S. HRG. 111–175

# STRENGTHENING THE SEC'S VITAL ENFORCEMENT RESPONSIBILITIES

## HEARING

BEFORE THE

SUBCOMMITTEE ON
SECURITIES, INSURANCE, AND INVESTMENT

OF THE

COMMITTEE ON
BANKING, HOUSING, AND URBAN AFFAIRS
UNITED STATES SENATE

ONE HUNDRED ELEVENTH CONGRESS

FIRST SESSION

ON

EXAMINING THE IMPORTANT ROLE OF THE SECURITIES AND EXCHANGE COMMISSION IN PROTECTING INVESTORS BY AGGRESSIVELY ENFORCING FEDERAL SECURITIES LAWS

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# C O N T E N T S

**THURSDAY, MAY 7, 2009**



**WITNESSES**



ADDITIONAL MATERIAL SUPPLIED FOR THE RECORD

# STRENGTHENING THE SEC'S VITAL ENFORCEMENT RESPONSIBILITIES

**THURSDAY, MAY 7, 2009**

U.S. SENATE,
SUBCOMMITTEE ON SECURITIES, INSURANCE, AND INVESTMENT,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
*Washington, DC.*

The Subcommittee met at 2:34 p.m., in room SD–538, Dirksen Senate Office Building, Senator Jack Reed (Chairman of the Subcommittee) presiding.

## OPENING STATEMENT OF SENATOR JACK REED

Senator REED. Let me call the hearing to order.

I want to thank you all for coming today, and particularly thank the witnesses and thank my colleague, Senator Bunning.

Today's hearing examines the important role of the Securities and Exchange Commission in protecting investors by aggressively enforcing Federal securities laws.

It is no secret that the Securities and Exchange Commission finds themselves in a challenging time, facing severe criticism—some fair, some not—for failing to prevent the subprime meltdown and subsequent financial crisis and, more recently, from its failure to detect and prevent the estimated $60 million Bernard Madoff Ponzi scheme. When the SEC falls behind on its responsibilities, these effects are seen not just on Wall Street but on Main Street throughout this country.

For instance, a philanthropic foundation that donated over $24 million last year to nonprofits around the country, including $350,000 in my own home State, closed its doors in January because the foundation's donors funds were being managed by Mr. Madoff.

As the SEC tries to restore its aggressive watchdog capacities, we are grateful that GAO joins us today to share the results of a study Senator Dodd and I requested back in March of last year that provides key in-depth information to help us consider improvements to the Securities and Exchange Commission. GAO's review of the SEC's enforcement division, which included in-depth focus group interviews with staff throughout the division, found that in recent years significant resource challenges and internal policy changes undermined the Agency's ability to bring enforcement actions and these problems occurred at the very time the SEC needed to be more aggressive than ever at overseeing our securities markets.

I just want to highlight a few of the more significant findings in the GAO report. The SEC managers and attorneys throughout the Agency agreed that two corporate penalty policies put in place in 2006 and 2007 had the effect of delaying cases and producing fewer, smaller penalties, with penalties declining at an accelerating rate, falling 39 percent in 2006, 48 percent in 2007, and 49 percent in 2008.

Staff also felt that the SEC had retreated—in their words—on penalties and made it more difficult for investigative staff to obtain formal orders of investigation which allow issuance of subpoenas for testimony and records. Formal orders decreased 14 percent since 2005.

In addition, a burdensome system for internal case review has slowed cases and created a risk-averse culture.

Finally, resources challenges have delayed cases, reduced the number of cases that can be brought, and potentially undermined the quality of some cases. Adjusted for inflation, the Division of Enforcement's fiscal year 2008 budget amount is down 8.2 percent from the fiscal year 2005 peak. Total enforcement staffing has declined 4.4 percent, and the number of front-line investigative attorneys declined 11.5 percent from 2004 to 2008.

I am, however, encouraged by the SEC's steps to address some of these problems, most notably to change policies to "take the handcuffs off of enforcement staff," as Chairman Schapiro has described it. I hope today to hear what additional improvements the SEC is considering.

It is clear to me that, although you can't address all of the SEC's challenges just by giving them new resources, GAO's report confirms what many of us have known for a while: the SEC needs more resources to effectively meet its mission of policing large and complex securities markets.

Last week, I sent a letter to the Appropriations Committee, cosigned by 12 of my Senate colleagues, requesting an increase in funding for the SEC to hire more examiners and enforcement attorneys and invest in technology that will help get the Agency on the same playing field as the institutions that it oversees.

I will continue to work with my colleagues to provide these resources and the oversight that is critical to the success of the Agency.

At this time, I would like to call on the Ranking Member, my colleague, Senator Bunning.

**STATEMENT OF SENATOR JIM BUNNING**

Senator BUNNING. Thank you, Mr. Chairman.

I appreciate our witnesses coming out this afternoon to talk about the report being issued by the GAO and about enforcement matters in general. I think the report provides some useful information, such as recommendations to review and revise the structure and policies of the Office of Collections and Distributions.

The report also adds to what we already know, there are real problems at the SEC. Some of those problems may be in the budget and resources of the Agency, but I think the much larger and more significant problems are in the structure and policies of the Agency. For example, there are too many layers in the chain of command.

I am also concerned that the tension between the staff of various divisions and the Commission itself not only reduces the overall effectiveness of the Agency, but also leads each to undermine the other.

I do think the new SEC Chairman has taken some positive steps, since she moved to the Commission, and her quick action on the recommendations of this report shows that she is willing to attempt to fix problems at the Agency.

However, we should not kid ourselves that all of the Agency problems will be fixed by new management. After all, the last agency the new Chairman was in charge of did not do anything to stop the Bernie Madoff fraud, as my Chairman has also brought out.

I also do not think just adding to the SEC's budget will fix all the problems. Every time this or any agency fails in their mission, they always claim they need more resources. In fact, that is what we heard after WorldCom and Enron. Yet, even after new laws and more staffing and funding, Madoff, Stanford, auction rate securities, and the whole subprime scandal, just to name a few, still happened under the nose of the SEC.

I think the new management should focus on spending its resources more effectively rather than just increasing its budget. For example, as the GAO report points out, it may make more sense to hire administrative and support staff to help the investigators rather than just adding to the numbers of attorneys. The Agency should also be looking at hiring experts in the field like accounting and computers, as well as those who have experience in our ordered, complicated markets to support existing investigations rather than hiring new investigators.

If the Agency truly needs more resources to accomplish this, Congress should consider the request, but that request should first explain how they will use their resources more effectively. One good place to start is with a flatter chain of reporting.

I look forward to hearing from our witnesses and look forward to more hearings in the future to look into the problems at the SEC and how we can address them.

Thank you.

Senator REED. Thank you very much, Senator Bunning.

Let me now introduce our panel. Our first witness will be Mr. Richard Hillman, the Managing Director of the Financial Markets and Community Investment Group at the Government Accountability Office. Mr. Hillman has served over 30 years with the GAO and has recently overseen reviews of TARP, regulatory modernization, hedge funds, private equity funds, BASEL II capital standards, and sovereign wealth funds. Welcome, Mr. Hillman.

Our second witness will be Mr. Robert Khuzami, the Director of the Division of Enforcement at the Securities and Exchange Commission. Before joining the Securities and Exchange Commission, Mr. Khuzami was a Federal prosecutor for 11 years with the United States Attorney's Office for the Southern District of New York and more recently as the General Counsel for the Americas at Deutsche Bank.

Our third witness today will be Professor Mercer Bullard, Associate Professor of Law at the University of Mississippi School of

Law where he teaches courses in securities, banking, and corporate law. He previously practiced in the SEC Enforcement and Investment Management Offices of WilmerHale and was an Assistant Chief Counsel in the SEC's Division of Investment Management. He is also the Founder and President of Fund Democracy, a mutual fund shareholder advocacy group.

Our fourth witness is Mr. Bruce Hiler, Partner and Head of the Securities Enforcement Group at Cadwalader, Wickersham & Taft LLP. His practice focuses on securities enforcement and regulatory defense, corporate and regulatory counseling, internal investigations, and securities litigation.

Thank you, gentleman, for joining us today. We will begin with Mr. Hillman.

**STATEMENT OF RICHARD J. HILLMAN, MANAGING DIRECTOR, FINANCIAL MARKETS AND COMMUNITY INVESTMENT, GOVERNMENT ACCOUNTABILITY OFFICE**

Mr. HILLMAN. Chairman Reed, Members of the Subcommittee, I am pleased to be here today to discuss the results of our recent study of the Securities and Exchange Commission's Division of Enforcement.

While the Division plays a key role in helping the Agency meet its mission by protecting investors and maintaining fair and orderly markets, in recent years questions have been raised about the capacity of the Division to manage its resources and fulfill its law enforcement responsibilities.

My prepared statement discusses the results of our recent study and the major recommendations we made to help ensure that the SEC is effectively and efficiently using its resources in bringing enforcement actions. I would like to focus my opening remarks on two important areas: the first related to the extent to which the Enforcement Division has an appropriate mix of resources; and the second on recent trends and penalties and disgorgement ordered and the effects of adoption and implementation of recent penalty policies.

Overall, enforcement resources and activities have been relatively level recently but the number of nonsupervisory investigative attorneys decreased 11.5 percent during fiscal years 2004 through 2008. Enforcement management told us that resource levels had not prevented the Division from continuing to bring cases across a range of violations but both management and staff said resource challenges had delayed cases, reduced the number of cases that could be brought, and potentially undermined the quality of some cases. Specifically, investigative attorneys cited the low level of administrative, paralegal and information technology support, and unavailability of specialized services and expertise.

Also, enforcement staff said a burdensome system of internal review had slowed cases and that there was a culture of risk aversion.

During our review, enforcement management had begun to examine how to streamline the case review, but their focus was more process oriented and did not give consideration to assessing organizational culture issues. To address these issues, we recommended that the Chairman further evaluate the level and mix of resources

dedicated to the Enforcement Division and assess the impact that the Division's current review and approval process where investigative staff work has on organizational culture and the ability to bring timely enforcement actions.

Regarding our work on penalties and disgorgements, we reported that the total penalty and disgorgements amounts can vary on an annual basis based upon the mix of cases concluded in any particular period. However, overall penalties and disgorgements ordered had declined significantly since the 2005–2006 period. Specifically, total annual penalties fell 84 percent from a peak of $1.6 billion in fiscal year 2005 to $256 million in fiscal year 2008. Disgorgements similarly fell 68 percent from a peak of $2.4 billion in fiscal years 2006 to $774 million in fiscal year 2008.

While a number of factors can affect the amount of penalty or disgorgements that enforcement staff seek in any individual enforcement action, enforcement management, investigative attorneys, and others agreed that two recent corporate penalty policies had a significant impact. In 2006, the Commission adopted a policy that focused heavily on two factors for determining corporate penalties: the economic benefit derived from wrongdoing; and the effect a penalty might have on shareholders.

Further, in 2007, the Commission adopted a policy—now discontinued—that required Commission approval of penalty ranges before settlement discussions. On their face, the penalty policies are neutral in that they neither encourage nor discourage corporate penalties. However, enforcement management and many investigative attorneys and others agreed that the two corporate penalty policies, as implemented, delayed cases and produced fewer and smaller penalties.

Further, the Commission's handling of cases under the policies transmitted a message that the corporate penalties were highly disfavored.

We identified other concerns, including the outward perception by some that the SEC had retreated on penalties, which made it more difficult for investigative staff to obtain formal orders of investigation which allows for the issuance of subpoenas for testimony and records.

Our review also showed that in adopting and implementing the penalty policies, the Commission did not act in concert with Agency strategic goals calling for broad communication with and involvement of the staff, in particular within the Enforcement Division, who had limited input into the policies that they were responsible for implementing. As a result, enforcement attorneys reported frustration and uncertainty in applying the penalty policies.

To begin to address these issues, we recommended that the Chairman determine if the 2006 corporate penalty policy was achieving its stated goals and any other effects that the policy may have in adoption and implementation.

We also recommended that the Chairman take steps to ensure that the Commission, in creating, monitoring, and evaluating policies, adheres to its strategic goals and follows other best practices for communication with, involvement of the staff affected by such changes. The SEC Chairman agreed with each of these recommendations and was taking steps to implement them.

Mr. Chairman, this concludes my prepared statement. I would be happy to answer any questions at the appropriate time.

Senator REED. Thank you very much, Mr. Hillman, not only for your statement, but for your very thoughtful and professional report, which will aid us immensely. I appreciate it.

Before I move on, let me say something I should have said initially. Am I pronouncing your name correctly, sir?

Mr. KHUZAMI. Absolutely right.

Senator REED. So it is Khuzami?

Mr. KHUZAMI. Correct.

Senator REED. Well, given my Rhode Island accent, that is amazing. So Mr. Khuzami, would you please give your testimony.

**STATEMENT OF ROBERT KHUZAMI, DIRECTOR, DIVISION OF ENFORCEMENT, SECURITIES AND EXCHANGE COMMISSION**

Mr. KHUZAMI. Thank you. Thank you, Chairman Reed, Ranking Member Bunning, Members of the Subcommittee. Thank you for inviting me to testify on behalf of the Securities and Exchange Commission.

I would also like to thank the GAO and its team for its report. I concur completely with their recommendations.

The Division of Enforcement is the public face of the SEC, in many ways. Our lawsuits and legal proceedings against those who lie, cheat, and steal in our securities markets give the investing public comfort that their interests are being protected. We have a long and proud history of aggressively pursuing wrongdoers and thus helping to maintain the integrity of our markets.

Now to echo the comments by Chairman Reed and Ranking Member Bunning in the beginning of this hearing, it is true that many have questioned our effectiveness in light of the revelations surrounding Bernard Madoff and his egregious misconduct. Let me be very clear, we failed in this instance in our mission to protect investors. Whatever explanations eventually surface, be they human failure, organizational shortcomings, or shortcomings in process, or all three, there are no excuses. And not a day goes by that we in the Enforcement Division do not regret the consequences.

But faced with this, we have done what any responsible public agency should do. We have used this episode as a wake up call to undertake a rigorous self-assessment of how we do our job. As our Chairman, Mary Schapiro has said, reinvigorating the Enforcement Division is a top priority for the Commission.

I am highly confident that we will succeed in this assessment. As a former Federal prosecutor, defense attorney and most recently as an in-house general counsel with a financial institution, I have seen the SEC from many different angles. But from whatever angle, I always saw integrity, excellence, dedication, and a passion for investor protection. Five weeks into the job, I can assure you and the public that these traits are alive and well at the SEC.

You have asked me to address the issues of changes we are making, resource needs, and steps Congress should consider taking to assist us in helping us achieve our mission.

With respect to changes, even before I arrived, the Commission began to initiate changes consistent with GAO's recommendations.

First and foremost, with respect to the abolition of the penalty pilot program. That effort continues uninterrupted. On my first day on the job, I asked the staff to embrace four principles. We need to be strategic, swift, smart, and successful.

To meet those goals, our self-assessment is considering the following: first, to reorganize the division into specialized groups focused on particular markets, products, entities, and transactions in order to build expertise to permit us to conduct investigations faster, more thoroughly, and with increased understanding in order to enable us to better spot patterns, trends, and motives.

Two, to adopt a more efficient management structure that streamlines our processes and frees up experienced managers to focus on making cases and investigating fraud.

Three, to adopt new metrics that are less about measuring our performance by the number of cases we file and more about the quality, timeliness, and deterrent impact of what we do.

Four, to revamp our system for handling tips and complaints to better gather, risk analyze, and triage that information.

And last, to expand our program to award cooperating witnesses who provide valuable information about wrongdoers.

Now this self-assessment has not come at the expense of our ongoing investigations. In the past 2 weeks alone we have brought cases against those involved in the credit default swap markets, subprime mortgages, Ponzi schemes, and money market funds. And you can expect to see more of those.

Now even with these changes, which we believe will make us more efficient, the fact remains that we have suffered from flatter, declining budgets in recent years, while at the same time the products, the markets, the transactions, and the schemes that we are duty bound to investigate become increasingly complex. The 7 percent increase included in the President's budget, released today, recognizes this fact. But even with that, the SEC will have significantly fewer resources than it had 4 years ago.

And I am prepared to lead the Division under the current measures, but I would welcome additional resources. We sincerely appreciate the support of Chairman Reed and many others on this panel, who have been strong advocates on this front, most recently by advocating for additional appropriations in fiscal years 2010 and 2011.

I also thank Senators Schumer, Dodd, and Shelby for their recent successful amendment to authorize additional enforcement funds. If we were to get those funds, we would use them in the following ways: first, as mentioned previously, administrative and paralegal support for our investigations and trials. Too much time is spent by lawyers and investigators on tasks more efficiently handled by others. On new information technology and databases to collect and analyze our documents. More lawyers in our trial unit to litigate cases. We need to have a strong courtroom capability to secure favorable settlements or win in court.

Last, I believe there may be some legislative changes that could clarify our authority so that we can better enforce the laws. This includes legislation to broaden our jurisdiction over hedge funds, securities based swaps agreements, and to expand our whistleblower program.

I am confident that through this self-assessment we will emerge stronger, bolder, and more effective in our mission. The source of my confidence is the men and women of the Division of Enforcement, since what has not changed at the Division is what they offer, an abundance of talent, core values of professionalism and fairness, and a total commitment to mission.

I would like to thank you again for inviting me today and the opportunity to appear before you and I look forward to answering your questions.

Senator REED. Thank you very much.

Professor Bullard.

**STATEMENT OF MERCER E. BULLARD, ASSOCIATE PROFESSOR OF LAW, THE UNIVERSITY OF MISSISSIPPI SCHOOL OF LAW**

Mr. BULLARD. Chairman Reed, Ranking Member Bunning, Members of the Subcommittee, thanks very much for the invitation to appear before you today to discuss the SEC's enforcement program. It is an honor and a privilege to appear before the Subcommittee today.

The GAO report that was released yesterday provides strong evidentiary support for what many of us have suspected for quite some time. The SEC's Enforcement Division's effectiveness has been compromised, both by a lack of resources and by poor leadership by the Commission itself.

The appointment of Mary Schapiro as Chairman is a strong step toward solving the problem of leadership at the Commission. Throughout her career, Chairman Schapiro has demonstrated a solid commitment to a vigorous and effective enforcement program. In her very short tenure, she has already taken decisive steps to end some of the practices that have hindered the Commission's enforcement program in recent years.

The problem of inadequate resources, however, remains unsolved. The Commission does not have the funds to provide the level of enforcement necessary to protect investors and promote efficient capital markets. I strongly recommend the Congress substantially increase the SEC's appropriation to enable Chairman Schapiro and the SEC's enforcement staff to do the job that they are better at than anyone else.

This is not just a matter of adequate enforcement. It is also a matter of justice for investigated entities. Inadequate resources often have the effect of unfairly increasing burdens on parties defending SEC investigations.

The importance of the SEC's enforcement program cannot be underestimated. The Commission is the leading voice for the enforcement of securities laws and the development of free capital markets, not only in the United States but worldwide. When the Commission speaks, it makes uniform law across all 50 States that private actors can rely on to guide their business practices. When the Commission remains silent, the void is filled with the noise of dozens of regulators and courts and private actions creating a patchwork of rules. It is incumbent on the Commission to provide the coherence and uniformity in the securities laws that only it can pro-

vide. And it is incumbent on Congress to provide the Commission with the resources it needs to do so.

In addition, the GAO report has highlighted certain problems that are internal to the Commission. First, the report shows that part of the SEC's resource problem may actually be an allocation problem. When there is inadequate administrative personnel or accountants or technology to support the lawyers working on a case, the solution may be to spend less money on the lawyers and more on the areas that are creating the resource imbalance.

Second, the report confirms the SEC's internal review process and multilayered staffing hinders its effectiveness. The SEC should eliminate one or more supervisory layers and streamline its review process.

Third, the SEC should not shy away from bringing cases involving industry-wide misconduct, but it does not need to bring every case. When industry-wide misconduct does not constitute a clear violation of securities laws however, no enforcement action should be brought. Instead, the SEC should clarify the law and conduct rule making as appropriate.

The most distressing aspect of the GAO report is the substantial evidence that individual Commissioners were permitted to effectively subvert the SEC's enforcement program. These Commissioners may have been motivated by genuine ideological differences with SEC policies, but their approach, coupled with a well-meaning desire for consensus, materially damaged staff morale and the SEC's authority and undermined the SEC's enforcement program.

Chairman Schapiro has indicated that she will not sacrifice the Agency's mission at the altar of consensus. I hope that future four-to-one and three-to-two votes on enforcement and regulatory matters will not be interpreted as a failure to fully consider all viewpoints on the Commission.

I also hope the Commissioners who find themselves in the minority will not feel it necessary to undermine the Commission's authority by publicly attacking its positions even after they have been given a full and fair internal hearing.

In conclusion, I would like to make a general observation that may relate to the friction that the GAO has identified between individual Commissioners and the staff. There is an illusion among some well-meaning proponents of free markets that when the SEC refrains from action, whether it be enforcement action or regulatory action, free markets are allowed to operate with greater freedom. This is not the case. When the SEC refrains from action, the result is often to impede the operation of free markets. SEC inaction creates a void that is filled by dozens of other private and public actors, all following their own conception of the meaning of the securities laws.

Like many securities lawyers, I began my career reviewing documents pursuant to a request from the SEC's Enforcement Division and from a State Securities Administrator and from a U.S. Attorney and from 22 private litigants. There are many sources of law that are waiting to step in when the SEC abdicates its responsibilities.

The only free market that is invigorated by SEC inaction is the free market for competing sources of regulatory authority, which

for financial services firms means regulatory chaos. The SEC alone has the authority to establish uniform regulatory policy and avoid the inefficiencies of legal uncertainty.

I hope that the proponents of free markets, among which I include myself, will keep this in mind.

Thank you, and I would be pleased to answer any questions you may have.

Senator REED. Thank you very much.

Mr. Hiler, and again, I am pronouncing your name correctly, I hope.

Mr. HILER. Absolutely.

Senator REED. Thank you, Mr. Hiler.

**STATEMENT OF BRUCE HILER, PARTNER AND HEAD OF SECURITIES ENFORCEMENT GROUP, CADWALADER, WICKERSHAM & TAFT LLP**

Mr. HILER. Thank you, Chairman Reed, Ranking Member Bunning, and Members of the Subcommittee.

I am pleased to have the opportunity today to testify concerning the responsibilities of the Securities and Exchange Commission in policing our financial markets and protecting investors.

I formerly served as an attorney in the Division of Enforcement, and as an Associate Director. I left the Commission in 1994 and since have represented clients in SEC and other governmental investigations, internal investigations, and securities litigation.

Although recently the Commission has come under fire for reported lapses in detecting the activities of some individuals in the marketplace, the Commission has long been viewed as a premier regulatory and enforcement agency. If there have been lapses, I am confident that the Commission will evaluate those situations and develop new policies and procedures to avoid them in the future.

In this regard, I think it's important to understand the effects that the vagaries of funding and resource allocation, the exponential expansion both of market activity and of sophisticated instruments and investment strategies, and the day-to-day pressure of operating in the glare of public scrutiny can have on any organization.

With that said, there still are a number of areas I believe the Commission's enforcement efforts could or should be modified or improved on. There are three areas which I would like to discuss today.

First, I believe that the efficient and speedy resolution of SEC investigations is important both for effective protection, investor protection, and enforcement efforts as well as for ensuring fairness and justice to the subjects of the investigations. In my view, these goals could be enhanced by having fewer layers of management between those working day-to-day on investigations and those who ultimately must recommend to the Division Director whether an investigation should be moved forward or closed.

Currently, in the Commission's D.C. headquarters, the Division has five Associate Directors indirectly supervising hundreds of attorneys and cases. The Associate Directors typically are among the most experienced professionals in the Division and they are looked

upon internally as having the judgment and expertise to make appropriate case recommendations.

Yet, these are also the individuals who have the least amount of time to be involved in the day-to-day decision making and the day-to-day review of facts on any particular matter as those facts are being discovered and analyzed. I believe there should be fewer layers between the Associate Directors and those directly working on investigations. This does not mean necessarily fewer management slots. Rather, I believe the number of senior experienced officials in the Enforcement Division should be dramatically increased.

These managers should be charged with direct involvement in the day-to-day activities of the matters under their supervision and such matters should be kept to a reasonable caseload so that they can become familiar with the key facts and issues as they develop, not only at the recommendation stage.

Second, efficiency must not be achieved at the expense of fairness or thorough evaluation. SEC investigations can involve sophisticated instruments and trading strategies, as well as complex issues such as accounting, risk analysis, and economic modeling, all of which fall outside the normal expertise of attorneys. These investigations do take time.

But I do believe that the addition of a cadre of experts in a variety of fields, such as I mentioned, to assist in enforcement inquiries will lead to more efficient and better informed decision making.

Third, I believe that the detection of fraudulent conduct is an extremely difficult task and that no one can expect the SEC or any agency will be able to anticipate specific frauds at specific entities. However, a regulator may be able to get an early warning sign of conduct which, though not illegal, on close examination the regulator may determine needs additional regulation or is not sufficiently understood that it poses unknown dangers to the financial system.

To do so, to get this early warning, I think a regulator must reach out to and foster an open line of communication with those in charge of compliance and management at the relevant entities. It is difficult to maintain open and timely communication where the regulator or the regulated views the other in an atmosphere of suspicion. I believe that in the last decade, increased scrutiny by criminal authorities of securities law matters and public pressure on the SEC to hold anyone and everyone responsible for the stock market crash of 1999, for corporate bankruptcies and defalcations, and more recently for the current economic turmoil have contributed to such an atmosphere.

I believe that the line between civil and criminal cases has been blurred and that there has been a shift to an inappropriately low level in what authorities view as conduct that demonstrates sufficient scienter or "state of mind" to make even a civil securities case.

It is possible for the Commission to adopt substantive internal guidelines to ensure it is making consistent, fair, and efficient decisions and judgments on the subjective judgments that are required to bring an enforcement action. I also believe that the Commission should have a major role in determining whether cases which predominantly involve Federal securities law issues and our capital

markets should be pursued by criminal authorities. Efforts in these two areas, I think, would help promote an atmosphere of communication and openness that could assist the Commission in all of its regulatory roles.

I am sure there are other areas that Members of the Subcommittee are interested in. I hope that I am able to be of assistance to you, and I will be happy to answer any of your questions.

Senator REED. Well, thank you very much, Mr. Hiler, and thank you all, gentlemen, for very fine testimony.

Let me begin and address a question first to Mr. Khuzami, but also to ask everyone to respond. Inherent in the GAO report is a recommendation, which Chairman Schapiro has already taken, to take the handcuffs off the Enforcement Division. One issue is how hard is that to maintain, not just in the next few months or years, but going forward? But, second, it raises, I think, a more fundamental issue, which is the relationship between the appropriate oversight of the Commission and the Commissioners and the Enforcement Division. So if you have some thoughts about that, Mr. Khuzami, please begin, and I will call on your colleagues also.

Mr. KHUZAMI. Thank you, Mr. Chairman. From my experience, since I have arrived at the Commission, which is approximately 5 weeks now, I have seen nothing but a great deal of interaction, discussion, and shared views between the Commissioners, the Chairman, myself, and the staff of the Division of Enforcement. To bring it down to practicalities, we have been in Chairman Schapiro's office on many occasions to discuss cases. The Commissioners have invited me into their offices to discuss their views and share them with me. And I cannot speak to the environment that existed prior to my arrival, but everything I have seen since then indicates that any policy matters or judgments are going to be fully informed with the views of the enforcement staff.

Senator REED. Thank you. The same general question, Professor Bullard, about in the long term how do you have a balance between the Commission's appropriate role and not handcuffing the Enforcement Division and initiative at the lower level?

Mr. BULLARD. I think I can really only just echo what the Enforcement Director has said, but I think I would add that it is important that Chairman Schapiro encourage strongly the members of the Commission, regardless of whether there are ideological positions that they bring to the table, to work out those issues they might have in the Enforcement Division internally. And I would encourage the enforcement staff to be very aggressive in communicating with those Commissioners, keeping them apprised of the development of cases, to try to reinvigorate the internal vetting of issues within the Commission.

The Commission has always had a very good practice of a healthy, vigorous internal debate. But as soon as that turns into what the GAO described as a situation where you had the staff cutoff not only from some key decisions but from the development of policies that really should have been conceived in the staff, then you have a staff that is working against the Commission and no longer can really function effectively as an agency.

Senator REED. Your comments, Mr. Hiler?

Mr. HILER. Yes, thank you.

Senator REED. Could you activate your microphone?

Mr. HILER. Sorry. You know, I think in every organization or agency there are going to be different points of view. I cannot say that I or my clients have felt that the Division of Enforcement staff has been shackled, unfortunately. But I wanted to go to one thing in the GAO report in this regard. I noted that staff members had talked about other Divisions hampering their enforcement activities and having to be—and that they did not like other Divisions having to review aspects of their cases. And we laugh out here in the private bar when people like me say, "When I was at the Commission," but I will say it anyway.

When I was at the Commission, I and my staff in Enforcement, when I was a branch chief and assistant director, we happily sought out the views of the other Divisions at the beginning of our investigation, throughout our investigation, and at the end of our investigation. And we did that because those Divisions have extreme expertise in the rules and regulations that we in Enforcement were trying to interpret, apply, and enforce. And so by the end of the investigation, we were probably all on the same page, and I don't recall many times, although there probably were some, where at the end of an investigation where I was trying to make a recommendation I felt that another Division was, you know, opposing me to some extent. But if they were going to oppose me, I had my view, and I felt completely confident that we could express our view to the Commission.

So I think it is just very important that there not be a sense of competition in the Commission between Divisions and that the Division of Enforcement also should feel free and should consult with those other Divisions right at the beginning of an investigation.

Senator REED. Mr. Hillman, your comment?

Mr. HILLMAN. I share many of the comments that have been discussed associated with this question. One in particular that I believe is very important is that there seemed to be a difference of view regarding the Commission's perspectives on penalties and that of the Enforcement Division. And in going forward, I think it would be very important for the Commission and the Division to come up with a shared set of goals and ideals for moving forward in the penalty and disgorgement area. Once that vision is established, then the Commission should seek out regular input from enforcement management and staff on policies and procedures in order to implement those goals.

Senator REED. Thank you very much.

I anticipate, since we are fortunate we have three Members here, several rounds, but let me now yield to the Ranking Member for his round of questioning, and then Senator Johanns, and then I have other questions. Senator Bunning.

Senator BUNNING. Thank you, Mr. Chairman.

Mr.—"Khuzaman"?

Mr. KHUZAMI. "Khuzami."

Senator BUNNING. "Khuzami," I am sorry. I should pay attention. Let me just—on the surface, some of the worst cases of fraud have been hiding in plain sight. Plain sight. Madoff, Stanford, subprime mortgage practices, and auction rate securities. What are you doing

differently now so that these things in plain sight are observed and treated quickly?

Mr. KHUZAMI. Well, Senator, we are taking a number of initiatives. I am not sure that in many of the matters that have been publicly identified that they are necessarily frauds that are in plain sight. Some of them are fairly difficult in terms of attempting to investigate them. But no matter, we are establishing—for example, we have a series of working groups set up nationwide focusing on specific areas of conduct, including subprime, hedge funds, auction rate securities, and historically, options backdating and other matters so that we can gather the necessary expertise and target our energy and resources into particular areas.

In the Ponzi scheme area, which is an area that we have focused our efforts on for a long period of time, you know, the challenge there, of course, is to make sure that you can find credible evidence of the wrongdoing. And, unfortunately, often investors are not a good source of that because they are receiving their out-sized returns and do not identify any wrongdoing. So the challenge there is to get inside the organizations and get credible evidence so that we can stop them.

But we are, with a renewed focus across all the areas that you have identified, dedicating our resources and sharpening our tools.

Senator BUNNING. The same person, what changes are being implemented to allow or encourage staff to bypass the normal chain of command if they feel serious issues or cases are not being properly addressed? That is where I hear we have had a problem.

Mr. KHUZAMI. Well, Senator, we are, as I indicated in my testimony, undertaking a review of the entire management structure, and so that will hopefully result in streamlined processes.

The other thing I would point to is simply, you know, I have appeared before the staff on numerous occasions already and made it very clear to them that we are focused on these cases and that they should be free to raise their hand and bring forth any issue that they feel needs attention with respect to their cases.

I do not sense any reluctance on the part of the staff to identify questions or issues in their cases. If anything, I think they feel a renewed sense of vigor and the importance of bringing cases in a timely manner.

Senator BUNNING. In your testimony, you mentioned that the Commission has filed 23 cases involving Ponzi schemes or Ponzi-like payments. With the report just now coming out that the SEC received warnings back in 2002 regarding the Stanford fraud investigation, how long was the SEC aware of these 23 or so particular cases before formal filings, you know, where a charge was made?

Mr. KHUZAMI. Senator, I would have to, in order to provide a thoughtful answer to you, perhaps have——

Senator BUNNING. No, a factual answer. I would rather have a factual answer.

Mr. KHUZAMI. How about thoughtful and factual?

I would like to be thorough in my response. I cannot tell you as I sit here right now what the history was, if any, with respect to these actions that we have brought. I will say with respect to the Stanford matter——

Senator BUNNING. Could you really get that to us, to the Chairman and myself, in writing a report on those 23?

Mr. KHUZAMI. Certainly.

Senator BUNNING. I would appreciate that very much.

Do you agree with Mr. Hiler's recommendation to increase the number of senior officials with smaller caseloads who can get more involved in individual cases—in other words, providing investigators with more access to key gatekeepers?

Mr. KHUZAMI. As a general matter, I agree, in a streamlined and targeted management system that has no more managers than necessary and those that exist have the resources and the time to dedicate to properly reviewing cases early on so that we do not waste resources on cases that are not worth pursuing, and that we can focus on moving those cases that we should be bringing in a faster manner. Now, whether or not that means adding resources at the associate level or a different level, those details remain to be seen. But I certainly agree with the general principle.

Senator BUNNING. Thank you, Mr. Chairman.

Senator REED. Thank you very much, Senator Bunning.

Senator Johanns.

Senator JOHANNS. Mr. Chairman, thank you. And to every member of the panel, thank you for being here today.

Mr. Hillman, if I could start with a few questions for you. I read the summary, if you will, of the recommendations from your report, and having been in charge of a complex Government organization, I have to tell you, to be very candid with you, I could pick up that language and I think drop it into every Federal department.

Here is what I am saying to you: I think every Federal department would say we do not have enough resources. They would probably say, yes, sometimes we do not even pay attention to our internal goals. The right hand does not always know what the left hand is doing. And I am not saying that to justify it. I am just saying that you are findings here leave me asking the question: Is there a story within the story?

And then I listened to the testimony about Mr. Madoff. You know, I said at the first hearing on that, "I don't get it. I really don't understand it." You had a whistleblower that pretty well called this guy out, kind of laid the road map for what was going on, and yet there was not follow-up, and people really, really were hurt by that.

So what I want to try to examine with my questions is: What is the story within the story? Is this a situation where you have a piece of the Federal government that is not getting along with the Commissioners? Is there a personality conflict? Is there a difference of opinion as to what the goals of the SEC are?

Mr. Hillman, let me start with you. Is that the case here?

Mr. HILLMAN. I think you raise an excellent question about what the real root causes are associated with the difficulties that we found within the Enforcement Division. We pondered that thought many times during the course of our review as well.

You are absolutely correct, many of the examinations that we have conducted at SEC and other regulatory agencies—banking regulators and others—we uncovered very similar practices. What I think was most startling by this review, however, was that the

unanimity of views from the enforcement management, from their middle management, from their investigative attorneys as to the problems that they were seeing within the Enforcement Division, which was startling and clearly in need of some attention to address organizational culture issues, to address organization communication issues, and to really set a tone at the top as to how penalties and disgorgements were going to be ordered.

Senator JOHANNS. See, and here is what worries me about that. I think the easy answer is always, "I need more resources." But then I kind of dig deeper into the report here, and on page 5 you say, you know, but the enforcement cases are about where they were when we talked to the attorneys involved, what they bring up is they need more support staff, the paralegals, *et cetera.* It is not like they are asking us to double the number of attorneys, although I suspect they would like additional help with attorneys.

So, again, Mr.—"Kozumi"?

Mr. KHUZAMI. "Khuzami."

Senator JOHANNS. "Khuzami." Everybody botches "Johanns," too. Although the Chairman got it right.

Mr. KHUZAMI. My mother sometimes mispronounces it. That is OK.

[Laughter.]

Senator JOHANNS. Here is what I am trying to figure out with you. I think there is always a new energy with new people. There was when I went to the USDA, and I do not know that I was any better or worse than the person before me. But it is culture and processes and not necessarily building more staff, or whatever, that solves problems.

Dig there with me. What is wrong with the culture? What is not working over there that literally you could have a whistleblower drop Madoff on somebody's desk and nothing happens? For me, as a former Cabinet member, that would have been a grenade. I would have been on the phone to GAO, to my Committee of jurisdiction, to the Solicitor General, to everybody I could get on the phone to, saying, "Oh, my Lord, what are we going to do about this?" And yet this just seemed to go on. What is wrong? What do you see?

Mr. KHUZAMI. Well, Senator, due to an ongoing Inspector General's report, I do not have the answers yet as to the sequence of events and what actually happened with respect to the complaints regarding Mr. Madoff. I do not know if it is predominantly the failings of a single or small number of staff members, which would be one thing; whether or not it represents a failure in process or organization. So when we get those findings, we will certainly look at them closely. But we are not waiting for them, either.

My sense is that there has been, you know, a certain lack of urgency about the mission. My sense is that, as Mr. Hillman has pointed out, there are policies or approaches that may not have been intended to be anti-enforcement or to discourage enforcement, but they were perceived as such or taken as such, and that sent a message down the line.

I think that the Division needs to do a better job to maintain current with the markets and the products and the transactions that they are obligated to investigate. Just for a simple example, if the

person who reviewed the Madoff complaint or any other complaint had specialized training in certain types of trading strategy, that might have resulted in a different result. And we do much more of that now than we did previously.

But the best way I know to change culture is, as was mentioned, starting with a tone at the top, which the Chairman and the Commissioners have done, to set policies that are fair and appropriate and that allow the Enforcement Division to do its job, because those policies will live far beyond my tenure or the tenure of any staff attorney, but they will continue to pollinate the Division with the sense of urgency and mission that it needs to effectively do its job.

Senator JOHANNS. Thank you, Mr. Chairman.

Senator REED. Well, thank you, Senator Johanns. And, again, I think we have the luxury of continuing our questioning, so let me initiate another series of questions.

We have talked about this issue of resources, and I think there is a general consensus agreement that additional resources, and perhaps more appropriate with respect to paralegals, investigative personnel, and others is appropriate. There is another aspect of resources, and that is predictability. And given that you are subject to the appropriations process, that is not entirely predictable.

There are other Federal regulatory agencies—FDIC being one—who have essentially a claim through their supervised entities on funds, and I just want your thoughts whether that model might be—or some form of that model might be appropriate for the SEC, that it would be, in fact, some type of funds that are always there, not subject to appropriations, that would provide the certainty for infrastructure improvements, technology improvements, hiring specialists, *et cetera.* So let me begin with, Mr. Hillman, your thoughts and then move down the line.

Mr. HILLMAN. We had done a study earlier looking at self-funding mechanisms of the regulators, across the banking regulators and securities regulators, and identified advantages and disadvantages of alternative approaches. The SEC, as you may know, is collecting fees associated with activities occurring within the financial markets. They receive registration fees for new stocks and bonds. They receive transaction fees paid over by national securities exchanges. They also have fees from proxy solicitations for mergers and acquisitions and the like. These fees do not come directly to the SEC. They are put within the Treasury's accounts, and the SEC has its own appropriations.

Some of the advantages of having SEC be removed from the appropriations process and going to a self-funding basis, based off the fee income which they are receiving, would be to have greater control over their budgets, have an ability to plan for their activities over a longer period of time, 5 years or more, perhaps, and have a greater ability to address its challenges in their workload areas.

Some of the disadvantages, however, have to do with the fact that a self-funding structure is not going to deal with all their problems that we are seeing within the SEC associated with, in the past, retention issues within their control, changing the mix of their resources and the like. It also significantly reduces the checks

and balance systems that currently exist within the budgetary and appropriations process.

Senator REED. Well, thank you very much.

Mr. Khuzami, your comments and thoughts?

Mr. KHUZAMI. Well, Mr. Chairman, I agree with your point absolutely about appropriations and resources. I told my staff on the first day that the appropriations was a little like the cavalry. You do not know if they are going to show up, when they are going to show up, and how long they are going to stay. And that is why it was incumbent upon us to organize our own house as efficiently as possible to make sure that the taxpayers received value for their dollar.

With respect to the issue of self-funding, I must say I have not spent really any time studying it. Obviously, the advantages are very appealing to me, but I think I will defer while the Chairman and the Commissioners consider those issues.

Senator REED. Professor Bullard and Mr. Hiler. Professor Bullard first.

Mr. BULLARD. I have spent a fair amount of time thinking about this issue, but it is not necessarily going to help you any because I have not really reached a firm conclusion what the best model is. I think the checks and balances point is right on the money. There is a lot of benefit to the political accountability. The SEC must demonstrate in contexts such as this one when it is going back to the hand that feeds it. On the other hand, having a more reliable source of income that is industry based has certain efficiencies.

I am sorry I cannot give you much of an opinion on that.

Senator REED. That helps.

Mr. Hiler.

Mr. HILER. Yes, I think that having some consistency at a certain level of funding is really imperative and would be extremely helpful for the Commission.

In terms of the checks and balances, I assume—I am a securities lawyer, but I assume that Congress could deal with that by calling the Commission and asking them to come over, submit their budget, see what is going on. But I think that would be a very good turn of events if the Commission could know from year to year that at least it has some source of funding and it does collect fees. I think years ago it used to be basically a surplus to the Treasury from when you balanced out what it was collecting in fees and so forth and what it was spending.

I think that some of the funds really, really should be best spent on paralegals, document control issues and document control assistance, IT and experts like we have all talked about in the GAO report and that I have talked about. I think that document control, knowing the size of these cases the SEC works on, that is one of the biggest consumers of time of an attorney, and they just do not have people there to help with that, and IT as well, and paralegals.

Senator REED. Can I just make the point that it might be in your expertise as a practitioner, on the other side the technology, both in the regulated industries and their attorneys, it must be phenomenal relative to the SEC. It is like, you know, sort of those Civil War militias going up against the 82nd Airborne.

Mr. HILER. Well, I will say that I do not feel that we have that much of an advantage. There are some very good attorneys, and they know their cases when we go up against them. They really know their cases. They know every document, and they have looked at it sideways and on the creases. So they make up for it in certain ways. But, yes, I think they are lagging behind in the technology, in the document control area for certain.

Senator REED. And just another point, too, and then I am going to recognize Senator Bunning, and we have been joined by Senator Schumer. In terms of understanding some of these new products, *et cetera,* the sophistication and the computer modeling is so significant, and I would assume even if you have suspicions or one of your attorneys, Mr. Khuzami, has suspicions, that to be able to understand what they are doing and feel that it is clearly wrong is a challenge without not only the computer technology but the market expertise that is on the other side. Is that a fair insight?

Mr. KHUZAMI. That is correct, Mr. Chairman. The challenge comes in a couple of different areas. One, it is understanding the markets. Two, it is being able to get the kind of training and other information that you need, particularly in the unregulated markets such as hedge funds and derivatives, in order to get the information and have it reported in a uniform way so you can put the story together and see whether or not there is suspicious or wrongful activity. And it is then the resources and the technology to be able to do that. So, as you say, it is a technological challenge across a number of fronts.

Senator REED. Thank you.

Senator Bunning, questions?

Senator BUNNING. Yes, thank you very much.

Mr. Khuzami, I would like to just ask you, What is a better measure of enforcement success—the amount of fines or the amount of cases handled? Or whatever else might come.

Mr. KHUZAMI. Well, yes, I think that would be a hard choice between the two of them because I think they both have some inadequacies. From my perspective, the best measure of both the performance of an individual attorney at the Commission as well as the overall program would be to focus less on quantity, although that still matters, but more on things like timeliness, how quickly do you bring a case. You know, the gap between conduct and atonement, if you will, the longer that stretches out, the less of a deterrent message you are able to send.

Two, you want to look at programmatic priorities. If the Enforcement Division decides that, you know, we see a lot of suspicious activity and insider trading by hedge funds, then we should be setting that as a priority and measuring our success on whether or not we are achieving results in that area.

And the third area that is of interest to me is really the deterrent impact, probably maybe the most important, but the most difficult to measure. How do you decide whether or not a case you bring has prevented others from doing the same thing? That is a big challenge. One of the ways I have seen it done successfully was by one of my predecessors, and it was not even in an enforcement case. But he announced to the Wall Street firms and said, "You have to scrub your own institutions and your own business people

and your own desks to look for conflicts of interest. And you better find them and identify them and remediate them, or we are going to come in and do it for you."

And I was at one of those financial institutions when that word came down, and we spent an enormous amount of time and money doing exactly that. We looked at our conflicts. We made disclosures. We cured some. We exited certain businesses.

Now, there was never a single case that was brought. Right? It would not show up in anybody's statistics. But the amount of good and effective deterrence that that achieved is probably immeasurable.

And so I would like to see us moving in some cases to more of a model like that where we can achieve that kind of deterrence, because ultimately, you know, we can sue people and try and get their money back, but we are all in a much better position if we stop it before it starts.

Senator BUNNING. To follow up, last year there were 700,000 complaints that were sent to the SEC that were not investigated or followed up on. Now, how can the SEC account for that?

Mr. KHUZAMI. Senator, I do not think it is the case that they were not followed up on. I think that is simply the raw number that was——

Senator BUNNING. Received.

Mr. KHUZAMI. ——received by the Commission. There was, in fact, and is, in fact, a rigorous program for collecting, investigating, monitoring, and referring those complaints that is in place.

Now, having said that, we all recognize that we can do a better job here, and one of the first things that Chairman Schapiro did was to order an independent vendor to study our processes, where we would be collecting all of these complaints in one area. Now it simply comes into too many different areas within the Commission. To collect it in one place, log it, analyze it, review it, look for patterns and trends across complaints to see if it tells a story, refer it out to the proper area, perhaps combine it with specialized units so that the people looking at these will have good eyes.

Senator BUNNING. But you have no idea how many were followed up on or were not followed up on out of the 700,000?

Mr. KHUZAMI. I am sure many, many, many of them were. I am happy to get those statistics.

Senator BUNNING. OK, I would appreciate that.

Mr. KHUZAMI. Sure.

Senator BUNNING. About more money and about better enforcement, you know, you were about to say something. I probably cut you off on the Stanford thing, and I did not mean to do that. If you have something to expand on that, now is the time. But a whistleblower on Madoff, and it took so long to get to the problem? That just—you know, to the ordinary citizen and to us sitting back who are watching SEC to enforce, we cannot imagine that happening.

Mr. KHUZAMI. I understand that, Senator. I mean, in the particular Stanford case you are referring to, there were—we did receive complaints early on, not necessarily particularly detailed or specific, but complaints. And there were a number of challenges in that case having to do with the cooperation not only of Mr. Stanford, but the inability to obtain documents from offshore, the co-

operation of the Antiguan authorities, and the lack of witnesses from the investors. And we continually, starting in approximately 2005, looked at that case going forward and continued to investigate. It was not a situation where someone gave us a complaint and we looked at it and decided there was nothing to do and moved on. We were continually investigating the case. It just took an extraordinarily long period of time in order to gather the evidence to bring the case. And once we did, we moved very quickly.

I agree that, you know, these cases should be brought in as timely a way that you can, and we are focused on that. But sometimes it just takes a considerable period of time to make a case.

Senator BUNNING. Good luck.

Senator REED. Thank you, Senator Bunning.

Senator Schumer.

Senator SCHUMER. Thank you, and I thank the witnesses.

My first bunch of questions may be all for Mr. Khuzami, but after he finishes, anyone can chime in.

The first one is about industry experts. The SEC, known as "the gem of the financial regulatory world" a long time ago, and the SEC's police, your Division, the Enforcement Division, was its public face and its iron fist. And now what we have seen after the financial crisis is how understaffed, inexperienced, and underfunded the Division of Enforcement has been under the previous administration. It is the idea Government is bad, cut it back, you know.

To oversee 30,000 registrants, 12,000 public companies, 4,600 mutual fund families, 11,000 investment advisers, *et cetera,* the Enforcement Division has a staff of 1,100. That is 10 percent less in absolute numbers than the staff it had in 2005. That is why Senator Shelby and I introduced the Safe Markets Act, to give the Enforcement Division the additional resources it needs. And Senator Reed, of course, has been a long-time champion of increased SEC funding.

It is also why I fought so hard for an amendment to the Fraud Enforcement Act on the floor last month to ensure that the SEC get the funding it desperately needs. That amendment passed, and a version of the bill with SEC funding intact, I am proud to say, just passed the House yesterday. So the SEC should be seeing the extra $40 million we fought to get you pretty soon.

Now, I want to know with some specificity how the SEC plans on using the $40 million, and I know Senator Bunning touched on this, but I would like to go a little bit further.

The Enforcement Division is almost exclusively staffed by attorneys, not by investment analysts who know how to crunch the numbers and analyze complex financial data and trades. You have announced a plan to reorganize the Division into specialist teams and give the enforcement attorneys more autonomy along the line of prosecutors at the U.S. Attorney's Office, and I applaud that. I think that is a good idea.

But do you plan to hire financial analysts, traders, and accountants with real industry knowledge and experience to help you investigate and oversee today's increasingly complex capital markets? And if so, give me some top-of-the-envelope idea of how many?

Mr. KHUZAMI. Well, Senator, we absolutely do plan on doing that. One of the advantages of having specialized groups is that

you will now have a fixed point within the organization where you can actually hire and assign these market specialists to a particular one. So if you have a structured products and securitization group, you can go out and hire structurers or traders, many of whom are currently unemployed, and bring them into the Division.

The numbers that we plan on hiring, you know, I do not have a firm number yet, but it depends in part on, you know, which kind of units we set up. But we get many inquiries from folks who want to help, retired traders——

Senator SCHUMER. But is it going to be a significant percentage, not one here or one there? I think there has been too much of a reliance on lawyers—I am not against lawyers; I am one—and not enough on the investigative type people who have had experience in the financial world.

Mr. KHUZAMI. It will be a significant number.

Senator SCHUMER. OK, good. When do you expect all of this to happen, your reorganization plan, including these new people?

Mr. KHUZAMI. Well, it is somewhat of an execution challenge to roll this out, obviously, when you talk about restructuring a large part of the Division. But we are going to start doing the initial planning stages very soon. We have identified a small number of specialized groups that we want to start out with, and I suspect that we will start this process in a matter of weeks.

Senator SCHUMER. Good. OK. The next question deals with sort of the siloization of investigations, which is not your fault. That is what Congress has done because of all our jurisdictional turf battles. Last year, the Enforcement Division received 700,000 tips, complaints, and referrals from the public and Federal agencies. When the Enforcement Division receives a tip, it now only has the ability to investigate SEC-regulated activities or entities. Do you think this is sufficient in protecting our markets? Or do you think the SEC should also have investigative powers over currently unregulated entities—hedge funds and unregulated products like credit default swaps—to ensure the integrity of our capital markets?

Mr. KHUZAMI. My answer to that, Senator, is a strong yes. My view is that we need access to hedge funds, credit derivatives, and other products, particularly the trading information, so that we can combine that with other information that we see in the regulated entities to make sure that we have a full picture of what is going on and to be able to detect wrongdoing.

Senator SCHUMER. Good. Next one. You know, the SEC has limited resources, but they may not be used most effectively. According to the data provided by the SEC, 40 percent of enforcement personnel and 20 percent of examinations personnel are based in Washington, DC, which, until last fall, was not the financial center of the country, and still is not the financial center—will not be again soon. New York is coming back.

But despite the overwhelming concentration of financial entities in the New York City metropolitan area, the SEC has stationed only 15 percent of its enforcement personnel and a quarter of its examination personnel there. That seems to me a misallocation of resources. While I think we need to put in certain rules and regulations to ensure that the relationship between regulators and the

regulated does not become close or too close, I also think agents have a much harder time staying on top of what is going on in the capital markets when they are 200 miles away.

Do you agree? Will you consider allocating or reallocating some of the personnel to New York City as part of the shake-up of your Enforcement Division?

Mr. KHUZAMI. Senator, I have not looked specifically at that issue, but I will certainly consider it. The one thing I will say is that our specialization effort will result in nationwide teams of investigators and attorneys looking at particular areas. So that in some sense, geographical location will become less important because you will have a team across the Nation focusing——

Senator SCHUMER. I know, but when the team is having lunch in Phoenix, they do not pick up as much information as they do in downtown Manhattan. So I am going to ask you again. What are you going to do about reallocating personnel to New York City?

Mr. KHUZAMI. I have not considered that in my 5 weeks, but I will certainly take that under advisement.

Senator SCHUMER. I think the SEC should move to New York City, at least the Enforcement Division as a whole. I do. I think it would do a much, much better job.

I also think the New York regional office is badly in need of permanent leadership, and soon. I would urge you to act quickly and consider naming someone like yourself who is a former Federal prosecutor with securities experience. How closer are you to naming someone? And are you considering the kind of people with the background I mentioned? I do not have anyone specific in mind.

Mr. KHUZAMI. We are in the very final stages of that process, and we have an abundance of highly qualified candidates, including those with the profile that you mention.

Senator SCHUMER. What is the likelihood one of them is going to be picked with that profile?

[Laughter.]

Senator SCHUMER. You are a lawyer. I can ask questions, too.

Mr. KHUZAMI. Well, I do not want to pre-judge the process

Senator SCHUMER. OK.

Mr. KHUZAMI. But I hear what you are saying.

Senator SCHUMER. OK, thank you. Finally—let us see. I have two more with the Chairman's indulgence. OK.

Unlike the other Divisions at the SEC—this is about small investor protection—the Division of Enforcement does not have a hotline the public can call. For instance, one of my constituents is a victim of one of the reserve funds. You charged their directors with fraud this week. The constituent has contacted my office regularly since the fund broke the buck last fall because there is no other place he can turn to ask questions, get status updates, register complaints about the way the situation is being handled, and that is an unacceptable situation.

I hear that the Office of Investor Education and Advocacy, which is charged with the mission of advising the small investor, has received so many calls, it maintains a database of investor complaints of fraud.

Do you agree that the Enforcement Division should have a hotline?

Mr. KHUZAMI. Senator, our entire complaint, tip, and referral process is under investigation. A hotline certainly sounds like a pretty good idea. I have no idea if that is in the works, but I will pass that suggestion along the line.

Senator SCHUMER. Could you please? Yes, and get back to me. On all of these, if you could get back to me in writing—within 5 days, is that OK? A week?

Mr. KHUZAMI. Yes.

Senator SCHUMER. OK, great. Can you explain to me how the Enforcement Division coordinates with the Office of Investor Education and Advocacy and other Divisions who receive calls about fraud and violations?

Mr. KHUZAMI. Senator, the complaints, tips, and referrals that we get come in from many different portals within the SEC, and that is one of the things we are trying to consolidate. They come in, but they are all collected in central areas and are analyzed and triaged and referred. We are going to be doing a better job of that, but that is the current structure.

Senator SCHUMER. So who receives the calls—I mean, again, they are all referred or triaged——

Mr. KHUZAMI. Yes.

Senator SCHUMER. ——and referred?

Mr. KHUZAMI. Yes.

Senator SCHUMER. So if you are two out of the three, you do not get any response?

Mr. KHUZAMI. I am sorry. I do not follow.

Senator SCHUMER. Well, if it is triaged, that is one——

Mr. KHUZAMI. Well, by triage, I mean spam and, you know, kind of the nonsense——

Senator SCHUMER. OK. But anyone who calls with an actual complaint or whatever will be given a call back.

Mr. KHUZAMI. They will be referred to the appropriate area, and the complaint will be followed up on.

Senator SCHUMER. OK, thanks.

Finally, last but not least, rule-making consultation. The Divisions of Corporation Finance, Trading and Markets, and Investment Management are the rule-making Divisions while Enforcement enforces the rules. During the rule-making process, the industry and the public are consulted and have the opportunity to submit comments.

Are you consulted, is the Enforcement Division consulted on the enforceability of the rules the other Divisions are writing?

Mr. KHUZAMI. Yes, Senator. When new rules are being proposed, the views of Enforcement, especially with respect to whether or not the proposed rules have an enforcement impact, we are consulted and permitted to voice our views in the same way that these other Divisions voice their views on our enforcement cases.

Senator SCHUMER. Permitted, but is it part of the process?

Mr. KHUZAMI. Yes

Senator SCHUMER. Good. And, finally, last question: Can you explain to me how the other Divisions train and assist the enforcement attorneys?

Mr. KHUZAMI. Well, all of our cases—well, first of all, we are well aware within the Division of the expertise in our other Divisions.

So if we have a question, we just pick up on the phone and call them.

There is a more formalized process as part of our case review where they get to review proposed actions and comment on them. One of the benefits of specialization, we hope, is that we can get that expertise in sooner to our investigations in order to take advantage of it. You know, why go outside first when you have got some of the best experts in the country in-house.

Senator SCHUMER. OK. Does anyone else have a comment on any of the things I mentioned? If not, then thank you all for being here, and thank you, Mr. Chairman.

Senator REED. Thank you, Senator Schumer.

I have two statements, one from Chairman Dodd and one from the President of the National Treasury Employees Union, to include in the record, and I have checked with the minority staff, and without objection, I would order these statements be made part of the record.

Senator REED. Let me just raise one question. Senator Schumer has highlighted a question about competition among the Divisions, Mr. Khuzami, and Mr. Hiler made that point, too, and you have responded. Is there anything else you would like to say about this issue of competition among Divisions?

Mr. KHUZAMI. Candidly, Mr. Chairman, I have not seen evidence of that. We really—to some degree—my view at this point is that it is a highly collegial environment. We kind of operate in similar but different spheres, so it is not the case that we are focused on the same issues. We get their inputs; they give us their input. And, to me, it is a very collaborative process that works well.

The only issues I have seen is whether—you know, sometimes things take too long to move through the process as you consult multiple Divisions, and we hope to be able to streamline that.

Senator REED. And let me ask another question which was suggested by one of Mr. Hillman's comments; that is, the retention of qualified attorneys. It might be easier now given that competing private companies are not as flush or lush, but that issue is always there in terms of maintaining highly qualified personnel.

I think both Professor Bullard and Mr. Hiler worked for the Commission, and then their academic and professional challenges left. Your comment on what we can do—and you might even want to think about this and get back to us—about providing appropriate incentives to attract the right people and then keep them there, provide long-term expertise. Do you have any comments?

Mr. KHUZAMI. Well, Senator, you know, the pay parity rules that were passed a few years ago that increased the salaries were very helpful in terms of retaining talent. We do fluctuate as markets fluctuate and the demand changes.

I think that one of the great benefits of refocusing on enforcement and specialization and the other things we are considering is that the Division, I think, is just going to be a more attractive place for people to work, and they will stay longer because they are doing good cases in an active way and their contributions are valued. And if the gentleman to my left wanted to return to the Division to work, we would be more than happy to consider it.

Mr. HILER. I am surprised to hear that, actually.

[Laughter.]

Mr. BULLARD. I do not think he has checked that with some of his colleagues.

Senator REED. I am glad we are able to have a job fair as well as a hearing. This is sort of doing double duty today.

Gentlemen, thank you very much for your very insightful testimony. I would ask that if any of my colleagues have additional questions they would submit them no later than May 13th so that we could get them to the witnesses. And I know some of the witnesses have suggested they will respond—is a week appropriate, Mr. Khuzami, given you—or we could make it 2 weeks.

Mr. KHUZAMI. Two weeks would be fine, if that is——

Senator REED. Let us just suggest that any requests for information by the Ranking Member or Senator Schumer or anyone on the Committee, if you could comply within 2 weeks, I would appreciate it very much.

That concludes the hearing. Thank you very much, gentlemen.

[Whereupon, at 3:53 p.m., the hearing was adjourned.]

[Prepared statements, response to written questions, and additional material supplied for the record follow:]

## PREPARED STATEMENT OF SENATOR CHRISTOPHER J. DODD

I am pleased that the Securities Subcommittee is holding today's hearing and commend my colleague, Senator Reed, for his work to enhance the performance of the Securities and Exchange Commission.

The SEC's Division of Enforcement has a vital role in promoting compliance with the securities laws. It is critical to promoting the integrity, fairness, and efficiency of U.S. financial markets. Strong enforcement promotes investor confidence and participation in these markets, which enables companies to raise capital, grow, provide jobs, and create wealth. It is important that this division be strong.

On March 20, 2008, Senator Reed and I asked the GAO to study the SEC's Division of Enforcement. We asked them to assess whether it has sufficient staff and funds to perform its mission. We also asked them to analyze the significant decrease in penalties and disgorgements the SEC has collected in recent years, and the policies which put speed bumps in the course of staff settlement negotiations. We asked the GAO to examine rumors of declining staff morale and to assess the Commission's progress in implementing suggestions made by a GAO study from August of 2007.

Since the date of our letter, there have been additional public concerns raised about enforcement. They came to a crescendo with revelations about the failures of the SEC and the self-regulatory organization it oversees to discover the Bernard L. Madoff Investment Securities Ponzi scheme—even after the SEC received extensive and credible tips.

Today's GAO study has identified several areas of concern. The number of attorneys responsible for primary enforcement declined 11.5 percent between 2004 and 2008—precisely at the time that some of the most egregious behavior, such as the Madoff Ponzi scheme, was occurring. The GAO has found significant shortcomings in the SEC's data technology that have hampered its enforcement work.

I am concerned about these and other shortcomings identified in the report, and hope that the SEC will carefully review GAO's recommendations and make necessary improvements. I am further disappointed that the SEC did not raise these problems directly with the Committee on any of the numerous occasions on which it appeared before us.

The Congress has recently given the Commission additional resources and stands ready to provide more as needed. However, we also need to take a hard look at the way the Commission has used the resources they have already been given.

While the decline in enforcement attorneys is certainly troubling, the GAO indicates that SEC enforcement has not effectively managed the staff it does have. Within one program, a Director complained that "most staff ostensibly in his office are in fact within the organizational structure of a different division." GAO indicates that complex approval procedures for investigations have led some attorneys to close cases rather than go through the bureaucracy needed to keep them open. This potentially allowed fraudsters to go unprosecuted.

Even though I recognize that the SEC needs more enforcement funding, I have some concerns about how they have used some of the funding they have already been given. For example, the SEC Inspector General reported last month that the Commission spent nearly $4 million rearranging offices in an apparent vain effort to improve communication among staff members. The Inspector General concluded that it was not clear that this "restacking" project was necessary or had any meaningful impact on communication among the staff or productivity. GAO said that "the SEC should have conducted a formal cost-benefit analysis of the restacking project and, had such an analysis been prepared, it may have led to the conclusion that the restacking project was not worth the costs and disruption to the Commission."

The Commission should assure Congress that it will manage its resources wisely, to promote the agency's mission.

The need for the government to detect and prosecute fraud and other financial crimes has never been more crucial. The Division of Enforcement is vital to protecting investors. It must have the talent and tools needed to perform a superior job. And we must also demand excellence for our money. We must ensure that money is being spent on management, programs, and procurements that work. We must insist that management be more efficient and that enforcement attorneys are held to the highest standards. American investors deserve nothing less.

I thank the GAO for its work and look forward to improved performance from the Division of Enforcement under its new leadership.

**PREPARED STATEMENT OF RICHARD J. HILLMAN**

MANAGING DIRECTOR,
FINANCIAL MARKETS AND COMMUNITY INVESTMENT,
GOVERNMENT ACCOUNTABILITY OFFICE

MAY 7, 2009

United States Government Accountability Office

GAO

Testimony

Before the Subcommittee on Securities, Insurance, and Investment, Senate Committee on Banking, Housing, and Urban Affairs

For Release on Delivery
Expected at 2:30 p.m. EDT
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# SECURITIES AND EXCHANGE COMMISSION

# Greater Attention Is Needed to Enhance Communication and Utilization of Resources in the Division of Enforcement

Statement of Richard J. Hillman, Managing Director
Financial Markets and Community Investment


GAO-09-613T

GAO
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Highlights

Highlights of GAO-09-613T, a testimony before the Subcommittee on Securities, Insurance, and Investment, Senate Committee on Banking, Housing, and Urban Affairs

## Why GAO Did This Study

In recent years, questions have been raised about the capacity of the Securities and Exchange Commission's (SEC) Division of Enforcement (Enforcement) to manage its resources and fulfill its law enforcement and investor protection responsibilities. This testimony focuses on (1) the extent to which Enforcement has an appropriate mix of resources; (2) considerations affecting penalty determinations, and recent trends in penalties and disgorgements ordered; and (3) the adoption, implementation, and effects of recent penalty policies. The testimony is based on the GAO report, *Securities and Exchange Commission: Greater Attention Needed to Enhance Communication and Utilization of Resources in the Division of Enforcement* (GAO-09-358, March 31, 2009). For this work, GAO analyzed information on resources, enforcement actions, and penalties; and interviewed current and former SEC officials and staff, and others.

## What GAO Recommends

GAO made several recommendations, including that the SEC Chairman (1) further review the level and mix of Enforcement resources, and assess the impact of the division's internal case review process; (2) examine whether the 2006 corporate penalty policy is achieving its intended goals; and (3) take steps to ensure appropriate staff participation in policy development and review. SEC agreed with the recommendations.

To view the full product, including the scope and methodology, click on GAO-09-613T. For more information, contact Orice Williams at 202-512-8678 or williamso@gao.gov.

# SECURITIES AND EXCHANGE COMMISSION

## Greater Attention Needed to Enhance Communication and Utilization of Resources in the Division of Enforcement

## What GAO Found

Recent overall Enforcement resources and activities have been relatively level, but the number of investigative attorneys decreased 11.5 percent over fiscal years 2004 and 2008. Enforcement management said resource levels have allowed them to continue to bring cases across a range of violations, but both management and staff said resource challenges have delayed cases, reduced the number of cases that can be brought, and potentially undermined the quality of some cases. Specifically, investigative attorneys cited the low level of administrative, paralegal, and information technology support, and unavailability of specialized services and expertise, as challenges to bringing actions. Also, Enforcement staff said a burdensome system for internal case review has slowed cases and created a risk-averse culture. SEC's strategic plan calls for targeting resources strategically, examining whether positions are deployed effectively, and improving program design and organizational structure. Enforcement management has begun examining ways to streamline case review, but the focus is process-oriented and does not give consideration to assessing organizational culture issues.

A number of factors can affect the amount of a penalty or disgorgement that Enforcement staff seek in any individual enforcement action, such as nature of the violation, egregiousness of conduct, cooperation by the defendant, remedial actions taken, and ability to pay. In 2006, the Commission adopted a policy that focuses on two factors for determining corporate penalties: the economic benefit derived from wrongdoing and the effect a penalty might have on shareholders. In 2007, the Commission adopted a policy, now discontinued, that required Commission approval of penalty ranges before settlement discussions. Setting aside the effect of any policies, total penalty and disgorgement amounts can vary on an annual basis based on the mix of cases concluded in a particular period. Overall, penalties and disgorgements ordered have declined significantly since the 2005-2006 period. Total annual penalties fell 84 percent, from a peak of $1.59 billion in fiscal year 2005 to $256 million in fiscal year 2008. Disgorgements fell 68 percent, from a peak of $2.4 billion in fiscal year 2006 to $774.2 million in fiscal year 2008.

Enforcement management, investigative attorneys, and others agreed that the two recent corporate penalty polices on factors for imposing penalties, and Commission pre-approval of a settlement range have delayed cases and produced fewer, smaller penalties. GAO also identified other concerns, including the perception that SEC had retreated on penalties, and made it more difficult for investigative staff to obtain formal orders of investigation, which allow issuance of subpoenas for testimony and records. Our review also showed that in adopting and implementing the penalty policies, the Commission did not act in concert with agency strategic goals calling for broad communication with, and involvement of, the staff. In particular, Enforcement had limited input into the policies the division would be responsible for implementing. As a result, Enforcement attorneys reported frustration and uncertainty in application of the penalty policies.

Mr. Chairman and Members of the Subcommittee:

I am pleased to be here today to discuss the results of our recent study of the U.S. Securities and Exchange Commission (SEC) Division of Enforcement (Enforcement).[1] The division plays a key role in helping the agency meet its mission of protecting investors and maintaining fair and orderly markets. Current economic conditions and recent turmoil in financial markets have underscored the importance of Enforcement's role. Each year, Enforcement brings hundreds of civil enforcement actions against individuals and companies accused of violating securities laws. However, we and others have criticized Enforcement's capacity to effectively manage its activities and fulfill its critical law enforcement and investor protection responsibilities on an ongoing basis. As you know, the alleged Madoff fraud—described as the largest Ponzi scheme in history—and the failure of Enforcement to detect the fraud during prior investigation of the firm have increased concerns about the adequacy of SEC's enforcement efforts.

This statement is based on our March 31, 2009 report, and focuses on: (1) the extent to which Enforcement has an appropriate mix of resources dedicated to achieving its objectives, including support staff, information technology, and access to specialized services; (2) the factors that influence the amount of penalties and disgorgements that are ordered and the total amount of these remedies in recent years; and (3) the adoption, implementation, and effects of two recent policies for determining corporate penalties.

To address our objectives, we analyzed information on trends in SEC resources, enforcement actions, and penalties, and reviewed relevant documents on the corporate penalty policies. We also met with SEC officials, former SEC commissioners, current and former Enforcement staff, and outside parties knowledgeable about Enforcement practices, such as securities defense attorneys and academics who study the securities industry and SEC. We held 11 small group meetings with a total of more than 80 front-line Enforcement staff—investigative attorneys, and first-level supervisors, known as branch chiefs—in four SEC offices across

[1]GAO, *Securities and Exchange Commission: Greater Attention Needed to Enhance Communication and Utilization of Resources in the Division of Enforcement*, GAO-09-358 (Washington, D.C.: Mar. 31, 2009).

the country (Chicago, San Francisco, New York, and Washington, D.C.).[2] We undertook this performance audit in accordance with generally accepted government auditing standards. These standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

## Summary

Overall Enforcement resources and activities have been relatively level recently, but the number of non-supervisory investigative attorneys decreased 11.5 percent during fiscal years 2004 through 2008. Enforcement management said resource levels have not prevented the division from continuing to bring cases across a range of violations, but both management and staff said resource challenges have delayed cases, reduced the number of cases that can be brought, and potentially undermined the quality of some cases. Specifically, investigative attorneys cited the low level of administrative, paralegal, and information technology support, and unavailability of specialized services and expertise. Also, Enforcement staff said a burdensome system for internal case review has slowed cases, and that there is a culture of risk aversion. SEC's strategic plan calls for targeting resources strategically, examining whether positions are deployed effectively, and improving program design and organizational structure. Enforcement management has begun examining how to streamline case review, but their focus is on process and does not give consideration to assessing organizational culture issues. To address these issues, we recommended that the Chairman further review the level and mix of resources dedicated to Enforcement, and assess the impact that the division's current review and approval process for investigative staff work has on organizational culture and the ability to bring timely enforcement actions.

A number of factors can affect the amount of a penalty or disgorgement that Enforcement staff seek in any individual enforcement action. For example, staff consider the nature of the violation, egregiousness of conduct, cooperation by the defendant, remedial actions taken, and ability to pay. In 2006, the Commission adopted a policy that focuses on two

[2]In this testimony, we collectively refer to investigative attorneys and branch chiefs with whom we spoke as "investigative attorneys." Also, while we spoke to a variety of Enforcement staff in small group meetings, the comments we received are not necessarily representative of the beliefs of all staff.

factors for determining corporate penalties: the economic benefit derived from wrongdoing and the effect a penalty might have on shareholders. In 2007, the Commission adopted a policy, now discontinued, that required Commission approval of penalty ranges before settlement discussions. Setting aside the effect of any policies, penalty and disgorgement amounts can vary on an annual basis based on the mix of cases concluded in a given period. However, overall penalties and disgorgements ordered have declined significantly since the 2005 through 2006 period. Penalties fell 84 percent, from a peak of $1.59 billion in fiscal year 2005 to $256 million in fiscal year 2008. Disgorgements fell 68 percent, from a peak of $2.4 billion in fiscal year 2006 to $774.2 million in fiscal year 2008.

Enforcement management, investigative attorneys, and others agreed that the two recent corporate penalty polices—on factors for imposing penalties, and Commission pre-approval of a settlement range—have, as implemented, delayed cases and produced fewer, smaller penalties. We identified other concerns, including the perception by some that SEC had "retreated" on penalties and made it more difficult for investigative staff to obtain "formal orders of investigation," which allow for issuance of subpoenas for testimony and records. Our review also showed that in adopting and implementing the penalty policies, the Commission did not act in concert with agency strategic goals calling for broad communication with, and involvement of, the staff. In particular, Enforcement had limited input into the policies it would be responsible for implementing. As a result, Enforcement attorneys reported frustration and uncertainty in applying the penalty policies. To begin to address these issues, we recommended that the Chairman determine if the 2006 corporate penalty policy is achieving its stated goals, and any other effects the policy may have had in adoption or implementation. We also recommended that the Chairman take steps to ensure that the Commission, in creating, monitoring, and evaluating its policies, adheres to its strategic goal and follows other best practices for communication with, and involvement of, the staff affected by such changes.

## Background

SEC is an independent agency created to protect investors; maintain fair, honest, and efficient securities markets; and facilitate capital formation. SEC's five-member Commission oversees SEC's operations and provides final approval of SEC's interpretation of federal securities laws, proposals for new or amended rules to govern securities markets, and enforcement activities. Enforcement staff located in headquarters and 11 regional offices conduct investigations through informal inquiries, interviews of

witnesses, examination of brokerage records, reviews of trading data, and other methods.[3] At the request of Enforcement staff, the Commission may issue a formal order of investigation, which allows the division's staff to compel witnesses by subpoena to testify and produce books, records, and other documents. Following an investigation, SEC staff present their findings to the Commission for its review, recommending Commission action either in a federal court or before an administrative law judge. On finding that a defendant has violated securities laws, the court or the administrative law judge can issue a judgment ordering remedies, such as civil monetary penalties and disgorgement. In many cases, the Commission and the party charged decide to settle a matter without trial. In these instances, Enforcement staff negotiates settlements on behalf of the Commission.

## Investigative Staffing Has Fallen and Resource Challenges Undermine the Ability to Bring Enforcement Actions

Total Enforcement staffing has declined 4.4 percent, from a peak of 1,169 positions in fiscal year 2005 to 1,117 positions in fiscal year 2008.[4] While overall Enforcement resources and activities have remained relatively level in recent years, the number of non-supervisory investigative attorneys, who have primary responsibility for developing enforcement cases, decreased by 11.5 percent, from a peak of 566 in fiscal year 2004 to 501 in fiscal year 2008. Enforcement management attributed this greater decline to several factors: promotion of staff attorneys into management during a hiring freeze, which left their former positions vacant; diversion of investigative positions to other functions; and reduction of opportunities for non-attorney support staff to move to positions outside the agency.

At the same time, staff turnover has decreased and staff tenure increased. The majority of Enforcement's non-supervisory attorney workforce has 10 years of experience or less, but the distribution of experience in this category has reversed in recent years. The portion with less than 3 years of experience has declined by about 50 percent, and the portion with 3 to less than 10 years of experience has increased by about 55 percent. The portion with 10 to less than 15 years, while small overall, has grown by

[3]The Commission delegates various authorities to the Director of Enforcement, such as instituting subpoena enforcement proceedings in federal court or demanding production of various records. *See* 17 C.F.R. § 200.30-4(10).

[4]After the Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (July 30, 2002), increased SEC's appropriations authorization, Enforcement staffing increased before subsequently declining. In fiscal year 2008, staffing increased, but remained below the post-Sarbanes-Oxley peak.

about 14 percent. Enforcement management welcomed these trends, but believed they resulted from a weaker private-sector job market for attorneys. They felt that had market conditions been better recently, departures would have been more numerous, which would have depressed the experience level.

Measured by the number of enforcement cases opened and number of enforcement actions brought annually, Enforcement activity has been relatively level in recent years. Case backlog has declined somewhat as the division has made case closings a greater priority. Nevertheless, Enforcement management and investigative attorneys agreed that resource challenges have affected their ability to bring enforcement actions effectively and efficiently. Enforcement management told us that the current level of resources has not prevented the division from continuing to bring cases across a range of violations. But management and staff acknowledged that current staffing levels mean some worthwhile leads cannot be pursued, and some cases are closed without action earlier than they otherwise would have been. More specifically, investigative attorneys cited the low level of administrative, paralegal, and information technology support, unavailability of specialized services and expertise, and a burdensome system for internal case review as causing significant delays in bringing cases, reducing the number of cases that can be brought, and potentially undermining the quality of cases. Enforcement management concurred with the staff's observations that resource challenges undercut enforcement efforts. Effective and efficient use of resources is important to accomplishing Enforcement's mission. SEC's strategic plan calls for targeting resources strategically, examining whether positions are deployed effectively, and exploring how to improve program design and organizational structure. Some attorneys with whom we spoke estimated that they spend as much as a third to 40 percent of their time on the internal review process. Recently, Enforcement management has begun efforts that seek to streamline the case review process. The initiative focuses on process, but our review suggests that organizational culture issues, such as risk aversion and incentives to drop cases or narrow their scope, are also present. If the division does not consider such issues in its initiative, it may not be as successful as it otherwise could be.

## Various Factors Affect the Amount of Penalties and Disgorgements Ordered, While Overall, Total Amounts Have Declined in Recent Years

Enforcement staff consider a number of factors when determining the dollar amounts of penalties and disgorgements, which in total have declined in recent years. To determine a penalty in an individual case, Enforcement staff consider factors such as the nature of the violation, egregiousness of conduct, cooperation by the defendant, remedial actions taken, and ability to pay. Disgorgement is intended to recover ill-gotten gains made, or losses avoided, through a defendant's actions. In 2006 and 2007, the Commission articulated certain policies for determining the appropriateness and size of corporate penalties. The 2006 policy—which the Commission said was based in part on the legislative history of a 1990 act that provided SEC with civil penalty authority—established nine factors for evaluating imposition of corporate penalties, but said two were of primary importance: (1) direct benefit to the corporation and (2) additional harm to shareholders.[5]

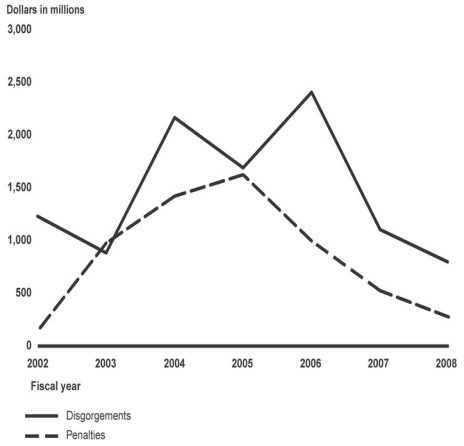
The 2007 policy, now discontinued, required Enforcement staff, when contemplating a corporate penalty, to obtain Commission approval of a penalty range before settlement discussions could begin. Cases that subsequently were settled within the range specified by the Commission were eligible for approval on an expedited basis. At the same time the Commission provided the settlement range, it also granted Enforcement staff authority to sue. According to Enforcement staff and former commissioners with whom we spoke, and as stated by the then-Chairman, the purpose of the policy, also known as the "pilot program," was to:

[5]*See* SEC, *Statement of the Securities and Exchange Commission Concerning Financial Penalties* (Jan. 4, 2006). In this statement, the Commission noted that SEC's authority to impose civil penalties was relatively new and that existing SEC penalty cases did not provide a clear public view of when and how the Commission would seek civil penalties against corporations. In describing a particular framework that it followed for penalty determinations in two cases, the Commission said it relied on the legislative history of the Securities Enforcement Remedies and Penny Stock Reform Act, Pub. L. No. 101-429, 104 Stat. 931 (Oct. 15, 1990). The act provided SEC general authority to seek civil money penalties in enforcement cases. Prior to this act, the SEC's authority to seek civil penalties was generally limited to cases filed in district court for insider trading violations. In its January 2006 statement, the Commission identified factors from the statute and its legislative history pertinent to the analysis of corporate issuer penalties, with the first two being of principal consideration: (1) the presence or absence of a direct benefit to the corporation as a result of the violation; (2) the degree to which the penalty will recompense or further harm the injured shareholders; (3) the need to deter the particular type of offense; (4) the extent of the injury to innocent parties; (5) whether complicity in the violation is widespread throughout the corporation; (6) the level of intent on the part of the perpetrators; (7) the degree of difficulty in detecting the particular type of offense; (8) presence or lack of remedial steps by the corporation; and (9) the extent of cooperation with Commission and other law enforcement.

- provide earlier Commission involvement in the penalty process;
- strengthen Enforcement staff's negotiating position; and
- maintain consistency, accountability, and due process.

Setting aside the effect of the implementation of any policy, the total amount of penalties and disgorgement ordered on an annual basis can vary according to the type and magnitude of cases concluded in a given period. As shown in figure 1, since reaching peaks in fiscal years 2005 and 2006, total annual penalty and disgorgement amounts have declined. While both penalties and disgorgements fell in recent years, penalties have been declining at an accelerating rate, falling 39 percent in fiscal year 2006, another 48 percent in fiscal year 2007, and then 49 percent in fiscal year 2008. Also, penalties declined in the aggregate by a greater amount than disgorgements. In particular, penalties fell 84 percent, from a peak of $1.59 billion in fiscal year 2005 to $256 million in fiscal year 2008. Disgorgements fell 68 percent, from a peak of $2.4 billion in fiscal year 2006 to $774.2 million in fiscal year 2008.

Figure 1: Dollar Totals of Penalties and Disgorgements, Fiscal Years 2002 through 2008




Source: SEC.

Compared to fiscal year 2006, SEC brought more corporate penalty cases in fiscal 2007, but for smaller amounts. In 2007, SEC brought 10 cases, compared to 6 in 2006. Four of the six cases in 2006 resulted in penalties of $50 million or more, with the two largest, American International Group, Inc. and Fannie Mae, totaling $100 million and $400 million, respectively. In contrast, in the fiscal year 2007 cases, only two issuers, MBIA, Inc., and Freddie Mac, were assessed penalties of at least $50 million.[6]

The distribution of enforcement actions by type of case generally has been consistent in recent years. Enforcement management said that the division has met its goal that a single category of cases not account for more than 40 percent of all actions.

[6]The parties settled without admitting or denying the charges.

## Recent Corporate Penalty Policies—Adopted and Implemented with Only Limited Communication—Have Delayed Cases and Discouraged Penalties

We found that Enforcement management, investigative attorneys, and others concurred that the 2006 and 2007 penalty policies, as applied, have delayed cases and produced fewer and smaller corporate penalties. On their face, the penalty policies are neutral, in that they neither encourage nor discourage corporate penalties. However, Enforcement management and many investigative attorneys and others said that Commission handling of cases under the policies both transmitted a message that corporate penalties were highly disfavored and caused there to be fewer and smaller corporate penalties.

According to a number of Enforcement attorneys and division managers, investigative attorneys began avoiding recommendations for corporate penalties. For example, when the question of whether to seek a corporate penalty is a close one, the staff will default to avoiding the penalty. Or, if investigative staff decides to seek a penalty, they will change their focus from pursuing what they otherwise would recommend as most appropriate to tailoring recommendations to what they believe the Commission will find acceptable. According to many investigative attorneys, the penalty policies contributed to an adversarial relationship between Enforcement and the Commission, where some investigative attorneys came to see the Commission less as an ally and instead more as a barrier to bringing enforcement actions.

Enforcement management told us they concurred with these observations about the effect of the application of the penalty policies. Although the Commission never directed there be fewer or smaller penalties, the officials said this has been the practical effect because Commission handling of cases made obtaining corporate penalties more difficult. Over time, the officials said they struggled with implementation and were unable to provide guidance to the staff, because they saw the Commission's application of the penalty factors as inconsistent. Furthermore, the widely held view in Enforcement was that the unstated purpose of the 2006 policy was to scale back corporate penalties.

Our review identified several other concerns voiced by Enforcement staff and others:

- That the policies have had the effect of making penalties less punitive in nature—by conditioning corporate penalties in large part on whether a corporation benefited from improper practices, penalties effectively become more like disgorgement.
- That the 2007 policy (Commission pre-approval of a settlement range) could have led to less-informed decisions about corporate penalties. That

is, the Commission would decide on a penalty range in advance of settlement discussions, when settlement discussions themselves can reveal relevant information about the conduct of the wrongdoer.

- That the policies have reduced incentives for subjects of enforcement actions to cooperate with the agency, because of the perception that SEC has retreated on penalties.

- That it became more difficult to obtain formal orders of investigation, which allow issuance of subpoenas to compel testimony and produce books. Since fiscal year 2005, the number of formal orders approved by the Commission has decreased 14 percent.

Our review also showed that in adopting and implementing the 2006 and 2007 corporate penalty policies, the Commission did not act in concert with agency strategic goals calling for broad communication with, and involvement of, the staff. In particular, Enforcement, which is responsible for implementing the policies, had only limited input into their development. According to Enforcement management, the broad Enforcement staff had no input into either policy. Senior division management did have input into the 2006 policy, but none into the 2007 policy. As a result, Enforcement attorneys say there has been frustration and uncertainty about application of the penalty policies.

Mr. Chairman, this concludes my prepared statement. I would be happy to respond to any questions that you or other members of the subcommittee might have.

## Contacts

For further information on this testimony, please contact Orice M. Williams at (202) 512-8678 or williamso@gao.gov, or Richard J. Hillman at (202) 512-8678 or hillmanr@gao.gov. Contact points for our Offices of Congressional Relations and Public Affairs may be found on the last page of this statement. Individuals making key contributions to this testimony include Karen Tremba, Assistant Director and Christopher Schmitt.

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## PREPARED STATEMENT OF ROBERT KHUZAMI

DIRECTOR,
DIVISION OF ENFORCEMENT,
SECURITIES AND EXCHANGE COMMISSION

MAY 7, 2009

**Introduction**

Chairman Reed, Ranking Member Bunning, and Members of the Subcommittee, thank you for inviting me to testify today on behalf of the Securities and Exchange Commission and its Division of Enforcement. I am both honored and proud to be here as the SEC's new Director of Enforcement. I am also extremely grateful for this Subcommittee's support and assistance in, among other things, efforts to increase our budget, meet our enforcement responsibilities, and fulfill our mission of protecting investors.

I would also like to thank the GAO and its team. I truly appreciate the careful work that is evident in the *GAO Report: Securities and Exchange Commission: Greater Attention Needed to Enhance Communication and Utilization of Resources in the Division of Enforcement* (GAO-09-358), and the extensive cooperation that our two agencies have shared not only with respect to this report, but with respect to others in the past. As our Chairman, Mary Schapiro, has noted, reinvigorating the SEC's Enforcement program is a top priority, and I fully concur with the GAO's recommendations.

In your letter inviting me to appear, you asked me to provide my views on: (1) the extent to which the resource shortages and enforcement policies of the SEC in recent years have hampered aggressive enforcement of securities laws; (2) what changes are needed to ensure that the SEC does not once again fall behind on its enforcement responsibilities; and (3) what changes Congress should consider to ensure adequate resources and authority for the SEC to fulfill its vital enforcement role.

As I will discuss in more detail, we have faced and are facing many challenges, including a complex and growing market and limited resources. It is critical not only that we do our job and do it right, but that in so doing, we help restore confidence in the agency and in the marketplace. In my testimony, I will outline for you our plan for addressing the challenges that we face. I will discuss some of the changes Chairman Schapiro has instituted since her arrival that have already helped our program. Additional resources in my view also would enhance greatly our ability to keep pace with ever-changing developments in a dynamic marketplace, as well as rapid advances in technology. Further in this regard, I will touch on some potential legislative changes.

The proposed plan I will outline dovetails with the GAO report and its recommendations concerning an alternative organizational structure and reporting relationship for the SEC's Office of Collections and Distributions; further review of the level and mix of Enforcement resources and the Division's current internal processes; review of the 2006 corporate penalty policy; and enhancing communications. And, I will address the GAO report and each of its recommendations in turn.

Before I begin, however, I am mindful that this panel—and the public—is deeply concerned about the Division's failure to detect the fraud perpetrated by Bernard Madoff. I am not here today to defend the agency's actions, nor am I in a position yet to explain precisely what went wrong. I am here to say that I will be the first to admit mistakes when they are made and to work toward preventing them from happening again. But, I am also here to ask that you consider this failure in the context of the Division's storied history of successful enforcement and vigorous efforts to protect investors, and the many talented and committed members of the enforcement staff who work very hard every day on behalf of investors.

My belief as a newcomer is that there may have been multiple things that contributed to the agency's failure to act timely in the Madoff matter. But, whatever the agency's internal investigation concludes in this regard, not a day goes by that I don't think about how we can stop the next big fraud.

I am here to pledge my best efforts toward revitalizing the Division and earning back the respect of investors. I know there is much to do, and we've gotten a lot of things started. But all of our ideas and initiatives will take time and effort. I look forward to discussing some of these efforts with you today and in the future. We expect that some of our improvements will require legislative assistance, and your interest in a stronger SEC is greatly appreciated.

**Background**

Since I am new to the SEC and this is the first time I am appearing before you, I hope you will permit me to tell you a little about myself and about the Division of Enforcement, particularly its recent successes. Over my career, I have been blessed to work in a wide range of legal jobs among some of the most talented members of the profession. These include positions as a judicial law clerk with the United States Court of Appeals for the Eighth Circuit; an associate with a long-established law firm in New York; 11 years as a federal criminal prosecutor of terrorism and white-collar criminal cases in the United States Attorney's Office for the Southern District of New York in Manhattan; and 7 years as a general counsel for a large financial services firm. Despite these experiences, and all that I learned from each one, I can say without hesitation or qualification that, to be asked by our Chairman, Mary Schapiro, to join the SEC, an institution with such a rich tradition of excellence and commitment to protecting investors, was the greatest day of my career.

Although I am new as a member of the SEC staff, over the years I have had much experience with the agency and particularly, with the Division of Enforcement. As a Federal prosecutor, defense counsel, and most recently, in-house counsel, I have worked with the Division—and against the Division—and I have seen it from many perspectives. Through it all, I consistently saw in the Division staff integrity, excellence, dedication, and a passion for investor protection. I saw professionalism and teamwork. I saw a commitment to justice. And in my 38 days as Director of the Division of Enforcement, I can assure you that despite the enormous challenges we have faced and are facing, I have seen these traits in abundance. They are alive and well and, in my view, one of the great, distinguishing safeguards of the integrity of our capital markets.

**The Division of Enforcement and Recent Successes**

The Enforcement Division is in many ways the face of our investor protection agency. Ours is the Division authorized to investigate and bring civil charges in federal district court or in administrative proceedings based on violations of the Federal securities laws. These violations include fraud by any person or entity, whether or not such actor is otherwise regulated by the SEC, as long as the violation is in connection with the offer, purchase, or sale of securities. In addition to fraud, we also investigate and prosecute regulatory misconduct, including registration, reporting, and recordkeeping violations relating to issuers, broker-dealers, municipal securities dealers, investment advisers, investment companies, and transfer agents.

We initiate investigations based on our own surveillance efforts, information from other regulators, and complaints and tips from investors and other members of the general public. Although we have delegated authority to initiate investigations on an informal basis, we require Commission approval in the form of a formal order of investigation, in order to issue subpoenas.

When we find violations of the Federal securities laws during our investigation, if appropriate, we recommend to the Commission that it authorize us to bring an enforcement action, including seeking any appropriate relief, against the alleged wrongdoers. Our potential remedies include: injunctions, cease-and-desist orders, disgorgement of ill-gotten gain, financial penalties, revocations of registration, undertakings to maintain or improve internal procedures, and bars from associating with broker-dealers or investment advisers, practicing before the Commission as an accountant or an attorney, serving as an officer or director of a public company, and participating in the offer or sale of a penny stock. In emergency actions, we often seek temporary restraining orders, asset freezes, appointments of receivers, and other ancillary relief. Whenever practicable, we seek to return monies to harmed investors. In addition, we frequently work closely with the Department of Justice, criminal investigators, and State and Federal regulators, including conducting parallel and coordinated investigations, and cooperating with prosecutions as appropriate.

We have brought many important and timely cases this year. Here is a small sample of our recent actions:

- *Public trust:* In March, we charged New York's former Deputy Comptroller and a top political advisor with allegedly extracting kickbacks from investment management firms seeking to manage the assets of New York's largest pension fund, the New York State Common Retirement Fund. Last month, we amended the complaint to add a former New York State political party leader, a former hedge fund manager, and a Dallas-based investment management firm and one

of its founding principals, in connection with the alleged multimillion dollar kickback scheme. [1]

- *Reserve Fund:* On Tuesday, we filed fraud charges in the Southern District of New York against the managers of the Reserve Primary Fund, a $62 billion money market fund whose net asset value fell below $1.00, or "broke the buck," in the fall. As part of this action, the Commission is seeking to consolidate the numerous lawsuits involving the Reserve Fund, and bring about an efficient and equitable *pro rata* distribution to shareholders of the fund's remaining assets, including the $3.5 billion set aside in the Fund's litigation reserve.
- *Insider trading:* Last week, we charged a former Citigroup investment banker and seven others for allegedly engaging in a widespread insider trading scheme that involved repeated tips about upcoming merger deals. [2]
- *Subprime mortgages:* In another important case filed last week, we charged two former executives at American Home Mortgage Investment Corporation for allegedly engaging in accounting fraud and making false and misleading disclosures, including misleading disclosures relating to the riskiness of the mortgages originated and held by the company, to conceal from investors the company's worsening financial condition in early 2007 as the subprime crisis emerged. [3]
- *Auction rate securities:* In February, as part of the auction rate securities settlements, we announced a settlement that would provide more than $7 billion in liquidity to thousands of customers who invested in auction rate securities before the market for those securities collapsed. [4]
- *Ponzi schemes:* Also last week, we obtained an emergency court order freezing assets and providing other relief against a California-based financier and his two companies for allegedly defrauding investors of hundreds of millions of dollars by misrepresenting investments in the life insurance policies of senior citizens and in timeshare real estate. The complaint alleged, among other things, that investors were misled by false claims that their returns would come from proceeds made on their investments, when instead some of the purported returns were paid out of funds raised from newer investors. [5] Since January, we have filed 23 cases involving Ponzi schemes or Ponzi-like payments, in which we charged that perpetrators fraudulently raised funds from new investors to pay "returns" to existing investors. [6] Of the 23, 19 cases sought emergency relief

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[1] *SEC v. Henry Morris, et al.,* Lit. Rel. No. 20963 (Mar. 19, 2009), Lit. Rel. No. 21001 (Apr. 15, 2009), Lit. Rel. No. 21018 (Apr. 30, 2009).

[2] *SEC v. Maher F. Kara, et al.,* Lit. Rel. No. 21020 (Apr. 30, 2009).

[3] *SEC v. Michael Strauss, Stephen Hozie, and Robert Bernstein,* Lit. Rel. No. 21014 (Apr. 28, 2009).

[4] *SEC v. Wachovia Securities, LLC,* Lit. Rel. No. 20885 (Feb. 5, 2009).

[5] *SEC v. Private Equity Management Group LLC, et al.,* Lit. Rel. No. 21013 (Apr. 27, 2009).

[6] The cases are:

1. *SEC v. Bradley L. Ruderman, et al.,* Lit. Rel. No. 21017 (Apr. 29, 2009) (sought emergency relief to halt an alleged $38 million Beverly Hills-based hedge fund fraud that included at least one Ponzi-like payment).

2. *SEC v. Private Equity Management Group LLC, et al.,* Lit. Rel. No. 21013 (Apr. 27, 2009) (sought emergency relief in California-based scheme involving hundreds of millions of dollars).

3. *SEC v. Donald Anthony Walker Young, et al.,* Lit. Rel. No. 21006 (Apr. 20, 2009) (sought emergency relief to halt alleged scheme involving a Philadelphia-area investment adviser and its principal, who misappropriated more than $23 million from investors);

4. *SEC v. Maximum Return Investments, Inc., and Clelia A. Flores,* Lit. Rel. No. 20997 (Apr. 13, 2009) (charged promoter and firm with allegedly operating a $23 million scheme primarily targeted at California's Hispanic American community);

5. *SEC v. Robert P. Copeland,* Lit. Rel. No. 20994 (Apr. 9, 2009) (charged Georgia attorney who allegedly fraudulently raised over $35 million from at least 140 investors in several States, including Georgia);

6. *SEC v. Market Street Advisors, et al.,* Lit. Rel. No. 20992 (Apr. 7, 2009) (sought emergency relief against Colorado adviser for allegedly conducting multimillion dollar scheme);

7. *SEC v. Oversea Chinese Fund Limited Partnership, et al.,* Lit. Rel. No. 20988 (Apr. 6, 2009) (sought emergency relief to halt alleged $50–75 million scheme involving a Toronto-based hedge fund and targeting members of the Chinese American community);

8. *SEC v. Edward T. Stein,* Lit. Rel. No. 20983 (Apr. 1, 2009) (sought emergency relief to halt alleged ongoing $55 million scheme);

9. *SEC v. Millennium Bank, et al.,* Lit. Rel. No. 20974 (Mar. 26, 2009) (sought emergency relief to halt alleged ongoing $68 million scheme involving the sale of bogus high-yield CDs issued by Caribbean-based bank and its Swiss affiliate);

10. *SEC v. Brian J. Smart, et al.,* Lit. Rel. No. 20946 (Mar. 12, 2009) (sought emergency relief to halt alleged ongoing scheme that raised $1.68 million from investors, including senior citizens);

in the form of an asset freeze to prevent the possible dissipation of investor assets and, in some instances, a temporary restraining order to halt ongoing conduct.

- *Other emergency actions:* In addition to the 19 emergency actions involving Ponzi schemes or Ponzi payments filed in the last 4 months, we have also filed several emergency actions related to other types of misconduct. In the last 2 weeks alone, we obtained an emergency court order to freeze the assets of a Connecticut-based money manager and the hedge funds that he controls, alleging that he forged documents, promised false returns, and misrepresented assets managed by the funds to illicitly raise more than $30 million from investors;[7] we obtained an asset freeze against a Florida-based adviser for allegedly misrepresenting the nature of $550 million in investments;[8] and we obtained emergency relief against a Texas businessman and his company—both subjects of a previous SEC enforcement action in 2001—for allegedly fraudulently raising approximately $40 million from hundreds of investors through a high-yield debenture offering.[9]

**Challenges and How To Refocus the Division of Enforcement**

These are challenging times. The financial industry has grown dramatically over the last decade in both size and scope. As evidenced by the current financial crisis, our markets attract a large and complicated group of participants that deal in a variety of new, complex, and ever-changing financial products. In today's market, the SEC oversees more than 30,000 registrants, including more than 12,000 public companies, 4,600 mutual fund families, 11,000 investment advisers, 600 transfer agents, and 5,500 broker dealers. In fiscal year 2008, the Enforcement Division received more than 700,000 complaints, tips, and referrals regarding potential violations of the Federal securities laws. Yet, our entire Enforcement staff nationwide—including lawyers, accountants, information technology staff, and support staff—is just above 1,100. Our mandate is broad, including not only regulatory misconduct by registered entities and persons but also fraud by any entity or person, whether registered or not, in connection with the purchase or sale or in the offer or sale of securities or security-based swap agreements. The challenge of our mandate grows as new financial products emerge that may fit the definition of a "security."

In the face of these growing challenges, the Division needs sufficient resources to meet its mandate. Yet, because of several years of flat or declining SEC budgets, the SEC has faced significant reductions. As a result, even after receiving a much appreciated budget increase in 2009, the SEC's workforce still will have significantly fewer staff than in 2005. As noted in the GAO Report, this decline is reflected in

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11. *SEC v. John M. Donnelly, et al.,* Lit. Rel. No. 20941 (Mar. 11, 2009) (sought emergency relief in alleged scheme based in Charlottesville, Virginia, and involving $11 million);

12. *SEC v. Anthony Vassallo, et al.,* Lit. Rel. No. 20943 (Mar. 11, 2009) (sought emergency relief in alleged $40 million scheme based in Northern California);

13. *SEC v. Shelby Dean Martin, et al.,* Lit. Rel. No. 20935 (Mar. 6, 2009) (sought emergency relief to halt alleged $10 million scheme based in North Carolina);

14. *SEC v. Ray M. White, et al.,* Lit. Rel. No. 20925 (Mar. 4, 2009) (sought emergency relief in alleged $11 million scheme based in Dallas);

15. *SEC v. Daren L. Palmer, et al.,* Lit. Rel. No. 20918 (Feb. 26, 2009) (sought emergency relief in alleged $40 million scheme based in Idaho Falls);

16. *SEC v. Billions Coupons, Inc.,* Lit. Rel. No. 20906 (Feb. 19, 2009) (sought emergency relief to halt alleged Hawaii-based scheme targeting deaf investors);

17. *SEC v. William L. Walters,* Lit. Rel. No. 20904 (Feb. 18, 2009) (charged former registered representative with allegedly operating a Ponzi scheme promising annual returns ranging from 20–40 percent);

18. *SEC v. Stanford International Bank, et al.,* Lit. Rel. No. 20901 (Feb. 17, 2009) (sought emergency relief in connection with an alleged $8 billion Ponzi scheme).

19. *SEC v. Craig T. Jolly, et al.,* Lit. Rel. No. 20890 (Feb. 9, 2009) (alleged $40 million Internet-based Ponzi scheme based in Spokane);

20. *SEC v. Rod Cameron Stringer,* Lit. Rel. No. 20857 (Jan. 21, 2009) (sought emergency relief in alleged hedge fund Ponzi scheme based in Texas);

21. *SEC v. CRE Capital Corporation and James G. Ossie,* Lit. Rel. No. 20853 (Jan. 15, 2009) (sought emergency relief to halt alleged ongoing $25 million Ponzi scheme based in Atlanta);

22. *SEC v. Gen-See Corp., et al.,* Lit. Rel. No. 20858 (Jan. 8, 2009) (sought emergency relief to halt alleged ongoing affinity fraud scheme targeting clergy, Catholics, and senior citizens); and

23. *SEC v. Joseph S. Forte, et al.,* Lit. Rel. No. 20847 (Jan. 8, 2009) (sought emergency relief to halt alleged $50 million scheme operating from Pennsylvania for 15 years).

7 *SEC v. Ponta Negra Fund I, LLC, et al.,* Lit. Rel. No. 21012 (Apr. 27, 2009).

8 *SEC v. Founding Partners Capital Management Co., et al.,* Lit. Rel. No. 21010 (Apr. 23, 2009).

9 *SEC v. Benny L. Judah, et al.,* Lit. Rel. No. 21009 (Apr. 22, 2009).

Enforcement's staffing levels as well. And our budget for new technology investments is still more than 50 percent lower than the 2005 level. If the SEC were to receive additional Enforcement resources, we would be able to continue rebuilding our staff and technology investments, which would reinvigorate the Enforcement Division and help restore investor confidence.

We have a talented and dedicated staff and the support of a Chairman and Commissioners who are committed to a strong Enforcement program. And, I am reminded daily that a change in culture within the division has already started to occur. The staff has redoubled their efforts to meet the challenges of this ongoing financial crisis. By way of comparison, since the end of January:

- We have filed at least 27 emergency temporary restraining orders. During roughly the same period last year, we filed 7.
- We have opened more than 287 investigations. During roughly the same period last year, we opened 217.
- The Commission has issued at least 138 formal orders. During roughly the same period last year, the Commission issued 57.

Chairman Schapiro also has begun to implement changes in our policies and procedures. For example, she streamlined the formal order approval process. As the Chairman has noted, in investigations that require the use of subpoena power, time is of the essence, and delay can be costly. To ensure that subpoena power is available to the staff when needed, the Chairman returned the SEC to a policy of faster consideration of formal orders, where appropriate, by a single Commissioner acting as duty officer. Another change, discussed more fully below, is the Chairman's abolition of the "penalty pilot" program, which had required Enforcement staff to obtain full Commission approval before the staff could begin settlement negotiations regarding civil penalty amounts with public issuer defendants.

But there is more to be done. With what I have already learned—and am still learning—as Division Director, I am prepared to make changes to the structure of the Division, how we conduct business internally, how we view the world, and most importantly, how we can rise to the challenge and fulfill our critical mission of enforcing the Federal securities laws, pursuing violators, and protecting investors, in a timely and effective way. We have heard the criticisms and the commentary, and we are doing what any responsible trustee of the public faith should do—we are using it to conduct a serious self-assessment to determine what we can do to improve and move forward, and be all the better for the adversity. We are learning as many lessons from the few things we have handled less effectively as we have learned from the many we have handled highly effectively. We need to do this so that we can restore investor confidence and send a strong message to would-be violators that the SEC is on the beat. As our Chairman noted before the full Banking Committee, the SEC is the only agency focused primarily on the protection of investors. As the agency's most public face in its efforts to protect investors, a strong Division of Enforcement is critical to the investing public's confidence in the integrity of our markets.

I met with Division staff my first day on the job and I asked the staff to embrace four principles:

- First, we have to be as strategic as possible. We need to use our resources as efficiently as possible and in a manner that achieves the greatest impact. This means a focus on cases involving the greatest and most immediate harm and on cases that send an outsized message of deterrence.
- Second, we have to be as swift as possible. A sense of urgency is critical. If cases are unreasonably delayed, if there is a wide gap between conduct and atonement, then the message—to the investing public that the SEC is vigilant and effective, as well as the message to those who might themselves be considering a step outside the law—is diluted. Timeliness is critical. Corporate institutions are dynamic and ever-changing. People come and go. When a case is brought years after the conduct, the fines and the penalties still hurt, but the opportunity to achieve a permanent change in behavior and culture is greatly reduced.
- Third, we have to be as smart as possible. Investigating cases or individuals past the point of diminishing returns is as inefficient as choosing the wrong case to investigate up front. This means a constant focus on investigative plans. We need to have regular decision points during the life-cycle of a case, where we determine on an informed basis how to shape the investigation and charge the case. We also need other tools to help us better track and analyze case progress, or lack thereof.

- And last, we have to be as successful as possible. We need to win. This means building strong cases so that defendants settle quickly on the Commission's terms or face a trial unit armed with compelling evidence.

There was, and is, little dispute over these goals. The challenge, as always, is one of execution. But I assure you that I am committed to implementing the changes necessary to achieve our goals. To that end, 10 days into the job, I assembled approximately nine advisory groups within the Division, staffed by senior personnel to assess and propose changes to virtually all significant aspects of our work and processes. The advisory groups looked at issues relating to, among other things, Division structure, case management and handling, streamlining, and better training. The marching orders in this top-to-bottom review were simple—in each context, ask yourselves, what works better? These advisory groups then gathered and presented their preliminary findings just 2 weeks later to a group of approximately 175 managers in the Division. The result was 2 days of commentary, feedback, and brainstorming. We also had the aid of a management consultant who has analyzed and restructured law firms and law departments in both the public and private sectors. The discussions were free-flowing and highly constructive.

The result of this exercise is that we have recognized critical items that need to be addressed if we are to improve our protection of investors. Consistent with the GAO's recommendations, I propose allocating additional resources to the following categories:

- *Administrative and paralegal support:* The Division's lawyers and accountants spend too much time doing document or organizational tasks that are better handled by paraprofessional personnel. This includes document collection, organization, uploading, and indexing, as well as tasks related to the collection and distribution of disgorgement and penalties. It would be much more efficient, and free-up much more time for high-value investigative tasks, if these efforts were transferred to administrative and support staff.
- *Information technology support:* The SEC is working on a number of technology initiatives designed to bolster its ability to detect, investigate, and prosecute wrongdoing. These initiatives include a review of how the SEC handles tips, complaints, and referrals; the improvement and expansion of the Division's document management, reporting, and case management capabilities; and the improvement of the SEC's ability to identify, track, and analyze data to identify risks to investors better.
- *Trial lawyers:* It is important that the Commission maximize the capacity and ability of its trial unit. Simply stated, we must convey to all defendants in SEC actions that not only do we assemble winning cases against them, but also we are prepared to go to trial and we will win. Only then can we expect to secure the type of settlements that both achieve justice for investors and save resources to be used in pursuing the next case. Without that credible threat, we are at a severe disadvantage. Our trial unit does an admirable job, but given the increased caseload, particularly the great increase in the number of emergency actions such as temporary restraining orders and asset freezes, it needs to grow.
- *Hiring a Chief Operating Officer/Business Manager:* the Division lacks a business manager or COO who can manage administrative, information technology, project management, and human resource issues. Additional staffing in the Office of Collections and Distributions would be welcome, as our attorney-investigators spend a significant amount of time doing collection and distribution work—approving distribution plans and distribution service providers—when they could be investigating cases.

Resources are critical, and I believe there is a compelling need at the Division for greater assistance. An increased budget would enhance significantly our ability to make the changes I believe we need to do our job to the best of our abilities. But as I told the SEC staff who gathered on my first day on the job, relying on new resources is a little like waiting for the cavalry—you don't know if they will come, you don't know when they will come, and you don't know how long they will stay. So it is our obligation—to those who are evaluating whether we should be afforded additional resources as well as to the taxpayer—to efficiently use the resources we already have.

To that end, our self-assessment effort is underway, in which we are asking ourselves a number of pointed questions to identify those changes that will allow us to be more efficient and successful. These questions include:

- *Specialization:* Should we increase our use of specialized groups organized along product, market, or transactional lines, in order to understand better the areas we investigate and to see patterns, links, trends, and motives? Would such a structure permit us to better gather in one place and harvest the accumulated expertise that exists throughout the Division, to target focused training at such a group, and to utilize outside market specialists better?
- *Management:* Would a different management model enable us to do our job with fewer managers, thus freeing up those managers—including many highly talented and experienced investigators—to conduct more investigations and bring more cases?
- *Approvals and Procedures:* The Division has a number of processes by which approvals must be secured at the highest level of the Division. Are these approvals necessary or can they be delegated to those running the investigations day-to-day? We are also considering whether changes to agency-wide procedures will help make our processes more efficient.
- *Metrics:* Can we de-emphasize the current quantitative metrics used to evaluate personnel and programs—the number of cases opened and the number of cases filed—in favor of a more qualitative standard, which includes concepts like timeliness, programmatic significance, and deterrent effect of a case?
- *National Program:* Can we undertake efforts to break down the roles that naturally exist when one is organized along a regional basis and think of ways to encourage and incentivize more collaboration across regions? (Specialization, in which groups are created that are staffed nationally, could be one way to do this.)
- *Complaints, Tips, and Referrals:* As Chairman Schapiro has previously noted, we have retained Mitre, a Federally Funded Research and Development Company, to advise us on how we can better collect, record, investigate, refer, and track the hundreds of thousands of complaints, tips, and referrals that we receive each year. How can we analyze them better in order to reveal links, trends, statistical deviations, and patterns that might not be observable when they are examined on a less-than-comprehensive basis?
- *Rewards:* Would it improve our program to use tools that we either already have, or would like to have, to reward persons for coming forward with information about wrongdoers before it is too late? Such tools include a whistleblower program and a greater use of benefits—reduced sanctions, immunity, or agreements similar to a deferred prosecution agreement—for persons who come forward to identify and provide evidence against those who violate the law. Some of the most credible and valuable evidence is gathered in this manner by criminal and other authorities, and we seek to determine if we are taking full advantage of this opportunity. As Chairman Schapiro has stated, we are actively considering coming to Congress soon with a request for authority to compensate whistleblowers who bring us well-documented evidence of fraudulent activity.
- *Cooperation:* Could we cooperate further with other law enforcement agencies and regulators to leverage resources more effectively? The Commission staff works closely with other authorities, for example, in securities-related criminal actions. The nature and extent of the cooperation varies from case to case and can include referrals, the sharing of information in parallel investigations, simultaneous actions, and staff assistance on criminal cases. Additional cooperation and coordination with criminal and other authorities may yield even better results.

These are, in broad strokes, some of the questions we are asking and changes we are considering. The focus, as I said, is on being more strategic, swift, smart, and successful in our job—protecting the investor.

**Potential Legislative Changes**

As I discussed earlier, I believe that an increased budget would enable us to address our resource concerns better, both in terms of staffing and technological support. We greatly appreciate the support we have received time and again from you, Chairman Reed, as well as Chairman Dodd, Ranking Member Shelby, and many others on the Banking Committee who have advocated for the SEC on this front.

With regard to specific legislative changes, there are a number of ways to broaden or clarify our authority so that we can better enforce the Federal securities laws and protect investors. I have discussed a number of items with Chairman Schapiro that would aid our enforcement efforts, including a whistleblower program, additional aiding and abetting authority, and legislation in areas such as swap agreements and hedge fund regulation. I understand that she will be providing some of these legisla-

tive recommendations to you very soon. These proposals will be aimed, in part, at ensuring we have sufficient authority and reach to combat fraud and other market misconduct.

We also expect to request other legislative measures we have discussed with you in the past, which would provide important substantive and procedural tools to the Enforcement Division. Some of those include giving the Commission the authority to seek penalties in cease-and-desist proceedings and authorizing civil money penalties against aiders and abettors under the Investment Advisers Act. We also believe providing for nationwide service of process in civil actions filed in Federal courts would afford significant savings of travel costs and staff time through the elimination of duplicative depositions and adds the benefit of having live witnesses and party testimony before the trial court.

**The GAO Report**

Let me now turn to the GAO Report. As Chairman Schapiro has noted, reinvigorating the SEC's enforcement program is a top priority for the Commission, and I welcome the GAO's report and recommendations. The GAO report and its recommendations are timely and dovetail with our proposed initiatives to strengthen our Enforcement Division, maximize our resources, and meet the challenges that lay ahead.

The GAO's report has identified four specific recommendations for actions that the SEC can take to enhance the operations of our enforcement program. I agree with each of the recommendations.

*To consider an alternative organizational structure and reporting relationship for the Office of Collections and Distributions*

The Commission in September 2007 established a new centralized office, the Office of Collections and Distributions, to expedite the distribution of Commission recoveries to injured investors. The Office is responsible for overseeing the distribution of billions of dollars to investors who have been injured by securities laws violations, implementing the Division's collections and distributions programs, and conducting litigation to collect disgorgement and penalties imposed in certain Enforcement actions. In addition, the Office tracks, records, and provides financial management assistance with respect to the distribution funds, and provides overall case management for the Division.

The GAO's review has identified the need for improvements to the Office's organizational structure. The SEC agrees with this recommendation and is working to identify and evaluate various alternatives for reforming the Office's organizational structure. We are considering how best to improve the administration of the Office of Collections and Distributions and to make sure that the Office's workflows and processes are run efficiently. By making the necessary changes, we hope to enhance the Commission's ability to collect disgorgement and penalties and swiftly and efficiently distribute the monies to harmed investors.

*To further review the level and mix of resources dedicated to Enforcement, and assess the impact that the Division's current review and approval process for investigative staff work has on organizational culture and the ability to bring timely enforcement actions*

Declining staffing levels have had an impact on the SEC's ability to pursue an aggressive enforcement program. The GAO report notes that the total number of staff who work in the enforcement program is down 4.4 percent since 2005, and the total number of nonsupervisory investigative attorneys is down even more significantly, by 11.5 percent, since 2004. The report also identifies the need for additional resources in Enforcement devoted to administrative and paralegal support, information technology support, and specialized services and expertise.

I concur with GAO's recommendation. Given the number of Enforcement Division staff as compared with the broad area that is potentially under our purview, it is clear that smart and strategic use of resources is critical to the success of our mission to protect investors. I have consulted at length with Division staff, as well as with the Chairman, to find ways to work smarter with our current resources and to identify the highest impact use of any additional funds that Congress may provide. As described above, I believe we need to allocate more resources to administrative and paralegal support, information technology, trial lawyers, and to hiring a COO/business manager. With regard to specialized services and expertise, as outlined above, I am also exploring the increased use of specialized groups as a way to enhance our understanding of the areas we investigate and our ability to see patterns, links, trends, and motives. Such groups may also provide a better forum in which to hire persons with specialized expertise in various aspects of the securities industry to improve our collective ability to detect fraud and prosecute violators.

Similarly, a national program that reaches across the current regional lines may enable us to share information and expertise better.

The GAO report also identifies the need to ensure efficiency in the internal case review process so that Enforcement staff can bring enforcement cases more quickly and spend more time on investigations. I concur with this recommendation. To this end, as outlined above, we are exploring changes in management structure and whether certain procedures and processes are necessary or can be improved.

*To examine the effects of the 2006 corporate penalty policy to determine whether the policy is achieving its stated goals, and any other effects the policy may have had in adoption or implementation*

In January 2006, the Commission issued a Statement Concerning Financial Penalties. The Statement identified two key considerations and seven additional factors to be considered in determining whether to impose a penalty. The two key considerations are (1) the presence or absence of a direct benefit to the corporation as a result of the violation; and (2) the degree to which the penalty will recompense or further harm the injured shareholders. The other factors are the need to deter the particular type of offense, the extent of the injury to innocent parties, whether complicity in the violation is widespread throughout the corporation, the level of intent on the part of the perpetrators, the degree of difficulty in detecting the particular type of offense, the presence or lack of remedial steps by the corporation, and the extent of cooperation with Commission and other law enforcement. The purpose of the guidelines was to provide "clarity, consistency, and predictability" to the issuer penalty process.

I concur with the recommendation in the GAO Report that the Commission examine whether the 2006 corporate penalty policy is achieving its intended goals. Although my tenure has only recently begun, I have already initiated discussions with various members of the staff and will report back to the Commission with findings and recommendations. To me, however, the focus of any penalty policy should be assurance that malefactors get appropriately severe sanctions to sufficiently deter them and others from engaging in similar misconduct in the future.

The GAO Report also raised concerns about the Commission's 2007 "penalty pilot" program. Before I arrived, Chairman Schapiro ended the 2007 "penalty pilot" program, which had required Enforcement staff to obtain a special set of approvals from the Commission in cases involving civil monetary penalties against public companies as punishment for securities fraud. I believe this decision has had a positive effect on Enforcement staff.

*To take steps to ensure that the Commission, in creating, monitoring, and evaluating its policies, follows the agency strategic goal and other best practices for communication with, and involvement of, the staff affected by such changes*

Finally, the GAO recommends that the SEC take steps to ensure that the Commission better involves, and communicates with, Enforcement staff in its decision-making process relating to the management of the Enforcement program. Again, I concur with this recommendation. Communication is a top priority and critical not only to the effective performance of our jobs but to one of our most important intangibles—the morale of our staff on the ground. I am a strong believer that all constituencies should be heard. Since my arrival at the SEC, I have conducted Enforcement-wide Town Hall meetings, I have met individually and in groups with many members of the staff and with the management of the Division, I have solicited commentary and feedback and brainstormed with Division managers on the restructuring of the Enforcement Division and other issues, and I have asked and will continue to ask for input from Enforcement staff and others. I intend to keep the lines of communication open not only within Enforcement, but with other SEC Divisions and Offices and with the Chairman and the Commissioners.

**Conclusion**

I would like to thank you again for the privilege and opportunity to appear before you today, and to thank the GAO and its staff for their hard work and cooperation. I would be happy to answer any questions you might have.

## PREPARED STATEMENT OF MERCER E. BULLARD

ASSOCIATE PROFESSOR OF LAW,
THE UNIVERSITY OF MISSISSIPPI SCHOOL OF LAW

MAY 7, 2009

Chairman Reed, Ranking Member Bunning, Members of the Subcommittee, thank you for the opportunity to appear before you to discuss the SEC's enforcement program. It is an honor and a privilege to appear before the Subcommittee today.

I began my career working on SEC investigations at WilmerHale, served as an Assistant Chief Counsel in the SEC's investment management division, and more recently have provided expert witness services in plaintiffs and defendants in private securities cases and public enforcement matters. I am currently an Associate Professor of Law at the University of Mississippi School of Law, the Founder and President of Fund Democracy, a nonprofit advocacy group for mutual fund shareholders, and a senior adviser with the financial planning firm Plancorp, Inc. I am testifying today based on my general securities law experience, rather than in my advocacy capacity.

### Introduction

The GAO Report, *SEC: Great Attention Needed to Enhance Communication and Utilization of Resources Within the Division of Enforcement,* provides strong evidentiary support for what many have known for quite some time. The SEC enforcement division's effectiveness has been compromised, both by a lack of resources and poor leadership by the Commission itself. The appointment of Mary Schapiro as Chairman is a strong step toward solving the problem of leadership within the Commission. Throughout her career, Chairman Schapiro has demonstrated a solid commitment to a vigorous and effective enforcement program. In her very short tenure, she has already taken decisive steps to end some of the practices that have hindered the Commission's enforcement program in recent years.

The problem of a lack of resources, however, remains unsolved. The Commission does not have the funds necessary to provide the level of enforcement necessary to protect investors and promote efficient capital markets. I strongly recommend that Congress substantially increase the SEC's appropriation to enable Chairman Schapiro and the SEC's enforcement staff to do the job that they are better at than anyone else. This is not just a matter of adequate enforcement; it is also a matter of justice for investigated entities. Inadequate resources often have the effect of unfairly increasing burdens on parties defending SEC investigations.

The importance of the SEC's enforcement program cannot be underestimated. The Commission is the leading voice for enforcement of securities laws and the development of free capital markets not only in the United States, but worldwide. When the Commission speaks, it makes uniform law across all 50 States that private actors can rely on to guide their business practices. When the Commission remains silent, the void is filled with the noise of dozens of regulators and courts in private actions creating a patchwork of rules. It is incumbent on the Commission to provide the coherence and uniformity in the securities laws that only it can provide. And it is incumbent on Congress to provide the Commission with the resources it needs to do so.

The remainder of this testimony is divided into two parts. The first part discusses some of the findings of the GAO Report and recommends reforms that the Commission should consider in the process of revitalizing its enforcement program. The second part discusses other issues that relate to a number of occasions on which the Commission has failed to take action in the face of known industry abuses, and proposes two analyses of what might be the causes of this problem.

### GAO Report

The GAO Report provides useful insight regarding how the Commission can most effectively and efficiently fulfill its enforcement role. The input provided to the GAO by SEC staff draws a very clear picture of potential areas of improvement, as discussed further below.

*Consensus Management.* The most striking aspect of the GAO's Report is the picture it presents of the apparent subversion of the SEC's enforcement program through the efforts of individual Commissioners. The GAO reported that individual Commissioners blamed "the quality of management" in the enforcement division for declining amounts of penalties and disgorgement, even while the same Commissioners apparently spearheaded efforts to require pre-approval of penalties. Individual Commissioners claimed that "the staff elect[ed] on its own to retreat from penalties," although the GAO found that staff consistently interpreted Commission positions to have been intended to have this effect. In a very revealing admission,

an individual Commissioner emphasized that it was "important to understand that the division worked at the direction of the Commission, not as an independent entity." This apparent desire by individual Commissioners to "remind the staff who's boss," coupled with Chairman Cox's publicly expressed preference for consensus on the Commission, was a recipe for disaster and explains much about the recent deterioration in the Commission's enforcement program. The GAO reports that penalty pre-approval policy was developed without input from the enforcement division when it should have been the division that produced the first draft of such a policy. The GAO reports that controversial cases were frequently re-calendered. The seriatim approval of investigations was suspended. As a whole, these findings paint a troubling picture of a concerted effort to impede the enforcement of the securities laws from within the Commission itself. [1]

This should not be read as a critique of the ideological views or motives of certain Commissioners, who may have had well-meaning intentions to introduce newer ideological perspectives to the Commission's enforcement culture. Indeed, I agree with their general ideological misgivings regarding the efficacy of certain corporate penalties and encourage the Commission to continue to work through the problem of promoting corporate deterrence without harming innocent shareholders. But there is a right way and a wrong way to seek to influence the culture of an organization. The GAO Report provides a roadmap of how the wrong approach taken by individual Commissioners, especially when coupled with the enabling effect of the Chairman's desire for consensus, can have disastrous consequences.

The Commission appears to be well on its way to correcting this situation. Chairman Schapiro has wasted no time in suspending the "penalty pilot" program and ordering a review of the 2006 corporate penalty statement; reinstating seriatim or individual approval of formal orders of investigation; and ending the re-calendaring process. These are important steps, but misguided, subversive interference by individual Commissioners will not cease unless the Chairman is willing to prosecute cases without reaching a consensus. Chairman Schapiro's March 25, 2009, letter to the GAO, in which she specifically noted that the re-calendaring resulted from a perceived need for "consensus," seems to signal that she will not tolerate the undermining of the Commission's enforcement program from within.

*Disfavoring Cases Involving Industry-wide Practices.* The GAO Report refers to a single statement by an enforcement manager that the Commission disfavors industry-wide "issues," preferring instead to handle these issues through the rule-making process. Certainly a single statement is not necessarily representative of an office-wide position, but it echoes sentiments frequently expressed in the securities bar and should be considered carefully. The statement raises two issues.

First, to the extent that "issues" is a euphemism for clear violations of the securities laws, then industry-wide cases are the most important cases for the enforcement division to bring. When clear misconduct has become pervasive, public confidence in the capital markets is undermined. A strong enforcement response is critical. That being said, an enforcement response to industry-wide violations need not include enforcement actions against every violator. As discussed in greater detail in the second part of this testimony, the Commission does not add value by investing resources in bringing dozens of cases involving the same misconduct once it has clearly established its position. Rather than pursuing the 15th or 20th mutual fund market timing case, the Commission should invest those resources in identifying other areas of misconduct before they becomes industry-wide. Chairman Schapiro's recent statement that the Commission has "150 active hedge fund investigations" [2] raises the question of whether the incremental benefit from the 20th, 50th, or 100th hedge fund investigation is greater than the incremental benefit that could be gained by assessing risks and identifying cases in other areas.

Second, if the term "issues" is a euphemism for misconduct that the law does not clearly prohibit, then no enforcement actions should be brought. This is the "gotcha" problem about which defense lawyers often complain. A small number of industry participants may seek a competitive advantage by engaging in questionable practices, and, when the Commission does nothing in response, an industry-wide issue is created when the practices become widespread. Enforcement cases should not be used to correct such misconduct. In this case, good enforcement practice is to ensure

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[1] There is strong evidence of similarly subversive intent with respect to various Commission rule makings where a number of public dissents seemed to have been written more for the purpose of aiding and abetting challenges to the Commission's authority than documenting constructive grounds of disagreement.

[2] Comments of Mary Schapiro, Chairman, Securities and Exchange Commission, before the Society of American Business Editors and Writers (Apr. 27, 2009) available at *http://www.sec.gov/news/speech/2009/spch042709mls.htm.*

that the SEC's operating divisions act promptly to provide public clarification of industry members' legal obligations, including rule making as necessary.

*Resource Allocation.* Many of the complaints expressed by SEC staff may reflect a failure to balance priorities rather than inadequate resources. For example, assume that an office of 12 attorneys needs two administrative staff, one accountant, and a $1,000 technology investment, but it has only one administrative person. The best solution may be to fill the next attorney vacancies with an administrative person and accountant and to spend the remaining funds on the technology. As noted in the GAO Report, however, the Commission may have a tendency to overhire lawyers.[3] This means that increasing the SEC's budget could actually exacerbate the complained about shortages. If, in the foregoing example, the Commission used additional funding to hire another 12 attorneys, the funding would actually make the resource shortfall worse. The shortfall of administrative staff, accountants, and technology would be increased. Thus, it may be top-heavy staffing that creates scarcity, not a lack of funding. The Commission should ensure that, regardless of funding levels, resources are allocated efficiently so as not to create unnecessary imbalances.

*Internal Review.* Another example of internally created resource constraints is what the Report describes as "the burden of the division's internal review."[4] As reported by the GAO, Commission action memoranda may be subject to five or six layers of overlapping review before being presented to the Commission. There are many legal offices in the Federal government that manage with a substantially flatter structure than the SEC. It is not unusual for a single attorney to supervise dozens of senior lawyers. In contrast, the Commission (not just the enforcement division) uses multiple supervisory layers that create inevitable backlogs. The Commission should flatten its reporting not only in the enforcement division, but throughout the Commission. The first step would be eliminate branch chief positions across the Commission and replace them with a kind of senior staff designation. Case supervision should be provided by an Assistant Director or Associate Director, but not both. Similarly, work product such as action memoranda should be reviewed by an Assistant Director or Associate Director, but not by both, before being reviewed by the Director. Many matters should be able to taken to the Commission without the Director's direct involvement. In addition, the Commission should also consider limiting more senior review to a summary document that is most likely to receive the most attention from the Commission. Conversely, Commissioners should not be expected to flyspeck every detail of every enforcement action, an expectation that, based on recent experience, may need to be expressly enforced by the Chairman.

**Other Issues**

One important SEC management issue that is not addressed by the GAO Report, or least this GAO Report, is the SEC's recent record of inaction with respect to known abuses in the securities industry. In a number of areas, the Commission has abdicated its policymaking responsibilities to State regulators and private litigants. The result has been a decline in public confidence in the markets, a reduction in investor protection, and an increase in uncertainty regarding applicable legal standards. This part of this testimony provides examples of this problem and proposes two analyses of its potential source and possible solutions.

For example, in the early part of the decade a number of States initiated enforcement actions relating to mutual fund trading practices and analysts' conflicts of interests. The problem of stale pricing by mutual funds and accompanying trading abuses had been well-known to the Commission for years. The Commission took no action to address these abuses which expanded to cover a large segment of the fund industry. Ultimately, whistleblowers took their cases to State regulators (in one case after having been rebuffed by the SEC), who then brought enforcement actions against dozens of fund managers, traders and salespersons.

State actions relating to analysts' conflicts of interest reflect a similar pattern. The problem of analysts' recommending securities in order to attract and retain investment banking business was well-known before the New York Attorney General began his investigation. The investment banking industry complained that State prosecutions threatened to create a 50-State patchwork of regulatory standards, a situation that could have been avoided if the Commission had previously established uniform standards governing analysts' conflicts. There has never been a more obvious or greater risk of analysts' conflicts than during the Internet boom of the late 1990s, yet the Commission was unable to provide effective oversight and address conflicts of interest before they became systemic.

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[3] See GAO Report at 29.
[4] See GAO Report at 28.

The Commission has continued to allow States to take the lead on other known abuses in the securities markets. Massachusetts, New Hampshire, and California have brought cases relating to the nondisclosure of conflict of interest payments in connection with fund sales. For years, the Commission was aware that funds were compensating brokers for selling fund shares by directing brokerage to the brokers' firms. It banned this practice only after State enforcement actions directed attention to the problem. The Commission also was aware that funds had been making undisclosed revenue sharing payments to brokers. The Commission has yet to establish a clear legal standard for the disclosure of such payments, leaving it to State regulators and the plaintiffs' bar to protect investors from such abuses.

Most recently, States have brought a slew of cases in connection with mutual funds in 529 plans that improperly allocated assets to high-risk investments. These plans offered investment options with substantial equity components for children who were expected to begin college in 1 to 2 years. Once again, the Commission is sitting on the sidelines, apparently willing to leave the solution to a national problem to the States. The result is likely to be a patchwork of conflicting court decisions on the disclosure obligations of mutual funds. In the meantime, investors who simply wanted an easy way to invest for their children's college education have been left wondering what is the purpose of securities regulation that can be so fatally inadequate. (I note that just prior to the finalizing of this testimony, Chairman Schapiro made remarks regarding target-date funds that may indicate a change in the SEC's approach to this area.[5])

In other areas, the Commission has abdicated its responsibility to establish uniform standards to private litigants and Federal courts. The most glaring example is excessive fee claims under section 36(b) of the Investment Company Act. That provision was enacted in 1970 specifically at the behest of the Commission in order to establish an express fiduciary duty for advisers with respect to compensation received from mutual funds. It granted express enforcement authority to the SEC, but the agency has never brought an excessive fees case. In contrast, the New York Attorney General extracted a number of settlements from funds that charged excessive fees and initiated litigation for charging excessive fees against at least one fund manager. Remarkably, the Commission criticized the NYAG for bringing these cases even while the Commission itself had never taken any steps to establish standards for excessive fees.

Not surprisingly, in the absence of clear regulatory guidance not one private claim under section 36(b) has prevailed in a litigated action (there have been substantial settlements). A U.S. Court of Appeals panel recently held that, in effect, a mutual fund fee set in a "free" market cannot be excessive. The Supreme Court has granted certiorari in that case, yet there is still no sign that it will have the benefit of any guidance from the agency responsible for creating and administering this Federal claim. The Commission remains silent. The Commission apparently believes that there is no such thing as an excessive mutual fund fee and that it has no responsibility to give content to statutory standards for which it is primarily responsible. It is likely that, even after the Supreme Court establishes a new standard for excessive fees cases, the industry and plaintiffs' lawyers will spend millions of dollars litigating its meaning, fund directors will continue to flounder when reviewing fund fee arrangements, and the Commission will sit by doing nothing.

Each of these cases involves an open and notorious problem in the securities markets that the Commission has ignored until forced to act under public pressure. This is not a complete list. One could add the failure of the auction-rate securities market and the options backdating scandal, among others. Indeed, the current liquidity crisis in fixed income instruments is partly the result of the SEC's failure to push more aggressively for the development of liquid debt markets. Somehow a division of the Commission that exists for the purpose of enforcing the securities laws has demonstrated willful blindness until abuses became so widespread that they were impossible to ignore. What enables or motivates State regulators with fewer resources and less depth of expertise than the Commission to bring these cases? Why does the Commission wait until misconduct reaches epic proportions before taking action?

There are no definitive answers to these questions. The following discussion provides two analyses of the SEC's enforcement program that are intended to foster debate and prompt action. The first analysis posits that a misapplication of the principle of deregulation has caused a kind of regulatory paralysis at the Commission that has resulted in the delegation of the SEC's enforcement responsibilities to less efficient, State and private legal mechanisms. The second analysis posits that the

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[5] See Remarks of Mary Schapiro, Chairman, Securities and Exchange Commission, before the Mutual Fund Directors Forum Ninth Annual Policy Conference (May 4, 2009) available at *http://www.sec.gov/news/speech/2009/spch050409mls.htm.*

dominant metrics used to measure the SEC's enforcement success has resulted in an inefficient and ineffective allocation of resources.

*The Myth of Deregulation*

One answer may be that the SEC staff as a whole has become paralyzed by a misapplication of deregulatory principles. One of the positive developments of the 1990s was the introduction of deregulatory thinking at the SEC. In its positive form, deregulation refers to regulation that seeks to maximize societal gain while minimizing societal cost. Deregulation, properly understood and applied, strengthens investor protection and capital markets. But the principle of deregulation as understood and applied by the Commission has long since devolved into a reductive version that equates deregulation with the simplistic mantra of "let free markets decide." The problem with this populist version of deregulation is that, in the absence of SEC action, the free markets are likely to have less influence, not more.

Effective deregulation does not mean nonregulation or inaction in the face of change. Deregulation refers to a kind of affirmative regulation. When the SEC's position on the law regarding an area of legal duties is unclear, deregulation does not always mean it should leave it to "free markets" to resolve the uncertainty. The idea that the markets in this sense are the "markets" of privately contracted arrangements is an illusion. In the absence of clear SEC guidance, the "markets" that guide the conduct of private actors are the panoply of alternative policymaking and dispute resolution structures that naturally fill in the void created by SEC inaction. They are the 50 State attorneys general; hundreds of State securities enforcement staff; thousands of State courts; hundreds of Federal bankruptcy courts, district courts, and courts of appeal; State and Federal banking regulators; the Department of Labor; the Department of Justice; and others. The list is a long one, but no one on it has the expertise—the capital markets expertise—and the ability to establish efficient, uniform capital markets standards as the SEC. When the Commission fails to establish standards of conduct, the standards will be established by other regulatory means. The result of this populist version of "deregulation" actually leads to more costly, less efficient regulation. This kind of "deregulation" leads to regulatory anarchy, not regulatory efficiency. It should be kept caged in the academic zoo where it was conceived and can do no real harm.

The operation of an efficiently "deregulatory" regime is not reflected in bureaucratic paralysis, but in decisive action that is based on full consideration of the costs and benefits of regulation. The view that "deregulation" means a kind of regulatory neutrality consigns the financial services industry to being whipsawed back and forth between periods of inaction and a convulsive overreaction This is not merely a problem with SEC enforcement. It is a problem across the full spectrum of financial services regulation. An extended period of populist deregulation (as opposed to productive deregulation) has left glaring problems unaddressed for years, and the current regulatory response in some areas has initiated some of the most excessive over-regulation this country has ever seen.

In short, the problems experienced in the SEC's enforcement program may reflect not industry capture, but deregulatory capture. The Commission was aware of, and "working" on, many of the problems underlying these enforcement matters before they surfaced as State and/or private claims. But the Commission was unable to resolve them. In this "deregulatory" era, the staff has become so paralyzed that it has become unable to take definitive policy positions or bring enforcement actions. This is consistent with the enforcement staff's statements that internal case review roadblocks "created a risk-averse culture." In many instances, this paralysis has not resulted in less regulation, but more. The SEC's failure to take definitive policy positions handcuffs its own enforcement efforts,[6] creates legal uncertainty, and increases private and State litigation.

The SEC's failure to correct stale pricing by mutual funds, commission overcharges by brokers, options backdating by executives, conflicted recommendations by analysts and similar misconduct early on in its evolution, and its continuing failure to establish standards for the disclosure of revenue sharing and excessive mutual fund fees, for example, impose costs not only on investors, but also on the financial services industry. When known misconduct becomes widespread, it becomes difficult for compliance officers and legal counsel to persuade their clients that the misconduct is illegal. Firms that seek to compete in a free enterprise market are undercut by those who compete by breaking the rules. In some cases, the internal tension

[6] The GAO reported that a number of SEC enforcement staff perceived "that other divisions have become too influential in effectively controlling Enforcement activities." GAO Report at 28. This is not surprising because the SEC's operating divisions are far more risk averse and susceptible to outside influence than the enforcement division.

created by the misconduct escalates until it reaches crisis levels and public pressure forces the Commission to act. The inefficiencies and competitive distortions created by ignored misconduct are resolved in an expensive, time-consuming spasm of litigation and over-regulation. In cases that never escalate to this level, the regulatory void created by SEC inaction operates as a permanent tax on financial services. Mutual funds are left defending revenue sharing and excessive fee cases brought by States and private litigants largely because the Commission has not established clear regulatory guidance.

The SEC's position on target-date funds provides another illustration. A number of target-date 2010 funds (intended for workers retiring around that year) have invested far more in equities than would normally be considered prudent. When Congress asked the Commission about this problem, the SEC's response was as follows:

> Given that there is variation among investment professionals regarding the appropriate allocation of assets as investors age, our review of target date funds has generally focused upon ensuring that prospectuses provide full disclose of the asset allocations in the funds and the corresponding strategies and risks related to these allocations. By ensuring [that] funds provide full disclosure, plan fiduciaries and investors are then able to assess the appropriateness of these funds as investment options.

This response is wrong as a matter of law and gratuitously provides litigation support to funds that use misleading names. But this critique is, admittedly, a policy critique. The deeper problem is that it is completely unresponsive. It does not address the fact that many investors will expect a target date 2010 fund to invest according to a typical allocation for someone very near retirement—regardless of what the prospectus says or how clearly it says it. Like the sponsors of these funds, the Commission is hiding behind the prospectus language that it permits to directly contradict the impression created by the fund's name, although recent statements appearing in press reports. And the lack of legal clarity on this issue will result in unnecessary losses for investors and unnecessary litigation for all concerned.

I believe that the Commission should require that a "Target-Date 2010 Fund" should be required to invest consistent with a conventional asset allocation for someone at the brink of retirement. But again, that is one viewpoint. The point here is not that the Commission should take a particular policy position, but that the Commission has no real policy on the issue at all. Even if the Commission were to take the position that the fund's name could not be inherently misleading—no matter how strongly suggestive it was—if the impression created by the name was corrected by fund disclosure (essentially codifying a kind of bespeaks caution analysis), investors and the industry would be better off than they are with the SEC's "deregulatory" pablum quoted above. The SEC's guidance regarding "full disclosure" is the functional equivalent of a prescription to go forth and litigate and let us know how it all comes out. (I note that just prior to the finalizing of this testimony, Chairman Schapiro made remarks indicating that the Commission was reconsidering a disclosure-only approach to the issue of target-date funds.[7])

*The Metrics of SEC Enforcement*

Another answer may be that the Commission has become captured by its own metrics. The most common measure of the enforcement division's performance has become the number of investigations it opens and cases it files in a fiscal year.[8] It is no coincidence that this metric matches up with the kind of epic investigations that the Commission often launches under public pressure. After bringing a few enforcement cases based on similar fact patterns, the deterrence benefit rapidly diminishes, but the efficiency with which the Commission can rack up additional settlements increases. The Commission uses a metric that provides an incentive to bring dozens of cookie cutter cases where it can spread the fixed costs of the investigation over a large caseload.

For example, consider the most recent settlement in the never-ending mutual fund trading scandal. The most recent of these cases was settled just 2 weeks ago. The alleged misconduct took place between 2000 and 2003, it was very similar to misconduct alleged in dozens of previous cases, and the charge was mere negligence. If this prosecution was typical, it involved numerous, often redundant and expansive document requests demanding immediate compliance followed by extended periods of SEC inactivity and silence. The individuals remained under the cloud of the in-

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[7] See *supra* note 5.

[8] See GAO Report at 21–22 ("Enforcement officials said they focus on two process-oriented performance indicators to track the division's activities: number of investigations opened annually, and number of enforcement actions filed annually.").

vestigation throughout this period with no indication as to the SEC's position on their culpability. At the end of the investigation, the settlement broke no new ground, provided no additional general deterrence, and did not even finalize the amount to be disgorged, that process having been left to a distribution consultant to be retained well into the next decade. Remarkably, most of the rule-making initiatives arising out of the mutual fund scandal were developed, proposed, and adopted long before many cases were closed. Most lawyers who defend SEC investigations probably would agree that the process leading to a settlement is usually far more costly and burdensome than the penalties ultimately imposed.

But bringing large numbers of cases in a limited number of areas of misconduct matches the metric of producing the largest number of settlements. By analogy, if the Center for Disease Control's success were measured by the number of swine flu victims who were cured after an outbreak had been identified, it would have an incentive to invest in curing large numbers of victims rather than in detecting the earliest signs of an epidemic and preventing its spread. While the Commission is developing its 50th mutual fund trading case, the staff working on that case is not seeking to identify the seeds of the next enforcement problem. When those seeds germinate and bloom into a systemic crisis, the Commission will shift resources to another endless series of cases while other problems begin to take root.

The BISYS case provides a current illustration of the likely overcommitment of resources to stale matters. In September 2006, the Commission reached a settlement with BISYS Fund Services, Inc., that was based on BISYS's payments to 27 unnamed fund managers in return for their recommending that their funds use BISYS as the fund's administrator. The arrangements were in place from June 1999 and July 2004, which means that more than 2 years already had passed before the Commission settled with BISYS. Since then, the Commission has settled with only one of the 27 fund managers, and that occurred another 2 years after the BISYS settlement, in September 2008.[9] The fund managers' arrangements with BISYS had already been terminated for over 4 years. Many of the funds have reached private settlements with the fund managers who were involved in the scandal. But the fate of the other 26 fund managers appears to remain unresolved. The investigations regarding the unlucky 26 are probably ongoing, with some inching toward a resolution and others floating motionless in an investigation purgatory awaiting a final decision on their fate.[10]

In lieu of the staff time invested in settling cases based on ancient misconduct, the Commission could have been looking for developing problems in other areas. This approach to the allocation of staff resources would result in a smaller number of settlements, however, and current indications are that the Commission is committed to keeping its numbers up. The SEC Chairman recently stated, for example, that the Commission has "150 active hedge fund investigations," "two dozen active municipal securities investigations," and "50 current investigations involving Credit Default Swaps, [CDOs] and other derivatives-related investments."[11] That totals 224 investigations, all of which are, not surprisingly, in areas that have recently received a great deal of public attention. While these matters should be investigated, is it prudent to commit the resources necessary to investigate 150 hedge funds? Why not only 20, or 50, or even 100? Are these investigations triggered primarily by allegations of alleged misconduct or by simply being a large hedge fund? Hedge funds and credit default swaps are generally purchased by sophisticated investors. What about investigations of the losses suffered in 529 plans by investors who will not be able to afford to send their children to college? Or in target-date 2010 funds by 65-year-old investors who will not be able to retire? Like the dozens of mutual fund trading, options backdating, and other massive investigations, the current slew of topical matters will take years to resolve.

The Commission needs to bring a smaller number of targeted enforcement cases covering a wide range of activities in real-time, not develop a massive caseload of factually similar cases in a narrow set of circumstances over a 5- or 10-year period. To do this, the Commission needs to develop new metrics, which will require new

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[9] See In the Matter of AmSouth Bank, Admin. Proc. No. 3-13230 (Sep. 23, 2008) available at *http://www.sec.gov/litigation/admin/2008/ia-2784a.pdf.*

[10] The GAO reports a 264 percent increase in case closings from 2007 to 2008, which officials attributed, in part, to new quarterly reports that list cases that are 5 or more years old. See GAO Report at 14. On the one hand, the staff should be applauded for this dramatic increase in case closing. On the other hand, cases should be considered old long before they reach the 5-year mark. In a real-time enforcement environment, any case older than 2 years should carry a rebuttable presumption that it should be closed.

[11] Comments of Mary Schapiro, Chairman, Securities and Exchange Commission, Before the Society of American Business Editors and Writers (Apr. 27, 2009) available at *http://www.sec.gov/news/speech/2009/spch042709mls.htm.*

settlement strategies. For example, it should develop a self-reporting approach to suspected widespread misconduct. The company internal investigation that is conducted promptly (within 4 months) and credibly and accompanied by a fair resolution for injured parties should be rewarded; the laggard that produces a half-hearted investigation without any clear resolution should be penalized and considered for formal prosecution. Entities do not engage in wrongdoing, people do, and those people generally do not include independent directors. If the Commission promises to reward shareholders whose independent directors engage in prompt investigation, cooperation, and mitigation, the shareholders and their boards will have a strong incentive to conduct an expedited, impartial investigation, leaving a smaller number of more egregious cases on which the SEC staff can focus. (Admittedly, the efficacy of this approach is undermined when the chairman is also the CEO whose oversight and individual conduct are inevitably the subject of investigation.)

Once these potential enforcement targets have been identified, the Commission should establish real-time enforcement guidelines that are designed to produce a settlement or a complaint within 18 months. This will often mean winnowing out the less egregious or more complex cases, even where there is known misconduct. But it is not the SEC's role to bring enforcement actions against every wrongdoer. It is the SEC's duty to use its unique position to deter misconduct, communicate and set uniform standards, and inspire confidence in the rules governing the financial markets. A small number of targeted enforcement actions brought (and section 21(a) reports issued) on a real-time basis will allow the Commission to invest resources in identifying abuses before they become systemic while sending strong signals to compliance officers about what kinds of conduct will not be tolerated.

This approach cannot succeed, however, without the development of explicit metrics against which the Commission publicly measures its performance that are keyed to fewer cases brought across a wider spectrum of misconduct. If the SEC's performance continues to be measured by the number of cases that it brings, it inevitably will, consciously or otherwise, tend to strategies that produce more cases. New metrics must be explicitly adopted and past performance re-evaluated in light of those metrics. The first step might be to determine the range of types of cases brought in the previous fiscal year and actively promote this measure as an alternative benchmark to gross numbers of enforcement actions. Whatever alternative metrics are developed, they must be accompanied by repeated reminders by the Commission and senior staff that the Commission cannot and does not seek to bring every case. Calls for ever more enforcement staff create an impression that if the Commission only had enough staff it could detect every fraud and bring every case. The Commission needs more staff, but the staff needs clear direction that is consistent with its limited but critical role in a broad spectrum of regulatory mechanisms.

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## PREPARED STATEMENT OF BRUCE HILER

PARTNER AND HEAD OF SECURITIES ENFORCEMENT GROUP,
CADWALADER, WICKERSHAM & TAFT LLP

MAY 7, 2009

Chairman Reed, Ranking Member Bunning, and Members of the Subcommittee: I am pleased to have the opportunity today to testify concerning the responsibilities of the Securities and Exchange Commission and its Division of Enforcement in policing our financial markets and protecting investors. I formerly served as an attorney in the Division of Enforcement and as an Associate Director of the Division. I left the Commission in 1994 and have since been a partner in two different law firms, where I have represented clients in SEC and other governmental investigations, internal investigations, and securities litigation.

Although recently the Commission, and particularly its enforcement efforts, have come under fire for reported lapses in detecting or in quickly reacting to the activities of some individuals in the marketplace, the Commission has long been viewed as a premier regulatory agency and, through its Division of Enforcement, a premier civil enforcement agency. If there have been lapses, I am confident that the Commission will evaluate those situations and develop new policies and procedures to avoid them in the future. In this regard, I think it is important to understand the effects that the vagaries of funding and resource allocation, the exponential expansion both of market activity and of sophisticated instruments and investment strategies, and the day-to-day pressure of operating in the glare of public scrutiny can have on any organization.

Nevertheless, from the standpoint of a private practitioner who also served in the SEC's Division of Enforcement, I have seen a number of areas in which I believe the Commission's enforcement efforts could or should be modified or improved. In particular, there are three areas which I would like to discuss briefly today: the management structure of the Division of Enforcement; the availability of specialized resources to enforcement attorneys; and the relationship between the Commission and the market participants it regulates.

First, I believe that the efficient and speedy resolution of SEC investigations is important both for effective public protection and enforcement efforts, as well as for ensuring fairness and justice to the subjects of the investigations. In my view, both the speed of resolution of enforcement investigations and the consistency and fairness of outcomes of those investigations could be enhanced by having fewer layers of management between those working day-to-day on investigations and those in the Division of Enforcement who ultimately must recommend to the Director of the Division whether an investigation should move forward or should be closed without action. However, this does not necessarily mean fewer management slots. Rather, in my view, it requires more positions for experienced, senior managers.

Currently, in the Commission's D.C. headquarters offices, the Division has two deputy directors and five associate directors. Through assistant directors and branch chiefs, the associate directors indirectly supervise hundreds of investigative attorneys, and they may be supervising dozens, if not scores, of investigations and active litigations, in addition to fulfilling other management responsibilities. The associate and the deputy directors typically are among the most experienced professionals in the Division, and they are looked upon internally as having the judgment and expertise to make appropriate case recommendations. Yet, these are also the individuals who have the least amount of time to spend on any one matter, and who are relatively infrequently involved in any one particular matter on the day-to-day decision making or day-to-day review of facts, as they are discovered or analyzed by those directly involved in the investigations.

In my view, there should be fewer layers between these senior individuals and those directly working on investigations. To best achieve this result, I believe the number of senior, experienced officials should be dramatically increased. These senior managers should be charged with direct involvement in the day-to-day activities of the matters under their supervision, and such matters should be kept to a reasonable case-load so that they can become familiar with key facts and issues as they develop, and can spend time directly reviewing the factual records.

Second, efficiency must not be achieved at the expense of fairness or thorough evaluation. The SEC has a long history of careful evaluation of important and complex issues and constantly must guard against public pressure to act too quickly or to be rushed to enforcement resolutions which may have significant policy implications. The matters which the SEC investigates can be extremely complex, and some conduct may easily be made to appear nefarious to the public and in media reports because of its novel or complex nature. SEC investigations can involve sophisticated instruments and trading strategies, as well as complex issues, such as accounting, risk analysis, and economic modeling, that fall outside of the normal expertise of attorneys. Although there are individuals at the SEC with expertise in some of these areas, their numbers should be increased and the Commission should organize these individuals by expertise outside of the Division of Enforcement. These experts should be available to consult and to work day-to-day on enforcement investigations. I believe that the addition of a cadre of experts in a variety of fields to assist in enforcement inquiries could lead to more efficient and better informed decision making, and may assist in determining when issues are better resolved by way of considered regulatory or policy judgments.

Third, I believe that the detection of fraudulent conduct is a difficult task, and no one can expect that the SEC or any agency will be able to anticipate specific frauds at specific entities. However, a regulator may be able to get early warning signs of conduct which may have become acceptable due to macroeconomic or social events, but which, on close examination, the Commission would like to halt or believes is not sufficiently understood such that it poses unknown dangers to the financial system. In order to get early warning signs of such conduct, I believe a regulator must maintain and foster an open line of communication with those in charge of compliance and management at the relevant entities. It is difficult to maintain open and sufficiently timely communication where the regulator or the regulated views the other with suspicion and where the regulated has reason to question the process by which its conduct is or will be judged. I believe that such an atmosphere of mutual suspicion began to develop in the last decade between the Commission and some of the entities with which it interacts.

I believe that the causes of this mutual suspicion are varied. However, I believe that increased scrutiny by criminal authorities of securities law matters and public pressure on the SEC to hold anyone and everyone responsible for the stock market crash in 1999, for corporate bankruptcies and defalcations, and, more recently, for the current economic turmoil have contributed to this atmosphere. Increased attention to securities cases by criminal prosecutors is not in and of itself a cause for concern, but I believe that the line between civil securities cases and criminal securities-based fraud cases has been blurred, and that there has been a shift to an inappropriately low level in what authorities view as conduct that demonstrates sufficient scienter or "state of mind" to make even a civil securities case.

The Commission should develop internal guidelines that set forth its views on the standards that should be applied in determining what constitutes "fraud" under the Federal securities laws. A starting point, for example, could be guidelines concerning permissible inferences that can be drawn in cases to support such a charge. The U.S. Supreme Court in *Tellabs, Inc. v. Makor Issues & Rights, Ltd.,* 551 U.S. 308 (2007), recently held that, in determining whether the pleaded facts in a private securities fraud case give rise to the required "strong" inference of scienter under applicable pleading standards, a court must take into account "plausible opposing inferences." *Id.* at 323. In other words, the court must consider "plausible, nonculpable explanations for the defendant's conduct," and the case should be permitted to proceed "only if a reasonable person would deem the inference of scienter cogent and at least as compelling as any opposing inference one could draw from the facts alleged." *Id.* at 324. It thus is possible for the Commission to adopt reasonable internal guidelines to ensure it is making consistent and fair decisions on the subjective judgments of whether to bring enforcement actions or continue to pursue investigations. I also believe that the Commission should have a major role in determining whether cases which predominantly involve Federal securities law issues and our capital markets structure should be pursued by criminal authorities. I believe that efforts in these two areas would help promote an atmosphere of cooperation and communication that could help assist the Commission in all of its regulatory roles.

There are other areas in which I know the Members of this Subcommittee are interested. I also believe that the SEC historically has responded positively to constructive assessment of its operations and programs. I hope that I am able to be of assistance to you, and I will be happy to answer your questions on this important subject.

**RESPONSE TO WRITTEN QUESTIONS OF SENATOR REED FROM RICHARD J. HILLMAN**

**Q.1.** As the Bernard Madoff case clearly illustrated, the SEC fell short in responding adequately to what were clear signs of fraud. It's not clear that this was a problem of a lack of resources. Do you have suggestions on steps the SEC could take to improve its oversight in this area? What information would better assist the SEC in identifying and acting upon problems such as market manipulation, insider trading, and other misconduct? What surveillance tools would help this effort?

**A.1.** Since we did not review SEC's oversight of Madoff's firm or the agency's actions regarding tips received about the fraud, we cannot specifically comment on the circumstances or any deficiencies SEC may have in handling this fraud case. However, in several GAO reports where we reviewed SEC's OCIE and Enforcement functions, we have made a number of observations and recommendations for improvement in its examination and surveillance-related effort.

SEC's routine examinations are risk based and as such, relatively low-risk areas are generally not examined. For example, in our 2005 report on mutual fund trading abuses, we noted that SEC staff did not examine for market timing abuses or assess company controls over that activity because they viewed market timing as low risk and determined that mutual fund companies had financial incentives to establish effective controls over frequent trading. We observed that SEC could strengthen its ability to detect market timing activities by conducting independent assessments of controls (through a variety of means including interviews, reviews of compliance reports or internal audit reports, and transaction testing as necessary) at a sample of companies to verify assessments about risks and the adequacy of controls in place to mitigate those risks. SEC could apply this process to other perceived low-risk areas.

In a 2007 report, we noted that since the detection of mutual fund trading abuses, OCIE has shifted its approach to examinations of investment companies and advisers from one that focused on routinely examining all registered firms, regardless of risk, to one that focuses on more frequently examining those firms and industry practices at higher-risk for compliance issues. The effectiveness of OCIE's revised approach largely depends on OCIE's accurately assessing the risk level of investment advisers. Since many firms rated lower-risk are unlikely to undergo routine examinations within a reasonable period of time, if at all, harmful practices could go undetected if firms are inappropriately rated as lower-risk. We noted that the method that OCIE employs to predict the level of risk for the majority of advisers has some limitations, particularly in that this method relics on proxy indicators of compliance risks without incorporating information about the relative strengths of a firm's compliance controls. We continue to believe May 7, 2009, that using compliance reports from firms could potentially help OCIE better identify higher-risk firms. In some cases, SEC will have to test the quality of the firm's internal audit function before relying on its assessments.

Self-regulatory organizations (SROs), rather than SEC, are responsible for the surveillance of the trading activity on their mar-

kets. As a result of a 1985 study, SEC determined that SROs had created a viable intermarket surveillance program, and terminated its then tentative Market Oversight and Surveillance System project by determining not to develop the direct surveillance capabilities the system would have allowed. SROs employ electronic surveillance systems to monitor market participants' compliance with SRO rules and Federal securities laws. One of the key surveillance systems employed by SROs monitors the markets for insider trading. Since SROs only have jurisdiction over entities and individuals that are part of their membership, any suspected violations on the part of nonmembers are referred directly to SEC's Enforcement Division. In a 2007 report, we noted that Enforcement's referral receipt and case tracking systems do not allow Enforcement staff to electronically search all advisory and referral information, which may limit their ability to monitor unusual market activity. We recommended that SEC considers system improvements.

Finally, as we noted in our 2009 report, some Enforcement attorneys felt that the division's in-house expertise in a range of areas was inadequate. These include forensic accounting, complex trading, and complex financial instruments. Several attorneys also said that the investigative staff do not have access to real-time trading information, which can be pivotal to bringing certain cases such as pump and dump schemes. Getting access to such specialized services and expertise would aid in case development. We recommended that SEC review the level and mix of Enforcement resources.

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**RESPONSE TO WRITTEN QUESTIONS OF SENATOR BUNNING FROM ROBERT KHUZAMI**

**Q.1.** In your testimony, you mentioned that the Commission has filed 23 cases involving Ponzi schemes or Ponzi-like payments. With the report just now coming out that the SEC received warnings back in 2002 regarding the Stanford fraud investigation, how long was the SEC aware of these 23 or so particular cases before formal filings where a charge was made?

**A.1.** Of the 23 cases involving Ponzi schemes or Ponzi-like payments referenced in the written testimony, we investigated and filed 18 of them, or 78 percent, within 6 months of the SEC becoming aware of possible misconduct through a complaint, tip, referral, or staff surveillance. Fifteen of the 18, or 83 percent, were filed within 2 months of the complaint, tip, referral, or surveillance. In three of those cases, or 16 percent, we filed charges within 2 weeks of becoming aware of the possible misconduct.

Of the remaining five cases, more time was needed to develop each case. As an initial matter, I note that complaints, tips, or referrals often lack specific, admissible evidence of wrongdoing; rather, further investigation must be undertaken before charges can be filed.

Turning to the remaining five cases, one was the Stanford matter that I referred to in my oral testimony. In that case, there were various impediments to filing charges, most notably the absence of sufficient evidence of wrongdoing, due in part to the lack of cooperation from Stanford and the Antiguan authorities. For a vari-

ety of reasons, the remaining four cases in this category were brought more than 1 year after the complaint, tip, or referral. In two of the remaining cases, the staff learned that the conduct had ended and that significant assets did not exist which might justify emergency action. Thus, the investigation continued to allow for evidence to be collected upon which the wrongdoers could be charged. In the third case, there was initially a lack of credible evidence of wrongdoing, since none of the victims complained, there was no investor list, and there was an absence of affirmative misstatements of fact. Subsequently, the staff worked diligently and ultimately obtained bank records to trace investor funds, an independent third party receiver was retained to marshal any remaining assets, and the case was filed. In the final case, once the staff became aware of the true nature of the conduct, the staff investigated and brought the action in an expeditious manner—moving from a formal order of investigation to filing in Federal district court in less than 2 months.

**Q.2.** Out of the 700,000 complaints, tips, and referrals received last year, how many were followed up on?

**A.2.** There are a variety of ways that complaints, tips, and referrals come into the SEC, including through various divisions and the agency's eleven regional offices. By volume, the Enforcement Division's Complaint Center (ECC) and the Office of Investor Education and Advocacy (OIEA) receive the vast majority of such contacts.

In Fiscal Year 2008, the Division received approximately 615,000 submissions through the ECC, an online mailbox of the Division of Enforcement that receives e-mail tips and complaints from investors and other members of the public. Every complaint received through the ECC is reviewed by a member of Enforcement staff, and passes through a multistage triage process. At each stage, some complaints are eliminated, either because they fall outside the agency's jurisdiction, or—later in the process—because they do not present compelling facts, do not establish the potential for a Federal securities law violation, or are judged not to be an efficient use of resources. In the later stages of this triage, reviewing staff may also forward a higher-quality complaint to Enforcement staff as a "referral" to be considered for further investigation or action. Even if e-mails are not formally referred, they are archived and can be researched should a future investigation be opened. Given the multilayered review and referral process, together with current technological and resource limitations, there does not currently exist a capability for specific tracking of each e-mail throughout its review and triage.

During that same time period, OIEA received approximately 81,000 investor complaints, questions, or other contacts. OIEA reviews the contacts received and decides whether to refer it to the Division of Enforcement, another SEC Office, or another regulator. A relatively small number of the contacts received by OIEA are tips or complaints referred to Enforcement for further action. The remaining contacts (questions, requests for information, comments, *etc.*) are handled by OIEA directly or sent to the appropriate SEC Office or Division for disposition.

In addition, the Division of Enforcement receives complaints, tips, and referrals from self-regulatory organizations, other regulators, other Divisions and Offices of the SEC, and correspondence from the public not routed through these other sources. Enforcement staff members also find matters to investigate through their own surveillance.

Last fiscal year, 1,224 matters under inquiry were opened based on information received from all sources.

On March 5, 2009, Chairman Schapiro announced that the agency is undertaking a comprehensive review of the process by which all complaints, tips, and referrals are handled. As part of that review, we are considering new processes and systems for receiving, tracking, analyzing, and acting upon the tips, complaints, and referrals from outside sources. The team overseeing this initiative expects to present to the Chairman in the near future recommendations regarding how to improve the efficiency, effectiveness, and overall management of how the agency addresses tips, complaints, and referrals, and how SEC staff utilizes the information received to protect investors.

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**RESPONSE TO WRITTEN QUESTIONS OF SENATOR SCHUMER FROM ROBERT KHUZAMI**

**Q.1.** How does the SEC plan to use the additional $40 million in funding that it may be receiving? Do you plan to hire financial analysts, traders, and accountants with real industry knowledge and experience to help you investigate and oversee today's increasingly complex capital markets? If so, how many?

**A.1.** We intend to hire staff with specialized expertise in financial services and other related areas, including product specialists, traders, and others. The exact numbers of these specialized hires will depend, among other things, on availability and competing demands for resources. For example, we also need to hire more trial lawyers, which will enable the SEC successfully to litigate increasingly complex cases and demand tough sanctions. We need additional support staff, since attorneys and others currently spend far too much time doing tasks more efficiently undertaken by paraprofessionals. Finally, we require improved information technology systems, including document management systems, so that cases can be investigated and brought more quickly and efficiently.

**Q.2.** When do you expect the reorganization, including the hiring of new staff, to occur?

**A.2.** Various workstreams have been examining different aspects of our structure and operation. Some recommendations, primarily those dealing with internal procedures and process, have already emerged from that process, and we are preparing to discuss those recommendations with other SEC divisions and others within the SEC, and then to commence implementation. Other aspects of our initiative, including recommendations as to specialized groups and management restructuring, will be forthcoming on a rolling basis starting in June 2009. The hiring of new staff is also conducted on a rolling basis, and we have already begun the task of reviewing résumés from various market specialists. We have also closed out

the posting for a new Business Manager for the Enforcement Division and expect to commence interviews immediately.

**Q.3.** Should the SEC have investigative powers over currently unregulated entities, including hedge funds, and unregulated products, including credit default swaps, to ensure the integrity of our capital markets?

**A.3.** I believe that it is critical to have investigative powers over unregulated entities, particularly hedge funds, and unregulated products, including credit derivatives. Although the SEC has antifraud authority in many of these areas, my view is that we need significant additional access to information regarding those entities and products. In particular, we need access to trading information to enable us to combine that information with information obtained from regulated entities to make sure that we have a full picture of the financial markets and to be better able to detect wrongdoing.

*Hedge Funds:* Unregistered and unregulated private funds, such as hedge funds, represent a significant segment of the financial markets that is predominately below the radar. The Commission currently lacks basic data about private funds and thus, lacks significant knowledge concerning an important segment of the market. It is essential that we have better knowledge of who these private funds and their managers are, how they meet their obligations to their investors, and the impact their investment activities have on the overall financial markets. Currently, without specific SEC authority to register and oversee private funds and their advisers, our access to this information is limited, which makes it much more difficult for the Commission to identify misconduct.

Registration of private funds will accomplish two important objectives. First, it will enable us to gather and compile comprehensive information about the entire private fund industry—permitting us to measure the size, influence, and impact of the industry in a manner currently unavailable to the Commission. Second, registration and rule-making authority over private funds will permit us to ensure that individual hedge funds are maintaining information, especially trading records, across financial instruments in a uniform manner. With uniform reporting and recordkeeping standards, we can then more effectively examine and investigate whether hedge funds and other institutional traders are engaging in manipulative conduct across financial instruments.

*Security-Based Swap Agreements:* Although the SEC has antifraud jurisdiction over security-based swap agreements, including credit default swap agreements, the agency does not have authority to promulgate rules related to reporting or recordkeeping in this area, which would provide the type of information we typically would use to identify suspicious trading patterns. This information gap substantially inhibits our enforcement efforts in this area. Although efforts to provide central clearing for credit default swaps will bring to this market much-needed transparency, providing the Commission with authority to impose uniform recordkeeping and reporting of derivative transactions, particularly by hedge funds and broker-dealers, will bring significantly more transparency to our complex financial markets. For example, with this authority, staff can more easily pinpoint where manipulative credit derivative

trading occurs in tandem with other trading strategies, such as short selling, that put selling pressure on particular securities. With enhanced regulatory authority over certain derivatives, SEC staff, particularly its examination and enforcement staff, can better surveil, examine, and uncover deceptive or manipulative conduct across both standard and complex financial instruments.

**Q.4.** Will you consider allocating or reallocating some of the personnel to New York City as part of the shake-up of your Enforcement Division?

**A.4.** We will undertake to review the allocation of resources to the New York Regional Office. Having said that, we are at the same time attempting to break down the silos that can flow from a regional structure, and to create a truly national program in which the connectivity amongst staff and offices is increased, thus facilitating the sharing of knowledge and efficient use of resources.

**Q.5.** How close are you to naming someone to lead the New York Regional Office? Are you considering naming someone who is a former Federal prosecutor with securities experience?

**A.5.** We are in the very final stages of the hiring process. We have an abundance of highly qualified candidates, including those with the profile you mention. We anticipate making an announcement shortly.

**Q.6.** Should the Enforcement Division have a hotline the public can call?

**A.6.** Although the public has a variety of ways it can contact the SEC, including phone lines, the establishment of an Enforcement hotline number is one item under consideration as part of the Commission's current assessment of its handling of complaints, tips, and referrals.

On March 5, 2009, Chairman Schapiro announced that the SEC enlisted the services of the Center for Enterprise Modernization, a federally funded research and development center operated by The MITRE Corporation. The MITRE Corporation is currently working with the SEC to (1) conduct a comprehensive review of internal procedures used to receive and evaluate tips, complaints, and referrals, (2) identify ways to improve the quality and efficiency of the agency's current procedures, and (3) recommend potential technology solutions that can assist the SEC staff in more effectively managing and utilizing tips, complaints, and referrals. This priority initiative is moving forward swiftly.

**Q.7.** How does the Enforcement Division coordinate with the Office of Investor Education and Advocacy and other Divisions who receive calls about fraud and other securities law violations? Do individuals who call with an actual complaint get a call back?

**A.7.** The complaints, tips, and referrals Enforcement receives come in from many different portals within the SEC. Complaints are routed to different groups in Enforcement for handling, and each group has developed its own protocol regarding how to process, review, and retain information regarding the referral or complaint. For example, online complaints and referrals from the Office of Investor Education and Advocacy are processed through Enforce-

ment's Office of Internet Enforcement, and SRO referrals are processed through the Office of Market Surveillance.

Complaints by individuals taken over the phone are referred and followed up on as appropriate. For example, the Office of Investor Education and Advocacy receives tips and complaints from individuals who call the Office's investor information number and refers these tips and complaints to Enforcement's Office of Internet Enforcement as appropriate.

This structure is currently under review. We are undertaking a comprehensive review of our processes and systems for receiving, tracking, analyzing, and acting upon the tips, complaints, and referrals from outside sources. The goal of the review is to improve the efficiency, effectiveness, and overall management of how the agency addresses tips, complaints, and referrals, and how SEC staff utilizes the information received to protect investors. In this regard, the Commission is seeking to establish a more centralized process that will more effectively identify valuable leads for potential enforcement action as well as areas of high risk for compliance examinations.

**Q.8.** Is the Enforcement Division consulted on the enforceability of the rules the other SEC Divisions are writing? Is it part of the process?

**A.8.** Enforcement does comment on SEC rule making, especially with respect to whether or not proposed rules have an enforcement impact. There is a process, although not formalized, by which Enforcement is consulted and reviews and comments on proposed rule making.

**Q.9.** How do the other Divisions train and assist the Enforcement attorneys?

**A.9.** We have a wealth of in-house expertise. During the course of any given inquiry or investigation, Enforcement staff can consult with staff of the other Divisions and Offices. Some cases—because they are more difficult, novel, or technical—may require more consultation than others. Topics can run the gamut from technical expertise on the specific requirements of a particular rule to broader questions of industry practice, how to charge a case, or how a contemplated case may impact the industry.

There is also a formalized process as part of our case review whereby the other Divisions and Offices review and comment on proposed Enforcement recommendations before Enforcement staff presents the recommendations to the Commission. The other Divisions and Offices may also comment on Enforcement recommendations when they are being presented to the Commission.

Part of our training for new hires includes presentations from the other Divisions and Offices about their areas of expertise and how they can be of assistance to Enforcement staff. In addition, the other Divisions and Offices may offer training sessions for their own staff, to which Enforcement staff is invited.

Finally, we hope that one of the benefits of specialization is having more in-house Enforcement expertise that our staff can turn to earlier in their investigations and more often.

**RESPONSE TO WRITTEN QUESTIONS OF SENATOR REED FROM MERCER E. BULLARD**

**Q.1.** As the Bernard Madoff case clearly illustrated, the SEC fell short in responding adequately to what were clear signs of fraud. It's not clear that this was a problem of a lack of resources. Do you have suggestions on steps the SEC could take to improve its oversight in this area?

**A.1.** I agree that the failure to detect Madoff's fraud was not the result of inadequate resources. I have described below the regulatory causes of the Madoff scandal, in order of importance, and suggested steps that the SEC could take to improve its oversight with respect to each cause.

*Cause 1:* The principal regulatory cause of the scandal was the failure of Madoff's primary regulator, the Financial Industry Regulatory Authority (FINRA) to detect his fraud. During the entire period of his fraud, Madoff was a broker-dealer regulated primarily by FINRA. Until 2006, when Madoff registered an investment adviser, FINRA was Madoff's sole Federal regulator.

FINRA's oversight responsibilities would have included confirming that client assets custodied with Madoff were actually in the possession of his broker-dealer firm. FINRA also is responsible for overseeing advisory activities of registered representatives of a broker-dealer provided away from the firm. It is not clear how FINRA could have been ignorant of Madoff's advisory activities. It appears he was widely known and sought after as a money manager. When interviewed by FINRA personnel in the course of inspections, did Madoff and his employees state that the firm and Madoff provided no money management services? If FINRA knew about his money management activities, it should have confirmed the firm's custody of client assets. In any case, Madoff's 2006 investment adviser registration stated that his broker-dealer was the custodian for client assets. This should have been a red flag for FINRA.

The SEC should take a number of steps to address the problems exposed by the Madoff scandal.[1] First, it should order FINRA to conduct an investigation of its failed oversight and report its findings to the SEC and your Committee. Second, it should revise its policies that improperly permit brokers such as Madoff who provide individualized investment advice to avoid regulation as investment advisers. Third, the SEC should abandon its plan to recommend legislation that would enable FINRA to become the primary regulator for investment advisers pending the completion of the two suggestions provided above. Fourth, Chairman Schapiro and Commissioner Walter should recuse themselves from any role in any of the three matters discussed above on the ground that their prior employment at FINRA creates at least the appearance of a conflict of interest.

*Cause 2:* A second regulatory cause of the scandal was the SEC's policy of permitting brokers who provide nonincidental investment advice to evade regulation as investment advisers. If Madoff had registered as an investment adviser in the early 1990s when his

[1] The SEC recently proposed new custody rules, but these rules would have not have applied to Madoff prior to 2006 because he was not a registered investment adviser prior to that date.

fraud began, it is highly likely that an investment adviser inspection would have uncovered his fraud many years ago.

The definition of investment adviser under Federal law does not apply to a broker who does not receive special compensation and whose advice is solely incidental to his brokerage services. The SEC has adopted an absurdly broad definition of "solely incidental" that until just recently allowed advisers who exercised discretionary authority over client assets but charged only commissions (such as Madoff) to evade registration as investment advisers. There is no and never has been a rational basis for believing that the exercise of discretionary oversight could be consistent with "solely incidental" services. The SEC conceded this only recently. The SEC's belated recognition of this fact will not prevent the next Madoff, however. Under SEC positions, it will be easy for a broker to claim not to exercise discretion while exercising effective control over client accounts and thereby run an unregistered advisory program that is exempt from adviser inspections. The SEC takes the position that any services provided "in connection with and reasonably related to" brokerage services can be considered "solely incidental." Under this interpretation, it is difficult to imagine any broker being unable to rely on the "solely incidental" exclusion. Any broker that wishes to ensure that only FINRA oversees its advisory operations can continue to do so.

The steps that the SEC should take in this respect are simple. It should apply the plain meaning of the broker exclusion's "solely incidental" trigger. Most "brokerage" services have become advisory in nature and should be regulated accordingly. When investors received personalized investment advice, they are entitled to—and intuitively expect—that the advice will be subject to the same fiduciary duties that apply to similar professional advice provided by lawyers and doctors. Under current SEC positions, brokers can create the appearance of acting as the client's agent while enjoying the benefit of a salesman's nonfiduciary status. This is not to say that the Madoff scandal reflects the failure to apply a fiduciary standard to his conduct. Rather, it is to say that the Federal securities regulatory scheme for retail services is designed and should be applied so as to provide additional investor protection as the relationship increasingly engenders trust and confidence in the regulated professional. Madoff's business model depended on a high level of client trust and confidence, but because of lax SEC positions that relationship was not subject to the heightened regulatory standards that would have caught his fraud much sooner, if not prevented it altogether.

*Cause 3:* A third regulatory cause of the scandal was the SEC's failure to act on tips from Harry Markopolos. This cause is only third in this discussion for two reasons. First, the tips did not begin until 1999, whereas the fraud had been perpetrated under FINRA's nose since the early 1990s, as discussed above. Second, earlier registration as an investment adviser also would have stopped Madoff's fraud long before 1999. Both failed FINRA oversight and Madoff's delayed registration as an adviser are far more significant factors in the scandal than the breakdown in the SEC's whistleblower procedures.

Indeed, whistleblower tips are an inherently inefficient means of achieving enforcement goals. It would be impossible for the SEC to conduct a complete investigation of every one of the hundreds of thousands of complaints that it receives each year. If it did so, it would do nothing else. The most efficient means of detecting fraud is through inspections and market monitoring.

That being said, whistleblowers can be a useful source of information, provided that it is understood and accepted that some credible allegations of violations inevitably will slip through the system. There is no mechanical system that will catch every credible complaint, and no system based on human judgments can eliminate the possibility of human error. We should expect and accept that there will be significant frauds that are revealed in complaints but not fully investigated. The costs of a system designed to investigate fully all such complaints would far outweigh the benefits.

Any system that failed to surface Markopolos's tips, however, could not have been reasonably designed to provide an effective means of reviewing complaints. In that case, the failure exposed a flawed system of reviewing complaints. Chairman Schapiro's proposed whistleblower reforms are the right way to address this problem. The SEC has enlisted the Mitre Corporation to assist it in developing an efficient system for managing and utilizing tips, complaints, and referrals. The SEC appears to recognize that the importance of applying modern information management systems in this context while avoiding promises of a perfect process.

*Cause 4:* A final cause of the scandal was the SEC's failure to inspect Madoff once he registered as an investment adviser in 2006. An SEC inspection would have included verification of custody of client assets, which would have uncovered his fraud. It should be noted, in this respect, that Madoff's fraud had been underway since the early 1990s, when he was subject only to FINRA's oversight, and Markopolos first provided information to the SEC in 1999. The failure to inspect Madoff was only a regulatory cause of the scandal to the extent that it operated from 2006 to 2008. It should also be noted that Madoff's registration occurred at the time when thousands of firms were newly registering in response to the SEC's new requirement that hedge fund managers register, but this does not excuse the failure to inspect Madoff in a timely manner.

At the time that Madoff registered, he claimed to have $17 billion in client assets under management. Although the failure to conduct inspections may, in some cases, be attributable to a lack of resources, the failure to inspect Madoff was not. When an advisory firm of that size files its initial registration, an inspection should be immediate. In other words, resources that are available should be devoted first to this kind of inspection. The failure was one of allocating resources, not a lack of resources.

The improvement that needs to be made to address this oversight is to ensure that certain filings automatically trigger an inspection, such as the new registration of an investment adviser with more than a certain amount of assets under management. Lori Richards, Director of the SEC's Office of Compliance Inspections and Examinations, spoke recently about the SEC's surveillance in which it analyzes data in investment adviser registration

forms to assess their relative compliance risks.[2] This is the kind of program that should trigger an immediate inspection for a new registrant such as Madoff. Richards stated that this analysis is run only once each year (in September), however. It should be run on a continuous basis with respect to all new registrations and certain types of registration amendments.

**Q.2.** What information would better assist the SEC in identifying and acting upon problems such as market manipulation, insider trading, and other misconduct? What surveillance tools would help in this effort?

**A.2.** The SEC generally has an effective system for identifying problems such market manipulation, insider trading, and other misconduct. The question of what information would better assist the SEC in acting upon problems once they have been identified is discussed below.

**Q.3.** The Enforcement Division faces key challenges in targeting its resources among a large and constantly changing universe of potential fraud. The SEC must act decisively to address new activities, while conserving precious resources for other important areas. How can the SEC most effectively target its resources to oversee a broad and changing set of issues?

What are the key factors the SEC should be identifying and considering to determine if and how to take action?

You note in your written testimony that the SEC does not add value by investing resources in dozens of cases involving the same misconduct once it has clearly established its position. Please elaborate on this statement.

**A.3.** I have combined my answers to these three questions because they are essentially interrelated.

The mission of the SEC's enforcement program should be to prevent, detect, and deter securities fraud, and to play the leading role in securities enforcement. Toward this end, the SEC has developed an effective strategy for efficiently allocating its resources, responding to a quickly changing business environment, and deciding when and how to take action in response to fraud. As noted in my testimony, however, the SEC may have a tendency to overinvest resources in multiple cases involving the same underlying conduct. This tendency results in an inefficient allocation of resources and diverts attention from developing problems in the financial services industry. It also undermines the SEC's leadership role in securities enforcement. The SEC should be more strategic in deciding when and how to take action in response to widespread fraud.

In a number of instances, the SEC has brought dozens of cases involving essentially the same kind of misconduct. In some of these cases, it has done not on its own initiative, but following the lead of State enforcement agencies and private litigants. In other areas of misconduct, it has not brought any enforcement actions, choosing to allow the law to be determined by multiple State actors and State and Federal courts without the uniformity that only the SEC can provide. The result is less effective protection for investors and more costly compliance for regulated entities.

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[2] Her speech is available at *http://www.sec.gov/news/speech/2008/spch121608lar.htm.*

The SEC should seek to identify potential areas of fraud, investigate them, and prosecute misconduct in a way that exploits the potential benefits of overlapping jurisdiction and efficiently manages its resources. There are many actors on the securities enforcement stage, but only one actor can provide the centralized leadership and uniformity that optimizes efficient and effective national securities enforcement. The SEC is uniquely situated to gauge the significance of potential areas of fraud across the country, uniquely skilled in understanding the ideal balance between investor protection and free markets, and uniquely equipped to coordinate enforcement activities across a wide spectrum of actors.

The SEC should respond to widespread abuses by using the full range of mechanisms that are available to accomplish its enforcement goals. For example, one might roughly organize potential mechanisms and the related investment of SEC resources for widespread misconduct, such as mutual fund market timing or options backdating, as follows:

- Federal and State criminal action followed by SEC administrative action,
- SEC administrative action,
- Joint SEC/State administrative Action,
- Section 21(a) investigation report,
- State administrative action,
- Private lawsuits,
- Nonlitigation private resolution (*e.g.,* board action),
- Private voluntary remediation pursuant to internal investigation,
- Rule-making/interpretive guidance, and
- Commission/Director speeches.

Each of these mechanisms can provide significant prevention and deterrence benefits, in many cases with a much smaller expenditure of SEC resources than would be incurred in a full-blown investigation. In cases of widespread misconduct, the egregiousness of the misconduct typically varies greatly. Some cases will militate for criminal penalties and administrative proceedings—the highest investment of SEC resources. At the other end of the spectrum will be marginal misconduct that can be addressed, for example, through Commissioner speeches reminding regulated entities of their responsibilities.

For the cases that warrant administrative action, the SEC does not need to bring every case itself. State securities commissioners and attorneys general have demonstrated their interest in securities enforcement. The SEC should not hesitate to refer cases for prosecution solely by State authorities, or to bring joint proceedings where the SEC's investment of resources can be reduced through a sharing arrangement. When misconduct is the subject to private litigation, the SEC should consider whether that mechanism will serve an adequate enforcement function in lieu of an SEC action. In some cases, the SEC may wish to intervene in such cases, which would still place less strain on SEC resources than a full-blown administrative proceeding. In other instances, a fund board or board

of an operating company may negotiate a settlement and airing of the facts that is adequate. A self-reported internal investigation with follow-on remedial measures can serve a similar purpose. The SEC's evaluation of its enforcement program should integrate all of these mechanisms, especially in view of the SEC's role in the administration of the FAIR Fund program.

The following discussion provides three illustrations of these principles. The first illustration is the mutual fund market timing scandal in which the SEC brought dozens of cases. The scandal was based partly on arbitrageurs' exploitation of mispriced fund shares, a problem that was known to the SEC and about which it had done nothing. Not surprisingly, a State attorney general brought the first market timing cases, with the result being that it, rather than the SEC, played the leading role in establishing standards in certain respects for mutual fund operations, governance and fees. To this day, the SEC has not brought an enforcement action for stale pricing. The same attorney general also took the lead in establishing standards for addressing analysts' conflicts in yet another problematic area of which the SEC was fully aware but inexcusably inactive.

The mutual fund scandal also illustrates the inefficient use of SEC resources by bringing dozens of cases even after the SEC's position has been clearly established in the area. The SEC should not bring every case when it discovers widespread abuses such as mutual fund market timing, analyst conflicts, and backdating options. Market timing cases are still being resolved today, more than five years after the scandal began. As discussed above, the SEC should evaluate the egregiousness of the conduct involved and take a range of actions that are matched to the conduct. In cases of widespread fraud, many of the implicated parties will not represent inherently bad actors, but rather firms whose well-meaning compliance procedures were not adequately designed to prevent abuses. When many industry participants engage in certain types of misconduct, the line between legal and illegal conduct becomes blurred and it becomes more difficult for compliance departments to take strong positions against the natural pressures of competition. In many cases, there is little gained by bringing an enforcement action rather than seeking a resolution through less resource-intensive approaches.

I have conducted an extensive review of the enforcement actions brought in the market timing scandal, and it is my opinion that the SEC brought far too many cases. It is likely that the options backdating cases reflect a similar problem. The SEC should more aggressively pursue alternative approaches to many of these cases, including handing off more investigations to States, issuing section 21(a) reports, and monitoring private resolutions and internal investigations. The SEC must be willing not to bring cases number 10 through 20 in one area in order to redirect those resources to bringing cases number 1 through 5 in areas that otherwise would go untended. SEC resources are finite, and every additional market timing or options backdating cases reflects an investment in resources that are not invested somewhere else.

The BISYS case provides a current illustration of the likely overcommitment of resources to stale matters. In September 2006, the

Commission reached a settlement with BISYS Fund Services, Inc., that was based on BISYS's payments to 27 unnamed fund managers in return for their recommending that their funds use BISYS as the fund's administrator. The arrangements were in place from June 1999 and July 2004, which means that more than 2 years already had passed before the Commission settled with BISYS. Since then, the Commission has brought cases with respect to only one of the 27 fund managers, the earliest occurring another 2 years after the BISYS settlement, in September 2008.[3] The fund managers' arrangements with BISYS had already been terminated for over 4 years. The fate of the other 26 fund managers appears to remain unresolved. The investigations regarding the unlucky 26 are probably ongoing, with some inching toward a resolution and others floating motionless in an investigation purgatory awaiting a final decision on their fate.[4]

The types of relationships involved in the BISYS case trigger complex regulatory issues. Every attentive mutual fund lawyer would have read the BISYS settlement with an eye to future settlements that would clearly delineate appropriate from questionable conduct. It is not the plain vanilla bribery case that needs further explication—there, severe punishment and the deterrence it creates should be the SEC's primary goal. No guidance is necessary. But among the 27 fund managers with whom BISYS had a relationship there are undoubtedly borderline cases, *i.e.,* fact patterns that compliance personnel might not immediately recognize as being questionable or crossing the line into illegality. Yet no such guidance has been forthcoming. The BISYS scenario remains an area of legal uncertainty. The SEC should bring more cases to clarify the contours of what it considers to be illegal conduct. (Many of the funds have reached private settlements with the fund managers who were involved in the scandal which may reflect an adequate enforcement resolution in those cases.)

A final illustration is the SEC's recent enforcement action for a violation of section 15(c) of the Investment Company Act.[5] The SEC settled charges with a fund manager for violating section 15(c)'s requirement that it provide material information to the fund's board that was necessary to for the board to evaluate the fund manager's fee. The SEC also found that the fund manager's actions constituted willful fraud under the Investment Advisers Act. These facts also would have formed the basis for liability under section 36(b) of the Investment Company Act, which creates a private and public cause of action against a fund manager that violates its fiduciary duty to the fund with respect to the fees it receives.[6] While the SEC has developed no precedent under section

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[3] See *In the Matter of AmSouth Bank,* Admin. Proc. No. 3-13230 (Sep. 23, 2008) available at *http://www.sec.gov/litigation/admin/2008/ia-2784a.pdf.*

[4] In the latest twist in the BISYS scandal, BISYS (now a Citigroup subsidiary) has submitted to the SEC a proposed plan to distribute settlement amounts to the 27 fund families that had marketing arrangements that were subject to original enforcement action. None of the fund families is named, notwithstanding the strong implication that each fund manager engaged in wrongful conduct and the distributions' indirect reflection of a finding that each fund manager engaged in wrongdoing.

[5] See *In the Matter of New York Life Investment Management LLC,* Admin. Proc. No. 3-13487 (May 27, 2009).

[6] It is not possible for someone not involved in the negotiation of this section 15(c) settlement to know definitively whether this particular case was the right opportunity to bring a section 36(b) claim (*e.g.,* perhaps the factual basis was not as strong as the record suggests and the

36(b), private litigants have brought numerous cases over many decades that have generated various interpretations by dozens of judges.[7] Conflicts among these judges' positions recently led the Supreme Court to take a section 36(b) case (*Jones v. Harris Associates*). The Court will be left to make this determination with virtually no guidance from the SEC.

The 15(c) case cited above illustrates the kind of opportunity that the SEC has failed to take to clarify the law and create efficiencies for shareholders and fund managers alike. The only beneficiaries of the uncertainty created by the SEC are litigators. After the Supreme Court decides Jones, the situation is likely to be exacerbated. The Court will provide guidance as to the standard for excessive fee cases, and Federal trial and appellate courts will spend years defining the precise contours of the new standard. This situation could have been avoided if the SEC had established clear standards under Section 36(b). Its failure to do so has imposed and continues to impose a heavy tax on investors.

The Commission is under pressure to generate a large number of enforcement actions, which can undermine its effectiveness as an enforcement agency. Chairman Schapiro stated recently that the SEC has "approximately 150 active hedge fund investigations . . . about two dozen active municipal securities investigations . . . and more than 50 current investigations involving Credit Default Swaps, Collateralized Debt Obligations and other derivatives-related investments." How will these investigations be winnowed to a group of enforcement actions? If the SEC finds a common type of fraud in these cases, will it feel compelled to bring an enforcement action in every case? If 120 cases can be made in the 150 hedge fund investigations, will the SEC bring all of them, thereby adding 120 actions to its headcount for the year? If it does, will that prevent it from committing additional resources necessary to supporting a handful of criminal prosecutions? What would the resources being invested in hedge fund investigations number 10 through 150 be invested in if not in those cases? What are the opportunity costs?

The enforcement division should develop a structure for conducting an opportunity cost analysis for every area in which the staff is investing resources. This structure would identify alternative areas of inquiry in which those same resources are not being invested and provide a cost-benefit analysis to determine whether prevention, detection, and deterrence goals continue to be best served by prosecuting multiple cases involving similar misconduct. Metrics should be developed to recognize and quantify the value of an enforcement program that prizes efficient utilization of resources rather than brute case totals. Securities enforcement is not a business activity, but the application of business principles can

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defendant refused to agree to a finding under section 36(b)). The point here is that the SEC's enforcement program should be designed so that the potential strategic benefits of bringing a section 36(b) claim in such a case would be thoroughly reviewed. The fact that the SEC has failed to provide guidance as to what constitutes a violation of section 36(b) illustrates a failure to apply this approach.

[7] In connection with the mutual fund market timing scandal, the New York State Attorney settled a number of claims for excessive fees in which the fund manager agreed to reduce its fees for a certain period. Remarkably, the SEC criticized the NYAG for bringing these claims, notwithstanding the SEC's own failure to establish any standard for excessive fees.

help the SEC greatly improve its process of deciding if and how to take action.

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**RESPONSE TO WRITTEN QUESTIONS OF SENATOR DODD FROM BRUCE HILER**

**Q.1.** It is important that the SEC continually strive to have an Enforcement staff with the expertise and industry experience to properly police the markets. You noted in your written statement that although there are individuals at the SEC with expertise outside of the normal expertise of attorneys (sophisticated financial instruments, trading strategies, accounting, risk analysis, economic modeling), it should expand the number of such experts. Please elaborate on this statement.

**A.1.** As I noted in my written statement, there already are individuals at the Commission with expertise in areas outside of the legal field. Many of these individuals are not in the Division of Enforcement. For example, members of the Office of Economic Analysis are available to perform market and economic analyses relevant to certain types of investigations. Members of the Office of the Chief Accountant, the Office of the General Counsel, the Division of Trading and Markets and the Division of Investment Management similarly are available to assist in analysis and interpretation of the rules which they have drafted for adoption by the Commission, and to provide input on the operation of the markets and market participants in the areas which those offices cover, *e.g.,* accounting issues, broker-dealer firms, mutual funds, clearing agencies, and transfer agents.

However, individuals in these other offices and divisions have other duties, and they are not regularly available to assist in the day-to-day investigative work of the Division of Enforcement. They also may not be readily identifiable by Enforcement personnel, and some Enforcement personnel may be reluctant to seek the advice of these individuals. For example, as noted in the GAO Report which was a topic of the May 7 hearings, some personnel in Enforcement who were interviewed expressed the view that other offices and divisions at the Commission "had become too influential in effectively controlling Enforcement activities." GAO Report at p. 28. As I noted in my oral response to a question from Senator Bunning, I believe that in fact it is important for members of the Division of Enforcement to consult with individuals in other offices and divisions on issues within the expertise of those offices early in an investigation and throughout an investigation. It is members of those offices who have drafted, proposed, analyzed the public comments on, and presented the rules and regulations being enforced to the Commissioners for consideration and adoption. The Commissioners do and should value the input of those offices. This type of in-depth consultation by the Division of Enforcement, if fully effectuated, however, would place an additional burden on the resources of those other offices and divisions.

In my view, to deal with the expertise issue, the Commission should either add experts in various fields to special units within the existing offices and divisions and assign them to be readily available to the Enforcement Division, or form a new office in

which it could group experts who would be available to assist the Division of Enforcement on a regular, day-to-day basis with investigations. These experts also could work with divisions other than the Division of Enforcement on special projects within their expertise. I think the areas of expertise most needed involve (i) knowledge of the structure of new, complex financial products, which are ever-evolving, and of the market forces driving the creation of those products, (ii) the ability to analyze risk associated with, and the reasoning behind, complex trading strategies and positions, (iii) knowledge of corporate treasury and earnings management strategies, and (iv) knowledge of various types of economic modeling.

It will be difficult to attract such individuals without something approaching pay parity with the private sector. I also believe that having a separate office of such experts will increase the likelihood of attracting well-qualified individuals. Having a separate office and title structure will allow the work of these individuals to be, and to be viewed as, more objective, and would give them additional prestige within the Commission. I believe that experts who are not "tied" to the Enforcement Division, will view the opportunity for broader exposure to the work of the other offices and divisions of the SEC, and for being able to interact more closely on a daily basis with colleagues with similar expertise and experience, as pluses in terms of recruiting.

**Q.2.** As the Bernard Madoff case clearly illustrated, the SEC fell short in responding adequately to what were clear signs of fraud. It is not clear that this was a problem of a lack of resources. Do you have suggestions on steps the SEC could take to improve its oversight in this area? What information would better assist the SEC in identifying and acting upon problems such as market manipulation, insider trading, and other misconduct? What surveillance tools would help this effort?

**A.2.** I am not in a position to comment on the Madoff situation. In addition to the fact that my law firm has clients who invested with Mr. Madoff, I simply am not privy to sufficient facts to make a judgment about the SEC's conduct in that matter. In my experience, however, it certainly is not the usual course of conduct for the SEC to fail to respond appropriately if there are "clear signs of fraud." Indeed, I and many in the private securities bar are more concerned over the SEC being pushed to act precipitously or to expand its view of what is fraudulent conduct in response to criticisms that it has "missed" frauds or has come late to the investigative party. I speak more to this below, in response to the third question presented to me.

In terms of resources and oversight relevant to discovery of situations like that alleged in the Madoff matter, the SEC does employ market and financial analysts who are available to assist on enforcement investigations, and many staff attorneys have experience in dealing with Ponzi schemes and misuse of investor funds by advisors. In my experience, the SEC presently relies on at least four sources for information about possible market manipulations and insider trading. I lump these two types of conduct together, because they are trading-based frauds, and thus have common sources of surveillance. First, and foremost, the stock and option exchanges

and the Financial Industry Regulatory Authority (FINRA) utilize sophisticated, computer-based systems for identifying possible manipulative trades or trades that may be indicative of trading on inside information. These entities compile and review this information and forward it to the SEC for investigation, though in certain cases, where they have "jurisdiction," they also investigate the matter themselves. Second, the SEC's Office of Compliance, Inspections and Examinations (OCIE) conducts inspections of regulated market participants, and attempts to identify possible illegal trading either by the participants or their customers. Third, the SEC relies on tips from members of the public who may have heard of possible manipulative or insider trading. Finally, SEC staff members monitor the markets and the press to spot irregular trading patterns that may be indicative of such conduct.

In terms of "other misconduct" mentioned in your question, there are numerous types of possible misconduct which the SEC regularly investigates, which differ significantly from the conduct alleged in the Madoff matter. These types of conduct sometimes involve different regulatory regimes or statutes within the SEC's responsibility. The sources of information used by the Division of Enforcement to uncover misconduct differ depending on the type of conduct or the entity engaging in the conduct—For example, OCIE examines registered investment advisers, broker-dealers and other regulated entities, and may uncover misconduct involving an adviser or broker-dealer vis-a-vis their customers. Those customers can include individuals, institutions and mutual funds. The Division of Trading and Markets or Investment Management may notice suspect activity in reviewing reports filed by the market participants with which they are generally involved. The Division of Corporation Finance may uncover misconduct in reviewing and commenting on public filings by issuers. An outside auditing firm or an insider at an entity also may uncover misconduct and report it to the Commission staff.

Despite the SEC's pursuit of and access to the above sources of information, as I noted in my written statement, it can be difficult for any agency to detect fraud at anyone of the thousands of entities over which an agency such as the SEC has some jurisdiction. Individuals who commit frauds generally try to hide them, and some conduct which may appear suspicious or "unusual" at first look, may be entirely legal, though novel or complex. Where an individual or individuals are determined to falsify books and records and where third parties who may review or be provided copies of those records fail to notice irregularity, it can be difficult for the SEC quickly to obtain credible evidence of that irregularity. The SEC's statutory authority also provides various surveillance tools, such as those mentioned above: regulated market participants are subject to inspection by the SEC and by self-regulatory organizations; independent audits are required of certain entities; financial condition filings and reports by certain entities are required and are available for review by the SEC, institutional investors and the public generally, and the exchanges and FINRA have sophisticated computer-based market surveillance systems. Despite all of this, an organization can only get through so much data per employee in a disciplined fashion, and fraud can be difficult to detect even by

auditors who have on-site and extensive access to the books and records of the entities which they audit.

In light of the above, I am not aware of additional, realistic surveillance tools which could assist the Commission. I am afraid that the best suggestion I can come up with to increase detection and prevention of fraud is a "boots on the ground" approach, and the suggestion I made in my written statement, and which I discuss below, concerning nonadversarial contact by regulators with market participants.

**Q.3.** In your statement you said that the SEC might be more successful at getting early warning signs of problems if it maintained more of an open line of communication with regulated firms, and moved away from the current atmosphere of suspicion that exists today. Can you expand on your thoughts? Does this present risk of regulatory capture?

**A.3.** In my experience, one of the best sources of information about risky conduct or possible misconduct may be someone with experienced-based knowledge of a particular industry or of an organization and its practices. This does not have to be an actual insider of the organization, and it does not mean that anything an insider or former insider says should be accepted at face value. Indeed, in my experience the Commission staff is, and should be, cautious about statements made by a potentially disgruntled employee or former employee of an entity, or by a competitor of an entity. And, of course, once an insider decides to expose possibly violative conduct, it has been ongoing for at least some period of time.

I believe that first-hand experience of SEC staff personnel with market participants, outside of an Enforcement inquiry or an inspection, is one of the best ways for the staff to assess the credibility of and the risks associated with a business organization. The SEC often forms advisory groups with which it consults on various issues, but it also is important to establish an open line of communication on a more regular basis with market participants and issuers and for the SEC to reach out to business leaders regularly to discuss business and regulatory issues informally. It is through such contact that the SEC can gain a more up-to-date understanding of the issues facing the markets and the risks associated with certain strategies. Through these communications the SEC can also move more quickly to give public guidance in areas involving complex or emerging issues, and to avoid after-the-fact review of conduct and situations which may develop in a fashion which the SEC later determines is not appropriate.

I do not believe that such contact will result in "regulatory capture." Those who work at the SEC are professionals who make certain sacrifices in choosing public service, and, though they are not immune from normal human reactions to more frequent contact between individuals, the context of the contact, the relative infrequency of it even if an open line of communication is established, the sensitivity on both sides to the interests which each participant ultimately serves, and the close monitoring of the SEC by Congress, the media and the public in general, I believe will provide sufficient protection from regulatory capture.

An open line of communication must be a two-way street to be effective. The regulated must be willing to respond. As I noted in my written statement, I believe that in the last 10 years, an atmosphere of suspicion has developed between the SEC and market participants and issuers in some cases. In my written statement I briefly noted my thoughts on the sources of this tension. One source is, that in stark contrast to the picture of weak SEC Enforcement efforts painted in the media, I believe that many market participants and issuers view the SEC's Enforcement efforts in this decade as very aggressive across the board. In the last 5 years, the SEC has conducted numerous market "sweeps," in which it sends requests for voluminous information to many market participants or issuers at the same time regarding different areas of concern or interest. The sweeps call for extensive document production as well as provision of written statements or information, and are very time consuming and expensive. Regulatory inspections have been often lengthy and may overlap with other regulatory bodies or even other offices within the SEC.

In addition, as expressed in the *Report on the Current Enforcement Program of the Securities and Exchange Commission,* issued by the U.S. Chamber of Commerce in March 2006 (Chamber of Commerce Report), it seems that "the current pro-enforcement atmosphere and criticisms of the Commission's enforcement program . . . have encouraged the Commission to advance aggressive theories through enforcement actions, where the relevant facts are far from clear." Chamber of Commerce Report at page 17. I and my law firm were counsel to David Andrews, who was engaged by the Chamber of Commerce to develop the Report, and I refer to it because of my participation in authoring it and because the views expressed in the Report are consistent with mine. The Commission relies extensively on the Staff to interpret facts discovered in an investigation and to recommend enforcement actions. This often requires evaluation of difficult factual issues and determination of whether malleable standards like "recklessness" or "materiality" are met. As noted in the Chamber of Commerce Report, although no one disagrees that clear cases of fraud should be pursued aggressively, there is a feeling "that there is a lack of appropriate consideration by the Commission of the difficulties with which executives are faced in interpreting complex disclosure, accounting and legal issues and in uncovering fraud." Chamber of Commerce Report page 17. As former SEC Chairman Donaldson cautioned in a speech in September 2003, "enforcement of the laws can, in some circumstances, become a vehicle for changing the rules . . . an enforcement proceeding can realign an industry standard in much the same way as a new rule, at times, making the line between rule making and enforcement unclear." [1] This issue also extends to consideration by criminal prosecutors dealing with securities law cases, and can be much more acute in such instances. See Chamber of Commerce Report at pp. 23–24.

Another source of tension between the Commission and industry participants and issuers is the Commission's use of its penalty pow-

[1] William H. Donaldson, Speech by SEC Chairman: Speech to NASAA Annual Conference (Sep. 14, 2003) (available at *http://www.sec.gov/news/speech/spch091403whd.htm*).

ers. The GAO Report which was a topic of the May 7, 2009, hearings, spent some time reporting its findings on the SEC's penalties program, and concluded, among other things that recent SEC policies "have had the effect of making penalties less punitive in nature . . . " and that there is "a perception that the SEC has retreated on penalties," GAO Report at page 7. I agree that the SEC's recent pilot program requiring that the Commission approve a range of possible penalties before the Enforcement staff was allowed to begin negotiating a settlement with an entity that is the subject of a possible enforcement action slowed the process. However, I disagree with the implication that penalties serve a deterrent purpose on corporate or other entities, and that penalties must be "punitive" and must "punish" entities for the misdeeds of their employees, at least where the entity itself is not an entirely corrupt organization. Rather, I believe that the publicity and cache given to the size of penalties in the public eye encourages the SEC to seek larger and larger penalties and discourages entities from engaging in a dialogue with the Commission staff about uncertainties over trading strategies or other activities. When coupled with an aggressive interpretation of standards for fraud liability, a move toward large corporate penalties only exacerbates tensions between the Commission and those it regulates.

One might not be concerned about such tension if penalties on entities truly did deter future conduct. However, corporations do not commit fraud; individuals who work for them do so. And I do not believe that monetary penalties appreciably increase the incentive of corporate boards or executives to attempt to prevent and detect fraudulent conduct. Honest corporate boards, executives and employees already have adequate incentive, and indeed, legal requirements, to police themselves and those who work around them. Corporations are required by the Federal securities laws, including recent additions under the Sarbanes-Oxley Act of 2001, to take extensive steps to set internal controls and to monitor and attempt to prevent and detect fraudulent conduct by employees. In addition, the monetary costs incurred by an entity which becomes involved in an SEC investigation are in effect a penalty, and are potentially enormous. The cost to the entity to retain counsel and experts to conduct an internal review, to defend the corporation in an investigation and often to provide separate counsel to its Audit Committee and employees can be in the tens of millions of dollars. Many of these direct costs may be defrayed by D&O insurance, depending on the amount that had been purchased, but insurance policy amounts run out and increased insurance costs in the future are real. Also, there is inevitable shareholder litigation which may take multiple forms and which requires additional counsel and experts to be retained. Settlements of shareholder actions can run into the hundreds of millions of dollars in egregious cases. The cost in person hours, morale, and loss of goodwill and good employees also can be very high, especially in light of more recent media and shareholder sophistication and attention to such issues. When conduct of some at a corporation begins to make headlines, whether or not involving egregious misconduct, the jobs of even those executives who were not involved in the conduct are at risk and their reputations are severely damaged. All of this provides adequate de-

terrence and incentive to the honest employees of a corporation or other entity to take strict measures to prevent and detect improper conduct.

Finally, I have never accepted that an individual who is brazen and self-interested enough to engage in a fraud at a public company or a regulated entity would be deterred, let alone punished, by the idea that if they are caught a penalty may be levied against his or her employer. Indeed, by the time the fraud is discovered and gets to a penalty stage, the offending employee(s) most certainly are gone and their last concern is about what happens to the entity.

I have heard the argument that if penalties do not deter, then why is there so much concern over them? Despite their best efforts, honest boards of directors, executives, and employees cannot be certain that they are preventing fraudulent activities by even senior executives. Thus, the concern over penalties and over an apparent race to satiate the public appetite for ever larger penalties is that an entity will someday be caught in the vise of public outcry and the practical need to resolve a matter in which the government is calling for a very large penalty as a result of conduct which honest executives or board members were unable to prevent. I also believe that the push for greater penalties and the publicity which it generates helps to advance the growing, inaccurate, and very unhelpful public perception that corporate America is corrupt or tends toward corruption, and that huge penalties are the only thing standing between honest investors and corrupt executives.

I believe that the above factors combine to create a perception among some issuers and regulated entities that increased dialogue and contact with Commission staff may only lead to second-guessing based on a lack of understanding, and possibly an investigation and a wide net being cast over almost anyone near some conduct that is deemed inappropriate or improper. Although this view may not be entirely justified, especially with rule-making divisions within the Commission, the trifecta of (i) the Commission being widely criticized and pushed to be more aggressive in the enforcement area; (ii) public pressure for ever-increasing entity penalties, and (iii) the case with which complex factual situations can be misinterpreted and read to infer misconduct under malleable legal principles, combine to put pressure on both the Commission and those whom it regulates and monitors to interact only in an adversarial or semi-adversarial setting.

**Q.4.** You noted in your testimony that the line between civil and criminal securities cases has been blurred. Can you share your thoughts on the role of the SEC with respect to criminal securities fraud cases?

**A.4.** As to the role of the SEC in criminal securities cases, I believe that the SEC should have a major, consultative role and should be intimately involved in decision making with criminal authorities where a case is predominately a securities law case or is a case that affects a regulated entity under SEC supervision. The SEC administers, enacts rules under, and interprets a number of statutes covering a variety of businesses and business organizations, including public companies, broker-dealers, investment advisers, and mu-

tual funds. These statutes and related rules are often complex and reflect long-reviewed and thought-out policy considerations. The SEC is charged with consistently applying these statutes and rules to the activities of individuals and entities to provide uniformity across all such activities in the areas of the SEC's expertise, no matter in what jurisdiction the individuals or entities operate in the United States. Indeed, the SEC's jurisdiction can reach to entities that are not predominately U.S. organizations.

Although some frauds are clear or brazen, the above considerations still apply to cases brought as "straight-forward frauds," which may not on their face involve any complex rule or regulation. Indeed, recent criminal securities "fraud" cases still involved interpretation of esoteric accounting principles or required the criminal authorities to pursue theories which involve those authorities advancing what they believe was or was not a proper business purpose for a transaction.

In an atmosphere where even a threatened criminal action or a threat by a State to shut down a major brokerage firm can have a dramatic and swift effect on that organization and the market as a whole, I believe that the agency charged with the strong public policy interests expressed in the Federal securities laws should have a major role in determination of whether actions involving conduct or entities directly within its jurisdiction should be criminally prosecuted under any particular set of facts. For a further discussion of issues relating to criminal enforcement of the Federal securities laws, I refer you to the Chamber of Commerce Report, pp. 22–24 and note 82 therein.

Once again I thank you for the opportunity to appear before the Subcommittee and to provide information on the important work which you are doing in the area of SEC enforcement. I hope that my comments are helpful, and I look forward to assisting you in the future if called upon.

ADDITIONAL MATERIAL SUPPLIED FOR THE RECORD

## PREPARED STATEMENT OF COLLEEN M. KELLEY

NATIONAL PRESIDENT,
NATIONAL TREASURY EMPLOYEES UNION

MAY 7, 2009

Chairman Reed, Ranking Member Bunning, and Members of the Subcommittee, I greatly appreciate the opportunity to provide testimony to this distinguished Subcommittee.

These are challenging times for the United States Securities and Exchange Commission and for its Division of Enforcement in particular—but these times also present a unique opportunity to engage SEC leadership to recognize and utilize what is best about government service to make the agency more responsive to our Nation's needs. During our Nation's current financial crisis, I am confident that the talents and expertise of front-line SEC employees, many of whom have been too often overlooked, can and will be tapped to help restore confidence in our Nation's capital markets achieve the fundamental goal of protecting our Nation's investors. As President of the National Treasury Employees Union (NTEU), representing more than 150,000 Federal employees in over 31 different agencies and departments throughout the government, including the over 2,500 bargaining unit employees at the SEC, I look forward to working with you to help the SEC succeed in its fundamental mission.

The challenges that we face as we work together to revive our economy and ailing financial institutions are complicated and broad ranging. But much has happened in the past several months. We have a new president and a new SEC chairman who see government as part of the solution to our Nation's challenges, rather than as the problem. We are hopeful that in this new era, the SEC will begin the work of restoring the morale of the SEC's front-line staff and rededicating the agency to its mission as the investor's advocate, rather than as an arbiter between those who favor a smart, efficient regulatory landscape and those who oppose it.

Indeed, a renewed dedication to public service has never been more important. I was proud that NTEU's award-winning public service campaign, "Federal Employees . . . They Work for U.S.," was well received throughout the country. We were proud to air radio spots on 65 stations, in 50 markets nearly 17,000 times, and TV spots that resulted in 14 million impressions. These ads reminded the public of the important work Federal employees do in an array of agencies and communities throughout the Nation.

NTEU believes that fundamental improvements to the SEC's Enforcement Division are long overdue. We support the new Director of the Division of Enforcement, Robert Khuzami, and his basic goal of a smart, swift, strategic, and successful enforcement program. In our view, Enforcement Division reforms should be carefully considered and based upon lessons learned about the Division's strengths and weaknesses over the past several years. And I think it is important to note, that whether in connection with market timing, options backdating, the subprime mortgage crisis, or the Madoff Ponzi scheme, the common thread among these failures has not been a failure of the front-line investigative staff, but rather a failure of past SEC management to acknowledge or respond swiftly to significant allegations of improper conduct and inordinately high systemic risks.

The extent to which the SEC's Division of Enforcement will be successful in its mission rests in large measure with the Federal employees charged with carrying out the agency's fundamental mission of enforcing the Federal securities laws to protect our Nation's investors. In the final analysis, a great country is the sum of the actions of its people—and in few, if any endeavors, does that hold more truth than in the work of the attorneys, accountants, and support staff who are employed in the SEC's Division of Enforcement. These highly skilled women and men have dedicated themselves to answering the call to public service. The change in administrations clearly provides a window of opportunity not only for improvements in the Division of Enforcement and the way it conducts itself—and thus how it serves the public—but in the way it attracts and retains those who perform the people's work.

### Improving the Organizational Structure of the Enforcement Division

The primary challenge currently faced by the front-line SEC enforcement staffers that NTEU represents is the existence of a multilayered and redundant management structure within the Division of Enforcement. Every four or five front-line enforcement employees currently report to a "Branch Chief," who reports to an Assist-

ant, who reports to an Associate. The vast majority of these front-line enforcement staffers are highly qualified, skilled, and motivated attorneys and accountants who are fully capable of handling their investigations independently, without the level of constant supervision that flows naturally from this ratio of managers to staff persons.

As a result of this structure, it often takes as long to determine what to do about a violation as it does to determine whether there was a violation in the first instance. This robs the Division of its ability to have a swift and timely regulatory impact.

NTEU generally supports President Obama's laudable reform goal of flattening management layers in the Federal government, as well as recent remarks by Enforcement Director Khuzami indicating a willingness to consider such changes. The SEC's Enforcement Division is an example of an entity that would be well served by a reduction in the number of redundant management layers. Such a flattening of the structure would improve the speed and efficiency of the enforcement program, while, simultaneously increasing front-line employee morale, engagement, and empowerment. Re-designating unnecessary enforcement managers would also result in a substantial increase of up to 20 percent in the number of front-line investigative enforcement staff who are actually investigating cases, without requiring an increase in funding from Congress.

**Need for Additional Market, Financial, and Accounting Expertise**

Mr. Khuzami has recently expressed the view that the SEC's enforcement program might benefit from hiring additional experts to assist the front-line staff in conducting their investigations, as well as by more effectively leveraging the experts that it already employs. NTEU supports this recommendation. The SEC's front-line enforcement attorneys are highly skilled experts at what they do—that is, identifying and developing evidence critical to evaluating possible violations of the Federal securities laws. However, in an increasingly complex global financial marketplace, those attorneys would benefit greatly from more readily available technical and analytical support staff. In recent years, the SEC has failed in providing this type of support.

As an example to place this issue in perspective, the Enforcement Division today employs approximately 500 nonmanagement investigative attorneys, but it has only nine bargaining unit "market surveillance" experts nationwide. Increasing the staff of market, accounting, and financial analysts and other investigative support staff available to work with SEC attorneys would be an efficient improvement that would help to achieve the Director's goal of smart, strategic, swift, and successful results.

**Reorganization of Enforcement into Specialist "Silos"**

During his first few weeks at the SEC, Mr. Khuzami has suggested that the agency might perhaps more effectively fight securities fraud by radically reorganizing its enforcement staff into a number of "specialist" groups that would target specific types of cases. Employees would shift in and out of particular specialty areas every couple of years. This type of specialist, or "silo," model would constitute a historic and fundamental sea change in the organization of the Division of Enforcement. It therefore requires extremely careful consideration and deliberation before implementation.

It is important to carefully consider the inherent logistical problems raised by attempting to shift to such a model. If employees are reassigned en masse into specialist "silos," will the agency transfer their cases to other employees if those cases do not fall under their current specialty? If so, how would it be an efficient use of agency resources to transfer numerous cases from staff possessing historical knowledge of those cases to staff having no such knowledge? If not, then what will specialization really mean? How long will employees be expected to stay in a particular specialty area? When their "tour of duty" in a particular specialty "silo" is over, will they transfer their uncompleted cases to other employees? Will this be efficient for the agency? If not then what will specialization really mean? To deal with these problems, will employ be expected to stay in certain specialty areas for extended periods of time, without the ability to work in other areas of the Federal securities laws? Who will decide which employees are reassigned to which groups, and what will be the criteria for such reassignments? What will be the long term impact of such decisions upon employee morale, and upon recruitment and retention?

Even beyond these logistical difficulties, there are fundamental questions about the efficacy of such a "silo" model that should be carefully considered by the SEC. Most of the highly skilled SEC enforcement lawyers and accountants that NTEU represents are organized into groups which handle all of the types of cases brought by the agency—most notably cases enforcing the Securities Act of 1933, the Ex-

change Act of 1934, the Investment Company Act of 1940, and the Investment Advisers Act of 1940. All of these types of cases have basic similarities, and a great many investigations involve violations under more than one provision. For this reason, the agency has traditionally believed that it is important for the front-line enforcement employees to possess a relatively broad knowledge of all of the securities laws, even if in some cases that knowledge is not particularly deep.

In fact, it is not at all unusual for one enforcement investigation to present issues that touch upon almost all aspects of the Federal securities laws. A hedge fund investigation may involve, among other things, insider trading, offering fraud, market manipulation, and accounting fraud, as well as violations of the Investment Advisers Act. This may be one reason why the SEC's historical experience with specialized groups has often resulted in such groups dissolving back into general enforcement. Cases frequently contain too many parts to classify easily. In addition, while the SEC has used task forces in the past, they have only existed for limited durations.

Thus, although there is some natural appeal to the broad concept of "specialization," the SEC's enforcement attorneys and accountants are already highly specialized by focusing on enforcement of the Federal securities laws. In this regard, the Division of Enforcement is different from the Department of Justice, where law enforcement is divided into specialist groups. Federal securities law is already a fairly narrow area of the law. By contrast, a typical U.S. Attorney's Office is divided into a number of different groups dealing with unrelated criminal activities. Even a small white collar crime group in a U.S. Attorney's Office, for example, deals with a broader class of investigations than just the violations of the Federal securities laws currently handled by the SEC's Enforcement Division.

By creating "specialized" groups, the SEC would in reality be creating micro-specialized groups. This could be akin to transforming SEC enforcement attorneys into assembly line workers who only attach one part during an assembly process. Although, perhaps, some simpler types of securities fraud cases could be completed more quickly in such an environment, the cost could very well be increased staff alienation and balkanization, and a generally less effective enforcement program, particularly with respect to larger, more complex cases.

NTEU shares Mr. Khuzami's ultimate objective, which we believe is to empower front-line enforcement investigators with the expertise and resources necessary to regulate increasingly complex financial markets. We believe, however, that the SEC should proceed very carefully with any plans to fundamentally shift the organization of the Enforcement Division toward a higher degree of specialization. In this regard, Federal labor law and the collective bargaining agreement between NTEU and the SEC set forth the negotiating process that is required before a large scale reorganization of the Division could occur. NTEU leaders look forward to engaging in a respectful and constructive dialogue regarding these issues with SEC management.

**Improved Enforcement Prioritization Metric**

NTEU supports Mr. Khuzami's call for the introduction of an improved Enforcement Division prioritization metric which would allow every front-line employee to effectively evaluate potential enforcement matters.

Walter Ricciardi, a Deputy Director in the Enforcement Division from 2005 to 2008, recently remarked in an April 1 speech in New York that SEC enforcement offices are evaluated on the number of cases, or "stats," that they bring in, rather than on the regulatory impact of those cases. This system, in which every case receives the same one-size-fits-all "stat," is woefully inadequate. Bringing an enforcement action against Enron yields one "stat," but an office could receive 100 "stats" for delisting 100 defunct companies for failing to file annual reports.

All cases are not the same, and treating them as though they are has the potential to create perverse incentives, as well as to devalue the important work of front-line employees. Most importantly, the SEC's prioritization metric should reflect actual harm to investors, current or potential.

**Empowering Front-Line Investigative Staff**

Over the past year, there have been a number of press reports regarding inquiries by Congress and the Office of the Inspector General concerning SEC investigations in which senior managers allegedly met with defense counsel outside the presence of the front-line staff assigned to those investigations. These reports led one Senator to comment in the press on what he perceives to be a "culture of deference" toward "big players" on Wall Street.

A renewed public commitment by Enforcement Division management to ensuring that front-line enforcement staff will be permitted to attend all meetings between management and defense counsel on the matters that those staffers are inves-

tigating would readily dispel such perceptions, while simultaneously reinforcing the important role of the front-line staff in enforcement investigations.

**Reducing Bureaucratic Tasks**

Today, front-line employees in the Enforcement Division expend a great deal of time on bureaucratic tasks such as the updating various internal databases and providing repetitive reports on their cases up the management chain. Simply reducing these types of activities would be an important step toward streamlining the enforcement process.

**Expanded Regulatory Authority**

NTEU supports increased regulatory authority for the SEC over unregulated investment instruments and entities, including explicit statutory authority to regulate hedge fund advisers as investment advisers and to require hedge funds to disclose the contents of their portfolios, leverage amounts, and counterparties.

**Funding and Staffing**

Any consideration of ways to strengthen the SEC's vital enforcement responsibilities should include a discussion of the important human capital issues currently facing the SEC. As the agency deals with what is perhaps the most challenging period in its history, its single most important asset continues to be its human capital—the stock of skills and knowledge embodied by the talented group of front-line employees who work at the agency and carry out its complex mission every day. For that reason, maintaining a sound strategy to both attract and retain the best possible work force will be critical to the long term success of the SEC's enforcement program.

During the previous administration, however, the SEC displayed what could only be viewed as a marked indifference to human capital issues. Far too often, the agency was hamstrung, understaffed, underfunded, and led by political appointees who were at best ambivalent about the agency's mission. By actively engaging the SEC's workforce and refocusing its mission, the agency's new management can take a fundamentally different path which will assist it in more effectively tackling our Nation's problems while simultaneously restoring vitality to the SEC, including its Division of Enforcement.

Last year, NTEU pressed the case in Congress for additional SEC staffing and an increase in the performance based pay budget requested by the agency, even as the prior administration was asserting that the SEC did not need any additional funds and that it expected substantial staff attrition in FY2009. In hindsight, it is now abundantly clear that permitting attrition to shrink the size of the SEC's staff, including its enforcement staff—a strategy which was actively pursued by the agency's previous management—could not have been more gravely off the mark. For that reason, I am heartened by the fact that current SEC Chairman Mary Schapiro has signaled a change in direction with respect to staffing issues. I strongly support additional funding to increase the agency's front-line staff.

But more needs to be done with respect to human capital issues at the SEC. For example, the agency should deliver on its agreement, made more than 2 years ago during its 2006 compensation negotiations with NTEU, to provide a 2 percent increase in its retirement match for SEC employees. In addition, SEC management should reverse the prior administration's approach of repeatedly slashing the funding for its performance based pay system.

The SEC's performance based pay system has had many flaws, both in its implementation and execution. This was clearly evidenced by NTEU's national arbitration victory against the agency in late 2007, which ultimately resulted in a $2.7 million monetary settlement after an arbitrator found that the system had had a discriminatory impact on hundreds of SEC employees. The most glaring problem with the merit pay system, however, has been past management's conscious decision to inadequately fund it. For fiscal years 2007, 2008, and 2009, the agency slashed its performance based pay budget, culminating in its most recent request to Congress for only a 1.5 percent increase for FY2009. This amount represented only half of the historic merit pay budget of 3 percent. Without SEC management support for adequate funding, the merit pay system will never work as intended.

NTEU is looking forward to working closely with new SEC Chairman Schapiro to alter the course of the misguided human capital policies of the past administration. Without fundamental change in the agency's approach to these issues, employee morale will continue to suffer, which will have a concomitant negative impact upon recruitment and retention—and ultimately upon the agency's ability to effectively enforce the Federal securities laws.

Finally, NTEU supports a self-funding mechanism for the SEC to ensure its independence in establishing its budget and staffing needs from the fees that it collects.

Currently, as you know, fees collected by the SEC go into the General Treasury and the agency is funded and staffed through appropriations. Other financial regulatory agencies represented by NTEU, however, such as the Federal Deposit Insurance Corporation, the Office of the Comptroller of the Currency, and the National Credit Union Administration, all have such control over the funds that they collect. The SEC should be afforded the same independence and discretion.

**Conclusion**

The challenges facing the SEC's Division of Enforcement in our Nation's current financial crisis are large and historically important. I think that it is important to remember in this context that the Chinese symbol for "crisis" contains both the symbols for "danger" and for "opportunity."

It is truly a new day for us all. The SEC has been through a lot in recent years, suffering from depleted resources and staffing, as well as poor judgment by prior management. But it also enjoys a deep reservoir of highly skilled, resilient, and capable employees who will continue to play a critically important role as we move ahead together to address the problems that we face.