discuss all questions answered during the previous two weeks. The responses should be reviewed for accuracy and to identify topics of interest. Topics of interest should be posted on the SEC Website, eliminating the concern about "nonpublic" guidance provided to some but not all. Over time, as the body of information available online increases, it would reduce the volume of telephone inquiries.

Status—Not implemented.

This recommendation has two components. The first part, posting a list of staff members, with email addresses and phone, who can answer questions on specific topics is simple and straightforward. One would assume that the merits of it are so obvious that it could be adopted quickly. Of course this is not the case at the SEC. While the Division of Corporation Finance posts the names and phone numbers of the division's supervisory staff, it posts email addresses only for key offices. This is far superior to the other regulatory divisions. Investment Management and Trading and Markets provide only a single division phone number and mailbox. There is no division organization chart or list of supervisors or office heads. Risk, Strategy, and Financial Innovation, as the newest division, is more progressive. It provides the names and titles of its supervisors, unfortunately without including phone numbers or email addresses. Of course the final word on the extent of the problem comes from the Division of Enforcement. The Dodd-Frank Act mandated that the SEC create a Whistleblower Office to receive, process, and coordinate all public tips on corporate misconduct. Notwithstanding its lack of a budget, the Commission created the office and appointed a head of the office during the spring of 2011. The

25 The request and staff response is available on the SEC website at http://www.sec.gov/divisions/corpfin/cf-noaction/2011/caq040811.htm.

office was included on the SEC website. All that was missing was a phone number that whistleblowers could use to call the office![26]

The second piece of this recommendation is not so easily adopted, but represents an opportunity for the Commission's staff to utilize the Internet to greatly improve its ability to both respond quickly to specific requests for guidance and disseminate this individualized advice to all interested parties. An important benefit of this proposal is the creation of a feedback process that would enable supervisors to monitor staff comments without stifling the willingness of the staff to inform and assist. While no action has been taken on the recommendation, it is hoped that the Commission will give it serious consideration.

RECOMMENDATION 5—Each division should attempt to provide a final response to a no-action request within 90 days of receipt. To promote compliance, each division should be required to send a quarterly advice memorandum to the Commission identifying all requests pending for 90 days or longer. The memo would identify the issues presented that must be resolved and provide a target date for resolution. The division should also indicate if it is unlikely that a no-action letter will be issued.

Status—Not implemented.

The problem of performance standards that fail to encourage or measure the right things and inadequate internal controls to promote effective action permeates the SEC. Each chapter of the 2009 Report provided examples of the problem and the consequences as well as recommendation to address the problem. In the case of staff no-action letters, this continues to be the case. The SEC measures the length of time between the receipt of a letter and the initial set of staff comments.[27] In effect the staff are measured on the basis of a preliminary step rather than with a metric that measures whether they reached a timely final decision on a request, either positive or negative. So instead of encouraging prompt action to bring about a result, this measure encourages prompt action that can prolong the process. As a result it is not surprising that the entire no-action letter process from start to finish can go on for a year or longer, even when the staff provide an initial interim response in a month or less.

This recommendation addresses the problem by creating internal deadlines for action and creating a process to monitor compliance. It is another instance where increasing the role of the Commissioners would be beneficial.

RECOMMENDATION 6—A no-action letter should be viewed as informal guidance rather than a method of setting regulatory policy. Because it is often difficult to distinguish interpretation from policy on a prospective basis, the Commission should annually issue interpretive statements that review, adopt, and codify significant staff positions contained in no-action letters. These releases could also be used to withdraw or revise a no-action position previously taken, based upon new facts or an analysis of how it has been interpreted. The Commission should issue these interpretive statements following an

26 Edward Siedle, Forbes.com, *SEC Whistleblower Office Does Not Want To Talk To You*, May 12, 2011, available at http://www.forbes.com/sites/edwardsiedle/2011/05/12/sec-whistleblower-office-does-not-want-to-talk-to-you/?partner=financial_newsletter.

27 SEC Congressional Budget Justification for 2012, Goal 2 Measure 7, p. 33. Available at http://www.sec.gov/about/secfy12congbudgjust.pdf.

opportunity for public notice and comment. The original recipient of a no-action letter could continue to rely upon the assurances provided in the letter. Any revisions or changes reflected in the Commission interpretative release would apply prospectively to third parties.

Status—Not implemented.

Only the five-member Commission may propose and adopt rules. When Congress amended the Securities Exchange Act in 1962 to permit the Commission to delegate authority to the staff, delegation of rulemaking responsibilities was expressly prohibited. Notwithstanding this limitation on the staff's role in rulemaking, at some time each division of the Commission has issued a no-action letter that has such broad and substantial impact that it became a *de facto* rule. Ironically, because staff no-action letters are not considered to be binding and final agency actions, they are not subject to judicial review, as a new SEC rule would be. To the extent that a no-action letter has the effect of setting regulatory policy, the lack of Commission involvement and judicial review is a significant problem.

Another often-heard remark is that the staff must carefully consider not only the question contained in the letter, but also the unstated questions that a too-broad interpretation may be construed to address. The concern about usurping the Commission's authority requires the staff to proceed with caution when responding to novel questions. In fact, many argue that a major reason for delay is the staff's legitimate concern that any guidance or interpretation must be carefully written to prevent its views from inadvertently setting a new standard.

It is probably impossible to develop a procedure that both ensures that the staff has sufficient discretion to quickly advise private parties on novel questions without ever going too far. This recommendation is designed to provide the staff with the capacity to quickly and flexibly provide regulatory guidance when needed and at the same time ensure that the Commission has an ongoing capacity to oversee the staff's interpretations and retain final authority over interpretive policy. To date the Commission has not acted on this recommendation. As the relationship between the Commission and the staff is identified as a priority issue in the BCG Report and the SEC Report to Congress on implementation, consideration of this recommendation may yet occur.

Appendix B: Investment Company Act Notices and Orders for 2011 and 2010

Table B.1

2011 Investment Company Act Notices and Orders

	Filing	Last Amend-ment	Notice	Order	Days from Fil-ing to Notice	Days from Notice to Order	Days from Fil-ing to Order	Date From Last Amend-ment to Order
FQF Trust, et al. (Order)	31-Dec-09	11-Jul-11	11-Jul-11	5-Aug-11	557	25	582	25
WNC Tax Credits 40, LLC, et al. (Order)	4-Apr-11		6-Jul-11	2-Aug-11	93	27	120	
J.P. Morgan Securities LLC, et al. (Order)	21-Jun-11	5-Jul-11	29-Jun-11	26-Jul-11	8	27	35	21
Sterling Capital Funds and Sterling Capital Management LLC (Order)	15-Oct-10	12-Jul-11	1-Jul-11	26-Jul-11	259	25	284	14
TIAA-CREF Funds, et al. (Order)	5-Oct-10	8-Jul-11	24-Jun-11	19-Jul-11	262	25	287	11
Russell Exchange Traded Funds Trust, et al. (Order)	18-Aug-10	19-May-11	22-Jun-11	19-Jul-11	308	27	335	61
HighMark Funds, et al. (Order)	10-Nov-10	29-Apr-11	16-Jun-11	12-Jul-11	218	26	244	74
COUNTRY Investors Life Assurance Company, et al. (Order)	1-Feb-11	13-May-11	9-Jun-11	7-Jul-11	128	28	156	55
Allianz Life Insurance Company of North America, et al. (Order)	14-Sep-10	26-May-11	10-Jun-11	6-Jul-11	269	26	295	41
Precidian ETFs Trust, et al. (Order)	1-Sep-10	3-Jun-11	9-Jun-11	1-Jul-11	281	22	303	28
Altegris Advisors, L.L.C. and Northern Lights Fund Trust (Order)	8-Dec-10	19-May-11	1-Jun-11	28-Jun-11	175	27	202	40
TIAA-CREF Life Insurance Company, et al. (Order)	7-Jul-10	6-May-11	1-Jun-11	28-Jun-11	329	27	356	53
UBS AG, et al. (Order)	9-May-11		9-May-11	6-Jun-11	0	28	28	
PennantPark Investment Corporation, et al. (Order)	12-May-10	2-May-11	6-May-11	1-Jun-11	359	26	385	30
HighMark Capital Management Inc., et al. (Order)	28-Dec-09	5-May-11	26-Apr-11	24-May-11	484	28	512	19
Russell Investment Management Company, et al. (Order)	2-Jul-09	20-Apr-11	20-Apr-11	16-May-11	657	26	683	26
Russell Investment Company, et al. (Order)	17-Feb-11	8-Apr-11	6-Apr-11	3-May-11	48	27	75	25
National Life Insurance Company, et al. (Order)	26-Jul-10	28-Mar-11	7-Apr-11	29-Apr-11	255	22	277	32
Fairholme VP Series Fund, Inc. et al. (Order)	23-Dec-10	22-Mar-11	28-Mar-11	26-Apr-11	95	29	124	35
Jackson National Life Insurance Company, et al. (Order)	8-Nov-10	29-Mar-11	31-Mar-11	25-Apr-11	143	25	168	27
American Family Life Insurance Company, et al. (Order)	10-Nov-10	28-Feb-11	24-Mar-11	21-Apr-11	134	28	162	52
Simple Alternatives, LLC (Order)	23-Jul-10	11-Mar-11	24-Mar-11	19-Apr-11	244	26	270	39
Eaton Vance Management, et al. (Order)	5-Mar-10	25-Feb-11	1-Mar-11	30-Mar-11	361	29	390	33
Riverside Casualty, Inc. (Order)	9-Mar-06	4-Feb-11	8-Feb-11	8-Mar-11	1797	28	1825	32
Capital International, Inc. (Order)	1-Oct-03	1-Feb-11	10-Feb-11	8-Mar-11	2689	26	2715	35
MetLife Insurance Company of Connecticut, et al. (Order)	26-Aug-10	27-Dec-10	28-Dec-10	24-Jan-11	124	27	151	28
iShares Trust et al. (Order)	7-Nov-08	11-Jan-11	27-Dec-10	24-Jan-11	780	28	808	13

2011 EXCLUDING ENTRIES THAT DID NOT END IN ORDER				
	Days from Filing to Notice	Days from Notice to Order	Days from Filing to Order	Date From Last Amendment to Order
TOTAL	11057	715	11772	849
AVERAGE	409.5	26.5	436.0	34.0
MEDIAN	259	27	284	32

Table B.2

2010 Investment Company Act Notices and Orders

	Filing	Last Amendment	Notice	Order	Days from Filing to Notice	Days from Notice to Order	Days from Filing to Order	Date From Last Amend-ment to Order
Nuveen Asset Management, et al. (Order)	5-Nov-10	10-Dec-10	8-Dec-10	30-Dec-10	33	22	55	20
American United Life Insurance Company, et al. (Order)	8-Jun-10	15-Oct-10	30-Nov-10	29-Dec-10	175	29	204	75
ETSpreads, LLC, et al. (Order)	18-May-10	9-Dec-10	18-Nov-10	14-Dec-10	184	26	210	5
Fifth Street Finance Corp., et al. (Order)	9-Sep-09	15-Nov-10	18-Nov-10	14-Dec-10	435	26	461	29
SSgA Funds Management, Inc., et al. (Order)	31-Jan-08	17-Nov-10	17-Nov-10	13-Dec-10	1021	26	1047	26
Nationwide Life Insurance Company, et al. (Order)	2-Apr-09	21-Oct-10	25-Oct-10	22-Nov-10	571	28	599	32
Citigroup Global Markets Inc., et al. (Order)	29-Jul-10	19-Oct-10	19-Oct-10	15-Nov-10	82	27	109	27
Citigroup Global Markets Inc., et al. (Order)	29-Jul-10	19-Oct-10	19-Oct-10	15-Nov-10	82	27	109	27
Van Eck Associates Corporation, et al. (Order)	14-Nov-08	7-Oct-10	7-Oct-10	3-Nov-10	692	27	719	27
Claymore Exchange-Traded Fund Trust, et al. (Order)	5-May-09	20-Oct-10	7-Oct-10	2-Nov-10	520	26	546	13
Dolby Laboratories, Inc. (Order)	26-Sep-08	30-Sep-10	1-Oct-10	27-Oct-10	735	26	761	27
Northern Lights Fund Trust, et al. (Order)	22-Jun-10	15-Oct-10	30-Sep-10	26-Oct-10	100	26	126	11
Highland Capital Management, L.P. and Highland Funds I (Order)	7-May-10	27-Sep-10	27-Sep-10	26-Oct-10	143	29	172	29
Capital Southwest Corporation (Order)	5-May-10	24-Sep-10	29-Sep-10	26-Oct-10	147	27	174	32
Van Eck Associates Corporation, et al. (Order)	23-Jan-09	25-Aug-10	1-Oct-10	26-Oct-10	616	25	641	62
RIEF RMP LLC and Renaissance Technologies LLC (Order)	25-Aug-05	21-Oct-10	28-Sep-10	26-Oct-10	1860	28	1888	5
Jackson National Life Insurance Company, et al. (Order)	8-Apr-10	24-Sep-10	27-Sep-10	25-Oct-10	172	28	200	31
American Fidelity Dual Strategy Fund, Inc. and American Fidelity Assurance Company (Order)	1-Oct-09	24-Sep-10	27-Sep-10	25-Oct-10	361	28	389	31
Elfun Trusts, et al. (Order)	9-Jul-08	18-Oct-10	27-Sep-10	25-Oct-10	810	28	838	7
Triangle Capital Corporation, et al. (Order)	11-May-10	1-Oct-10	30-Sep-10	22-Oct-10	142	22	164	21
American Capital, Ltd. (Order)	5-Nov-09	16-Sep-10	14-Sep-10	8-Oct-10	313	24	337	22
Tri-Continental Corporation, et al. (Order)	26-Dec-07	14-Sep-10	10-Sep-10	5-Oct-10	989	25	1014	21
Tudor Employee Investment Fund LLC and Tudor Investment Corporation (Order)	6-Dec-05	1-Sep-10	3-Sep-10	29-Sep-10	1732	26	1758	28
Transamerica Asset Management, Inc., et al. (Order)	28-May-09	17-Aug-10	3-Sep-10	28-Sep-10	463	25	488	42
Aston Funds, et al. (Order)	21-May-10	16-Aug-10	26-Aug-10	27-Sep-10	97	32	129	42
The Integrity Funds, et al. (Order)	30-Mar-10	10-Aug-10	25-Aug-10	21-Sep-10	148	27	175	42
WisdomTree Asset Management Inc., et al. (Order)	23-Dec-09	27-Aug-10	13-Aug-10	8-Sep-10	233	26	259	12
Kohlberg Capital Corporation (Order)	20-Jan-09	29-Jul-10	3-Aug-10	31-Aug-10	560	28	588	33
Blackstone Group, L.P. (Order)	16-Oct-08	26-Aug-10	5-Aug-10	31-Aug-10	658	26	684	5
GE Asset Management Incorporated, et al. (Order)	27-Jul-10	30-Jul-10	30-Jul-10	25-Aug-10	3	26	29	26
Millington Securities, Inc., et al. (Order)	2-Oct-09	7-Jul-10	30-Jul-10	25-Aug-10	301	26	327	49
Virtus Opportunities Trust, et al. (Order)	3-Feb-10	20-Jul-10	27-Jul-10	23-Aug-10	174	27	201	34
Goldman, Sachs & Co., et al. (Order)	16-Jul-10	21-Jul-10	21-Jul-10	18-Aug-10	5	28	33	28
Northern Funds, et al. (Order)	30-Sep-09	30-Jul-10	23-Jul-10	18-Aug-10	296	26	322	19
Federated Enhanced Treasury Income Fund, et al. (Order)	15-Jan-10	9-Jul-10	14-Jul-10	10-Aug-10	180	27	207	32
AXA Equitable Life Insurance Company, et al. (Order)	27-Aug-09	23-Jul-10	7-Jul-10	29-Jul-10	314	22	336	6
Nationwide Life Insurance Company, et. al. (Order)	18-Feb-10	1-Jul-10	2-Jul-10	27-Jul-10	134	25	159	26
Lazard Global Total Return and Income Fund, Inc., et al. (Order)	25-Jul-05	8-Jun-10	24-Jun-10	21-Jul-10	1795	27	1822	43

	Filing	Last Amendment	Notice	Order	Days from Filing to Notice	Days from Notice to Order	Days from Filing to Order	Date From Last Amend-ment to Order
Korea Finance Corporation (Order)	8-Feb-10	25-Jun-10	25-Jun-10	20-Jul-10	137	25	162	25
Pruco Life Insurance Company, et. al. (Order)	2-Nov-09	15-Jul-10	18-Jun-10	15-Jul-10	228	27	255	0
DWS Advisor Funds, et al. (Order)	28-May-08	18-Jun-10	9-Jun-10	7-Jul-10	742	28	770	19
EQ Advisors Trust, et al. (Order)	29-Sep-09	3-Jun-10	4-Jun-10	30-Jun-10	248	26	274	27
FFCM, LLC and FQF Trust (Order)	28-Jan-10	27-May-10	2-Jun-10	29-Jun-10	125	27	152	33
Hercules Technology Growth Capital, Inc. (Order)	9-Nov-09	25-May-10	26-May-10	22-Jun-10	198	27	225	28
Kinetics Mutual Funds, Inc., et al. (Order)	19-Jan-10	12-May-10	17-May-10	14-Jun-10	118	28	146	33
Jackson National Life Insurance Company of New York, et al. (Order)	23-Oct-09	22-Apr-10	10-May-10	3-Jun-10	199	24	223	42
AdvisorShares Investments, LLC and AdvisorShares Trust (Order)	28-Jul-09	14-May-10	6-May-10	28-May-10	282	22	304	14
Claymore Exchange-Traded Fund Trust 3 et al. (Order)	20-May-08	23-Apr-10	23-Apr-10	18-May-10	703	25	728	25
Calvert Social Investment Fund, et al. (Order)	17-Nov-09	23-Mar-10	19-Apr-10	17-May-10	153	28	181	55
Pax World Funds Trust II, et al. (Order)	24-Sep-09	22-Apr-10	26-Apr-10	17-May-10	214	21	235	25
Northern Lights Fund Trust, et al. (Order)	9-Apr-09	16-Apr-10	16-Apr-10	12-May-10	372	26	398	26
Jackson National Life Insurance Company, et al. (Order)	24-Sep-09	29-Mar-10	7-Apr-10	30-Apr-10	195	23	218	32
Pioneer Bond Fund, et al. (Order)	26-Mar-10		31-Mar-10	27-Apr-10	5	27	32	
WNC Tax Credits 38, LLC, et al. (Order)	28-Aug-09	1-Apr-10	2-Apr-10	27-Apr-10	217	25	242	26
Medallion Financial Corp. (Order)	12-Jun-09	31-Mar-10	1-Apr-10	26-Apr-10	293	25	318	26
Legg Mason Partners Equity Trust, et al. (Order)	7-Aug-09	30-Dec-09	26-Mar-10	21-Apr-10	231	26	257	112
MetLife Insurance Company of Connecticut, et al. (Order)	21-Sep-09	23-Mar-10	25-Mar-10	20-Apr-10	185	26	211	28
MCG Capital Corporation (Order)	4-Sep-09	16-Mar-10	25-Mar-10	20-Apr-10	202	26	228	35
Rydex Series Funds, et al. (Order)	27-Aug-09	22-Mar-10	23-Mar-10	20-Apr-10	208	28	236	29
RMR Real Estate Income Fund, et al. (Order)	31-Dec-03	30-Sep-09	23-Mar-10	20-Apr-10	2274	28	2302	202
SeaCo Ltd. (Order)	9-Feb-10	16-Mar-10	17-Mar-10	9-Apr-10	36	23	59	24
Integrity Life Insurance Company, et al (Order)	3-Sep-09	10-Mar-10	10-Mar-10	7-Apr-10	188	28	216	28
Lincoln Investment Advisors Corporation, et al. (Order)	22-Dec-09	26-Mar-10	9-Mar-10	31-Mar-10	77	22	99	5
Lincoln Variable Insurance Products Trust, et al. (Order)	22-May-09	9-Mar-10	5-Mar-10	31-Mar-10	287	26	313	22
The Chile Fund, Inc. (Order)	29-Jan-10	5-Mar-10	8-Mar-10	30-Mar-10	38	22	60	25
The Chile Fund, et al. (Order)	27-Jul-09	25-Feb-10	2-Mar-10	30-Mar-10	218	28	246	33
First Trust/Aberdeen Global Opportunity Income Fund, et al. (Order)	26-Jan-05	11-Aug-09	26-Feb-10	24-Mar-10	1857	26	1883	225
Millington Securities, Inc., et al. (Order)	27-Oct-08	25-Feb-10	25-Feb-10	22-Mar-10	486	25	511	25
iShares Trust et al. (Order)	29-Aug-08	26-Feb-10	16-Feb-10	10-Mar-10	536	22	558	12
U.S. One, Inc. and U.S. One Trust (Order)	20-May-09	1-Feb-10	2-Feb-10	1-Mar-10	258	27	285	28
Assurant, Inc., et al. (Order)	21-Jan-10	26-Jan-10	26-Jan-10	23-Feb-10	5	28	33	28
ShariahShares Exchange-Traded Fund Trust, et al. (Order)	31-Jul-08	1-Feb-09	29-Jan-10	22-Feb-10	547	24	571	386
MetLife, Inc. et al. (Order)	21-Jul-08	27-Nov-09	30-Dec-09	26-Jan-10	527	27	554	60
Investools Inc., et al. (Order)	11-Dec-09	16-Dec-09	16-Dec-09	12-Jan-10	5	27	32	27
Cash Account Trust, et al. (Order)	30-Jul-09	16-Dec-09	16-Dec-09	12-Jan-10	139	27	166	27

2010 EXCLUDING ENTRIES THAT DID NOT END IN ORDER				
	Days from Filing to Notice	Days from Notice to Order	Days from Filing to Order	Date From Last Amendment to Order
TOTAL	30009	1954	31963	2844
AVERAGE	400.1	26.1	426.2	38.4
MEDIAN	218	26	246	27

ABOUT THE AUTHOR

JONATHAN G. KATZ

Jonathan G. Katz was Secretary of the U. S. Securities and Exchange Commission for twenty years. Katz's tenure as Secretary spanned seven SEC Chairmen and four Acting Chairmen. In this position, Katz coordinated and managed the Commission's agenda and participated in all Commission meetings. His responsibilities encompassed all aspects of the Commission's regulatory and enforcement programs; advising the Commissioners and the staff of the SEC on policy and procedure and past practices. Because these duties entailed regular involvement in all aspects of the agency's work, Katz acquired an extensive knowledge of the wide range of regulatory responsibilities of a financial regulator and how they can be best performed.

Since his retirement in January 2006, Katz has served as a consultant on SEC regulatory requirements. He has been a panelist or featured speaker at numerous conferences in the United States and internationally, and has also testified before the U.S. Congress on reforming the SEC. He has written several articles on capital market regulation. 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 Katz. In 2010 he published a companion article in the University of Pittsburgh Law Review on the SEC enforcement program, *Reviewing the SEC, Reinvigorating the SEC.*

Katz has also served as an advisor to international organizations and foreign governments on the development and regulation of capital markets in developing countries. Since his retirement, Katz has worked with foreign governments and markets in Mexico, India, Thailand, Vietnam, Russia, Turkey, South Africa, the Philippines, Syria, Chile, Saudi Arabia, and Egypt.

Katz received a BA degree in economics from Colgate University and a JD degree from the University of Pittsburgh School of Law. He is an active member of the Board of Directors and President-elect of the Association of SEC Alumni.

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CENTER FOR CAPITAL MARKETS COMPETITIVENESS

Center for Capital Markets Competitiveness
1615 H Street, NW
Washington, DC 20062
www.uschamber.com/ccmc
Tel 202-463-3162