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How To Fix The SEC

Law360, New York (March 05, 2009) -- In remarks this February at the annual SEC Speaks conference in Washington, D.C., new SEC Chairman Mary Schapiro pledged "determination, hard work, toughness, and above all, an unrelenting will to stand up for investors" during her tenure at the agency's helm.[1] Her remarks were timely.

The list of recent SEC fumbles reads like a bullet-point summary of the current financial crisis: the Bear Stearns implosion, the short-selling rule gaffe and, of course, the Madoff Ponzi scheme.

Schapiro also promised to make what appear to be meaningful changes to certain SEC policies, including ending the commission's "penalty pilot" program, which requires the staff of the SEC's Enforcement Division to obtain special approval from the commission in certain cases involving public companies, and streamlining the process by which the commission issues formal orders of investigation, which allow the Enforcement staff to issue subpoenas for documents and sworn testimony.

Both changes would speed up the enforcement staff's investigation process, which, as Ms. Schapiro tacitly acknowledged, is currently bogged down by cumbersome commission rules. But Ms. Schapiro and her colleagues will need to go further if they hope to reverse the torpor of the Bush years and reorient the SEC.

Some of the momentum will need to originate in Congress — new legislation empowering the SEC to fully regulate hedge funds and tame feral derivatives markets would be an auspicious start. The SEC, however, can also act in a more modest way to transform itself from within.

The following proposals, while not the structural overhaul the agency ultimately needs to right itself, would, in the short term, help the SEC rebound from its recent drubbing.

1. Give the regional offices and senior staff in the home office more autonomy.

At its inception shortly after the long stock market slide of 1929-32, the SEC was a model of the anti-laissez-faire ethos that characterized federal government initiatives during the New Deal.

As such, it was designed to centralize within one federal agency the regulation of widely disparate areas of the country's financial sector, including investment companies, national securities markets, broker-dealers and public disclosure by and governance of issuers, among others.[2]

The commission of today retains the same basic structure established 75 years ago: a highly centralized organization that processes all important decisions and many mundane ones, in both the regulatory and enforcement areas, through five commissioners nominally lead by a single chairman appointed by the president.

But the financial world has changed markedly since 1934. The aggregate value of all shares on the New York Stock Exchange at the beginning of the stock market crash in 1929 was about $90 billion.

By 2000, capitalization of the NYSE was edging toward $12.4 trillion. Between 1981 and 2000 alone NYSE market capitalization increased eleven-fold.[3] U.S. mutual fund assets, which totaled $2 trillion 15 years ago, have grown to nearly $10 trillion today.[4]

The commission's workload has grown in tandem, and to keep up with the boom the commission has enjoyed an expanding budget while steadily increasing the size of its staff.

Today, the commission's reach is nearly limitless, with 11 regional offices spanning the entire country, thousands of staff members and authority to regulate conduct occurring in foreign countries and cyberspace.

But a bigger war chest and more bodies alone will not solve the commission's current problems, and the organizational model that worked well in the 1930s has today become a hindrance.

While centralization may be necessary in the rulemaking arena — it stands to reason that the commission should speak with a single voice when establishing the framework of permissible behavior — it's a hobble to enforcement.

Nowhere is this defect more apparent than in the Enforcement Division's "action memorandum" process, whereby Enforcement staff members prepare lengthy memoranda detailing the legal and factual bases for proposed litigation, which are then reviewed, usually numerous times, by the SEC's senior staff in Washington.

After each round of reviews, which often include comments from the commissioners' staff and senior staff in the commission's other divisions, the memorandum is sent back down to the Enforcement staff to make the revisions necessary to address the senior staff's concerns.

Revisions may include lengthening or shortening the list of proposed defendants or charges, adding to the memo's factual recitation to further explain the basis for a given charge or the involvement of non-respondents, or anything else the senior staff deems important. The process often lasts for months, with three or four rounds of revisions to even a routine action memorandum being commonplace.

The most pernicious problem with this process is that it consumes much valuable time, almost single-handedly rendering the commission's goal of real-time enforcement unachievable.

The "action memo process," as it's known, can and usually does linger on well after the senior staff in Washington and the junior staffers who investigate a case reach agreement on the defendants to be sued and the violations to be charged.

Government being what it is, complete consensus is very hard to come by, irrespective of how many times or by whom an investigation is reviewed. Indeed, the commissioners who review an action memorandum are often different from those who granted authority to formally launch the investigation in the first place, with correspondingly different views on what and who should be charged.

Less obvious but just as problematic is the effect the process has on the morale of junior staffers who investigate suspected violations.

Not surprisingly, junior attorneys and their immediate supervisors, who sometimes spend years investigating a case, are usually the most knowledgeable about its nuances and are in the best position to determine who ought to be charged, and with what.

But that prerogative is routinely usurped by senior staff members in Washington who often

have no more information about a case than what they glean from reading the staff's draft action memorandum.

Enforcement by fiat is demoralizing to Enforcement staffers who rightly sense that their work is often lightly cashiered to placate other SEC divisions only tangentially concerned with the outcome of an Enforcement action, or to accommodate the whims of the senior Enforcement staff.

The solution is to vest the directors of the regional and home offices with more decision-making authority. Not every Enforcement case needs to be reviewed by, say, the SEC's Division of Investment Management or its Office of the Chief Accountant, and even fewer need to be reviewed by the commissioners themselves.

In this regard the United States Attorney's Office could serve as a model. The bulk of routine charging decisions there are made by the U.S. Attorney for a given district and his or her staff in their respective districts, without significant input from Washington.

The benefits of this approach in the SEC context would be a far more streamlined, and therefore faster, investigative process and a heightened sense of case ownership by staff members who are currently managed from a distance, sometimes with scant regard to the facts on the ground.

2. Abolish the distinction between attorneys who investigate violations and those who litigate them.

Nearly as debilitating to the Enforcement Division's efficacy is the peculiar Enforcement policy whereby staff attorneys who investigate potential violations and shepherd new cases through the action memorandum process are segregated from the trial attorneys responsible for litigating the cases after a complaint has been filed.

The theory behind this structure seems reasonable enough: it allows the commission to maintain a pool of attorneys with special expertise in litigating securities cases and serves as a check on investigating attorneys who are sometimes overly invested, both personally and professionally, in their cases by the time they ripen into litigation.

In practice, however, the policy creates negative incentives and fosters a lack of accountability for enforcement actions once they reach the litigation stage.

It causes staff attorneys and their supervisors on the investigative side to focus almost exclusively on “hits” — Enforcement shorthand for cases approved by the commission and filed (or immediately settled) as either district court or administrative actions — and pay short shrift to the probability of a case’s success after it proceeds to litigation.

After all, once the case is filed and control is transferred to a different group of trial attorneys successes and failures alike are assignable to others and a staff attorney’s sense of responsibility for the case naturally fades.

Similarly, trial attorneys are often heard to complain that cases they inherit are riddled with mistakes made by the staff attorneys who investigated them, thus tacitly absolving trial counsel of responsibility for litigation that goes awry.

The vagaries of litigation are well known to government and private attorneys alike, and so “hits” are undoubtedly a useful metric by which the commission’s paymasters in Congress can measure the agency’s success. This is why directors of Enforcement old and new never tire of emphasizing the number of Enforcement cases filed each year.[5]

Moreover, the practice of segregating staff and trial attorneys varies from office to office, with some staff attorneys participating to varying degrees in litigating the cases they investigate.

Nonetheless, as practiced in most offices, the split creates an unnatural division between investigations and litigation and skews charging decisions and litigation strategy by fragmenting responsibility, all of which hampers the commission’s ability to fairly and vigorously enforce the federal securities laws.

3. Eliminate a level of management in the staff ranks.

A related problem concerns the various levels of review Enforcement matters must pass through before they are presented to the Commissioners for consideration.

In the SEC’s Regional Offices, for example, an Enforcement investigation generally must survive four levels of review before it is passed along to Washington for final approval: in ascending order above the staff attorney level, an investigation is reviewed by a branch chief, an assistant regional director, an associate regional director and the regional Director.

While some review of raw investigative work product is of course necessary, and while there

is real value in having an experienced Enforcement hand smooth the rough edges of an investigation before it is scrutinized by senior staff in Washington, one level of review should be eliminated.

Which one isn't critical since any management gaps up or down will be filled by the remaining managers, but eliminating either the branch chief or assistant regional director position would cut down considerably on the bottlenecks that currently plague the investigatory process and presumably free up resources to put more staff attorneys and examiners in the field.

4. Make cooperation credit meaningful for individuals and other non-issuers.

According to the latest iteration of the SEC's Enforcement Manual, "[t]he SEC encourages and rewards cooperation by parties in connection with staff's investigations."[6]

A detailed explanation of what constitutes "cooperation" in the commission's view is set out in thirteen paragraphs of the commission's "Seaboard Report," the product of an action in which the commission decided not to charge a cooperative corporation even though it determined that an employee of the corporation had violated the securities laws.[7]

For issuers and other corporate respondents, the guideposts established by the Seaboard Report are meaningful in practice.

Corporations that follow the steps enumerated in the Report — including conducting internal investigations to uncover violations, voluntarily enhancing internal financial controls, terminating culpable employees and self-reporting and otherwise cooperating with the staff—can assume that any charges brought against them for violations committed by their officers, directors or employees will be scaled back.

That is, for issuers and other entities that follow the commission's rules, "cooperation credit" serves its intended purpose of encouraging wrongdoers to self-report and otherwise ease the staff's investigatory burden.

The same is not true for individuals, despite the staff's constant refrain that cooperating individuals are rewarded when charging decisions are made.

Individuals who play peripheral roles in corporate wrongdoing are often wooed by the staff into cooperating with vague assurances of lenient treatment, only to find themselves

charged with the maximum violation possible given the facts, or "rewarded" with a practically meaningless reduction in charges.

Ironically, in some cases, the cooperating individual would not have been charged at all but for the information he or she provided to the staff.

Because the securities industry is vast and the commission's resources are limited, the federal securities regulatory scheme is based on a foundation of voluntary disclosure.

By working together, the theory goes, regulator and regulated are better able to police markets and market participants than the government acting alone. The notion of "cooperation credit" is an outgrowth of this scheme, and it works well.

However, the entities that currently enjoy the benefits of this policy can only operate through the directors, officers and employees who run them, and those individuals are therefore in the best position to learn about and report wrongful conduct before it spirals out of control.

Like individual criminal defendants who are routinely offered substantially reduced sentences for cooperating in criminal investigations, the SEC must make cooperation credit for individuals and other non-issuer respondents something more than an empty promise if it wishes to fully realize the benefits of the voluntary reporting scheme on which the SEC's success depends.

5. Expand the SEC's examination staff.

In light of revelations that the SEC's Enforcement staff apparently overlooked opportunities to discover and shut down Bernard Madoff's Ponzi scheme, it is currently fashionable to lay responsibility for the Commission's recent foibles disproportionately at Enforcement's feet. But the Enforcement Division is generally brought in to investigate problems only after they have been discovered by someone else.

While Enforcement lawyers and accountants conduct their own, often lengthy investigations of potential securities laws violations, and many times uncover previously unknown violations in the course of their work, as its name suggests the principal task of the Enforcement Division is to enforce the securities laws, not discover infractions of them in the first instance.

Instead, the initial lines of defense are the commission's broker-dealer and investment management examiners in the Office of Compliance Inspections and Examinations (OCIE), and the staffers in the Division of Corporation Finance.

The OCIE examination staff conducts periodic examinations of broker-dealers, investment advisors and other industry participants aimed at identifying possible violations at their source.

Similarly, the Corporation Finance staff is responsible for combing through issuers' public filings for possible inadequate or otherwise problematic disclosures, which could be early indicators of larger problems at the disclosing entity.

Because OCIE and Corporation Finance staffers are a continuous presence in the industry, reviewing issuers and regulated entities on a routine basis in good times and bad, they are in a much better position than the Enforcement staff to identify violations before they cause harm to investors.

The expansion of the OCIE and Corporation Finance staffs therefore seems like the best bet, at least within the existing framework of the agency, for detecting securities violations in their infancy and preventing large-scale financial disasters before Enforcement action becomes necessary.

Harry Markopolis, the now-famous financial analyst and fraud examiner invited to testify before Congress earlier this year about the SEC's investigation of Bernard Madoff, claims to believe that "SEC securities lawyers, if only through their investigative ineptitude and financial illiteracy, colluded to maintain large frauds such as the one to which Madoff later confessed ..."

Like much of Mr. Markopolis' testimony about the SEC, this assessment is considerably overwrought.

The SEC is staffed, by and large, with competent lawyers, accountants and examiners who believe in the SEC's mission and work hard, to the extent permitted by the agency's organizational strictures, to pursue their respective regulatory agendas fairly and zealously.

But those often-Byzantine strictures, the product of an organizational structure left over from an era when the ballpoint pen was cutting-edge technology, ultimately overwhelm even the most well-intentioned efforts of the staff.

The commission is not, of course, wholly responsible for this; its mandate is circumscribed in important respects by statute and judicial rulemaking. But it still has ample room to make changes from within. Those suggested above are a reasonable place to start.

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[1] Mary L. Schapiro, Chairman, U.S. Securities and Exchange Commission, Speech at the Practicing Law Institute's SEC Speaks in 2009 Program (Feb. 6, 2009) (transcript available at www.sec.gov/news/speech/2009/spch020609mls.htm).

[2] Joel Seligman, The Transformation of Wall Street 416 (3d ed. 2003).

[3] Id. at 623.

[4] See Schapiro, Speech at the Practicing Law Institute's SEC Speaks in 2009 Program.

[5] See Id.

[6] See SEC Enforcement Manual at 99 (available at www.sec.gov/divisions/enforce/ enforcementmanual.pdf).

[7] See 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 (the "Seaboard Report"), Sec. Rel. No. 44969 (Oct. 23, 2001) (available at www.sec.gov /litigation/investreport/34-44969.htm).

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