ENSURING EFFECTIVENESS, FAIRNESS, AND TRANSPARENCY IN SECURITIES LAW ENFORCEMENT

HEARING

BEFORE THE

SUBCOMMITTEE ON CAPITAL MARKETS, SECURITIES, AND INVESTMENT

OF THE

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ENSURING EFFECTIVENESS, FAIRNESS, AND TRANSPARENCY IN SECURITIES LAW ENFORCEMENT

Wednesday, June 13, 2018

U.S. House of Representatives,
Subcommittee on Capital Markets,
Securities, and Investment,
Committee on Financial Services,
Washington, D.C.

The subcommittee met, pursuant to notice, at 2:08 p.m., in room 2128, Rayburn House Office Building, Hon. Bill Huizenga [chairman of the subcommittee] presiding.

Present: Representatives Huizenga, Hultgren, Poliquin, Hill, Emmer, Mooney, MacArthur, Davidson, Hollingsworth, Maloney, Sherman, Lynch, Scott, Foster, Sinema, Vargas, Gottheimer, and Waters.

Also present: Representative Capuano.

Chairman Huizenga. The committee will come to order, and without objection, the Chair is authorized to declare a recess of the committee at any time.

This hearing is entitled, "Ensuring Effectiveness, Fairness, and Transparency in Securities Law Enforcement."

I now recognize myself for 2 minutes to give an opening statement.

Today's hearing on "Ensuring Effectiveness, Fairness, and Transparency in Securities Law Enforcement" will focus on the Securities and Exchange Commission's (SEC) approach to enforcing Federal securities law, and whether its activities and initiatives are complementary to all three prongs of its statutory mission, to protect investors, to maintain fair, ordinarily, and efficient markets, and to facilitate capital formation.

According to the Division of Enforcement's annual report issued November 2017, in Fiscal Year 2017, the SEC brought 754 enforcement actions, and obtained almost $3.7 billion in disgorgement and civil penalties resulting from those actions.

Additionally, $1.07 billion was returned to harmed investors.

Enforcement activities are an integral part of any regulatory agency, but especially for the SEC. Hardworking families in west Michigan and across the Nation rely on capital markets to save for everything from college to retirement.

We must work to ensure the United States continues to maintain the most efficient capital markets so that Mr. and Mrs. 401(k) have

the opportunity to safely invest in a better future and receive the greatest return on their investment.

This hearing will further discuss areas of the law that would benefit from greater clarity to ensure that the SEC investigations have an appropriate scope and minimize instances of the practice known as regulation by enforcement.

Additionally, the hearing will examine the role of administrative proceedings in the enforcement of Federal securities laws, including whether Congress should advance legislation like H.R. 2128, the Due Process Restoration Act of 2017.

We will also explore whether Congress should clarify the SEC's authority to seek disgorgement, including what is the appropriate statute of limitations for disgorgement sought by the SEC.

Last, we will examine whether the lack of clarity between Federal and various State standards for securities fraud, as well as other potential violations, is chilling participation in our capital markets. The United States capital markets are the gold standard. We can all acknowledge that our markets are widely recognized for being the deepest, most liquid, and the most competitive markets in the world, and Congress must identify any inconsistencies or disparities between State and Federal laws, and take appropriate action to ensure greater consistency and predictability in the application of these rules and regulations.

I look forward to hearing from our witness today.

The Chair now recognizes the Ranking Member of the subcommittee, the gentlelady from New York, Mrs. Maloney, for 5 minutes for an opening statement.

Mrs. MALONEY. Thank you, and I thank you for holding this important hearing, and I thank all of our panelists for being here.

Proper enforcement of all the securities laws helps maintain investor confidence in our markets. Investors need to know that their rights will be protected and that bad actors, who try to take advantage of them, will be punished.

It is for this reason that I would like to focus on one of the bills we are discussing in this hearing today, H.R. 5037, the Securities Fraud Act of 2018.

This bill is deeply, deeply troubling to me. The bill would completely preempt all State civil securities fraud laws, and would actually preempt most, and likely all State criminal security fraud laws, too.

I have very serious problems with both the premise of this bill and the drafting of the bill, which has managed to make a bad idea even worse.

First, the premise of the bill is fundamentally flawed. Companies don't need relief from State securities fraud laws; they need to stop committing securities fraud. The idea that securities fraud should be illegal and that States should be able to police securities fraud within their own borders should be uncontroversial.

I believe that fraud is fraud, and that States should be free to regulate any form of securities fraud that they see fit.

Second, the way the bill is drafted, it actually preempts all State criminal securities laws, in addition to civil securities fraud laws. The bill's findings section says that States should retain the authority over criminal securities fraud, but then the bill proceeds to

strip States of the authority over all criminal securities fraud cases.

The reason is simple: The bill says that no State, and I quote, "Shall regulate securities fraud with respect to an issuer," end quote. This preempts both civil and criminal security fraud laws.

The bill then later states that States can bring criminal securities fraud cases, but only, and I quote, "Consistent with this section," end quote. But that section of the bill has already stated that no State law can regulate any securities fraud, even criminal securities fraud. It is literally impossible for any criminal securities fraud case to be consistent with that section, which means that all criminal securities fraud laws at the State level would be preempted under this bill.

But I am particularly opposed to this bill because in New York State, we have a powerful securities fraud law, called the Martin Act, which is a broader definition of fraud than other States, and therefore, serves as an effective deterrent for misconduct in the securities market.

The Martin Act has been very successful, and I will strongly oppose any attempts to weaken this important law.

For example, I have a letter here from the New York Attorney General's Office, which opposes H.R. 5037, and they highlight several cases that they brought under the Martin Act that they would no longer be able to bring under this bill.

For example, just last year, they brought a case under the Martin Act against a small-time investment advisor in Queens who had defrauded about 58 investors out of $11 million. These are the kinds of cases that only the State security regulators, like the New York Attorney General's Office can bring, because the SEC simply doesn't have the resources to pursue every small-time fraud like this.

Unfortunately, H.R. 5037, seems to be aimed directly at the Martin Act, and by preempting these State laws, the bill would allow small-time fraud to run rampant.

Before I close, I want to submit for the Record letters of opposition to H.R. 5037 from the North American Securities Administration Association, the New York Attorney General, the Massachusetts Secretary of the Commonwealth, New Jersey Attorney General, and the Council of Institutional Investors.

Chairman HUIZENGA. So moved, without objection.

Mrs. MALONEY. Thank you, and I look forward to this hearing from our witness, and especially from Mr. Borg, who is one of the State security regulators, whose authority would be weakened under this bill.

Thank you, Mr. Chairman, and I yield back.

Chairman HUIZENGA. The gentlelady yields back.

While I have a moment, I had neglected to do one small point of business. I just ask unanimous consent for any member to participate in today's hearing, although not a member necessarily of the subcommittee. As long as that Member is a member of the full committee, we welcome that participation today.

With that, the Vice Chairman from Illinois, Mr. Hultgren, is recognized for 2 minutes for an opening statement.

Mr. HULTGREN. Thanks, Chairman Huizenga, for holding this hearing. Thank you to our witnesses for being here.

I think we can all agree that our securities laws are critical to providing structure and certainty to both issuers and investors participating in our capital markets. In turn, this certainty drives the capital formation and investor returns that are foundations of our American economy.

It is important that Congress regularly review how the securities laws are being enforced and identify opportunities for our regulators to be more effective.

Today's hearing is especially helpful in light of the testimony we heard in the subcommittee from the SEC's Division of Enforcement last month. In their testimony, the co-directors of enforcement underscored a number of things that I hope our witnesses can provide some more insight into today.

Specifically, I believe that enforcement of our securities laws should prioritize protecting the least sophisticated investors, in other words, those that are most susceptible to fraud.

Similarly, I agree that the basis for enforcement of our securities laws should not be the broken-windows approach that has been used by the Commission in the past. I am concerned that this could cause the SEC to overlook more significant investor protection issues that require more long-term resources to investigate.

Finally, the recent Kokesh decision has ignited an important debate about the statute of limitations for disgorgement by the Commission.

Last April, now-SEC Commissioner Hester Peirce testified in our hearing on the Financial CHOICE Act about the importance of making reforms to the Commission's approach to enforcement, such as increased transparency, expanding opportunities for parties to present their positions in person, and allowing parties to opt out of administrative proceedings and into district court.

I hope these are ideas that our committee can further develop and advance.

I look forward to our witness testimony today, and look forward to hearing the recommendations for improving the enforcement of our securities laws.

With that, I yield back.

Chairman HUIZENGA. The gentleman yields back.

The Chair recognizes the gentleman from New Jersey, Mr. MacArthur, for 1 minute for an opening statement.

Mr. MACARTHUR. Thank you, Mr. Chairman.

I think we all know we have problem in our public markets. The year I graduated from college in 1982, there were about 5,800 public companies. It is about the same number we have today, except that our economy has more than doubled during that period.

There are a lot of reasons why companies aren't going public, but the one I hear most often, the one I have experienced in my own life, is that business people are scared to death of overzealous attorney generals that criminalize mistakes and make it difficult for businesses to go forward.

It hurts Main Street investors, it hurts employees who want to invest in their companies, and I think there is a simple remedy. The Securities Fraud Act, that we will discuss in part today, re-

tains in States policing power over criminal fraud, but it moves civil fraud to a single definition that requires intent, and it allows companies to repair to the Federal courts rather than being twisted in the wind in multiple States with different definitions, and I look forward to discussing that in more detail.

I yield back.

Chairman HUIZENGA. The gentleman's time has expired.

Today, we welcome the testimony of Mr. Bradley Bondi, who is a partner at Cahill Gordon & Reindel LLP.

We also welcome Mr. Joseph Borg, who is the Director of Alabama Securities Commission. He is here on behalf of NASAA. This is the good NASAA, the Financial Services NASAA, North American Securities Administrators Association.

We also welcome Mr. Thomas Quaadman, who is the Vice President for the Center for Capital Markets Competitiveness from the U.S. Chamber of Commerce.

Professor Andrew Vollmer, who is a Professor of Law and Director of the John W. Glynn, Jr. Law and Business Program at the University of Virginia School of Law.

Each of you will be recognized for 5 minutes to give an oral presentation of your testimony, and without objection, each of your written statements will be made part of the record as well.

With that, Mr. Bondi, you are recognized for 5 minutes.

STATEMENT OF BRADLEY J. BONDI

Mr. BONDI. Good afternoon, Chairman Huizenga, Ranking Member Maloney, and distinguished members.

My name is Brad Bondi, and I am honored to appear before you today.

I am a practicing attorney and partner with the law firm Cahill Gordon & Reindel, where I lead the firm's securities enforcement and regulatory practices. Much of my law practice is devoted to representing public companies and financial institutions in securities enforcement cases before the SEC.

I previously served in senior positions in the Government, including as counsel to SEC Commissioner Paul Atkins, and then SEC Commissioner Troy Paredes.

Although I am affiliated with a number of organizations, my views today are my own, and do not necessarily represent those of my law firm or my clients.

The SEC is an agency that I greatly admire and respect. In my years of serving on the Commission and in private practice, I have worked with many talented, dedicated, hardworking professionals at the SEC.

My observation is that the SEC, as a whole, overwhelmingly, has sought to abide by its mandate, and for the most part, has been successful in doing so.

Nevertheless, there are some areas where the SEC can improve. One area where I believe the SEC has strayed from its mission is in its approach to financial penalties of public companies and disgorgement.

A penalty against a company is directly borne by its shareholders. In other words, investors for whom it is the SEC's mission to protect.

Previously, the Commission had a penalty statement that spelled out the circumstances in which it would seek a penalty against shareholders, but in 2013, several commissioners disavowed it.

The amount of a monetary penalty is unpredictable because the SEC has nonarticulated criteria and metrics for calculating how much it will penalize a company, and, also, its approach to the remedy of disgorgement. This unpredictability negatively impacts companies. For example, the inability to predict the size of a potential penalty hinders the markets for mergers and acquisitions because potential bidders cannot accurately forecast regulatory exposure.

I commend SEC Chairman Clayton and the current commission for taking what appears to be a more measured and thoughtful approach to assessing monetary penalties, and I encourage the Commission to release a renewed penalty statement explaining the circumstances in which the SEC will seek a shareholder penalty and articulating the standards for disgorgement.

I understand that in the wake of the Supreme Court's decision in Kokesh, there has been discussion about extending the statute of limitations for disgorgement and financial penalties.

Although I believe it is critical for the SEC to pursue those who commit fraud, I am concerned that the cost of extending the applicable statute of limitations may greatly outweigh the benefits. Five years is the longest period of limitations and repose found in any Federal securities law. Extending the statute of limitations beyond that would create uncertainty for the investing public because of the possibility the SEC may prosecute stale claims.

It also could open up the door for inefficiencies in the way the SEC investigates if more time is allotted to bring those actions.

In my two decades of experience as a defense lawyer, an SEC investigation into potential securities law violations by a public company, even an investigation that ultimately does not find any violations of law, can take several years, distract management, and cost the company tens of millions of dollars. The cost of that investigation is directly borne by the shareholders of the company.

Of particular concern are SEC enforcement investigations that begin after a news story about a high profile company, prompting the enforcement staff to pursue one theory of liability, but then morph into an open-ended investigation that wanders into other areas of a company in search of a potential violation.

SEC investigations can impede entrepreneurship and innovation.

I understand the current leadership at the SEC is cognizant of these concerns and has been working to address them. Policies and procedures in this area need to be improved.

I have been asked to comment about H.R. 2128, the Due Process Restoration Act of 2017. H.R. 2128, I believe, is a step in the right direction, but it may, in fact, go a bit too far and cause the SEC to initiate all enforcement actions in Federal district court.

Yet not all enforcement actions require the formality of Federal district court. Some cases, such as those involving disciplinary actions against registered investment personnel and so-called follow-on action could be adequately brought as administrative proceedings.

I have also been asked to comment on H.R. 5037, entitled Securities Fraud Act of 2018. From my experience, I generally agree with the observation in that bill that imposing different State regulatory requirements for civil securities fraud on national markets increases risk, creates inefficiencies, raises cost, and can harm the efficient operation of these critical markets without providing material investor protection.

While I think that H.R. 5037 represents a thoughtful and encouraging effort toward greater uniformity and predictability, I would offer two suggestions.

First, consider adding a dollar threshold above which the cases could be preempted by the Federal enforcement regime, and below which would still be within the State realm for enforcement. States are oftentimes the front line on these smaller micro cap fraud cases involving public companies.

The second consideration would be to—with that added threshold—also add related cases such as those against underwriters, officers, and directors that would avoid the split Federal/State enforcement of what really is the same case in controversy.

Chairman HUIZENGA. The gentleman's time has expired.

Mr. BONDI. Thank you, Mr. Chairman.

[The prepared statement of Mr. Bondi can be found on page 36 of the appendix.]

Chairman HUIZENGA. Thank you.

Mr. Borg, you are recognized for 5 minutes.

STATEMENT OF JOSEPH P. BORG

Mr. BORG. Thank you, and good afternoon. I am Joseph Borg, Director of the Alabama Securities Commission, and President of the North American Securities Administrators Association.

I am privileged to have served as Director of the Alabama Securities Commission since 1994, and have been elected as NASAA's president three times.

State security regulators have protected Main Street investors for the past 100 years, longer than any other securities regulator. We are responsible for administering State securities laws that serve to protect your constituents from fraud. We are often referred to as the cops on the beat, because we are the regulators closest in proximity to your constituents.

Thank you for the honor to testify before the subcommittee.

The committee has requested NASAA's views on two bills; H.R. 5037, the Securities Fraud Act, would amend the Exchange Act to prohibit States from pursuing many civil securities fraud cases.

The bill is drafted in such a way that a defendant would argue, and a court could find that States are preempted from pursuing civil fraud violations in connection with any transaction involving publicly traded securities. This will place all retail investors at risk because such securities are widely held by the investing public.

State anti-fraud provisions serve as a powerful deterrent to improper conduct by companies of all sizes. States' ability to pursue enforcement activity against issuers of securities, including independently, and when necessary and appropriate, is one of the reasons investors have confidence in America's capital markets.

Further, under the bill, certain State criminal securities fraud prosecutions must quote, “comply in all respects,” end quote, with Federal legal requirements without defining what this means.

Defendants in a State criminal prosecution will argue the broadest possible reading of this language. Thus, for practical purposes, this requirement will be preemptive and no State judge will agree to suspend all State criminal law procedures.

Here is the way it would work. I am the prosecutor: Judge, you have to use Federal law here. Mr. Borg, this is a State court. I am a State judge. We apply State law. I suggest you go find yourself a Federal prosecutor. Federal courthouse is over in Birmingham. Case dismissed.

No one will be left to protect Main Street investors.

I imagine with the fraudsters, including the ones I have prosecuted, would be very pleased with such a result.

Finally, 5037 will deprive defrauded investors of a choice of forum. It represents a direct threat to State pension funds and other investors who seek to opt out of shareholder class action litigation, and instead, advocate on their own, as it would require them in all cases to litigate exclusively in Federal courts.

In summary, for all the reasons I just enumerated, which I have discussed further in my written testimony, 5037 is a misguided and dangerous bill, enacting policies that will make it more difficult, and, in some cases, impossible, for State regulators, the regulators closest to Main Street investors, to hold accountable the most powerful companies on Wall Street, and serves no valid interest.

For all these reasons, NASAA opposes 5037 and strongly encourages the committee to reject it.

Turning now to H.R. 2128, the Due Process Restoration Act, this bill would benefit SEC enforcement actions, the respondents in SEC enforcement actions, by providing them with a broad right of removal to Federal district courts, and raising the burden of proof in SEC administrative proceedings from preponderance of the evidence to clear and convincing evidence.

This bill will have adverse consequences for the public interest. As detailed in my written testimony, NASAA sees no good reason for Congress to enact 2128, and several reasons why these changes would disrupt our securities markets and the efficient functioning of the Federal judiciary.

My written testimony addresses other issues, including SEC enforcement resources, the expanding marketplace for private securities offerings, strong penalties as a deterrent to fraudulent conduct, and the need for legislation granting the SEC authority to bring Federal court claims for discouragement and restitution for the benefit of harmed investors.

I will be happy to discuss these issues further.

I will close by reiterating my opposition to 5037. In more than 24 years as a securities regulator, I don’t believe I have ever seen a legislative proposal that so alarms and offends me.

Should Congress pass this bill, my office’s efforts, as well as my colleagues in your States, to protect investors from serious violations of securities law will be eviscerated. Real investors in your districts, you can call them mom-and-pop investors, call them Mr.

and Mrs. 401(k), but real investors, real people, will suffer as a result of this misguided and irresponsible legislation.

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

[The prepared statement of Mr. Borg can be found on page 114 of the appendix.]

Chairman HUIZENGA. With that, Mr. Quaadman, you are recognized for 5 minutes.

STATEMENT OF THOMAS QUAADMAN

Mr. QUAADMAN. Thank you, Chairman Huizenga, Ranking Member Maloney, members of the subcommittee. Thank you for holding this hearing today.

A prosperous and growing economy needs efficient capital markets in order to grow, and those markets actually need a strong securities regulator to make sure that it is fair and balanced. Fair and balanced regulation of the capital markets provides certainty and confidence to invest and raise capital for both investors and businesses. In other words, we need a strong cop on the beat.

We have seen the treatment of securities cases evolve over the last generation. We have seen a rise in the use of administrative proceedings that have made administrative law judges (ALJs) the primary means of adjudication. In fact, we have also seen these cases morph from being civil proceedings to being quasi-criminal proceedings.

Before 2016, there were serious due process issues regarding the use of administrative proceedings. There is no discovery, no right to deposition, no jury trial, a lack of evidentiary rules, and the use of hearsay.

Because of these concerns, in 2015, the Chamber issued a report with 20 recommendations to strengthen SEC enforcement and address some of these due process issues.

We believe that there should be continued use of administrative proceedings in administerial matters such as stop orders as well as license revocations.

If administrative proceedings are going to be used in more complex cases, then there need to be due process reforms such as discovery, deposition, rights that conform with the Federal rules of civil procedure.

We also believe that there should be a right of removal for jury trial under limited circumstances so that a defendant, and not a Government agency, decide if a jury trial is appropriate for a defense.

We believe that these reforms will make the SEC a stronger enforcement agency, as well as give defendants the right of appropriate due process in order to defend themselves.

These recommendations led to amendments to SEC rules of practice for the first time in 20 years, and while some of those reforms were a good step forward, they are very limited and pale in comparison to those procedures that are in the Federal rules of civil procedure.

Additionally, the constitutional issues regarding the use of administrative law judges were not addressed by the SEC at that

time, and may be addressed by the Supreme Court within the next several days.

The Chamber strongly supports H.R. 2128, the Due Process Restoration Act. We believe that this right of removal under limited circumstances is an appropriate way for a defendant to remove a case, a complex case, to district court where more complex cases have historically been treated in article 3 courts. This would also allow for defendants to decide if they want to have a jury trial.

We also believe that a standard of proof of clear and convincing is necessary, since many of these proceedings are actually quasi-criminal in nature.

The Chamber also supports the Securities Fraud Act. Under our constitutional system, we have a bifurcated system of regulation. Those transactions that happen in interstate commerce are regulated by the Federal Government, and those transactions that happen on an intrastate basis are regulated by the States.

Under the 1921 Martin Act, the New York State Attorney General, through the listing of public companies on the New York Stock Exchange and NASDAQ, has become, over the last 15 years, a de facto national securities regulator.

What is additionally troubling is that under the Martin Act, the New York State Attorney General does not have to prove intent to defraud. What we have also seen is litigation through press releases with selective press leaks being put out in the press in order to drive settlements.

These name and shame campaigns are one of the reasons why we have seen a lack of desire of businesses to want to go public.

H.R. 5037 sets up commonsense guardrails to preserve the distinction between national and State cases. H.R. 5037 would not impact the ability of any State to bring a criminal case, nor would it impact the ability of a State to pursue a case for a sale of securities that was not done through a national exchange.

We believe that the passage of these bills would help provide for stronger enforcement and is certainly needed for healthy capital markets, and I am happy to take any questions you may have.

[The prepared statement of Mr. Quaadman can be found on page 129 of the appendix.]

Chairman HUIZENGA. The gentleman yields back.

Professor Vollmer, you are recognized for 5 minutes.

STATEMENT OF ANDREW N. VOLLMER

Mr. VOLLMER. Mr. Chairman, Ranking Member Maloney, members of the subcommittee, I appreciate having this opportunity to talk about some of the issues with SEC enforcement.

My written statement addresses four separate topics. I am going to use this opportunity for oral comments to address two of them. One is the question about disgorgement and the limitations period, and the second is the role of SEC administrative proceedings.

As I noted in my written statement, my comments are solely my own views and are not on behalf of any other person.

I start out with a paragraph to try to set a tone for my written statement, and the theme running through all of my comments is that SEC enforcement of the Federal securities laws needs to be tough but fair. Fair treatment of defendants helps achieve the

goals of the Federal securities laws. But it is sometimes a value in short supply.

Let me talk about the disgorgement question and the possibility of extending the statute of limitations.

We are thinking more about that issue because of the Kokesh decision. My view is that the 5-year period in 2462 is already too long, and it should not be extended absent compelling empirical data that the SEC is not capable of bringing a large number of important cases within the existing 5-year period.

I don't think we have that data, and I am dubious that it exists, but that is the research that the Congress would need to extend the statute of limitations.

The reason I am opposed to extending the statute is because 5 years is a very long time already. Limitations periods are extraordinarily important to society, and you never hear anyone talk about the values protected by limitations period except the Supreme Court when it analyzes statutes of limitation.

The second reason that I urge you not to lengthen the limitations period is that, in my experience, there is a strong correlation between limitations periods and the length of investigations. One of the principal problems with SEC enforcement today is that the investigations are too long.

There are serious social harms that occur from SEC investigations and from unduly long statutes of limitation, and my written statement describes what those social harms are.

My written statement also refers to another problem that I think Congress needs to address, and that is the SEC staff's use of tolling agreements to circumvent the current limitations period.

If Congress is thinking about extending the statute, I would urge it to consider the following additional factors.

First, as I said, obtain information about whether a problem really exists and the size of the problem. If the problem is limited to a certain category of cases, let's address the category of cases as an exception.

Second, I have heard various people try to connect disgorgement and extended limitations period to investor damage or investor loss. A limitations period should not be connected to investor loss. Congress has never given the SEC the power to calculate a monetary penalty based on investor loss or damage. It would be a dramatic break with the model that we currently use in the United States of allowing private plaintiffs to recover loss and having the SEC obtain different forms of relief.

I will spend 10 seconds on the second topic, and that is the role of SEC administrative proceedings.

The basic problem is that they are inherently unfair to defendants. If Congress agrees with that, it has a couple different paths it could follow. One would be a very broad removal right. I favor a very broad removal right, and that would be to let the SEC make the first choice of forum, but then give every defendant in an administrative proceeding an unqualified, unreviewable power to remove.

[The prepared statement of Mr. Vollmer can be found on page 140 of the appendix.]

Chairman HUIZENGA. The gentleman's time has expired.

With that I recognize myself for 5 minutes for questioning.

I appreciate the testimony that we have before us today, and maybe, Professor Vollmer, we will continue where you left off.

Last month, the SEC's Division of Enforcement co-directors testified in front of the subcommittee that the SEC has been unable to collect over $800 million in disgorgement since Kokesh, which is not an unmeaningful percentage, considering that they had imposed $4 billion in penalties and disgorgement since 2016. Fairly significant amount of money and percentage-wise, as well as money.

But since Kokesh, many have called for extended statute of limitations, and I am just curious if you can briefly give some of that context and whether there just are not simply clear statutes of limitations, and what we can do to do that. Mr. Bondi, I would like you to address that as well. Does extending the statute of limitations for disgorgement run the risk of allowing more time for the SEC to just investigate and bring cases, as Professor Vollmer was drawing the correlation between that length of time, and maybe, Mr. Bondi, we can start with you.

Mr. BONDI. Thank you, Mr. Chairman.

I do think extending the statute of limitations is going to create a tremendous risk that the SEC will have investigations that linger on for multiple years, and these wandering investigations are really a threat to shareholders of public companies because, oftentimes, they don't lead anywhere, and they don't even actually lead to an enforcement case, but they cost the company and, in turn, its shareholders tens of millions of dollars.

In terms of extending the statute of limitations, I agree wholeheartedly with Professor Vollmer that I think the SEC needs to actually demonstrate what cases it could not have brought within 5 years. Five years is the longest statute of limitations or repose under Federal securities law. I would like to see them demonstrate which are the cases that they couldn't bring. They have the ability to seek tolling agreements from companies or persons that are under investigation, and, oftentimes, they do.

It would be really interesting to understand what are those cases that still linger and make up that amount.

Chairman HUIZENGA. But certainly there has to be examples out there of fraud discovered beyond that 5 years, and then how do you go back and deal with that? Is this somehow inconsistent with the SEC's traditional mission?

Mr. BONDI. I would like to see what frauds haven't been discovered after 5 years. I hear a lot about that, and I hear that there were frauds that were discovered many years back, but I do think that—

Chairman HUIZENGA. Would you put the Madoff situation in that category?

Mr. BONDI. They did discover within 5 years, brought it, and keep in mind too, the SEC does have the ability—

Chairman HUIZENGA. My understanding of that was the fraud had been happening for far more than 5 years.

Mr. BONDI. It was, but as I understand, they also brought an action and disgorged an amount that actually was greater than the amount that was even at Madoff.

But in any event, the SEC has the ability, in cases of extreme fraud like that, to seek penalties and to seek other types of remedies that could then be put into a fair fund under Sarbanes-Oxley and distributed to shareholders to make up for any amount that somehow lingered past the 5 year statute of limitations.

Chairman HUIZENGA. I have a minute and 15, and I think, Professor Vollmer, you have been fairly clear both in your written and in your oral statements.

Mr. Quaadman, how often do the State enforcement agencies bring State charges that are substantially the same as those brought against the same defendant by their Federal counterparts?

Mr. QUAADMAN. There is a study from Professor Amanda Rose from Vanderbilt that shows that Federal enforcement agencies bring cases 91 percent of the time as State enforcement agencies do, and, in fact, there is even a split between those State securities regulators that are elected that bring four times as many cases as those who are appointed.

Chairman HUIZENGA. Are there cases where States, then, have brought enforcement actions, even after a company has already settled with the SEC?

Mr. QUAADMAN. That happens an awful lot. There is a lot of duplication that is going on, and one of the things we talked about in our 2015 report was actually to get at that duplication issue.

Chairman HUIZENGA. Mr. Borg, I will let you address that a little bit as well, both that situation and then how do we further elaborate how these actually are investigations that are new and different than what has happened at the SEC?

Mr. BORG. Mr. Chairman, with regard to those cases, the big cases that we work with, and I will give you examples, Comtronics, HealthSouth, Morgan Keegan, Enron, WorldCom. These are cases that my office was involved in. In each one of those cases, yes, there was a State component, but those cases were worked with the SEC, sometimes with FINRA, on occasion there might even be a CFTC (U.S. Commodity Futures Trading Commission) case.

The question is not whether or not they were completely separate actions. Yes, we do work on a cooperative and collaborative basis.

Chairman HUIZENGA. You don't feel they were duplicative?

Mr. BORG. No, sir, I don't. Think about some of the cases that we have had in the past, especially the bigger cases, the Mutual One timings. That was all done cooperatively and collaboratively.

Chairman HUIZENGA. My time has expired.

With that, the Ranking Member is recognized for 5 minutes.

Mrs. MALONEY. Thank you.

Following up with Mr. Borg, I would like to ask you about H.R. 5037.

Do you believe you would be able to bring any criminal securities fraud cases if this bill were enacted?

Mr. BORG. The way it is set up, it says I have to apply Federal law in all respects. I don't know if that means Federal law in all respects including civil procedure, criminal procedure, and all the other items that go with prosecuting a case.

I am a prosecutor. I know what needs to be done with regard to a judge.

If I have a judge sitting in State court who has been trained for State law, trained for State procedures, he is not, I guarantee, is not going to listen to me when I say: Judge, suspend everything you have been elected to do here and apply Federal law.

The times we apply Federal law is when we are looking for some other guidance or something to apply to State law, but not apply Federal law.

At that point, his argument to me is going to be very simple: You are in the wrong court. The Federal court is over in Birmingham, go find yourself a Federal prosecutor.

Now, I will have to find a Federal prosecutor to take the case, because they are the ones, DOJ, that prosecute those criminal cases in Federal court, not State securities regulators.

Mrs. MALONEY. Under this bill, the Department of Justice would be the only agency with the authority to bring a criminal securities fraud case. Given that the Department of Justice has limited resources, and only brings a small number of criminal securities fraud cases per year, do you believe that this bill would effectively allow some securities fraud to go completely unpunished?

Mr. BORG. Yes, ma'am, especially the smaller ones. Now, they may have an interest in some $10 million case, but as a practical matter, given the priorities of the U.S. Attorney's Office right now, which include the opioid addiction issues, immigration issues and whatnot, there is insufficient staff there to worry about Mrs. Johnson in Elba, Alabama, who was taken on a $10,000 churning case in listed stock securities. That is not going to be a case they are going to try.

In essence, I can't bring it, they won't bring it because they don't have the resources or the inclination. That means that harm goes unresolved, and that is just too bad for Mrs. Johnson. We can't have that.

Mrs. MALONEY. Thank you. Stepping away from the criminal fraud issue, I am still extremely concerned about preempting even civil securities fraud laws.

Mr. Borg, could you talk a little bit about what kinds of civil securities fraud causes this bill would prevent you from bringing? Can you talk about any specific examples of cases you have brought recently?

Mr. BORG. Yes, ma'am. Let's talk about listed company cases, and I will just list them. I gave some earlier.

One of the first cases I prosecuted against a New York Stock Exchange company was Comtronics, it was actually located in Alabama, for fraudulent invoices. Basically they raised their stock price with phony information.

We were involved in the HealthSouth case. We worked with the U.S. Attorney's Office.

Morgan Keegan was a subsidiary of one of the 15 largest banks in the country.

Enron and WorldCom we worked on behalf of the retirement systems and made a recovery there.

The types of cases on the smaller scale will include churning listed securities. I gave you the example of maybe Mrs. Johnson in Elba, Alabama.

On the broker/dealer side engaged in pump and dump to manipulate sales of securities, that happens a lot. Also on the broker/dealer side, recommending unsuitable listed securities, usually tied to a churning or just to make some commissions.

On the advisor side again, pushing an overconcentration of listed company shares.

These are cases we see on a regular basis, and we strive to enable our residents to recover their savings when they fall victim to such frauds.

With a preemption, that is not going to happen, and I don't know anybody else who will do it.

Mrs. MALONEY. OK. Do you think that it is appropriate for the Federal Government to tell States how they can and can't define fraud?

Mr. BORG. I think that is for my legislature to decide. My legislature has decided what the elements are.

Now, I will say this: 43, 44 States have the Uniform Securities Act, so we are fairly similar because we do—under the Uniform Act, same folks that brought you the Uniform Commercial Code, the Uniform Probate Code, the Uniform Gift to Minors Act, and whatnot.

My legislature defines what it says is required in my State, and my job is to enforce that. Same as occurs in every other State.

Mrs. MALONEY. Thank you.

Finally, you said you thought this bill was particularly dangerous. Why do you think it would be particularly dangerous to enact this bill right now?

Mr. BORG. You have already heard testimony from others about the decrease in the SEC's case numbers with regard to bringing cases. We are the ones on the beat. We hear the first cases. We are the ones that know all the complaints. We are the ones that actually will bring those cases. If they are coming down in numbers, that is more duty on us. We have a duty to protect our citizens, and we intend to do so.

Mrs. MALONEY. Thank you very much. My time has expired.

Chairman HUIZENGA. The gentlelady's time has expired.

With that, the Vice Chairman of the committee, Mr. Hultgren from Illinois, is recognized for 5 minutes.

Mr. HULTGREN. Thank you, Mr. Chairman. Thank you all again for being here.

Section 881 of the Financial CHOICE Act would require the SEC to establish a process for closing investigations. Specifically, it calls for the Commission within a timely manner, two different things; one, to make a determination of whether or not to institute an administrative or judicial action in a matter or refer the matter to the DOJ for potential criminal prosecution; and number two, requires the Commission to inform the subject of the investigation that the matter is closed if the Commission does not pursue an action or refer it to DOJ for criminal prosecution.

Mr. Quaadman, I wonder if I could address my first question to you. Can you discuss how this provision would prevent the Commission from abusing its investigation powers? Are there instances where investigations could remain open despite little or no reason to impose this burden and uncertainty on a market participant?

What are the effects on a public company when they are required to disclose an investigation, even when there is not necessarily a finding of guilt?

Mr. QUAADMAN. The reason why we started looking at SEC enforcement in 2015 was that we had released a managerial reform SEC report in 2011, and one of the last recommendations in there was about this issue of cases being open and not being closed.

There are numbers that are kept at the SEC as to cases being open, but they were never closed. As a result of that, we actually had one of our members come in and started to talk about how there was an issue that they had with internal control dealing with tax, and it was referred to the SEC by an employee. The SEC came back. What it then did is it created this whole situation where that company had to preserve all of its emails at the cost of $1 million a month. That case went on for years, and there was never indication from the SEC as to what direction that case was going in.

Additionally, we should also understand too, for that company, they actually corrected the problem as soon as they were told about it, but again, this dragged on for years, and for a very long period of time.

Mr. HULTGREN. Thanks.

Professor Vollmer, your testimony notes the SEC enforcement process should, among other things, allow for an ability to bring cases that lack merit to a rapid close.

Would you support legislation requiring the Commission to establish a process for closing investigations, and are there any specific criteria that the Commission should consider when establishing such a process?

Mr. VOLLMER. Thank you, sir. I would support that. I think the principal issue is a time limit, and that is what the legislation needs. I connect the length of investigations to limitations periods. The SEC staff decides on how long cases can be investigated by whether they have a deadline set by the statute of limitations. I would be in favor of that.

I referred specifically to early mechanisms for testing the merits, specifically during administrative proceedings, so during the litigation phase, and there is not currently the equivalent to a motion to dismiss.

Mr. HULTGREN. Section 884 of the Financial CHOICE Act would require the SEC to institute a process to permit recipients of a Wells notice to appear before the Commission or its staff in person, and to vote on whether to bring an administrative or judicial action against an individual.

Again, Professor, can you please discuss how this would improve due process or enforcement of the securities laws by the Commission, and are there any cases in which efficient delegation of authority to the Director or direction of the Division of Enforcement is inappropriate?

Mr. VOLLMER. There are inappropriate delegations. In particular, the delegation to the Director about the ability to open what is called a formal order of investigation, or essentially, the power to issue subpoenas.

That is wholly inappropriate for the commissioners to have delegated to the staff, and so, I would encourage you to look at that.

Repeat the—

Mr. HULTGREN. Yes, the first one was how would you improve due process for enforcement of the securities laws by the Commission?

Mr. VOLLMER. I have addressed some of these topics in a Law Review article that I wrote. Rather than go over those points, let me address the one particular point that you mention, and that is, allowing commissioners to attend an oral Wells submission.

I actually don't think that would make a big difference in very many cases. Of course, it might in a few, but the lawyers always have the opportunity and take the opportunity to meet in person with the senior staff of the Division of Enforcement. You are correct, they do not get a chance to meet with commissioners. That might be useful in some circumstances, but generally, I think it is more effective for the lawyers to submit their views in writing, which is what they do.

Mr. HULTGREN. Thank you. My time has expired. I yield back.

Chairman HUIZENGA. The gentleman's time has expired.

The Ranking Member is recognized for 5 minutes for questioning.

Ms. WATERS. Thank you very much.

I would like to direct this question on disgorgement to Mr. Borg.

In your view, is the Supreme Court's decision in Kokesh versus SEC, that SEC disgorgement is a penalty subject to the 5-year Federal statute of limitations consistent with earlier jurisprudence on disgorgement?

Mr. BORG. My opinion on the Kokesh case is that the SEC should do everything they can to get money back for investors. The statute of limitation issue, we actually faced that in Alabama not too long ago. The Supreme Court had issued a case that the decision that, of course, the cause of action for recovery and for criminal penalties and everything else started from the date of the inception of the crime, occurrence, whatever it was.

We fixed that. We fixed that unanimously in my legislature by going to 5 years from date of discovery. That is one alternative you might want to consider.

The question is how long did it take to discover it? I think that issue was mentioned earlier by the chairman.

In the current frauds, it takes a long time sometimes to find these frauds. The fraudsters are hiding information, whether it is financial information buried in a financial statement of a company, or convincing the victims not to report.

The statute of limitations, if it starts from the date of the occurrence, in many cases, is not going to allow for recovery.

I do not believe a disgorgement or recovery to investors should be considered a penalty, and I do not think there should be a statute of limitations on recovering for the victims of a crime.

The idea that the statute of limitations should be cutoff at 5 years, no matter when it occurred or when anybody knew about it, only encourages those fraudsters to hide it as long as they can, and that is not in the public interest.

Ms. WATERS. Thank you very much.

Let me just move on to H.R. 2128, Due Process Restoration Act of 2018, continuing with you, Mr. Borg.

H.R. 2128 would help alleged fraudsters by allowing them to choose where their case is tried. What is more, this bill would further help these bad actors by subjecting the SEC to a heightened burden of proof when an enforcement is brought in an administrative form.

Could you describe how this bill could affect the SEC's ability to effectively enforce Federal securities laws, and how do administrative proceedings help ensure efficient policing of our capital markets?

Mr. BORG. Yes, ma'am. This bill will benefit respondents in SEC enforcement actions by providing them the broad right of removal to Federal district courts. I have been a prosecutor a long time. Venue is usually selected in both Federal and State courts in the best interest of the public, not the best interest of the defendant.

If I was a defendant and I could move to Federal court for significant delays and I was financed enough, that defendant could continue his business until that case is over.

This will invariably lead the SEC, because of the change from preponderance of evidence to clear and convincing in the ALJ matters, to either go straight to Federal court, and therefore, overload the Federal courts, that is a possibility. The bill would raise that burden of standard to the point where we are going to have inconsistent decisions. The same fact pattern or the same type of interpretation of law, if you are in ALJ and you are clear and convincing, that is one standard, and let's go to Federal court and have a different standard. The precedence on that is going to be difficult to resolve, and I think now you have set two different standards for one particular law.

The SEC might likely forego bringing enforcement actions through the administrative process. If that is the case, litigating those actions will require a lot more time, a lot more money, and a lot more resources.

Ms. WATERS. Thank you very much.

I think we should all be concerned about any and all efforts to tie the hands of the SEC or to undermine their ability to do what it is they are mandated to do. I think that we need further clarification on some of these issues that are not only in 2128, but in some of the other legislation that may be coming down the pike, and I thank you for being here and I yield back the balance of time.

Chairman HUIZENGA. The gentlelady yields back.

With that, the gentleman from Minnesota, Mr. Emmer, is recognized for 5 minutes.

Mr. EMMER. I thank the Chair. I thank the panelists for being here today.

I would like to get into it this way: To have a valid and credible justice system, and maybe, Professor Vollmer, I will start with you, since you do this in the academic world, and you have to present this to folks, my perspective, to have a valid and credible justice system, number one, you need a clearly defined rule of law. Two, you need a fair and impartial process to resolve alleged violations of laws, disputed claims, and in short, that is the due process piece. People have to have the ability to have a fair and impartial arbiter, someone that decides it. Three, and I think this is incredibly important and often underestimated, you need the public's confidence

and legitimacy of the law and of the process that actually metes out justice.

We have been asking—or I have listened to my colleagues ask a lot questions about the State and Federal systems today, and unlike some of the testimony I have heard today, I have a lot of confidence in our State court judges. Granted, I only practiced civil law, I wasn't over on the criminal side very often, but if you went into a State district court, and you had a State district court judge, and you had a case that was going to be the State law preempted by Federal law, State judges are entirely capable of applying the Federal law.

It is not that far of a stretch to imagine them being able to do it. But if you are on the other side of the bench and you have the State people you have to worry about, you have the Federal courts you have to worry about, and then you have the SEC too that you have to worry about.

I would like to talk about these administrative proceedings at the SEC.

Professor, do all of the Federal rules of civil procedure and the Federal rules of evidence apply to SEC administrative proceedings?

Mr. VOLLMER. None of them do.

Mr. EMMER. Do respondents in SEC administrative proceedings have the same discovery rights as defendants in Federal district court proceedings?

Mr. VOLLMER. No, they don't.

Mr. EMMER. Just so anybody who hasn't practiced in a court of law understands, that is the ability of the defendant to find out whatever the other side has if they are accusing them of violating or doing wrong.

Mr. VOLLMER. More importantly, obtain information from third parties.

Mr. EMMER. Right. Do respondents in SEC administrative proceedings have the right to a jury trial?

Mr. VOLLMER. No, they don't.

Mr. EMMER. Mr. Quaadman, in your opening statement you referred to some of this.

Are there time limits in terms of when an SEC administrative proceeding needs to be completed, Professor?

Mr. VOLLMER. Yes.

Mr. EMMER. How does this compare to the time limits in a Federal district court proceeding?

Mr. VOLLMER. There are no time limits in Federal district court proceedings.

Mr. EMMER. The argument that we are going to have different standards being applied if we pass some reform, we already have different standards being applied, correct?

Mr. VOLLMER. There are many differences between administrative proceedings and Federal district court proceedings.

Mr. EMMER. Are you concerned, Professor, that respondents in SEC administrative proceedings have fewer due process rights compared to those who are actually having their case or their future determined in a Federal district court proceeding?

Mr. VOLLMER. Oh, I think that we should be deeply concerned about it.

Mr. EMMER. My colleague Warren Davidson from Ohio has a bill, H.R. 2128, called the Due Process Restoration Act. Have you taken a look at this, Professor?

Ms. VOLLMER. I have, yes.

Mr. EMMER. Can you just comment on how this could—let's talk about facts first, because I talked about the perception. You have to perceive that you have a fair and impartial process.

Isn't it true that, over the past several years, the SEC has been picking its own forum, its administrative procedures, and then it has been winning more and more in its own forum?

Mr. VOLLMER. I think the data is actually not entirely complete on that, those two questions. I think there are open issues about the data.

Mr. EMMER. Prior to the passage of Dodd-Frank, the SEC historically brought approximately 60 percent of its new cases as administrative proceedings. In contrast, over 80 percent of the new enforcement actions in the first half of Fiscal Year 2015 were filed as administrative proceedings.

They are clearly filing more as administrative proceedings.

Mr. VOLLMER. Yes, I think you have to be careful about cases filed versus settled cases.

Mr. EMMER. Let's attack that quick, as my time is running out. That is the problem. They have been bringing them in administrative proceedings that they have the advantage, they have been winning on above-average numbers, and guess what, now they just file them or they threaten to file them, and you don't want to go through that process, so you pay before it ever happens.

Mr. VOLLMER. Actually, my point is slightly different. Defendants sometimes prefer to—when they are going to settle at the initiation phase, they would prefer to settle in an administrative case rather than a Federal district—

Mr. EMMER. I appreciate it. You and I have a difference. I think many of them settle because the cost that they are going to have to put up to fight the Government just doesn't make it worth it. That is why we should change this law.

My time—

Mr. VOLLMER. We don't have a difference at all.

Chairman HUIZENGA. The gentleman's time has expired.

Mr. VOLLMER. I agree with that completely. This is solely a question of what—

Chairman HUIZENGA. The gentleman's time has expired.

Mr. EMMER. Thank you. I appreciate it. We will continue this offline.

Chairman HUIZENGA. The gentleman from California, Mr. Sherman, is recognized for 5 minutes.

Mr. SHERMAN. As we go down this road, I should comment that both the cost and the benefits of securities enforcement are far greater than we might think at first blush. The costs of securities enforcement not only include the salaries of Mr. Borg and his compatriots and those of his brethren at the SEC, but they include the private-sector cost of complying—but not just the private-sector cost of complying when there is an investigation, but, also, all of the business opportunities that aren't pursued because one more

reason not to do it is this whole expensive process. The jobs, not created.

On the other hand, the benefits of securities enforcement are greater, because we tend to focus on, "A-ha, here is Enron, here is Madoff, here is how much money was recovered for investors." That is just the tip of the iceberg on the benefits of enforcement. The chief benefit of enforcement are the frauds that don't happen, the documents, the disclosures to investors that are made more clear, the corners that are not cut.

Mr. Borg, you pointed out a number of areas in which the statute you criticize, or the proposed statute you criticize, is unclear. I would just say that we shouldn't, at this stage, be urging people to vote against legislation because it is unclear; we should be urging the authors to make it clear. Your earlier testimony identifies certain areas where this statute should either do the extreme thing that you don't think we should do or clearly not do that extreme thing. But we should clarify statutes and then decide.

Mr. Quaadman, we have a unique history in this country that has led us to shared sovereignty between a Federal and subnational governments. So we have securities law enforcement at both the national and subnational level. Does any other country do it that way? It seems very peculiar to anyone not familiar with American history.

Mr. QUAADMAN. No. Most other nations do it on a national level. Canada does do it a little differently, that they have their securities regulation done on the provincial level.

But I do want to add that I—

Mr. SHERMAN. But there is no country that does it at both levels.

Mr. QUAADMAN. No.

Mr. SHERMAN. There is no evidence that the German stock market or the British stock market is a place for fools who want to be defrauded because they benefit only from one level and not two levels of securities enforcement.

Mr. QUAADMAN. Correct. In fact—

Mr. SHERMAN. OK. I do want to go on.

Mr. Borg, we tend to focus on the big companies that do register with the SEC, that do big things, that have big pots of money that we can go after and at least try or pretend to comply with our securities laws.

I got an offering from an initial coin offering. Anybody can invest. No government official has ever been asked to review this document. There is no investor protection at all. They imitate, by calling it an initial coin offering, the documents that are filed when there is.

Why haven't you protected the people of Alabama from the DDF initial coin offering and similar complete failures to even acknowledge that securities laws exist except for the purpose of imitating those investment documents created in compliance?

Mr. BORG. We have a number of cases ongoing. I can cite about eight—

Mr. SHERMAN. These folks—shouldn't this just be a slam dunk? They are offering an investment to the public, unregistered by anywhere.

Mr. BORG. We do have a number of cases pending. Some respond to our cease-and-desist as we do the investigations. A lot of them are considered securities. Some are considered commodities. We have jurisdiction for both. NASAA, 44 States just completed a crypto-sweep, with 75 potential defendants.

Mr. SHERMAN. But the DDF initial coin offering is still taking in money right now.

Mr. BORG. I am not familiar with that particular one. I could cite a lot of others. I would be more than happy to take a look at it and, if necessary, bring an appropriate action. I just don't know that particular one. But considering the 75 that we have looked at—

Mr. SHERMAN. Will you be putting people in jail or just stopping them from defrauding people of additional funds?

Mr. BORG. That depends if they are overseas and we can get them or not, and that depends on whether or not there was an actual fraud where the money has been taken, received, and spent. In essence, if it is lying, cheating, and stealing, yes, we should.

Can I get them? Do I have jurisdiction? That is something we will have to look at on a case-by-case basis. But we are not ignoring this section. We are—

Mr. SHERMAN. Please propose any new legislation you need.

Thank you.

Mr. BORG. Yes, sir. We—

Chairman HUIZENGA. The gentleman's time has expired.

The Chair recognizes the gentleman from New Jersey for 5 minutes.

Mr. MACARTHUR. Thank you.

Mr. Quaadman, do you believe that duplicative State and Federal regulation is chilling interest in our public markets?

Mr. QUAADMAN. There is no question about it. As I said in my oral statement, it is one of the reasons why businesses aren't going public.

As I was going to mention before, I had a meeting with the deputy Governor of the Bank of England a few years ago where he was directly complaining about that and started to talk about how that is going to impact the ability of the U.S. to be competitive globally.

Mr. MACARTHUR. Does it negatively affect our global competitiveness?

Mr. QUAADMAN. It absolutely does, because you can have a situation where New York State, through the Martin Act, is suddenly, let's say, with the financial analyst issue, is entering into a settlement that regulates things nationally that, also, international companies have to comply with.

Mr. MACARTHUR. Mr. Bondi, are you familiar with the Securities Fraud Act? Have you reviewed it?

Mr. BONDI. I am.

Mr. MACARTHUR. Mr. Borg tried to make an argument that, because the bill doesn't specify whether it is Federal procedural or substantive law that we are talking about, that it would effectively shut down any State AG prosecution of criminal fraud. I don't concede that point, but if that were true, that is so easily remedied by amendment that that could be clarified in a moment. I think that is more of an excuse than a real reason.

But let me ask you, since you are familiar with the bill: Is this accurate, that all criminal fraud, whether it is public or not public companies, all criminal securities fraud would still be at the State level, that non-public companies would all be at the State level, that public companies that are not engaged in interstate commerce would all be at the State level? Is that true?

Mr. BONDI. That is true.

Mr. MACARTHUR. This is a narrowly defined bill that is only targeting public companies who have to report immediately if they are even accused of civil fraud—this trial by press release. If they are merely accused of civil fraud, they have to report it to their shareholders, with great negative effect on their companies, and it makes them less competitive on the world stage.

Would you agree that this is a very narrowly defined bill that is simply protecting public companies engaged in interstate commerce?

Mr. BONDI. Yes, Congressman, I think this is very narrow.

I would disagree with Mr. Borg about churning cases as an example of something that would be preempted. As I understand in my reading of the case, those types of cases could continue at the State level. Congressman, I think that it could be even further narrowed and still achieve the goals by perhaps inserting a market capitalization—

Mr. MACARTHUR. I want to explore that with you. That is actually what made me turn to you, is I heard that point, and I am concerned that we don't take cops off the beat. I think that was Mr. Borg's expression. That is not what I am after here. I am not trying to stop State AGs from going after bad actors. We have a responsibility to protect people.

But there are a handful of States that do not use a uniform definition of fraud, and they are wreaking havoc on public companies. Since some of them, like New York, for example—there is a nexus between nearly every public company in the country and the New York AG—the lack of that State alone adopting a uniform standard gives that particular AG the ability to wreak havoc across public markets, which they have done successively AG after AG.

But I do want to explore your suggestion. You mentioned in your opening remarks that you thought that a size limitation might help. Could you unpack that a little bit?

Mr. BONDI. Yes, Congressman.

In other areas, Congress has imposed certain capitalization amounts in terms of preemption. For example, in the registration of hedge funds, there is an amount above which the hedge fund has to be to be registered at a Federal level. Otherwise, if it is below that amount, it doesn't have to register with the SEC.

I would agree that, in many cases, especially with microcap fraud cases, very small public companies that are traded on national exchanges, the States are oftentimes the front line of those cases. I agree with that statement by Mr. Borg.

I think one way to address this in the legislation is to put in a market capitalization amount about the issuer. Maybe it is $50 million of market cap—

Mr. MACARTHUR. I am running out of time. I would actually like to explore that with you.

One last question. Professor Vollmer, I have tried to strike a fair balance between protecting States' policing powers and preserving regulators' ability to pursue fraud within their borders and giving public markets a life here. Do you think that this bill strikes that balance?

Mr. VOLLMER. I think it does excellent work in trying to strike a balance. I actually think it is too narrow. I think that there should be broader Federal preemption. But I understand there are competing considerations.

Mr. MACARTHUR. Thank you. I yield back.

Chairman HUIZENGA. The gentleman's time has expired.

The Chair now recognizes the gentleman from Georgia, Mr. Scott, for 5 minutes.

Mr. SCOTT. Thank you, Mr. Chairman.

I first of all want to preface my remarks by just sharing with the panel that there are some good points in this legislation. But I have a few troubling concerns here that alarm me since the Trump Administration has taken over.

First, if you recall, in February 2017, then-Acting Chairman Michael Piwowar revoked subpoena authority from roughly 20 senior enforcement officials, which meant only the Director was left to approve any formal investigation.

Then the second troubling point was that the Trump Administration made a decision, as you will recall, to stop all hiring, which resulted in the SEC imposing a strict hiring freeze, which has prevented the SEC from even replacing their departing staff.

But it doesn't stop there. There have been actions in our courts, with the Supreme Court ruling of Kokesh v. the SEC, that have resulted in significant crippling of the SEC's disgorgement authority, according to current co-directors of the Enforcement Division.

Finally, we mustn't forget the Republicans' efforts here in Congress to never increase the SEC funding for the SEC Enforcement Division, even though it has zero effect on our national deficit because the SEC is funded by fees.

You can see, taken all together, it is very troubling.

Now, Mr. Quaadman, I want you to know that I agree with you and the goal of the Chamber of Commerce. I have always been at the front of the spear here in this committee in making sure that, as you put it—I couldn't have put it any better—quote, you said in your report that "there needs to be identifying problems and shortfalls of our financial regulatory system so that the United States can compete in the global economy'—and, I add, remain and always remain number one in the global economy.

But with what is going on in the Administration, I get skeptical about whether legislative action is necessary. Let me ask the panel, do you think we have conclusive evidence here that H.R. 2128 and H.R. 5037 are solving serious problems in our markets?

Especially you, Mr. Borg, do you think that these two bills are necessary?

Mr. BORG. No, sir, I do not.

I think that there is a misconception here about what is stopping IPOs or further development. Let's take a look for a moment at history.

Back when I started 24 years ago, the private market for capital was very, very small. It has grown. Congress has mandated it. It has passed laws to encourage the shift from IPOs to private market. The private market now is bigger than the public market. That is one. The second thing, of course, is that the crowdfunding—Reg A, Reg A-plus—is another alternative vehicle for capital formation.

The capital formation shift has occurred at Congress' direction. I don't pass a positive or negative on that. But to say that the capital has decreased in the public sector through IPOs or whatnot is incorrect unless you take into consideration what we have done to move that sector from public to private. I think that is an important factor that has not been considered. Just looking at the number of IPOs is not going to make it.

Mr. SCOTT. Right. Yes, Mr. Quaadman.

Mr. QUAADMAN. Yes, Mr. Scott, if I can answer, we think both bills are important.

Number one, 2128. We don't have due process in the administrative proceedings at the SEC. In fact, it has been reported where SEC staff has talked about the use of ALJs in administrative proceedings because it is the home-field advantage. This would correct a wrong where the Government, and not the defendant, decides if they should have a jury trial.

5037 is also very important, too, because the Martin Act—you have to understand this: There is a confluence of the public companies being listed on the exchanges in New York and this law where now the New York State attorney general can be a national regulator and has sought to have that role.

We should also remember that even yesterday the New York State Court of Appeals issued a ruling where they issued concerns about the fact that the Martin Act does not provide for proof to defraud or intent to defraud, which they have now limited the statute of limitations from 6 years from common law fraud to 3 years.

Mr. SCOTT. Right.

I wanted to just put this in to Mr. Davidson and the authors of the bill real quick, if they felt that—if they could, within the bill, increase the funding at the SEC Enforcement Division, and would you guys be willing to urge the Administration to lift the hiring freeze. If you could do that, then I would like to look at it more carefully.

Chairman HUIZENGA. The gentleman's time has expired.

Mr. SCOTT. Is that possible?

Chairman HUIZENGA. They will have a chance to respond at the questioning.

Next, we will recognize the gentleman from Maine, Mr. Poliquin, for 5 minutes.

Mr. POLIQUIN. Thank you, Mr. Chairman, very much. Appreciate it.

Thank all for being here today.

It is so important to make sure we do everything we can to help our businesses grow and expand and hire more workers and pay them more. You can see what is happening with the GDP growth now, which is about double what it was a short year and a half or so ago. Things are going in the right direction.

I am very interested in Mr. MacArthur, my terrific associate from New Jersey, his bill, 5037. I am sure you folks have been discussing it today. I have been in and out a little bit here.

But, my concern here is a constitutional concern when it comes to the 10th Amendment and States' rights and everything else, but, at the same time, making sure that we make it as easy as we can for businesses to sell themselves or part of themselves to the public. It gives an opportunity for small savers in the State of Maine to invest in America and, at the same time, allow these companies to raise the capital they need to be successful.

Mr. Quaadman, if you don't mind commenting on this, and then I will turn it over to Mr. Borg too. I would like to hear what you both have to say. Do you think that the SEC would still be able to do its job, enforcement job, effectively if they were the sole entity dealing with companies listed on national exchanges?

Mr. QUAADMAN. Yes, so first off, I think we have to remember the Founding Fathers made this decision with the Constitution 200 years ago that if there is a transaction in interstate commerce the Federal Government is going to regulate that; if it is intrastate, then it is going to be the State that is going to regulate that. I think that is a very important distinction that was made with the founding of the Constitution.

I think it is also important to remember here, too, that 5037, number one, preserves the right—in our reading of it, preserves the right of States to pursue criminal actions. It preserves the right to take other actions. However, when you are dealing with a statute such as the Martin Act and, as I said earlier, with that confluence of those exchanges being listed in New York, that it would have those cases going to Federal court because we are dealing with an interstate commerce issue.

That Vanderbilt study that I had mentioned earlier looked at 2,000 public companies and found that the SEC was bringing cases—or Federal agencies were bringing cases in 91 percent of the cases that States were. We are not going to see a drop-off in enforcement. We are going to see the proper rationalization, as was mandated under the Constitution, with this bill.

Mr. POLIQUIN. Uh-huh. Thank you very much, Mr. Quaadman.

Mr. Borg, would you care to comment on this issue?

We have a terrific State regulator in your space, Judith Shaw up in Maine. You might know Judith. She is wonderful. And—

Mr. BORG. I do.

Mr. POLIQUIN. She has weighed in on this. I am trying to sort this out and see—

Mr. BORG. Yes, sir. She has sent to you a letter outlining her objections to 5031.

With all due respect to Mr. Quaadman, there is one item in the Constitution he forgot about: The States have a right to protect their citizens from fraud and whatever it might be.

Also, with regard to the fact that States are somehow impeding this process, this committee has had over 20 hearings in the last number of years talking about increasing IPOs or what is impeding the ability to go public, and not one of those hearings has ever brought up State involvement as an issue. We have talked about Reg D's and everything else. This Congress alone, six hearings

have been held, and not one has ever said that the States are the problem.

I think we are focusing on the wrong issue here. The fact of the matter is that, if States are going to protect their citizens from actions that affect their citizens, then they have a right to do so without being overridden by a Federal preemption such as 5037.

Mr. POLIQUIN. Mr. Borg, before I run out of time, if you don't mind, I would like to turn it back over to Mr. Quaadman.

Because I know your body language was such that you might disagree a little bit with Mr. Borg. If you want to comment on that.

Mr. QUAADMAN. Yes, I just have to disagree with that last statement, because I have testified at a couple of those IPO hearings here at this committee. We have raised these issues before, and we have raised the Martin Act before. This is not a new issue that is being raised.

Mr. POLIQUIN. Mr. Borg, you have the last word.

Mr. BORG. The Martin Act is a New York law. I think that is something that the folks in New York should decide. I think this argument over the Martin Act, if that is what we are talking about, the Martin Act, ought to be in Albany.

I am addressing 5037 that is going to affect my State and 49 other States. I am not here talking—I am no expert on the Martin Act. If this is a Martin Act issue, then I think it ought to be handled up in Albany or wherever their legislature meets.

Mr. POLIQUIN. To be continued. Thank you, gentlemen. I really appreciate it very much.

Thank you, Mr. Chairman. I yield back my time.

Chairman HUIZENGA. The gentleman yields back.

With that, we welcome our colleague and guest to the subcommittee, Mr. Capuano from Massachusetts, who is recognized.

Mr. CAPUANO. Thank you, Mr. Chairman. I thank you for your indulgence. I appreciate it. I came over today because this is an important issue.

Mr. Borg, could you tell me again what your title is?

Mr. BORG. I am Director of the Alabama Securities Commission. I am the current President of the North American Securities Administrators Association.

Mr. CAPUANO. What State was that again?

Mr. BORG. Alabama.

Mr. CAPUANO. Alabama. Has Alabama changed? Are you now the bastion of liberalism, like Massachusetts?

Mr. BORG. We are there to protect our citizens, whatever it takes, and that is what we are going to do.

Mr. CAPUANO. I am not aware—that is a lovely State, but I am not aware that you have a reputation for being a progressive or a liberal—not you, but the State. So that what you do is, in your estimate, within a conservative viewpoint, the protection of consumers.

Mr. BORG. My legislature has passed the laws. They have seen fit to say that we need to enter this space and protect our citizens, and we have done so.

Mr. CAPUANO. How many other States do this?

Mr. BORG. I hope all the other States do this.

Mr. CAPUANO. That is what I thought. I am under the impression that every State does this.

Now, we talk here regularly about insurance regulation. Now, on insurance regulation, I think I hear the mantra pretty much all the time to leave it to the States. Have you heard that argument relative to regulation of insurance companies?

Mr. BORG. I have. I understand that there is exclusive jurisdiction to the States with regard to insurance regulation.

Mr. CAPUANO. Right, because they do a decent job.

Mr. BORG. There is no Federal regulator for insurance.

Mr. CAPUANO. Right.

I came today because all the nice talk is one thing, but the concept of taking protections away from small investors just strikes me as anathema. It just strikes me as—look, if the SEC is doing a great job, the truth is we don't need the States. But they have to look me in the eye and tell me the SEC has done a great job all the time and they haven't missed anything and that the States are nothing but doubling up. If that is the case, I haven't heard that from anybody, and I don't quite know why we are here. I am not sure what the problem is we are trying to solve, and I would really like to hear it.

Look, every regulation is overregulation to some people. I get that. But, in this particular case, especially when we have a gentleman from Alabama—no one has ever said that Alabama is guilty of overregulating anything. If all the States are overregulating, I would like to hear that from somebody on the panel.

Are all the States overregulating? Or is it just a couple of States you are trying to target?

Mr. QUAADMAN. Mr. Capuano, I would just say, as I mentioned earlier, I think what we have here is a situation where we have one State where you have a confluence of the two major exchanges of the United States being located in that State, we have the Martin Act being used over the last 15 years in such a way there is litigation through press release, there has never been a case brought into court except for once where New York State—

Mr. CAPUANO. We are here targeting one State.

Mr. QUAADMAN. I think that is where we have the biggest problem, because that is where we have—the New York State attorney general has set themselves up to be a de facto national regulator—

Mr. CAPUANO. I get that. Then why don't we have a bill just to stop New York State from doing this and leave the other 49 to do it? Leave Alabama alone.

Mr. QUAADMAN. Our view is—and I have great respect for Mr. Borg and what he does down in Alabama. Our review of it is that—our reading of 5037 is that it would actually just do that. It would take care of those cases up in New York. If there is more clarity that is needed there, that is fine.

Mr. CAPUANO. All of a sudden, if Massachusetts were to—now, one of reasons the other States don't do it is because we know New York happens to be the biggest one of the bunch, and they take care of business for us, to a certain extent.

At the same time, I am sure you know that when they move, many other States will join in with them. They are the lead dog because they are the biggest dog.

Let's assume for the sake of discussion that the entire State of New York were to go to sleep tomorrow and stop doing whatever

it is you don't like about it. What if Mr. Borg stepped up and said, now that New York is not doing this, maybe we need to step up a little bit? What would that argument be?

Mr. QUAADMAN. I also remember the Massachusetts State regulator saying that people shouldn't by Apple stock because it was risky.

I think it is really important to remember we have an SEC that is looking at these things from a national level, from an international level. We are talking about the sales of securities listed on national exchanges. If it is something that is not listed on a national exchange, that it falls within the purview of the States, we don't have a problem with that.

Mr. CAPUANO. The SEC has never issued a single ruling that you disagreed with. That is good, I guess. There is nothing wrong with that. That is a good thing, if you feel that comfortable with them. Because there are a couple of things they have done that I haven't agreed with.

Mr. QUAADMAN. We haven't agreed with some things either, which is why we also support 2128, which I would hope you do too, in terms of due process.

Mr. CAPUANO. I am all for due process. What I am not for—

Chairman HUIZENGA. The gentleman's time has expired.

Mr. CAPUANO. —Is taking people's protections away.

Thank you, Mr. Chairman, for your indulgence.

Chairman HUIZENGA. With that, the gentleman from Ohio, Mr. Davidson, is recognized for 5 minutes.

Mr. DAVIDSON. Thank you, Chairman.

To our guests, thank you for your expertise and for the preparation you have given, the testimony you have already given, and for the lengthy dialog that has already occurred. As one of the sponsors of one of the bills that has been talked about a bit, it is nice to be able to discuss it—and a cosponsor of Mr. MacArthur's bill.

I appreciate the committee for having this hearing and for devoting the time that it has taken.

Mr. Quaadman, in your testimony, you state that the administrative proceedings have, quote, "created an imbalance within the system that endangers the right of defendants and undermines the use of appropriate enforcement tools while raising important questions regarding the separation of powers between the Executive and Judicial Branches of Government."

This is one of the reasons why I introduced H.R. 2128, the Due Process Restoration Act. This bill provides respondents in SEC enforcement cases with the ability to have their case removed from the SEC's administrative proceedings and sent to a Federal district court. It essentially puts them at parity with the SEC. If the SEC can choose their venue, so can the defendant.

Can you please elaborate more about the concerns regarding separation of powers? Specifically, how would legislation like H.R. 2128 help alleviate this imbalance?

Mr. QUAADMAN. If you take a look at the Federal Rules of Civil Procedure, none of the traditional things that you have seen in an Article III court exists in an administrative proceeding at the SEC.

I think one example is very illustrative of that, and that is of Nelson Obus at Wynnefield Capital. See, he was involved in a case

that went on for at least 12 to 14 years, cost him millions of dollars, and he was one of last people to get into Federal district court before some of the changes with Dodd-Frank, which really shifted things into administrative proceedings.

As a result of the right of discovery, he was able to uncover information that led to cross-examination that led to his exoneration. He has even said, had that case happened several years later, had it gone into administrative proceeding, he would have never had the right of discovery, he would have never gotten that information, he would have never had the cross-examination, he would never have been exonerated.

I think we have to be very careful—let's forget for a second about if this is a securities issue or not—if we are going to have American citizens being brought before American tribunals where they don't have the right to defend themselves.

I think what your bill does is it allows that defendant, under certain circumstances and limited circumstances, to go into Federal district court and to get a jury trial, which, in our view, is a matter of fundamental fairness and due process.

Mr. DAVIDSON. Frankly, it is a constitutional protection, and I think it is core to the oath that we all swore. I think it should be a bipartisan thing to support and defend the Constitution in this way.

As a huge supporter of the Ninth and Tenth Amendments, I respect some of the arguments that have been laid out here. But even as we talk about Mr. MacArthur's bill, the idea that there could be no limited safe harbor as a condition of going public, as a consequence of a publicly traded stock on civil litigation, I think, misses the point.

I respect the emphasis on the Martin Act, but if you look at the things that were done in the name of investor protection, it was really advancing a cause on climate change, not investor protection, that not just New York but Massachusetts, the Virgin Islands, Illinois, California, and others put pressure that affects investors, affects shareholders. You have this market-distorting behavior that hurts all shareholders, including shareholders in my State of Ohio. You have a need for legislative certainty here.

I am particularly interested in initial coin offerings and working on a bill for that. These offerings can present another avenue for businesses to raise capital and increase liquidity. We have seen a myriad of State and Federal regulations, and now we are seeing enforcement action, and perhaps regulation by enforcement is one of the concerns that folks have expressed to our office. A hope that somehow the courts create some cohesive framework.

Do you think these concerns about the patchwork hold water? Or do you see a role for Congress bringing clarity in this matter for the SEC and CFTC to create regulatory certainty, Mr. Quaadman?

Mr. QUAADMAN. We think there is definitely a role for Congress here. We, in fact, are putting together our FinTech agenda, which we are going to look at ICOs, and we are going to release that next month. Treasury is going to do something like that, as well, this month.

We think there needs to be a strong regulatory structure on this, that there are investor protections, there is balance, there is fair-

ness. It is also important to remember this is also a matter of international competitiveness as well.

Mr. DAVIDSON. Very well said.

I see my time has expired, and I yield.

Chairman HUIZENGA. The gentleman's time has expired.

With that, the gentleman from Arkansas, Mr. Hill, is recognized for 5 minutes.

Mr. HILL. I thank the chairman. Thanks for holding this hearing.

I appreciate our panel and your expertise, for coming down and spending the afternoon with us. We are grateful for your expertise on this topic.

I have to say from listening to the excellent dialog, Mr. Borg and Mr. Quaadman, thanks for bringing that robust debate about these issue to the committee, and I appreciate all my colleagues' involvement in it, because it really is helpful. We don't always get to do that in these hearings. Being able to drill down and have some exchanges is helpful.

I hear the concerns that Mr. MacArthur's legislation is perhaps too broad for the North American securities administrators across the country and they have concerns about that and also their States' rights. That is something that maybe needs more work in the bill, because the issue of interstate commerce and international exchange competitiveness for listing is a big concern to this committee too. It is a classic case of public policy where we are working to balance those interests.

Mr. Borg, do you have a couple of narrowing suggestions, maybe, on further tailoring that would get at this issue of international competitiveness? Since our exchange and our listing entities are all in the State of New York; we are not moving them. I am not going to foot the bill for that project. Although New York tax structures may drive them out one day, but let's assume they stay in New York for now.

Do you have some suggestions? Because I know you all probably had to talk about this in preparation for the testimony.

Mr. BORG. Certainly, I am looking at this bill as to how it affects my State and other States as well. I am not versed in the Martin Act, and there has been a lot of discussion today about where the Martin Act is and how it applies and how it doesn't. I do know New York has filed with the committee a rather extensive letter on New York law, and I would be out of my territory to talk about New York law.

With regard to the idea that foreign markets somehow are scared of this area, I will tell you that there are studies about—and I have heard this overseas as well—that the markets in the United States, because of the protections afforded, the amount of regulation, is one reason why they are attractive to good overseas—

Mr. HILL. I agree. We have the rule of law. We have terrific liquidity and terrific players, diversity of players, a lot of expertise in bringing companies to the public market and sustaining their marketability. We are the biggest in the world. We also have the largest set of buyers of that market, for now. We have many competitors around the world.

But there is also data about the barriers if you are comparing markets and litigation is a concern to you. I saw some recent data,

I think in April or March, from the Business Roundtable and their corporate governance survey that indicated that there are some foreign markets that are more attractive for certain kinds of listers.

I think this is an issue. I think Mr. MacArthur raises a good point and we ought to be sensitive to it and try to find the right spot where we are not impeding the administrative responsibilities in the private placement market and broker oversight and firm oversight that you have in our States.

Mr. Quaadman, we have been working on our JOBS 3.0 here in the Congress, on things that can enhance capital formation. One that I noted in my last couple of decades of working in the securities industry is how Sarbanes-Oxley raised costs and didn't get any concomitant increase in efficiency or compliance by requiring a PCABO-approved audit firm for small, noncustodial introducing brokers.

I wondered, would you support our idea of making that—it has gotten waivers in the past umpty-ump years from Sarbanes-Oxley in 2002. But making a permanent waiver, would you support that?

Mr. QUAADMAN. Yes, look, the Chamber is a strong supporter of internal controls, but we support a waiver and we support the direction that you are going in.

I think one thing to remember, the first two letters in PCAOB stand for "Public Company." Most of the brokers that you are talking about, number one, aren't public companies, number two, don't hold securities, so that the audit that they are being subjected to by the PCAOB doesn't match their model.

The other thing I would just say, too, is, when you are taking a look at a Bernie Madoff situation, what you need is the bank records and what you need is the revenue statements, and you put those two things together and you are going to find out if there is a problem. You are going to have that information. What we are trying to solve here is not going to prevent that information from being in the hands of regulators.

Mr. HILL. Right. Thank you.

Mr. Chairman, I yield back.

Chairman HUIZENGA. The gentleman's time has expired.

With that, the gentleman from Indiana, Mr. Hollingsworth, is recognized for 5 minutes.

Mr. HOLLINGSWORTH. Good afternoon. I really appreciate everybody being here and second what Representative Hill said about the vigorous debate that we have undertaken today. I think it is necessary.

Something that Hoosiers have been concerned about for some time and continue to express to me every time I am back home in the district is some of the silent encroachment upon their rights of due process and ensuring that they have the opportunity to understand that which is being brought against them and they have the opportunity to defend themselves vigorously in a court of law.

Mr. Bondi, I had a couple questions for you based on some of the testimony you have had, so we may bond here for a moment, if you might.

I know that one of the things that you talked about before was some of the forum shopping, and that particularly concerns me with regard to—I think it was the Cyan decision earlier this year

by the Supreme Court, in that 33 class actions could be brought in State court and are not removable to Federal court.

I guess we had some concerns when that decision came down that, ultimately, this would lead to a lot of forum shopping. This would lead to, also, law being developed in different ways in different places versus a coherent system of law being developed all the way across the country, from sea to shining sea.

I wonder if you might be able to elaborate on that.

Mr. BONDI. Yes, I agree, Congressman. I think that is a real concern. What we are seeing, I think, in the defense bar is plaintiffs that are looking for the most favorable forum to extract the largest possible settlement. It exists also at the regulatory level, I think, what we are seeing here with the administrative law proceedings.

Mr. HOLLINGSWORTH. Yes.

I know one of things that Hoosiers are focused on—and, really, the previous Governor of Indiana, Mitch Daniels, really talked about this a lot—is we all want to make sure that the bad actors that exist out there get hit with a sledgehammer, but, ultimately, we don't want to impede capital markets, we don't to inhibit good actors from being able to service their customers, to be able to create new innovations, and ultimately be able to continue U.S. competitiveness around the world.

I think that is really important, that we don't develop law in a way that will continue to be a drag on overall capital markets' effectiveness, but, instead, we create law that will ensure that bad actors are taken out of the market but ultimately we are not harming good actors in the market.

Another question that I had for you is elaborating on the standard that the SEC demonstrate a "reasonable approximation"—quotation marks around that—for its disgorgement calculation. Just better understanding of how the SEC might develop that, is there public guidance about that, what does that look like, but it certainly seems like a really wide spectrum.

Mr. BONDI. Yes, Congressman. It definitely is a wide spectrum. The difficulty is most of the cases the SEC brings are settled cases. The standard that the SEC applies, this reasonable approximation standard, never really gets challenged in an Article III court. If it is an administrative proceeding, sometimes it never even reaches an Article III court and it is dealt with an ALJ judge.

It is particularly poignant in the case of books and records and internal controls violations, where the SEC might take a books and records violation and then disgorge an extraordinarily high amount that was associated, for instance, with a foreign bribe. Where, instead of bringing an FCPA case for that foreign bribe, they bring a books and records internal controls case and say all of the ill-gotten gains from that foreign bribe were related to that one entry that was incorrect in the books.

There needs to be some standard here. I think either Congress should impose it or the SEC should come up with a standard by the way it calculates disgorgement.

Mr. HOLLINGSWORTH. We have talked a lot about forum shopping in the course of this testimony, but really talking about limiting the ability for these actions to be brought and really shop the different ways that they might be able to attack these actions to be

able to get the largest penalty. I think that is what we are trying to hold back.

We want to make sure that any nefarious activities by individuals, that they pay the price for that, but we don't want to shop around so that they pay the largest possible price, in terms of the avenue taken. Is that fair?

Mr. BONDI. That is fair.

Mr. HOLLINGSWORTH. OK. Great.

I think the other thing—this is something that you cited in your written testimony—is the NYU study that, in the first half of 2018, the percentage of new enforcement actions against public companies—and I want to make sure I get this right—that were brought as administrative proceedings declined to 80 percent, down from 94 percent in the second half of 2017.

Is this an encouraging trend that you see in response to some of the public outcry about this, some of the articles that have been about this, some of the challenges that have been brought to this process? Or, what do you attribute that decline to?

Mr. BONDI. Yes, absolutely. I think the new Commission, particularly Chairman Clayton and the enforcement directors, are very much cognizant about this perception of unfairness associated with the ALJ proceedings. I think they are taking better courses to determine when and where to bring ALJ proceedings. I think the statistics are very, very encouraging.

Mr. HOLLINGSWORTH. Great.

Look, I know, a lot of times, on this committee we talk about esoteric financial products, we are talking about aspects of law that maybe don't touch everyday lives for Hoosiers. But what does touch them every single day is making sure that they have due process and making sure they have confidence in the legal system and being able to defend themselves or an individual accused of a crime is able to defend themselves.

Thank you all for being here. I appreciate the testimony.

Chairman HUIZENGA. The gentleman's time has expired.

I would like to thank our witnesses today for their testimony. I think this was helpful.

The Chair notes that some Members may have additional questions for this panel, which they may wish to submit in writing. Without objection, the hearing record will remain open for 5 legislative days for Members to submit written questions to these witnesses and to place their responses in the record. Also, without objection, Members will have 5 legislative days to submit extraneous materials to the Chair for inclusion in the record.

Again, we appreciate your time and your expertise, and we look forward to continuing these conversations.

The hearing is adjourned.

[Whereupon, at 3:52 p.m., the subcommittee was adjourned.]

A P P E N D I X

June 13, 2018

Statement before the United States House of Representatives
Committee on Financial Services
Subcommittee on Capital Markets, Securities, and Investment
On Ensuring Effectiveness, Fairness, and Transparency in Securities Law Enforcement

Statement of Bradley J. Bondi

June 13, 2018

The views expressed in this testimony are those of the author alone and do not necessarily represent those of any other individual or organization.

STATEMENT OF BRADLEY J. BONDI
BEFORE THE UNITED STATES HOUSE OF REPRESENTATIVES
COMMITTEE ON FINANCIAL SERVICES
SUBCOMMITTEE ON CAPITAL MARKETS, SECURITIES, AND INVESTMENT
HEARING ON "ENSURING EFFECTIVENESS, FAIRNESS, AND TRANSPARENCY IN SECURITIES LAW ENFORCEMENT"

JUNE 13, 2018

Chairman Huizenga, Ranking Member Maloney, and Distinguished Members. My name is Bradley J. Bondi. I am pleased to appear before you today to share my views in this hearing on "Ensuring Effectiveness, Fairness, and Transparency in Securities Law Enforcement," and, in particular, my views on H.R. 2128 ("Due Process Restoration Act of 2017") and H.R. 5037 ("Securities Fraud Act of 2018").

BACKGROUND

I am a practicing attorney and a partner with the law firm Cahill Gordon & Reindel LLP, where I lead my firm's securities enforcement and regulatory practices. I am admitted to the bars of New York, Washington, D.C., and Florida. Much of my law practice is devoted to representing public companies and financial institutions in securities enforcement matters before the Securities and Exchange Commission ("SEC").

I previously served in senior positions in government including as counsel to SEC Commissioner Paul Atkins and then to SEC Commissioner Troy Paredes. While at the SEC, I was detailed to the Financial Crisis Inquiry Commission where I served as deputy general counsel and led one of the three investigative teams examining the causes of the financial crisis. More recently, I served in a leadership role on President Trump's transition team, advising on financial services matters and leading the landing team to the Export-Import Bank of the United States.

In addition to my law practice, I serve as an adjunct law professor at Georgetown University Law Center and George Mason University Antonin Scalia Law School where I teach courses on securities law and the SEC. I am also a senior fellow with the Center for Financial Stability, a nonprofit, nonpartisan, and independent think tank focusing on financial markets for the benefit of investors, officials, and the public. My writing and scholarship focuses on SEC enforcement matters.

I have appended to my written testimony a relevant article that I authored last year entitled, "Improving the SEC's Enforcement Program: A Ten-Point Blueprint for Reform" and a still-relevant article I co-authored 10 years ago with then-Commissioner Paul Atkins entitled, "Evaluating the Mission: A Critical Review of the History and Evolution of the SEC Enforcement Program," which was published by the Fordham Journal of Corporate and Financial Law.

Although I am affiliated with several organizations, I am testifying today in my individual capacity, and my views are my own. My views do not necessarily reflect those of my law firm or its clients.

PRELIMINARY STATEMENT REGARDING THE SEC

The SEC is an agency that I greatly respect and admire. In my years serving at the Commission and in private practice, I have worked with many intelligent, dedicated, and hard-working professionals at the SEC. My observation is that the SEC as a whole overwhelmingly has sought to abide by its mandate and for the most part has been successful in doing so. Nevertheless, there is always room for improvement, and I am here today to discuss a few areas where I think the SEC may have strayed from its mission and to offer suggestions on how to realign the agency with its mission.

THE SEC'S THREE-PRONG MISSION IN THE CONTEXT OF ENFORCEMENT

The SEC's mission is composed of three objectives: "to protect investors; maintain fair, orderly, and efficient markets; and facilitate capital formation."[1] In the area of enforcement, the SEC has focused historically on the investor-protection prong of the mission, with a particular focus on the retail investor. A robust enforcement regime to defend the markets against fraud is essential to encouraging capital formation. Enforcement almost always involves a balancing of competing interests both at a case-specific level and at a policy level. A decision aimed at protecting one group of investors could have a detrimental impact on a different group of investors. Similarly, a decision aimed at protecting investors could harm market efficiency or chill capital formation. The balancing of conflicting interests must be guided by the principles of predictability, transparency, and the rule of law.

The SEC's approach to issuer penalties and disgorgement is an area that could threaten the balance of the SEC's three-part mission. In recent years, the SEC has focused on bringing large numbers of enforcement cases and obtaining large financial settlements. At the end of its 2016 fiscal year, the SEC issued a press release announcing that the 868 enforcement actions it filed in 2016 were a "new single year high."[2] It also announced that it had obtained approximately $4 billion in disgorgement and penalties that year. This was the third year in a row that the SEC announced a record number of enforcement actions.[3]

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[1] *See* Securities and Exchange Commission Agency Financial Report: Fiscal Year 2017 at 4 (Nov. 13, 2017), *available at* https://www.sec.gov/files/sec-2017-agency-financial-report.pdf.

[2] *See* Press Release, SEC, *SEC Announces Enforcement Results for FY 2016* (Oct. 11, 2016), Release No. 2016-212, *available at* https://www.sec.gov/news/pressrelease/2016-212.html.

[3] *See* Press Release, SEC, *SEC's FY 2014 Enforcement Actions Span Securities Industry and Include First-Ever Cases* (Oct. 16, 2014), Release No. 2014-230, *available at* https://www.sec.gov/news/press-release/2014-230 ("In the fiscal year that ended in September, the SEC filed a record 755 enforcement actions . . . ."); Press Release, SEC, *SEC Announces Enforcement Results for FY 2015* (Oct. 22, 2015), Release No. 2015-245, *available at* https://www.sec.gov/news/pressrelease/2015-245.html ("In the fiscal year that ended in September, the SEC filed 807 enforcement actions . . . .").

The number of enforcement actions and the amount of disgorgement and penalties purportedly demonstrate the success of the SEC's enforcement program. But if the aim of the program is to protect investors and *deter* wrongdoing, then the high numbers of enforcement actions and penalties are, at best, a poor way to measure that protection and deterrence. At worst, record numbers are an indication that securities law violations are increasing in number and severity. After all, few would consider a local police force successful in deterring crime if it announced record numbers of arrests year after year.

In addition, the SEC's focus on achieving record numbers could have the practical effect of disproportionately allocating scarce resources towards pursuing a large volume of minor or unintentional violations involving large companies (and thus leading to large penalty figures) at the expense of pursuing fewer but more complicated cases involving intentional wrongdoing such as Ponzi schemes, boiler rooms, and bucket shops, which have a disproportionately negative impact on retail investors. An overemphasis on enforcement statistics also may lead the SEC to develop and pursue theories of liability that exceed the bounds of the SEC's congressionally-authorized enforcement power.[4]

An emphasis on obtaining large penalties against corporations creates incentives that may be misaligned with the core mission of the SEC to protect investors, namely the innocent shareholders who must bear the cost of a corporate monetary penalty. I commend SEC Chairman Jay Clayton and his Enforcement Directors for their de-emphasis of statistics and for their work to better align the Division of Enforcement with the SEC's mission. I believe the SEC is heading in the right direction and I hope my constructive comments today will assist with that effort.

EVALUATING THE STANDARDS FOR MONETARY PENALTIES AND DISGORGEMENT

A review of the history of SEC corporate penalties is necessary to evaluate whether the agency's penalty scheme is aligned with the SEC's mission. The Remedies Act of 1990 enabled the SEC to seek monetary penalties against public companies. At the time, the Senate Committee on Banking, Housing, and Urban Affairs cautioned that the costs of monetary penalties might be passed on to shareholders, and the Committee expected that the SEC would seek a monetary penalty only when the securities law violation had resulted in an improper benefit to shareholders.[5] In cases in which shareholders are the principal victims of the violations, the

[4] This so-called "regulation by enforcement" is contrary to the SEC's rulemaking authority and violates fundamental principles of due process that require regulatory agencies to provide a notice and comment period for new or modified rules. *See* Bradley J. Bondi, *Dangerous Liaisons: Collective Scienter in SEC Enforcement Actions*, 6 N.Y.U. J. L. & Bus. 1, 16 n.64 (2009) (quoting then-Commissioner Paul Atkins, who said, "[i]f we are to enforce the rule of law, we must follow the rule of law in our approach"); *see also Theodore W. Urban*, SEC Administrative Proceeding File No. 3-13655, Initial Decision Release No. 402 (Sept. 8, 2010), *dismissed* by Exchange Act Release No. 66359 (Jan. 26, 2012).
[5] *See* S. Rep. No. 101-337, at 17 (1990).

Committee expected that the SEC, when appropriate, would seek penalties from the individual offenders acting for a corporate issuer.

In view of Congress's concern for shareholders, for the first 12 years after the passage of the Remedies Act, the SEC imposed issuer penalties sparingly. But, in April 2002, the SEC brought a case against Xerox Corporation that marked a sea change in the SEC's approach to seeking penalties. The SEC imposed an unprecedented $10 million penalty on Xerox for financial fraud, a penalty three times larger than any previous amount for a similar case.[6] Since the Xerox case, the SEC has levied many civil penalties of $10 million or more. In 2003, the year after the Xerox case, the total amount of monetary penalties (excluding disgorgement) imposed by the SEC on companies increased to approximately $1.1 billion from approximately $101 million in the prior year.[7] Since then, penalties against corporations have continued to climb. The high-water mark to-date is a $550 million penalty that the SEC obtained in a settlement with an investment bank in July 2010.[8]

In January 2006, a unanimous Commission issued the Statement of the Securities and Exchange Commission Concerning Financial Penalties, often known simply as the SEC's "Penalty Statement."[9] The stated purpose of the Penalty Statement was to provide the maximum possible degree of clarity, consistency, and predictability in explaining how the SEC exercises its corporate penalty authority. In the Penalty Statement, the SEC identified two principal considerations for determining whether a monetary penalty against a company is appropriate: (1) the presence or absence of a direct benefit to the company as a result of the securities law violation and (2) the degree to which the penalty will recompense or further harm the injured shareholders. After the Penalty Statement, annual aggregate monetary penalty amounts dropped significantly. In 2008, for example, the SEC imposed approximately $256 million in monetary penalties,[10] down from approximately $1.2 billion and $1.5 billion in 2004 and 2005, respectively.[11]

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[6] *See* Press Release, SEC, *Xerox Settles SEC Enforcement Action Charging Company With Fraud* (Apr. 11, 2002), Release No. 2002-52, *available at* https://www.sec.gov/news/headlines/xeroxsettles.htm; *see also* James Bandler and Mark Maremont, *Xerox Will Pay $10 Million Penalty to Settle SEC Accounting Charges*, Wall St. J. (Apr. 2, 2002), *available at* https://www.wsj.com/articles/SB1017682255642049000.

[7] *See SEC 2002 Annual Report*, at 1 (Jan. 1, 2002,) *available at* https://www.sec.gov/pdf/annrep02/ar02full.pdf ("Civil penalties ordered in SEC proceedings totaled approximately $101 million."); *SEC 2003 Annual Report*, at 15 (Jan. 1, 2003), *available at* https://www.sec.gov/pdf/annrep03/ar03full.pdf ("Obtained orders in SEC judicial and administrative proceedings requiring securities violators . . . to pay penalties of approximately $1.1 billion.").

[8] *See* Press Release, SEC, *Goldman Sachs to Pay Record $550 Million to Settle SEC Charges Related to Subprime Mortgage CDO*, Release No. 2010-123, *available at* https://www.sec.gov/news/press/2010/2010-123.htm. Interestingly, in that case there was no allegation of any harm to a retail investor.

[9] *See* Press Release, SEC, *Statement of the Securities and Exchange Commission Concerning Financial Penalties* (Jan. 4, 2006), Release No. 2006-4, *available at* https://www.sec.gov/news/press/2006-4.htm.

[10] *See Select SEC and Market Data Fiscal 2008, available at* https://www.sec.gov/files/secstats2008.pdf.

[11] *See United States Securities and Exchange Commission 2004 Enforcement and Market Data, available at* https://www.sec.gov/files/secpar04stats%2C0.pdf; *Select SEC and Market Data Fiscal 2005, available at* https://www.sec.gov/files/secstats2005%2C0.pdf.

In recent years, some commissioners have disavowed the Penalty Statement. In September 2013, the then-Chair of the SEC observed that the Penalty Statement is non-binding and, while recognizing that it sets forth useful considerations, said that each commissioner has discretion within his or her statutory authority to reach a conclusion on whether a penalty is appropriate and how high it should be.[12] A few weeks later, another SEC Commissioner agreed and commented that the Penalty Statement "constituted a fatally flawed approach to assessing the appropriateness of corporate penalties" because it focused on whether the company had benefited from the misconduct and shareholder harm instead of punishing misconduct and deterring future violations.[13] Since 2013, the average annual amount of monetary penalties (excluding disgorgement) imposed has been approximately $1.165 billion.[14] The disavowal of the Penalty Statement has created unpredictability regarding the criteria that the SEC considers when determining whether to impose a penalty.

The amount of a monetary penalty is also unpredictable because in recent years the SEC has not articulated criteria or metrics for calculating how much it will penalize a company. This unpredictability negatively impacts companies. For example, the inability to predict the size of a potential penalty hinders the market for mergers and acquisitions because potential bidders cannot accurately forecast regulatory exposure.

The current Commission appears to be taking a more measured approach to assessing monetary penalties. The aggregate amount of penalties in 2017 was $832 million, a decline of approximately 35% from the near-record $1.273 billion in penalties imposed in 2016.[15] I commend the Commission for this more measured approach, and I encourage the Commission to release a renewed penalty statement explaining the circumstances in which the SEC will seek a monetary penalty.

There also has been growing uncertainty over the SEC's treatment and approach to the equitable remedy of disgorgement. The SEC can seek to force defendants to disgorge ill-gotten gains. Courts have required the SEC to demonstrate a causal connection between the property to be

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[12] Mary Jo White, Chair, SEC, Remarks before the Council of Institutional Investors Fall Conference: *Deploying the Full Enforcement Arsenal* (Sept. 26, 2013), *available at* http://www.sec.gov/News/Speech/Detail/Speech/1370539841202.

[13] Luis A. Aguilar, Commissioner, SEC, Remarks before the 20th Annual Securities Litigation and Regulatory Enforcement Seminar: *A Stronger Enforcement Program to Enhance Investor Protection* (Oct. 25, 2013), *available at* https://www.sec.gov/news/speech/2013-spch102513laa.

[14] The penalty amount was $1.167 billion in 2013, $1.378 billion in 2014, $1.175 billion in 2015, $1.273 billion in 2016, and $832 million in 2017. *See Select SEC and Market Data Fiscal 2013*, *available at* https://www.sec.gov/files/secstats2013.pdf; *Select SEC and Market Data Fiscal 2014, available at* https://www.sec.gov/files/secstats2014.pdf; *Select SEC and Market Data Fiscal 2015, available at* https://www.sec.gov/files/secstats2015.pdf; *Select SEC and Market Data Fiscal 2016, available at* https://www.sec.gov/files/2017-03/secstats2016.pdf; and *SEC Division of Enforcement Annual Report: A Look Back at Fiscal Year 2017*, *available at* https://www.sec.gov/files/enforcement-annual-report-2017.pdf.

[15] *See Select SEC and Market Data Fiscal 2016, available at* https://www.sec.gov/files/2017-03/secstats2016.pdf; and *SEC Division of Enforcement Annual Report: A Look Back at Fiscal Year 2017*, *available at* https://www.sec.gov/files/enforcement-annual-report-2017.pdf.

disgorged and the wrongdoing.[16] The remedy of disgorgement is used often in insider trading cases to recover the profits made by trading on material, nonpublic information. The remedy also is applied in areas where investors have been defrauded by fraudulent investment scams.

In other areas, however, the remedy of disgorgement has become untethered from the underlying offense, which creates unpredictability and the potential for harm to shareholders. For example, in cases involving payments to foreign government officials, disgorgement has been applied as a remedy for violating the books and records and internal controls provisions of the Securities Exchange Act of 1934.[17] But in cases in which the SEC has not charged any violation of the FCPA's anti-bribery provisions, the connection between the incorrect recording of a payment to a foreign official and any ill-gotten gain resulting from that payment is tenuous.[18] It is the bribe, not the misrecording of it, which caused the ill-gotten gain; so a violation of the recording provision should not provide a sufficient causal link for disgorgement. This tenuous approach and the imprecise "reasonable approximation" standard for determining the amount of disgorgement[19] creates the potential that a disgorgement sanction will not be commensurate with the amount of ill-gotten gains. Unfortunately, the SEC's approach to disgorgement often goes unchallenged and unreviewed by a court. As a result, the standard for obtaining disgorgement is less predictable.

This lack of transparency and predictability with respect to monetary penalties and disgorgement is contrary to the SEC's mission to maintain fair, orderly, and efficient markets and to facilitate capital formation. In July 1934, Joseph P. Kennedy, the first chairman of the SEC, stated there would be no concealed punishment for businesses subject to the SEC's jurisdiction.[20] In that spirit of transparency, the SEC should provide clear, principled guidance regarding when it will seek a penalty or disgorgement and how it will calculate the amount.

EXTENDING THE STATUTE OF LIMITATIONS FOR DISGORGEMENT AND PENALTIES

One area of the securities laws in which there has been a welcome clarification is the statute of limitations applicable to cases in which the SEC seeks disgorgement and penalties. The Supreme Court's recent unanimous decision in *Kokesh* v. *SEC* held that the Commission's

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[16] *See SEC* v. *First City Financial Corp., Ltd.*, 890 F.2d 1215, 1231 (D.C. Cir. 1989) ("Since disgorgement primarily serves to prevent unjust enrichment, the court may exercise its equitable power only over property causally related to the wrongdoing.").
[17] *See* 15 U.S.C. § 78m(b)(2)(A)-(B) (requiring public companies to make and keep accurate books, records, and accounts and to devise and maintain internal accounting controls).
[18] *See also In re Rockwell Automation Inc.*, Admin. Proc. No. 3-14364 (May 3, 2011) (imposing $1.7 million in disgorgement in an FCPA case); *SEC* v. *Chevron Corp.*, No. 07-cv-10299 (S.D.N.Y. Nov. 20, 2007) (imposing $25 million in disgorgement in an FCPA case); *SEC* v. *Textron*, No. 07-cv-1505 (D.D.C. Aug. 31, 2007) (imposing $2.3 million in disgorgement in an FCPA case).
[19] *See SEC* v. *First City Financial Corp., Ltd.*, 890 F.2d 1215, 1231 (D.C. Cir. 1989) ("disgorgement need only be a reasonable approximation of profits causally connected to the violation.").
[20] Joseph P. Kennedy, Chairman, SEC, Remarks before the National Press Club (July 15, 1934) at 3, *available at* https://www.sec.gov/news/speech/1934/072534kennedy.pdf.

disgorgement remedy constitutes a "penalty" and is therefore subject to the five-year statute of limitations in 28 U.S.C. § 2462.[21]

I understand that in the wake of *Kokesh* there has been discussion about extending the statute of limitations for disgorgement and penalties. Title 28 U.S.C. § 2462 sets a five-year limitations period for the SEC in seeking any civil fine, penalty, or forfeiture. It states:

> Except as otherwise provided by Act of Congress, an action, suit or proceeding for the enforcement of any civil fine, penalty, or forfeiture, pecuniary or otherwise, shall not be entertained unless commenced within five years from the date when the claim first accrued if, within the same period, the offender or the property is found within the United States in order that proper service may be made thereon.[22]

Although I believe it is critical for the SEC to pursue those who commit fraud, I am concerned that the costs of extending the applicable statute of limitations may greatly outweigh the benefits. Statutes of limitations and statutes of repose serve a vital societal interest in providing stability and certainty, and preventing the litigation of stale claims.[23] Five years is the longest period of limitations or repose found in any of the federal securities laws. Extending the Section 2462 statute of limitations beyond that would create uncertainty for the investing public because of the possibility of the SEC prosecuting stale claims. It also could open the door for inefficiencies in the way the SEC investigates cases if more time is allotted to bring actions. SEC investigations already are time and resource consuming affairs. In FY2016, the SEC planned to bring 65% of enforcement actions within the first two years of opening an investigation.[24] It achieved a 53% rate.[25] In FY2017, the SEC also targeted 65%. It achieved a 52% rate.[26] The SEC is targeting 65% again in 2018.[27] Investigations are costly on those responding. A July 2015 Chamber of Commerce report cited a survey indicating that the average costs for responding to a formal

[21] *See Kokesh* v. *SEC*, 137 S. Ct. 1635 (2017). Previously, in 2013, the Supreme Court held in *Gabelli* v. *SEC* that civil penalties sought by the SEC also are subject to a five-year statute of limitations under Section 2462. *See* 568 U.S. 442 (2013).
[22] *See* 28 U.S.C. § 2462.
[23] *Kokesh*, 137 S. Ct. at 1641 ("Statutes of limitations 'se[t] a fixed date when exposure to the specified Government enforcement efforts en[d].' . . . Such limits are "'vital to the welfare of society'" and rest on the principle that "'even wrongdoers are entitled to assume that their sins may be forgotten.'") (citation omitted); *see also Artis* v. *District of Columbia*, 138 S. Ct. 594, 607-08 (2018) ("We do not gainsay that statutes of limitations are 'fundamental to a well-ordered judicial system.'"); *Gabelli*, 568 U.S. at 448 ("the basic policies of all limitations provisions [are] repose, elimination of stale claims, and certainty about a plaintiff's opportunity for recovery and a defendant's potential liabilities") (citation omitted).
[24] *See* Securities and Exchange Commission Fiscal Year 2018 Congressional Budget Justification Annual Performance Plan and Fiscal Year 2016 Annual Performance Report at 35 (May 23, 2017), *available at* https://www.sec.gov/reports-and-publications/budget-reports/secfy18congbudgjust.
[25] *See id.*
[26] *See* Securities and Exchange Commission Fiscal Year 2019 Congressional Budget Justification Annual Performance Plan and Fiscal Year 2017 Annual Performance Report at 109 (Feb. 12, 2018), *available at* https://www.sec.gov/reports-and-publications/budget-reports/secfy19congbudgjust.
[27] *See id.*

investigation surpassed $1 million for 70% of the formal investigations surveyed; and they surpassed $20 million for 10% of those investigations.[28]

In my two decades of experience as a defense lawyer, an SEC enforcement investigation into potential securities law violations by a public company—even an investigation that ultimately does not find any violations of law—can take several years, distract management, and cost the company tens of millions of dollars. The cost of that investigation is borne directly by the shareholders of the company. Of particular concern are SEC enforcement investigations that begin after a news story about a high-profile company, prompting the Enforcement Staff to pursue one theory of liability, but then morph into open-ended investigations that wander into other areas of a company in search of a potential violation. This is particularly disconcerting when it comes to new companies, start-ups, and technology companies that oftentimes find that scrutiny in the press translates into scrutiny by the Enforcement Staff. SEC investigations can impede entrepreneurship and innovation. I understand the current leadership of the SEC is cognizant of these concerns and has been working to address them. Policies and procedures in this area could be improved.[29]

Extending the statute of limitations also could interfere with the SEC's ability to facilitate capital formation. As H.R. 5037 states in its findings, there is declining interest in the United States public market. Extending the statute of limitations would increase the regulatory risk and operating costs of accessing the United States' capital markets and could further chill interest in America's capital markets.

In considering any proposed legislation to extend the applicable statute of limitations, it would be helpful for the SEC to explain to this Committee and to the public what, if any, cases the SEC has failed to bring as a result of being time barred. As a practical matter, and speaking from experience, the SEC has the ability to seek a tolling agreement from a person or entity under investigation, thereby stopping the running of the limitations period. It may be that few cases, if any, are missed by the SEC as a result.

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[28] *See* U.S. Chamber of Commerce Center for Capital Markets Competitiveness, *Examining U.S. Securities and Exchange Commission Enforcement: Recommendations on Current Processes and Practices* at 40 (July 2015), *available at* https://www.centerforcapitalmarkets.com/wp-content/uploads/2015/07/021882_SEC_Reform_FIN1.pdf.

[29] Relatedly, the SEC should remove the names of Enforcement Staff from SEC press releases announcing enforcement actions. Currently, these releases identify the individual attorneys who supervised, led, and assisted in the investigation. This individual recognition can incentivize the Enforcement Staff to pursue headline-grabbing enforcement actions and sanctions, such as a record penalty amount. Former Enforcement Staff members often tout these high-profile actions on their law firm profiles after they leave government service. The incentive to seek recognition for bringing a high-profile enforcement action can cloud the Staff's focus when determining, for example, whether to commence an investigation against a high-profile company or individual, the scope of such an investigation, the appropriate time to close such an investigation, and the size of the penalty to be imposed if a securities law violation has occurred. The mission of the SEC would be better served by removing individual incentives to seek public recognition.

RESTORING CREDIBILITY TO ADMINISTRATIVE PROCEEDINGS

The SEC's administrative proceedings also have garnered a significant amount of recent attention. The SEC has the authority to pursue enforcement actions in administrative proceedings over which an administrative law judge appointed by the SEC presides. Until the Dodd-Frank Act, only registered individuals and entities such as broker-dealers and investment advisers were subject to enforcement actions in administrative proceedings. By registering with the SEC, these entities effectively agreed to be subject to the SEC's administrative enforcement jurisdiction in a manner analogous to an attorney who agrees to be subject to the rules of the bar of the state where he or she is licensed to practice.

Through the Remedies Act of 1990, Congress authorized the SEC to impose monetary penalties on regulated entities in administrative proceedings. It also authorized the SEC to pursue remedial relief such as "cease-and-desist" and disgorgement orders against non-regulated entities, but it did not authorize the SEC to seek monetary penalties against issuers and non-regulated persons in administrative proceedings. The concern among members of Congress and internally at the SEC was that if the same remedies against issuers were available to the SEC under both judicial and administrative proceedings, then the SEC might be perceived to have an incentive to conduct more enforcement actions through its own administrative proceedings, rather than before a federal district court judge.[30] The Dodd-Frank Act of 2010 removed this important distinction by authorizing the SEC to impose monetary penalties against issuers in administrative proceedings and authorized the SEC to bring actions against non-regulated persons and entities.

Since the enactment of Dodd-Frank, several respondents have challenged the constitutionality of the SEC's administrative proceedings by filing lawsuits in federal district court arguing that the SEC's administrative proceedings process is unconstitutional.[31] Others argue that administrative proceedings threaten to deprive them of liberty and property without due process, and that the SEC had unfairly singled them out in administrative proceedings in violation of the equal protection clause. To date, most courts have rejected these arguments. Nevertheless, some market participants continue to believe that administrative proceedings are unfair because respondents in administrative proceedings do not enjoy all of the procedural safeguards that are afforded to defendants in federal district court, particularly with respect to depositions, document discovery, rules of evidence, and the ability to confront accusers.

This perceived unfairness may be due to the fact that the SEC appears to have won more frequently in administrative proceedings than in district court. In 2015, The Wall Street Journal reported that from October 2010 through March 2015, the SEC won 90% of its administrative proceedings, while in the same period the SEC prevailed in only 69% of the cases it brought in

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[30] Paul S. Atkins & Bradley J. Bondi, *Evaluating the Mission: A Critical Review of the History and Evolution of the SEC Enforcement Program*, 13 FORDHAM J. CORP. & FIN. L. at 393-94.

[31] The issue of whether administrative law judges of the SEC are officers of the United States within the meaning of the appointments clause of the Constitution is presently before the Supreme Court. *See Lucia* v. *SEC*, Docket No. 17-130 (argued April 23, 2018).

federal district court.[32] Furthermore, a 2016 study suggested that, after Dodd-Frank, the SEC has shifted weaker cases from district court to administrative proceedings or has brought actions as administrative proceedings that it would not have brought at all before Dodd-Frank.[33]

In July 2016, the SEC adopted amendments updating its rules of practice governing administrative proceedings.[34] Most importantly, the amended rules extend the length of the prehearing period to allow respondents more time to prepare for administrative hearings; allow for depositions in complex cases (not just when witnesses are unavailable to testify at the hearing); and permit the exclusion of "unreliable" evidence. Although the amendments provide some new safeguards to respondents, they fall short of the procedural safeguards afforded to defendants in federal district court. And, above all, they do not establish criteria for determining when the SEC will bring a case in an administrative proceeding rather than in federal court.

A recent report suggests that the SEC might be moving away from its reliance on administrative proceedings. According to a May 2018 report by the NYU Pollack Center for Law & Business and Cornerstone Research, in the first half of 2018, the percentage of new enforcement actions against public companies that were brought as administrative proceedings declined to 80%, which was down from 94% for the second half of 2017.[35] According to the report, this is the lowest percentage since the first half of 2014.[36] I commend the Commission for this encouraging trend.

I have been asked to comment on H.R. 2128, The "Due Process Restoration Act of 2017." H.R. 2128 would allow respondents in an administrative proceeding to remove the proceeding to federal district court and thereby avail themselves of the procedural safeguards of federal court, namely the robust federal discovery system, pre-trial motions, and trial before a jury. It also would raise the standard of proof in an administrative proceeding from "preponderance of the evidence" to a higher "clear and convincing." In other words, the burden of proof for the SEC would be higher in an administrative proceeding than in federal court.

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[32] Jean Eaglesham, *SEC Wins With In-House Judges*, Wall St. J. (May 6, 2015), *available at* http://www.wsj.com/articles/sec-wins-with-in-house-judges-1430965803.

[33] Adam C. Pritchard & Stephen Choi, *The SEC's Shift to Administrative Proceedings: An Empirical Assessment* (2016), Law & Economics Working Papers, Paper 119, *available at* http://repository.law.umich.edu/cgi/viewcontent.cgi?article=1233&context=law_econ_current.

[34] *See* Press Release, SEC, *SEC Adopts Amendments to Rules of Practice for Administrative Proceedings* (July 13, 2016), Release No. 2016-142, *available at* https://www.sec.gov/news/pressrelease/2016-142.html; *see also* Bradley J. Bondi *et al.*, *SEC Adopts Amendments to Rules of Practice for Administrative Proceedings*, Cahill Gordon & Reindel LLP (July 15, 2016), https://www.cahill.com/publications/firm-memoranda/10130405/_res/id=Attachments/index=0/CGR%20Memo%20-%20SEC%20Adopts%20Amendments%20to%20Rules%20of%20Practice%20for%20Administrative%20Proceedings.pdf.

[35] *See* SEC Enforcement Actions against Public Companies Continue Sharp Decline, NYU Pollack Center for Law & Business and Cornerstone Research (May 15, 2018), *available at* http://www.stern.nyu.edu/experience-stern/news-events/sec-enforcement-actions-against-public-companies-continue-sharp-decline.

[36] *See id.* at 2.

While I believe that reform of the administrative process is warranted, and H.R. 2128 is one attempt, the bill may go too far and have the effect of causing the SEC to initiate all enforcement actions in federal district court. Yet, not all enforcement actions require the formality of federal district court. Some cases, such as those involving disciplinary actions against registered investment professionals and so-called "follow-on" actions following a criminal prosecution, could be adequately brought as administrative proceedings, thereby avoiding adding to the already crowded federal docket.

An alternative to consider is a return to the pre-Dodd-Frank jurisdiction of administrative proceedings (that is, to limit administrative proceedings to only those against registered individuals and entities such as broker-dealers and investment advisers); to provide additional due process safeguards such as the ability of respondents to take depositions and to make pre-trial motions; and/or to limit administrative proceedings to disputes below a certain dollar amount.

IMPOSITION OF FEDERAL JURISDICTION OVER CIVIL SECURITIES FRAUD ACTIONS

I also have been asked to comment on H.R. 5037 entitled, "Securities Fraud Act of 2018." H.R. 5037 would provide the federal government with exclusive authority to prosecute civil securities fraud by preempting all state enforcement of civil securities fraud involving an issuer listed on a national securities exchange. H.R. 5037 also would require any criminal proceedings for securities fraud that are brought by the states to comply with the same legal requirements for bringing such claims under federal law.

From my experience, I generally agree with H.R. 5037's observation that "[i]mposing differing State regulatory requirements for civil securities fraud on national markets increases risk, creates inefficiencies, raises costs, and can harm the efficient operation of these critical markets, without providing material investor protection benefits."

At present, states may pursue civil enforcement of securities laws against public companies that are trading on national exchanges. That allows a single state to become a national securities regulator. There have been a few notable instances in which states have brought aggressive enforcement actions against public companies even where those companies already had settled with the SEC and paid substantial penalties. The inability of a public company to achieve certainty in a settlement with the SEC and the threat of another enforcement action by a state harms the investing shareholders who must bear the burden of any penalty.

Fortunately, with only a few rare exceptions, the states have worked closely and cooperatively with one another and with the SEC to ensure the fair and just enforcement of securities laws, and I commend the North American Securities Administrators Association ("NASAA") and its President, Alabama Securities Commissioner Joe Borg, for their efforts to coordinate and develop a uniform set of laws.

States serve an important role in the investigation and enforcement of securities laws. In 2016, the states conducted 4,341 investigations and brought 2,017 enforcement actions.[37] In total, the states obtained $231 million in restitution for investors.[38] Importantly, the vast majority of the matters investigated and brought by the states were not matters that also were being pursued by the SEC.

While the underlying idea of H.R. 5037 represents a thoughtful and encouraging effort toward achieving greater uniformity and predictability in the state and federal enforcement of securities laws, I have four primary concerns with the bill. First, the bill would prohibit state regulators from pursuing civil violations of law, no matter the size. At present, state regulators are often on the front line pursuing microcap fraud cases, much of which the SEC is not pursuing as a result of efforts by the states. Indeed, allowing state regulators to bring these localized enforcement actions conserves the SEC's resources and often serves as the most efficient avenue to pursue these cases. Second, the bill would place a tremendous burden on the SEC to pursue all actions involving publicly-traded companies that previously were pursued by the states. This would necessitate expanding the SEC's budget and resources. Third, the legislation might have the intended consequence of causing some state regulators to convert what otherwise might have been brought as a civil fraud case to a criminal case in order to avoid federal preemption. Fourth and finally, the legislation appears to preempt only actions against issuers, while presumably allowing states to pursue related matters against underwriters, officers, and directors. Any preemption should cover all related matters.

As an alternative, the Committee may wish to consider preempting state law with a uniform federal standard for securities fraud, but to allow enforcement by both the states and the federal government with a "first in time" approach to avoid duplicate enforcement actions.[39] A single federal standard would lower the uncertainty of having to deal with multiple state standards and address the root concern with certain over-expansive state laws. If the Committee wishes to pursue the current legislation, it may wish to consider preempting only cases involving publicly-traded companies above a certain market capitalization amount to alleviate the potential overburdening of the SEC.

CONCLUSION

For the most part the SEC does an excellent job adhering to and fulfilling its mission. However, in furtherance of its mission to protect investors and facilitate capital formation, the SEC should adopt clear standards and be more transparent with respect to its approach to penalties, disgorgement, and administrative proceedings.

Congress can help improve the SEC's enforcement program. The bills that I have commented on today represent encouraging and good faith efforts to do just that. But Congress should act

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[37] *See NASAA 2017 Enforcement Report*, NASAA (Sept. 26, 2017), *available at* http://nasaa.cdn.s3.amazonaws.com/wp-content/uploads/2017/09/2017-Enforcement-Report-Based-on-2016-Data.pdf.

[38] *Id.*

[39] In developing a uniform standard, the drafters should be wary about creating any new causes of action.

cautiously and seek to strike an appropriate balance between administrative proceedings and federal court actions and between federal securities law enforcement and state securities law enforcement. H.R. 2128 helpfully seeks to address the important need for due process safeguards in SEC enforcement proceedings. But it potentially goes too far with respect to administrative proceedings and could result in overburdening the federal courts. H.R. 5037 helpfully seeks to clarify the division of enforcement authority between the federal and state governments. But it potentially eliminates useful functions of state securities enforcement regimes that are complementary to the SEC. I am hopeful that as Congress deliberates over these bills it will find the appropriate balance.

Thank you. I would be pleased to answer any questions.

APPENDIX 1

CENTER FOR FINANCIAL STABILITY
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Improving the SEC's Enforcement Program: A Ten-Point Blueprint for Reform

Bradley J. Bondi

August 17, 2017

With any new Presidential administration comes a new Commission at the Securities and Exchange Commission ("SEC") and an opportunity to evaluate the regulatory priorities. The Division of Enforcement is a key component of the SEC's regulatory program and has enormous influence on the behavior of investors and other market participants. Since its creation, the Division of Enforcement has grown in size and power as Congress has authorized the SEC to enforce additional laws and to seek additional remedies. At the same time, the SEC's enforcement practices have shifted in response to various factors, including financial crises, significant financial frauds, and Congress's legislative priorities.

With the transition to a new Commission, the SEC should take the opportunity to review, evaluate and improve its enforcement program. In light of the SEC's mission to protect investors; maintain fair, orderly, and efficient markets; and facilitate capital formation, the SEC should take steps to ensure it is allocating resources properly, striking an appropriate balance between regulation and enforcement, and protecting the rights of investors and industry participants. Below is a brief, ten-point summary of suggestions for improving the SEC's enforcement program.

1. Establish Clear Enforcement Priorities Focused on Intentional Violations by Individuals Who Commit Significant Frauds and Refer Criminal Matters to Criminal Agencies

The SEC should prioritize seeking out and penalizing those individuals, such as Bernie Madoff and Allen Stanford, who commit intentional wrongdoing through schemes designed to defraud investors. The "broken windows" approach, promoted by then-SEC Chair Mary Jo White, disproportionately emphasizes small and sometimes unintentional securities law violations in the hope that doing so will deter more significant violations. But a practical consequence of this is the disproportionate expenditure of the SEC's limited resources on small and unintentional violations, often against well-intentioned executives and chief compliance officers for negligence-based violations or honest mistakes. As a result, more significant and intentional violations, such as Ponzi schemes, boiler rooms, and bucket shops, may go undetected, unpunished, and undeterred.

The SEC should coordinate more closely with other federal and state agencies, including the Department of Justice ("DOJ") and State Attorneys General, to pursue and bring to justice Ponzi schemers and other fraudulent schemers. In the past, competition between the SEC and DOJ has prevented the most severe charges from being levied against individuals as the SEC Staff has been reluctant to "lose" a case to the DOJ by involving the DOJ in the investigation. Under

an improved system, the SEC would consult the DOJ and the relevant State Attorney General during the SEC's investigation and not hesitate to refer matters where federal or state criminal charges clearly are warranted.

2. Reconsider the "Broken Windows" Policy

The SEC should reconsider its broad application of the broken windows policy for enforcing the securities laws. The broken windows approach, which is rooted in criminal law, is based on the idea that law enforcement's refusal to tolerate minor violations of the law will aid in preventing major violations of the law. While the broken windows philosophy may have worked well for law enforcement concerned with public safety, it is not an appropriate approach to securities regulation. Petty street crime and major crime share a common element: criminal intent. In contrast, not everyone who violates the securities laws *intends* to do so. For example, an investment adviser who pores over the lengthy, detailed, and complicated regulations applicable to her industry may, despite her best efforts, inadvertently violate a rule. That is much different than the state of mind of a Ponzi schemer who intentionally defrauds individuals out of their life savings. Yet a broken windows approach suggests taking a hard line to enforcement in each case and ignores the mental state of the alleged violator. The SEC should consider abandoning this policy as it applies to unintentional violations of securities law and instead focus its resources on identifying and punishing intentional misconduct while providing useful regulatory guidance to those in the industry who are earnestly trying to comply with the law.

3. Place Less Emphasis on Enforcement Statistics and Penalty Amounts

The SEC should develop and use better metrics for measuring success. Last October, at the end of its 2016 fiscal year, the SEC issued a press release announcing that the 868 enforcement actions it filed in 2016 were a "new single year high."[1] It also announced that it had obtained approximately $4 billion in disgorgement and penalties. This was the third year in a row that the SEC announced a record number of enforcement actions.[2]

The number of enforcement actions and the amount of disgorgement and penalties purportedly demonstrate the success of the SEC's enforcement program. But if the aim of the program is to protect investors and *deter* wrongdoing, then the high numbers of enforcement actions and penalties are, at best, a poor way to measure that protection and deterrence. At

[1] *See* Press Release, SEC, *SEC Announces Enforcement Results for FY 2016* (Oct. 11, 2016), Release No. 2016-212, *available at* https://www.sec.gov/news/pressrelease/2016-212.html.
[2] *See* Press Release, SEC, *SEC's FY 2014 Enforcement Actions Span Securities Industry and Include First-Ever Cases* (Oct. 16, 2014), Release No. 2014-230, *available at* https://www.sec.gov/news/press-release/2014-230 ("In the fiscal year that ended in September, the SEC filed a record 755 enforcement actions . . . ."); Press Release, SEC, *SEC Announces Enforcement Results for FY 2015* (Oct. 22, 2015), Release No. 2015-245, *available at* https://www.sec.gov/news/pressrelease/2015-245.html ("In the fiscal year that ended in September, the SEC filed 807 enforcement actions . . . .").

worst, record numbers are an indication that securities law violations are increasing in number and severity. After all, few would consider a local police force successful in deterring crime if it announced record numbers of arrests year after year. In addition, the SEC's focus on achieving record numbers could have the practical effect of disproportionately allocating scarce resources to pursuing a large volume of minor or unintentional violations involving large companies (and thus leading to large penalty figures) at the expense of pursuing fewer but more complicated cases involving intentional wrongdoing such as Ponzi schemes, boiler rooms, and bucket shops, which have a disproportionately negative impact on retail investors. A focus on enforcement statistics also may lead the SEC to develop and pursue theories of liability that exceed the bounds of the SEC's congressionally-authorized enforcement power.[3]

The SEC's past emphasis on obtaining large penalties against corporations, coupled with press releases that identify its Enforcement Staff attorneys by name,[4] creates incentives that may be misaligned with the core mission of the SEC of protecting investors, namely the innocent shareholders who must bear the cost of a corporate monetary penalty.

4. Update the Benefits for Assisting the SEC as Articulated in the Seaboard Report

Since 2001, the SEC has had a written policy, often known as the Seaboard Report[5], for determining whether, and how much, to credit self-policing, self-reporting, remediation, and cooperation. When it issued the Seaboard Report, the SEC stated that such credit could range from the extraordinary step of taking no enforcement action to bringing reduced charges, seeking lighter sanctions, or including mitigating language in documents used to announce and resolve enforcement actions.

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[3] This so-called "regulation by enforcement" is contrary to the SEC's rulemaking authority and violates fundamental principles of due process that require regulatory agencies to provide a notice and comment period for new or modified rules. *See* Bradley J. Bondi, *Dangerous Liaisons: Collective Scienter in SEC Enforcement Actions*, 6 N.Y.U. J. Law & Bus. 1, 16 n.64 (2009) (quoting then-Commissioner Paul Atkins, who said, "[i]f we are to enforce the rule of law, we must follow the rule of law in our approach"); *see also Theodore W. Urban*, SEC Administrative Proceeding File No. 3-13655, Initial Decision Release No. 402 (September 8, 2010), *dismissed* by Exchange Act Release No. 66359 (January 26, 2012).

[4] Similarly, the SEC should remove the names of Enforcement Staff from SEC releases. The University of Southern California famously does not put players' names on the back of its football jerseys. The purported reason is to emphasize the achievement of the team and not any individual player. The SEC should take a similar approach to its releases announcing enforcement actions. Currently, these releases identify the individual attorneys who supervised, led, and assisted in the investigation. This individual recognition can incentivize the Staff to pursue headline-grabbing enforcement actions and sanctions, such as a record penalty amount. Former Enforcement Staff members often tout these high-profile actions on their law firm profiles after they leave government service. The incentive to seek recognition for bringing a high-profile enforcement action can cloud the Staff's focus when determining, for example, whether to commence an investigation against a high-profile company or individual, the scope of such an investigation, the appropriate time to close such an investigation, and the size of the penalty to be imposed if a securities law violation has occurred. The mission of the SEC would be better served by removing individual incentives to seek public recognition.

[5] Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934 and Commission Statement on the Relationship of Cooperation to Agency Enforcement Decisions, Exchange Act Rel. No. 44969 (Oct. 23, 2001), *available at* https://www.sec.gov/litigation/investreport/34-44969.htm.

For the SEC, the policy helps uncover and prevent activity harmful to investors that might otherwise go unreported. But companies likely will come forward only to the extent the cooperation policy provides predictable benefits for alerting the SEC to concerns. Some commentators have observed that, under the Seaboard framework, companies and their counsel are unable to assess the implication of self-reporting, which has resulted in a hesitation to take steps that ultimately would benefit the SEC and investors. Others have observed that the "carrots," which the SEC established to encourage cooperation and conserve government and shareholder resources, have become smaller or less certain while the "stick" for failing to cooperate has gotten larger.

The SEC should revisit and update the Seaboard Report to clarify (1) the benefits available for companies that self-police, self-report, cooperate with the SEC, and remediate misconduct and (2) how companies can qualify to receive these benefits, leading to improved investor protection.

5. Evaluate and Clearly Articulate the Reasons for Imposing a Monetary Penalty on Shareholders

In 1990, Congress passed the Remedies Act, which enabled the SEC to seek monetary penalties. At the time, the Senate Committee on Banking, Housing, and Urban Affairs cautioned that the costs of monetary penalties might be passed on to shareholders, and the Committee expected that the SEC would seek a monetary penalty only when the securities law violation had resulted in an improper benefit to shareholders.[6] In cases in which shareholders are the principal victims of the violations, the Committee expected that the SEC, when appropriate, would seek penalties from the individual offenders acting for a corporate issuer.

From 1990 to 2002, the SEC imposed penalties sparingly. The SEC's April 2002 case against Xerox Corporation marked a shift to seeking penalties more frequently and in higher amounts. The $10 million penalty imposed on Xerox for financial fraud was an unprecedented amount at the time and about three times larger than the previous record amount for a similar case.[7] Since the Xerox case, the SEC has levied many civil penalties of $10 million or larger. In 2003, the year after the Xerox case, the total amount of monetary penalties (excluding disgorgement) imposed by the SEC on companies increased to approximately $1.1 billion from approximately $101 million in the prior year.[8]

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[6] S. Rep. No. 101-337, at 17 (1990).

[7] *See* Press Release, SEC, *Xerox Settles SEC Enforcement Action Charging Company With Fraud* (Apr. 11, 2002), Release No. 2002-52, *available at* https://www.sec.gov/news/headlines/xeroxsettles.htm; *see also* James Bandler and Mark Maremont, *Xerox Will Pay $10 Million Penalty to Settle SEC Accounting Charges*, Wall St. J. (Apr. 2, 2002), *available at* https://www.wsj.com/articles/SB1017682255642049000.

[8] *See SEC 2002 Annual Report*, at 1 (Jan. 1, 2002,) *available at* https://www.sec.gov/pdf/annrep02/ar02full.pdf ("Civil penalties ordered in SEC proceedings totaled approximately $101 million."); *SEC 2003 Annual Report*, at 15 (Jan. 1, 2003), *available at* https://www.sec.gov/pdf/annrep03/ar03full.pdf ("Obtained orders in SEC judicial and administrative proceedings requiring securities violators . . . to pay penalties of approximately $1.1 billion.").

The total annual penalties in fiscal years 2004 and 2005 were approximately $1.2 billion and $1.5 billion, respectively.[9] Then, in January 2006, a unanimous Commission issued the Statement of the Securities and Exchange Commission Concerning Financial Penalties, often known simply as the SEC's "Penalty Statement."[10] The purpose of the Penalty Statement was to provide the maximum possible degree of clarity, consistency, and predictability in explaining how the SEC exercises its corporate penalty authority. In the Penalty Statement, the SEC identified two principal considerations for determining whether a monetary penalty against a company is appropriate: (1) the presence or absence of a direct benefit to the company as a result of the securities law violation and (2) the degree to which the penalty will recompense or further harm the injured shareholders. After the Penalty Statement, annual monetary penalty amounts dropped significantly. In 2008, for example, the SEC imposed approximately $256 million in monetary penalties.[11]

In recent years, some commissioners have disavowed the Penalty Statement. In September 2013, then-Chair Mary Jo White observed that the Penalty Statement is non-binding and, while recognizing that it sets forth useful considerations, stated that each commissioner has discretion within his or her statutory authority to reach a conclusion on whether a penalty is appropriate and how high it should be.[12] A few weeks later, then-Commissioner Luis Aguilar agreed with Chair White's assessment and stated that the Penalty Statement "constituted a fatally flawed approach to assessing the appropriateness of corporate penalties" because it focused on whether the company had benefited from the misconduct and shareholder harm instead of punishing misconduct and deterring future violations.[13] Since 2013, the average annual amount of monetary penalties (excluding disgorgement) imposed has been approximately $1.25 billion.[14] The disavowal of the Penalty Statement creates unpredictability regarding the criteria the SEC considers when determining whether to impose a penalty. For an agency that demands from companies that their disclosures be transparent, the SEC historically has offered little transparency of its own.

[9] *See United States Securities and Exchange Commission 2004 Enforcement and Market Data, available at* https://www.sec.gov/files/secpar04stats%2C0.pdf; *Select SEC and Market Data Fiscal 2005, available at* https://www.sec.gov/files/secstats2005%2C0.pdf.

[10] *See* Press Release, SEC, *Statement of the Securities and Exchange Commission Concerning Financial Penalties* (Jan. 4, 2006), Release No. 2006-4, *available at* https://www.sec.gov/news/press/2006-4.htm.

[11] *See Select SEC and Market Data Fiscal 2008, available at* https://www.sec.gov/files/secstats2008.pdf.

[12] Mary Jo White, Chair, SEC, Remarks before the Council of Institutional Investors Fall Conference: *Deploying the Full Enforcement Arsenal* (Sept. 26, 2013), *available at* http://www.sec.gov/News/Speech/Detail/Speech/1370539841202.

[13] Luis A. Aguilar, Commissioner, SEC, Remarks before the 20th Annual Securities Litigation and Regulatory Enforcement Seminar: *A Stronger Enforcement Program to Enhance Investor Protection* (Oct. 25, 2013), *available at* https://www.sec.gov/news/speech/2013-spch102513laa.

[14] The penalty amount was $1.167 billion in 2013, $1.378 billion in 2014, $1.175 billion in 2015, and $1.273 billion in 2016. *See Select SEC and Market Data Fiscal 2013, available at* https://www.sec.gov/files/secstats2013.pdf; *Select SEC and Market Data Fiscal 2014, available at* https://www.sec.gov/files/secstats2014.pdf; *Select SEC and Market Data Fiscal 2015, available at* https://www.sec.gov/files/secstats2015.pdf; and *Select SEC and Market Data Fiscal 2016, available at* https://www.sec.gov/files/2017-03/secstats2016.pdf.

The amount of the monetary penalty is also unpredictable because the SEC in recent years has not articulated criteria or metrics for calculating how much it will penalize a company. This unpredictability negatively impacts companies. For example, the inability to predict the size of a potential penalty hinders the market for mergers and acquisitions because successor companies cannot accurately forecast their regulatory exposure.

This lack of transparency and predictability with respect to monetary penalties is contrary to the SEC's mission to maintain fair, orderly, and efficient markets and facilitate capital formation. In July 1934, Joseph P. Kennedy, the first chairman of the SEC, stated there would be no concealed punishment for businesses subject to the SEC's jurisdiction.[15] In that spirit of transparency, the SEC should provide clear, principled guidance regarding when it will seek a penalty and how it will calculate the amount.

6. Restore Credibility to Administrative Proceedings

The SEC has the authority to pursue enforcement actions in administrative proceedings over which an administrative law judge appointed by the SEC presides. Historically, only registered individuals and entities such as broker-dealers and investment advisers were subject to enforcement actions in administrative proceedings. By registering with the SEC, these entities effectively agreed to be subject to the SEC's administrative enforcement jurisdiction in a manner analogous to an attorney who agrees to be subject to the rules of the bar of the state where he or she is licensed to practice.

In 1990, the Remedies Act authorized the SEC to impose monetary penalties on regulated entities in administrative proceedings. It also authorized the SEC to pursue remedial relief such as "cease-and-desist" and disgorgement orders against non-regulated entities, but it did not authorize the SEC to seek monetary penalties against issuers in administrative proceedings. The concern among members of Congress and internally at the SEC was that if the same remedies against issuers were available to the SEC under both judicial and administrative proceedings, then the SEC might be perceived to have an incentive to conduct more enforcement actions through its own administrative proceedings, rather than before a federal district court judge.[16] The Dodd-Frank Act of 2010 removed this important distinction by authorizing the SEC to impose monetary penalties against issuers in administrative proceedings.

In recent years, several respondents have challenged the constitutionality of the SEC's administrative proceedings by filing lawsuits in federal district court arguing that administrative proceedings threaten to deprive them of liberty and property without due process and that the SEC had unfairly singled them out in administrative proceedings in violation of the equal protection clause. To date, most courts have rejected these arguments. Nevertheless, some

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[15] Joseph P. Kennedy, Chairman, SEC, Remarks before the National Press Club (July 15, 1934) at 3, *available at* https://www.sec.gov/news/speech/1934/072534kennedy.pdf.

[16] Paul S. Atkins & Bradley J. Bondi, *Evaluating the Mission: A Critical Review of the History and Evolution of the SEC Enforcement Program*, 13 Fordham J. Corp. & Fin. L. at 393-94.

market participants continue to believe that administrative proceedings are unfair because respondents in administrative proceedings do not enjoy all of the procedural safeguards that are afforded to defendants in federal district court, especially with respect to depositions, document discovery, rules of evidence, and the ability to confront accusers.

This perceived unfairness may be due to the fact that the SEC wins more frequently in administrative proceedings than in district court. In 2015, *The Wall Street Journal* reported that from October 2010 through March 2015, the SEC won 90% of its administrative proceedings, while in the same period the SEC prevailed in only 69% of the cases it brought in federal district court.[17] Further, a 2016 study suggested that, after Dodd-Frank, the SEC has shifted weaker cases from district court to administrative proceedings or has brought actions as administrative proceedings that it would not have brought at all before Dodd-Frank.[18]

In July 2016, the SEC adopted amendments updating its rules of practice governing administrative proceedings.[19] Most importantly, the amended rules extend the length of the prehearing period to allow respondents more time to prepare for administrative hearings; allow for depositions in complex cases (not just when witnesses are unavailable to testify at the hearing); and permit the exclusion of "unreliable" evidence. While the amendments provide new safeguards to respondents, they fall short of the procedural safeguards afforded to defendants in federal district court. And they do not establish criteria for determining when the SEC will bring a case in an administrative proceeding rather than in federal court.

The SEC could enhance the perception of fairness of its administrative proceedings by adopting additional procedural safeguards that more closely align the proceedings with those in federal district court and by clearly articulating the criteria it uses for determining whether to bring a case in an administrative proceeding instead of in federal district court.

7. Establish an Advisory Committee To Evaluate the Enforcement Program

In July 2008, then-Commissioner Paul Atkins and I called for an independent advisory committee to evaluate the SEC's enforcement program.[20] Such an advisory committee could be useful at this stage to the SEC. In the spirit of the Wells Committee convened by Chairman William Casey in 1972, the new advisory committee could conduct an independent review of the SEC's enforcement program and recommend any changes needed to modernize enforcement practices. The charge to this advisory committee should be: "What changes

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[17] Jean Eaglesham, *SEC Wins With In-House Judges*, Wall St. J. (May 6, 2015), *available at* http://www.wsj.com/articles/sec-wins-with-in-house-judges-1430965803.

[18] Adam C. Pritchard & Stephen Choi, *The SEC's Shift to Administrative Proceedings: An Empirical Assessment* (2016), Law & Economics Working Papers, Paper 119, *available at* http://repository.law.umich.edu/cgi/viewcontent.cgi?article=1233&context=law_econ_current.

[19] *See* Press Release, SEC, *SEC Adopts Amendments to Rules of Practice for Administrative Proceedings* (July 13, 2016), Release No. 2016-142, *available at* https://www.sec.gov/news/pressrelease/2016-142.html.

[20] Paul S. Atkins & Bradley J. Bondi, *Needed: Independent Panel to Evaluate SEC Enforcement Program*, Forbes (July 7, 2008), *available at* https://www.forbes.com/2008/07/05/atkins-bondi-sec-oped-cx_pabb_0707atkins.html.

should be made to make the SEC's enforcement program more effective in its efforts to deter misconduct and to encourage compliance with federal securities laws, while keeping with the SEC's stated mission of protecting investors; maintaining fair, orderly, and efficient markets; and facilitating capital formation?" As the Wells Committee did, this advisory committee also could examine whether the SEC is taking appropriate steps to protect the rights of respondents and to provide appropriate due process. The advisory committee could be composed of a diverse cross-section of private-practice attorneys, former SEC officials, economists, and academicians – each bringing to the table a unique perspective.

8. Rescind the Delegation of Formal Order Authority

Historically, the Commission approved formal orders of investigation after the Enforcement Staff prepared a memorandum for the Commission summarizing the facts known at the time and the possible securities law violations. The historical process had at least three important benefits.21 First, under the prior system, before seeking a formal order the Enforcement Staff often would engage in informal detective work. This frequently involved seeking information, on a voluntary basis, from the entity under investigation. This informal work sometimes provided the Enforcement Staff assurance that there had been no wrongdoing and allowed the Staff and the entity to forego a more elaborate and costly investigation. Second, under the prior system the Commission was involved in the early stages of enforcement cases, allowing it to provide guidance to the Enforcement Staff prior to the time that the Staff was authorized to compel testimony and issue wide-ranging document subpoenas. The Commission's approval of a formal order also provided an important check on the Enforcement Staff's investigative power and may have prevented questionable investigations. Third, under the prior system, the fact that the Enforcement Staff had opened an investigation was raised to the highest levels of the SEC, including to the Commission, senior officers in the Division of Enforcement, directors of the other divisions, as well as anyone who attended the closed Commission meeting where the matter was discussed. This allowed enhanced communication and expertise to be incorporated into the early decision-making and formulation of the investigative plan.

In 2009, the Commission delegated authority to the Director of Enforcement to open formal orders of investigation and issue subpoenas. The Director then subdelegated this authority to Regional Directors, Associate Directors, and Specialized Unit Chiefs. This delegation reduced the Enforcement Staff's incentive to conduct informal, initial detective work, removed the beneficial early involvement of the Commission, and eliminated a critical opportunity for the Enforcement Staff to communicate and cooperate regarding investigations.

In February 2017, the Commission rescinded the subdelegation of formal order authority. Now, requests for formal orders will be approved by the Director of Enforcement. The Commission should go one step further and rescind the delegation of formal order authority entirely,

[21] For additional information, *see* Bradley J. Bondi, *A Questionable Delegation of Authority: Did the SEC Go Too Far When It Delegated Authority to the Division of Enforcement to Initiate an Investigation?* Center for Financial Stability, (Sept. 20, 2016), *available at* http://www.centerforfinancialstability.org/research/Bondi_092016.pdf.

thereby restoring the benefits associated with encouraging the Enforcement Staff to conduct investigations informally, involving the Commission early in the investigative process, and communicating and cooperating with other Enforcement Staff.

9. Re-evaluate the SEC's Admissions Policy

The SEC should re-evaluate how it determines whether to require a party to admit fault as a condition of settlement. Since the establishment of the Division of Enforcement in 1972, the SEC routinely has allowed parties to settle enforcement actions without admitting fault.[22] The neither-admit-nor-deny concept grew out of the practical reality that the Enforcement Staff would be more likely to obtain a settlement and thus conserve SEC resources if the Staff did not insist on an admission of wrongdoing, which can have damaging collateral consequences.

In 2013, the SEC modified this practice by announcing that it would seek more admissions of wrongdoing from individuals and entities as a condition of settling enforcement cases. And the Director of Enforcement at the time stated that the SEC would not consider the collateral consequences to an individual or entity when determining whether to seek an admission. This policy created four primary concerns. First, it marked a fundamental shift in emphasis from protecting investors to attempting to punish wrongdoers, which may be at odds with the SEC's goals of protecting investors and facilitating capital formation. An admission of wrongdoing may result in additional harm to shareholders by exposing a company to costly shareholder litigation or depriving it of the ability to obtain government contracts. Second, the admissions policy lacks clear guidance and fails to consider the collateral consequences to the shareholders of the alleged wrongdoer company. This makes the admissions policy susceptible to subjective application without considering the individualized conduct of the responding party. Third, the admissions policy is susceptible to being used directly or indirectly as a negotiating tool by which the SEC may seek a higher penalty in exchange for not seeking an admission. For example, the Enforcement Staff may make overtures that, if a party were to agree to a higher penalty, the Staff would not push for an admission of wrongdoing. Fourth, pursuing admissions of wrongdoing consumes valuable SEC time and resources.

One suggestion that would allow the policy to remain intact while taking into consideration the above observations would be to remove any discretion from the investigative staff and place that discretion into the hands of the trial unit to evaluate whether the evidence is so strong that it would risk taking the matter to trial. Another possible solution would be for the Enforcement Staff to obtain from the Commission at the start of settlement negotiations a determination regarding whether the Commission would insist on an admission of wrongdoing.

That course would enable the parties to negotiate under the same understanding of whether an admission is, in fact, likely to be sought.

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[22] For additional information, *see* Bradley J. Bondi, *An Evaluation of the SEC's Admissions Policy*, Center for Financial Stability (July 7, 2016), *available at* http://www.centerforfinancialstability.org/research/Bondi_070716.pdf.

10. Expand the Division of Enforcement's Trial Unit and Integrate the Trial Attorneys into the Investigative Units

Assuming the SEC focuses more on intentional wrongdoing by individuals, as recommended in Point 1 above, the SEC's trial load will increase. The SEC should increase the number of attorneys in its trial unit to meet the increased caseload.

At the same time the SEC expands the trial unit, SEC trial unit attorneys should be more fully integrated into the investigative units of the Division of Enforcement. During her tenure, Chair White made some progress in this regard after the SEC suffered a series of defeats at trial, but more integration can be done.[23] Structurally, the Division of Enforcement's trial attorneys are separate from the investigative attorneys. This antiquated organizational structure has resulted in inefficiencies and loss of information that have impacted the Division of Enforcement's effectiveness. With this bifurcated structure, enforcement actions run the risk of proceeding to trial without sufficient "trial" evidence obtained during the investigation. By more fully integrating trial attorneys into the investigative units, the attorneys tasked with proving securities law violations at trial will have a greater role in charging decisions and gathering evidence of violations early in investigations.[24] This likely will strengthen the development of admissible evidence during the investigation and result in stronger enforcement actions. In addition, trial attorneys provide an important check on the investigative staff to ensure that the elements of a securities law violation are met prior to initiating a lawsuit or settling an enforcement action.

[23] *See* Jean Eaglesham, *SEC Takes Steps to Stem Courtroom Defeats*, Wall St. J. (Feb. 13, 2014), *available at* https://www.wsj.com/articles/sec-takes-steps-to-stem-courtroom-defeats-1392336091.

[24] *See also* Troy A. Paredes, Commissioner, SEC, Remarks at the 2009 Southeastern Securities Conference (Mar. 19, 2009), *available at* https://www.sec.gov/news/speech/2009/spch031909tap.htm.

APPENDIX 2

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Evaluating the Mission: A Critical Review of the History and Evolution of the SEC Enforcement Program

Paul S. Atkins* Bradley J. Bondi†

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ARTICLES

EVALUATING THE MISSION: A CRITICAL REVIEW OF THE HISTORY AND EVOLUTION OF THE SEC ENFORCEMENT PROGRAM

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The United States Securities and Exchange Commission (the "SEC" or "Commission") is nearing its seventy-fifth anniversary, a milestone that will be marked by reflection on the past and contemplation of the future.[1] During this time of introspection, the Commission should take the opportunity to examine the manner in which it has reacted to the growth and changes in its regulatory authority and in the capital markets. One constant throughout its history has been the SEC's need to balance competing interests. The SEC's stated mission reflects this tension. Today, that mission is composed of three objectives: "to protect investors; maintain fair, orderly, and efficient markets; and facilitate capital formation."[2]

Historically, the SEC's mission has focused on investor protection. As the SEC and its regulatory powers have grown in response to the ever more complex and international financial services markets, the seemingly straightforward mission of investor protection has become more intricate and multidimensional, prompting questions such as, "Who are the investors that should be protected?" and "How should they be protected?" After all, investors range in sophistication, size, activity, goals, needs, and other attributes. They include traditional individual and institutional investors in the securities markets, traders, and foreign entities seeking to invest in the United States.[3] Choices that the SEC makes in its rulemaking and other activities can favor or disfavor one group of investors over another. A rule beneficial for one investor may be detrimental to another, depending on an investor's investment strategy or changing circumstances. Indeed, because investors ultimately pay for inefficiencies arising from regulatory mandates

1. The SEC was created on July 2, 1934 during a period of heated debate over the country's economic turmoil. That day was literally heated: 93 degrees Fahrenheit, to be exact. The Federal Trade Commission met in an unairconditioned, temporary building in Washington, D.C., located on the present site of the Federal Reserve Building, to vote the SEC into existence pursuant to the Securities Exchange Act of 1934. Frank V. Fowlkes, *Agency Report/Congress Prods SEC To Get Firmer Grip on Nation's Securities Industry*, NATIONAL JOURNAL, Feb. 20, 1971, at 385.

2. U.S. SEC. & EXCH. COMM'N, 2006 PERFORMANCE AND ACCOUNTABILITY REPORT 5, *available at* http://www.sec.gov/about/secpar/secpar2006.pdf [hereinafter 2006 REPORT].

3. One group of foreign investors, sovereign wealth funds, has received much attention by the press in recent years. Sovereign wealth funds are estimated currently at $2.5 trillion and expected to grow to $10 to 15 trillion by 2015. Robert M. Kimmitt, *Public Footprints in Private Markets*, FOREIGN AFFAIRS, Jan./Feb. 2008, at 1-2, *available at* http://www.foreignaffairs.org/20080101faessay87109/robert-m-kimmitt/public-footprints-in-private-markets.html.

through direct or indirect costs, diminished returns, and reduced choice, the rules must be made with careful analysis and deliberation. Congress acknowledged this potential harm in 1996 when it revised the SEC's statutory mandate to expressly require the SEC "to consider or determine whether an action is necessary or appropriate in the public interest" and to "consider, in addition to the protection of investors, whether the action will promote efficiency, competition, and capital formation."[4]

This multidimensional aspect of investor protection applies not only to rulemaking, but also to enforcement matters. Each enforcement matter involves in some degree a balancing of competing interests, some at a pragmatic, case-specific level and others at a higher policy level. For example, in distributing money recovered in an enforcement action against a bankrupt company, the SEC conceivably could decline a distribution to all investors and instead choose a distribution that favors one class of investor over another, such as common stockholders over senior debtholders, which by virtue of their preferred position may have had greater recovery per dollar invested than did common stockholders, but still fell short of their desired recovery. In its overall enforcement program, the SEC's decisions about resource allocation, charges to be brought, and relief to be sought may enhance the protection of one group of investors at the potential cost of another. Advancing a novel legal theory may protect the group of investors in a particular case, but have unintended detrimental consequences to investors as a whole.[5]

The enforcement decisions of the SEC must be guided by the multidimensional nature of the SEC's mission of protecting investors; maintaining fair, orderly, and efficient markets; and facilitating capital formation. The difficult choices of balancing conflicting interests must be guided by the transcendent principles of predictability, fairness, and transparency, culminating in the rule of law. These principles are the defining characteristics of the U.S. markets.

In order to assess the SEC's application of these principles to its enforcement decisions, this Article investigates the shifting focus of the SEC's enforcement program from its inception to the present day. The Article explores the development and usage of the SEC's statutory enforcement powers in the context of due process and fairness. Finally,

4. Securities Exchange Act of 1934 § 3(f), 15 U.S.C. § 78c(f) (2006).

5. *See, e.g.*, *Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc.*, – U.S. –, 128 S.Ct. 761 (2008).

the Article calls for the Commission to appoint an independent advisory committee to conduct a detailed review and evaluation of the policies and procedures of the enforcement program in light of the changes in the SEC's statutory authority over the course of the last three decades.

THE ORGANIZATION OF THE SEC

The SEC is governed by five commissioners, all of whom are appointed by the President with the advice and consent of the Senate.[6] One of the commissioners is designated as chairman by an executive order of the President.[7] To ensure bipartisanship, Congress specified that only three of the five commissioners can belong to the same political party.[8]

The SEC is organized into four primary operating divisions and nineteen "offices," or special service units, each of which is headquartered in Washington, D.C. The SEC's staff, numbering approximately 3500, is located in Washington, D.C. and throughout its eleven regional offices.[9] The SEC's largest division—and the focus of

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6. Securities Exchange Act of 1934 § 4, 15 U.S.C. § 78d (2006).

7. *See* Reorganization Plan No. 10 of 1950, 15 Fed. Reg. 3175 (1950), *reprinted in* 5 U.S.C. 901 *et seq.* (2006), *and in* 64 Stat. 1265 (1950); *see also* 2006 REPORT, *supra* note 2, at 7. This power of the President to designate (or remove) the chairman by executive order does not apply to similar agencies. For example, the chairmen of the Board of Governors of the Federal Reserve and the Commodity Futures Trading Commission are separately nominated and confirmed to their positions as chairmen, although they have separate terms as governor or commissioner, respectively. *See* 12 U.S.C. § 242 (2008) and 7 U.S.C. § 2(a)(2)(B) (2008).

8. Securities Exchange Act of 1934 § 4. The first five commissioners were Democrats Joseph P. Kennedy, James M. Landis and Ferdinand Pecora, and Republicans George C. Mathews and Robert E. Healy. The commissioners elected Joseph P. Kennedy to serve as the first chairman. *See* Fowlkes, *supra* note 1, at 385.

9. *See* U.S. SEC. & EXCH. COMM'N, 2007 PERFORMANCE AND ACCOUNTABILITY REPORT 2, *available at* http://www.sec.gov/about/secpar/secpar2007.pdf [hereinafter 2007 REPORT]. The SEC has grown tremendously since its inception. In 1942, the SEC had a staff of 1700 employees. In order to make room for wartime agencies, the SEC was forced to relocate to Philadelphia in 1942. By the time it returned to Washington in 1948, the staff had decreased to 1150. By 1955, there were only 666 employees. Fowlkes, *supra* note 1, at 383.

this Article—is the Division of Enforcement, which has more than 1100 employees, and has grown by more than 40% in the past fifteen years.[10]

THE SEC'S AUTHORITY UNDER THE FEDERAL SECURITIES LAWS

Today, the SEC is charged with administering the Securities Act of 1933,[11] the Securities Exchange Act of 1934,[12] the Trust Indenture Act of 1939,[13] the Investment Company Act of 1940,[14] the Investment Advisers Act of 1940,[15] and certain provisions of the Sarbanes-Oxley Act,[16] some of which fall outside of the earlier securities laws.[17]

The Commission is vested with statutory authority to conduct any investigation it deems necessary to determine whether a person has violated federal securities laws and the rules and regulations

10. The Enforcement Division is currently the largest of the divisions and offices of the SEC, with more than 1100 personnel. *See* Christopher Cox, Chairman, Opening Remarks to the Practising Law Institute's SEC Speaks Series (Feb. 9, 2007), *available at* http://www.sec.gov/news/speech/2007/spch020907cc.htm. According to information provided by the SEC to Congress, the total number of employees in the Enforcement Division at the end of fiscal year 2008 is expected to be 1124—up from 781 in 1992.

11. Securities Act of 1933, 15 U.S.C. §§ 77a-77aa (2006).

12. Securities Exchange Act of 1934, 15 U.S.C. §§ 78a-78nn (2006); *see generally* Securities and Exchange Act of 1934, http://www.sec.gov/about/laws.shtml#secexact19 34 (last visited May 8, 2008) (discussing some of the many powers granted by the 1934 Act, including regulating corporate reporting, proxy solicitations and tender offers).

13. Trust Indenture Act of 1939, 15 U.S.C. §§ 77aaa-77bbbb (2006) (focusing on debt securities such as bonds, debentures, and notes that are offered for public sale).

14. Investment Company Act of 1940, 15 U.S.C. §§ 80a-1 to a-64 (2006) (regulating the organization of companies, including mutual funds, that engage primarily in investing, reinvesting, and trading in securities, and whose own securities are offered to the investing public).

15. Investment Advisers Act of 1940, 15 U.S.C. §§ 80b-1 to b-21 (2006) (regulating investment advisors).

16. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (2002) (codified in scattered sections of 11, 15, 18, 28 and 29 U.S.C.) (mandating a number of reforms to enhance corporate responsibility and financial disclosures and to combat corporate and accounting fraud). The Sarbanes-Oxley Act also created the Public Company Accounting Oversight Board to oversee the activities of the auditing profession..

17. On February 8, 2006, the repeal of the Public Utility Holding Company Act of 1935 took effect, relieving the SEC of what once arguably was its primary focus. The Act provided for the regulation of multi-state utilities by the SEC. Public Utility Holding Company Act of 1935, 15 U.S.C. § 79 (repealed 2006).

promulgated thereunder.[18] As part of this investigative authority, the Commissioners—and any officer to whom the Commissioners' authority is delegated—have the power to "administer oaths and affirmations, subpena [sic] witnesses, compel their attendance, take evidence, and require the production of any books, papers, correspondence, memoranda, or other records which the Commission deems relevant or material to the inquiry."[19] The Commission has delegated these tasks to the Director of the Division of Enforcement, who undertakes them pursuant to formal orders that the Commission grants in individual matters.[20] If the Commission concludes that a securities law has been violated, the Commission may bring an action in federal court or in an administrative proceeding against the purported violators.

THE ESTABLISHMENT OF THE ENFORCEMENT DIVISION

Among its various other roles, the SEC acts to enforce the federal securities laws,[21] and it has built a strong reputation for professionalism and effectiveness in its enforcement program. At the time the Commission was established in 1934, the Commission's "Legal Division" was responsible for conducting investigations pertaining to federal securities law violations.[22] Within the first two years, the Commission assigned that duty to its regional offices.[23] For the next four decades, the regional offices were primarily responsible for conducting investigations and bringing enforcement actions while the Commission's Trading and Markets Division "played a largely supervisory and coordinating role supporting the regions and referring criminal cases to the Justice Department for prosecution."[24] By 1944,

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18. *See e.g.*, Securities Act §§ 8(e), 20(a); Securities Exchange Act § 21(a); Investment Company Act § 42(a); Investment Advisers Act § 209(a).

19. Securities Exchange Act § 21(b). Congress has granted similar authority in other provisions of the federal securities laws. *See* Investment Company Act § 42(b); Investment Advisers Act § 209(b).

20. 17 C.F.R. § 200.30-4(a)(1) (2008).

21. 2007 REPORT, *supra* note 9, at 2.

22. DANIEL M. HAWKE, A BRIEF HISTORY OF THE SEC'S ENFORCEMENT PROGRAM 1934-1981, at 2 (SEC Historical Society 2002), *available at* http://www.sechistorical.org/collection/oralHistories/roundtables/enforcement/enforcementHistory.pdf.

23. *Id.* A copy of the 1939 organization chart of the SEC is *available at* http://www.sechistorical.org/collection/papers/1930/1939_SEC_OrgChart.pdf.

24. *Id.* During the SEC's first decade, the Justice Department had a 95% conviction rate from the indictments that it brought based on referrals from the SEC. *Id.*

after only a decade of existence, the SEC had gathered information "concerning an aggregate of 44,399 persons against whom Federal or State action had been taken with regard to securities violations" and had obtained permanent injunctions against 1,057 firms and individuals.[25]

The second decade of the SEC's existence was marked by World War II and its aftermath. During the war, the SEC's headquarters moved temporarily to Philadelphia to make room for wartime operations in Washington, D.C.[26] When the SEC finally returned to Washington in 1948, it occupied temporary buildings that were erected during the war.[27] Despite the inconveniences caused by the war and post-war budget cuts, the SEC continued to bring a constant number of enforcement actions during this time.[28]

Beginning in the late 1950s and continuing through the 1960s, the enforcement program underwent a remarkable transformation, and the enforcement resources in the SEC's Washington, D.C. headquarters increased. With the added resources, the headquarters began to bring more actions for violations of the securities laws. During the *entire decade* of the 1950s, the home office brought a total of approximately fifty cases. Yet during the 1960s, that number escalated substantially – the home office brought approximately forty cases *per year*.[29]

The 1960s witnessed landmark decisions in the field of securities law in cases brought by the SEC, such as *SEC v. Texas Gulf Sulfur Co.*[30] and *SEC v. VTR, Inc.*[31] In *Texas Gulf Sulfur*, the Second Circuit adopted the SEC's application of Rule 10b-5 to insider trading cases by requiring insiders in possession of material, nonpublic information either to abstain from trading on such information or to disclose such information

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at 13 (quoting TENTH ANNUAL REPORT OF THE SECURITIES AND EXCHANGE COMMISSION, at 3).

25. *Id.* at 13 (citing TENTH ANNUAL REPORT OF THE SECURITIES AND EXCHANGE COMMISSION, at 2-3).

26. *Id.* at 14.

27. *Id.*

28. *Id.*

29. *See* JOEL SELIGMAN, THE TRANSFORMATION OF WALL STREET: A HISTORY OF THE SECURITIES AND EXCHANGE COMMISSION AND MODERN CORPORATE FINANCE 360-61, 363 (3d ed. 2003). The impetus for the transformation was the enforcement staff's massive investigation into fraudulent practices by the American Stock Exchange. *See* HAWKE, *supra* note 22, at 2-3.

30. *See* SEC v. Tex. Gulf Sulfur Co., 401 F. 2d 833 (2d Cir. 1968), *cert. denied*, 394 U.S. 976 (1969).

31. *See* SEC v. VTR, Inc., 410 F. Supp. 1309 (D.D.C. 1975).

before trading.[32] In *VTR*, the SEC persuaded a federal district court to approve as a remedy for the securities law violation the appointment of independent directors and to order restitution.[33] The *VTR* decision marked the beginning of a long series of civil cases obtaining ancillary relief in addition to an injunction against further misconduct.[34]

The growth in the number of actions being brought by the SEC sparked discussions, led by Chairman William J. Casey, about "concentrat[ing] resources by focusing all enforcement and investigative activity in one division."[35] In August 1972, the Commission reorganized the operating structure of its divisions by combining the enforcement programs of the divisions of Trading and Markets, Corporation Finance, and Investment Management into a newly created, stand-alone division.[36] The new "Division of Enforcement" would oversee all enforcement actions brought by the SEC.[37]

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32. *See Tex. Gulf Sulfur*, 401 F. 2d at 848-52.

33. *See VTR, Inc.*, 410 F. Supp. 1309.

34. SELIGMAN, *supra* note 29, at 362.

35. U.S. SEC. & EXCH. COMM'N, THIRTY-EIGHTH ANNUAL REPORT OF THE SECURITIES AND EXCHANGE COMMISSION xxvii (1972), *available at* http://www.sec.gov/about/annual_report/1972.pdf. It has been suggested that this reorganization was initially resisted on the

> belief that enforcement responsibility should not be separated from the divisions of the Commission that deal with substantive regulation. The belief was that as the regulators developed new principles of regulation, if enforcement became too separate from such development, it might reflect the uncertainties of the rules and the appropriate nature of regulation.

Symposium, *Securities Law Enforcement Priorities*, 17 SETON HALL LEGIS. J. 7, 9 (1993) (statement by Leonard M. Leiman).

36. HAWKE, *supra* note 22, at 3. In 1971, there were 40 lawyers in the enforcement group of the Division of Trading and Markets. Fowlkes, *supra* note 1, at 380. The Commission, on November 14, 2007, restored the name of the "Division of Market Regulation" to the "Division of Trading and Markets." *See* Press Release, U.S. Sec. & Exch. Comm'n, SEC Renames Division of Market Regulation as Division of Trading and Markets (Nov. 14, 2007), *available at* http://www.sec.gov/news/press/2007/2007-229.htm. The Commission changed the name of the "Division of Corporate Regulation" to the "Division of Investment Management" in 1972. *See* Interview by Richard Rowe with Allan Mostoff (Oct. 30, 2002), *available at* http://www.sechistorical.org/collection/oralHistories/interviews/mostoff/mostoff100202Transcript.pdf.

37. HAWKE, *supra* note 22, at 3.

THE WELLS COMMISSION AND ITS RECOMMENDATIONS

On January 27, 1972, in a speech to the New York State Bar Association underscoring the importance of cooperation and collaboration between the Commission and the securities bar, Chairman Casey announced the creation of an advisory committee[38] to "review and evaluate the Commission's enforcement policies and practices and to make such recommendations as they deemed appropriate."[39] Chairman Casey called upon the private securities bar to contribute to improving the enforcement program by developing procedural safeguards to protect against abuses of the rights of prospective defendants.[40] Stressing the value of input from the private sector, Chairman Casey explained:

> [I] consider it essential for the Commission to redouble its efforts to keep in touch with the best thinking on investor protection at the private bar, in the accounting profession, and in the financial community generally. As one step — and I hope that it will prove a significant step — toward that end, I have created a special committee of three highly experienced practicing lawyers who will at my request examine the SEC's enforcement policy and practices, engage in frequent dialogue with the members of the Commission and with our staff, seek and sift the suggestions of the bar and make recommendations to the Commission for worthwhile improvements to our time-honored ways.[41]

Although the official name of the committee was the "Advisory Committee on Enforcement Policies and Practices," it is better known as the "Wells Committee" after its chairman, John A. Wells, a prominent lawyer and partner at the New York law firm of Royall, Koegel &

38. William J. Casey, Chairman, U.S. Sec. & Exch. Comm'n, Address to the New York Bar Association (Jan. 27, 1972), *available at* http://www.sec.gov/news/speech/1972/012772casey.pdf [hereinafter Casey Speech].

39. U.S. SEC. & EXCH. COMM'N, REPORT OF THE ADVISORY COMMITTEE ON ENFORCEMENT POLICIES AND PRACTICES (June 1, 1972), *reprinted in* ARTHUR F. MATHEWS ET AL., ENFORCEMENT AND LITIGATION UNDER THE FEDERAL SECURITIES LAWS 1973, at 275 (Practicing Law Institute 1973) [hereinafter WELLS COMMITTEE ADVISORY REPORT]; Memorandum from John A. Wells et al., Chairman, SEC Advisory Committee on Enforcement Policy and Practices (Mar. 2, 1972), *available at* http://www.sechistorical.org/collection/papers/1970/1972_0302_Casey.pdf [hereinafter Wells Memo].

40. Casey Speech, *supra* note 38, at 4-5.

41. *Id.*

Wells.[42] The Wells Committee also included former SEC chairmen Ralph H. Demmler and Manual F. Cohen, both of whom had taken an active interest in the workings of the enforcement program.[43] Howard G. Kristol, who served as special counsel to Chairman Casey, acted as a liaison to, and unofficial member of, the Wells Committee.[44]

The Wells Committee's stated mandate[45] was: first, "to advise on how the SEC's enforcement objectives and strategies may be made still more effective;"[46] second, to assess the due process implications of the enforcement practices;[47] third, to evaluate the enforcement policies and procedures;[48] fourth, "to make recommendations on the appropriate blend of regulation, publicity and formal enforcement action and on methods of furthering voluntary compliance;"[49] and fifth, "to make recommendations on criteria for the selection and disposition of enforcement actions and on the adequacy of . . . sanctions imposed in Commission proceedings."[50]

The Wells Committee was composed of three of the brightest minds of the securities bar, but the Committee did not conduct extensive, independent research and analysis. Instead, the Committee solicited comments from persons outside the Commission who were affected by the SEC's enforcement activities to "determine whether fairness could be more certainly assured, consistent with the need for effective enforcement."[51] The Wells Committee started its work in January 1972 and published a detailed report with forty-three recommendations for the Commission in June of the same year—an impressive achievement by any measure.[52] The report represented a candid and honest assessment of the enforcement program and reflected the substantial input the Committee received from the private bar.

42. *Id.* at 5-6. John Wells later formed a well-known law firm called Rogers & Wells.

43. *Id.*

44. Howard G. Kristol—Biography, *available at* http://www.duanemorris.com/attorneys/howardgkristol.html (last visited May 9, 2008).

45. Wells Memo, *supra* note 39.

46. *Id.* at 1.

47. *Id.*

48. *Id.*

49. *Id.* at 2.

50. *Id.*

51. WELLS COMMITTEE ADVISORY REPORT, *supra* note 39, at 3.

52. *Id.* at ii-viii.

The Wells Committee Recommendations

The most significant recommendations, from the perspective of a person defending against an SEC enforcement proceeding, are numbers 16, 17 and 20 of the report:[53]

> 16. Except where the nature of the case precludes, a prospective defendant or respondent should be notified of the substance of the staff's charges and probable recommendations in advance of the submission of the staff memorandum to the Commission recommending the commencement of an enforcement action and be accorded an opportunity to submit a written statement to the staff which would be forwarded to the Commission together with the staff memorandum.
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> 17. The procedures whereby a prospective defendant or respondent is permitted to present to the Commission his side of the case prior to authorization of an enforcement action should be reflected in a rule or published release.
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> 20. The Commission should adopt procedures permitting discussions of settlement between the staff and the prospective defendant or respondent prior to the authorization of a proceeding.[54]

These three recommendations became the impetus for what is now known as the "Wells Submission."

Providing prospective defendants with notice of potential charges and allowing them to respond, as reflected in Recommendations 16 and 17, was not a novel concept within the walls of the SEC. Even prior to the report of the Wells Committee, the SEC, under Chairman Hamer Budge, had afforded prospective defendants an opportunity to be heard by the Commission. A September 1, 1970, internal directive of the Commission[55] required the Enforcement staff to include within its

53. Harvey L. Pitt et al., *SEC Enforcement Process, Internationalization of the Securities Markets – Business Trends and Regulatory Policy*, C489 ALI-ABA 109, 238 (1989).

54. WELLS COMMITTEE ADVISORY REPORT, *supra* note 39, at iv-v.

55. *See* Fowlkes, *supra* note 1 (describing the positions of the commissioners). It should be noted that this directive was supported by commissioners of both political parties.

memoranda recommending action by the Commission "any arguments or contentions as to either the facts or the law . . . which have [been] advanced by the prospective respondents and which countervail those made by the staff . . . ."[56] The purpose of the procedure was "to afford the Commission an opportunity to consider the position of the prospective defendant or respondent on any contested matters prior to authorization of a proceeding."[57]

The Wells Committee observed that "[a]s a practical matter, only experienced practitioners who are aware of the opportunity to present their client's side of the case have made use of [such] procedures."[58] The Committee felt that the process of providing notice to prospective defendants and allowing them to respond to the allegations before the Commission formally charged them was critical to protecting their rights and ensuring overall fairness.[59] The Committee recommended that the Commission codify the procedure through formal rulemaking.[60]

Unlike Recommendations 16 and 17, Recommendation 20 of the Wells Committee—to allow the staff to engage in preliminary settlement negotiations with a prospective defendant before the Commission authorized a proceeding[61]—was a significant departure from then-existing procedure. The 1970 internal directive required the staff to seek approval from the Commission to bring an action or proceeding prior to discussing its settlement.[62] Under the 1970 internal directive, the Enforcement staff could allow a defendant or respondent to present proposals and arguments prior to Commission authorization, so long as that person initiated the discussions.[63] The staff, however, was precluded from negotiating settlement terms or disclosing to the defendant or respondent the "recommendation it intend[ed] to make to the Commission."[64] This process, which itself represented a departure from prior procedure for negotiating settlements, grew out of a concern

56. This 1970 directive was made public solely as a result of pretrial discovery in *SEC v. National Student Marketing Corporation*. *See* SEC v. Nat'l Student Mktg. Corp., 68 F.R.D. 157, 166 appx. A (D.D.C. 1975) [hereinafter 1970 Internal Directive].

57. WELLS COMMITTEE ADVISORY REPORT, *supra* note 39, at 31.

58. *Id.* at 31-32.

59. *Id.*

60. *Id.* at 32.

61. WELLS COMMITTEE ADVISORY REPORT, *supra* note 39, at iv-v.

62. 1970 Internal Directive, *supra* note 56, at 165.

63. *See id.* The staff was permitted to discuss the facts and nature of the alleged violations. *Id.*

64. *Id.*

by the Commission that "its discretionary authority regarding the institution of proceedings [would be] substantially impaired."[65] According to Commissioner A. Sydney Herlong, the 1970 internal directive was designed to prevent the staff from "bludgeoning" companies into consent settlements by using the threat of public proceedings that might never be approved.[66] Commissioner Herlong, who was one of two Democrats on the Commission, explained:

> The staff sometimes is overly zealous and they sometimes want quick settlements to clear up their files. Sometimes they would beat people over the head for a consent decree. We had reports from some people who weren't pleased with the treatment.[67]

Responding to comment letters, the Wells Committee recommended that the Commission withdraw this mandate and return to the prior procedure of allowing staff leeway to negotiate settlements with prospective defendants prior to having the authority to commence an action or proceeding.[68] The Wells Committee believed that "frank discussions between the staff and opposing counsel concerning the staff's conclusions and probable recommendation to the Commission would encourage settlements."[69] To address concerns with abuse, the Committee proposed that the Director of Enforcement or a regional administrator be responsible for supervising settlement negotiations and that the proposed defendant or respondent be shown the evidence that the staff has assembled in support of its case.[70] As the Wells Committee observed, "When the staff refuses to disclose its evidence or the theory of its case to the respondent's attorney before the hearing, the attorney,

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65. WELLS COMMITTEE ADVISORY REPORT, *supra* note 39, at 35. Philip A. Loomis, then general counsel of the SEC, explained that the Commission abandoned the practice of considering settlements negotiated without prior Commission authorization because the Commissioners felt hindered by a pre-decided result. *See* Fowlkes, *supra* note 1, at 381. Commissioner Richard B. Smith "offered essentially the same reason, saying that he missed the opportunity to hear industry's side of a case and that it struck him as bad administrative procedure." *Id.*

66. Fowlkes, *supra* note 1, at 381.

67. *Id.*

68. WELLS COMMITTEE ADVISORY REPORT, *supra* note 39, at 35.

69. *Id.*

70. *Id.* at 35-36.

not knowing what his client faces, may be unable or reluctant to recommend a settlement."[71]

The Wells Committee recommendation of a return to the pre-1970 procedure of allowing staff to negotiate settlements prior to Commission approval was met with favor by many members of the securities bar. In a May 23, 1972 letter to the Wells Committee concerning the proposed change, Arthur F. Mathews, a former SEC enforcement lawyer, wrote:

> [T]he changed enforcement policy has, although unintended, worked to the severe detriment of many defendants and prospective defendants who wish to achieve an acceptable consent settlement in lieu of litigation and who are not concerned that the Staff might "bludgeon" them. Rather, such persons usually are concerned with the continuing blasts of adverse publicity showering upon them, first by public institution of charges by the Commission, and later upon the conduct of a hearing or the announcement of the terms and conditions of a settlement subsequently negotiated. Such continuous publicity may be extremely unfair, particularly where serious allegations publicized upon institution of an action, are dropped subsequently by Staff and the Commission in accepting a consent settlement of the action.[72]

The notable aspect of this debate is that both sides were concerned with fairness and due process. Those in support of requiring Commission approval prior to settlement were concerned with the uneven negotiating position of the Commission's staff and the prospective defendant. Those in support of allowing informal settlement procedures prior to Commission approval believed that fairness would be advanced by limiting the time under which a prospective defendant could be exposed to adverse publicity. The ultimate conclusion of the Commission, however, emphasized the due process concerns of Commission oversight.

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71. *Id.* at 37. Today, there are no specific guidelines concerning the amount and type of information that staff must share with a prospective defendant, so practices vary among the staff and across the regional offices.

72. Letter from Arthur F. Mathews of Wilmer, Cutler & Pickering, to the Advisory Committee on Enforcement Policies and Practices 30 (May 23, 1972). Stanley Sporkin, then an associate director, agreed, stating that "it saved everybody a lot of bother and was welcomed by many of the people we regulate because it gave them a means of settling quickly." Fowlkes, *supra* note 1, at 381.

The Commission's Response to the Wells Recommendations

The recommendations of the Wells Committee were met with mixed responses within the agency. Although the private securities bar generally applauded the recommendations from the Wells Committee, the SEC staff disagreed with many of them, and the commissioners were reluctant to adopt formal rules.[73] With respect to Recommendations 16 and 17, the Commission "agree[d] that the objective [was] sound," but "concluded that it would *not* be in the public interest to adopt formal rules for that purpose."[74] The Commission apparently felt hamstrung by the mandatory-sounding nature of the phrase "except where the nature of the case precludes." The Commission believed that the formal adoption of the proposals "could seriously limit the scope and timeliness" of enforcement actions and inject issues "irrelevant to the merits."[75] As a result, the Commission indicated that, where "practical and appropriate," it would allow, on an informal basis, prospective defendants to provide written submissions before a charging decision was reached by the Commission.[76]

Although it did not immediately embrace Recommendations 16 and 17, the Commission eventually adopted the substance of these recommendations in procedural rules in November 1972, formulating today's Wells submission process. The process as adopted provided a proposed defendant or respondent with the opportunity to respond to charges.[77] The Commission notified the public of the opportunity for prospective defendants or respondents to "submit a written statement to the Commission setting forth their interests and positions in regard to the subject matter of the investigation."[78] SEC procedural rules directed the staff, in its discretion, to advise prospective defendants or respondents "of the general nature of its investigation, including the indicated violations as they pertain to them, and the amount of time that may be available for preparing and submitting a statement prior to the

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73. *See* Pitt et al., *supra* note 53, at 63.

74. Procedures Relating to the Commencement of Enforcement Proceedings and Termination of Staff Investigation, Securities Act Release No. 5310, [1972-1973 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 79,010, at 82,183-86 (Sept. 22, 1972) (emphasis added) [hereinafter SEC Release No. 5310].

75. *Id.* at 2.

76. Stephen A. Glasser, *SEC Adopts Rules Changes in Areas of Enforcement*, N.Y.L.J., Sept. 29, 1972.

77. *See* 37 Fed. Reg. 23,829 (Nov. 9, 1972) (codified at 17 C.F.R. § 202.5(c)).

78. 17 C.F.R. § 202.5(c) (2006).

presentation of a staff recommendation to the Commission for the commencement of an administrative or injunctive proceeding."[79] The Commission, however, explained that a prospective defendant's opportunity to submit a response was not absolute, and the Commission expressly reserved the right to take any action while awaiting a submission by a proposed defendant or respondent.[80]

The Commission rejected Recommendation 20 of the Wells Committee, which would have permitted settlement discussions prior to authorization from the Commission to commence an action or proceeding.[81] Apparently, the Commission continued to harbor concerns that its discretionary authority regarding the institution of proceedings would be substantially impaired.[82] Irving Pollack, then director of the Division of Enforcement, explained the reason for rejecting the recommendation as two-fold: first, it would be difficult for the Commission to reject a settlement already reached between staff and a prospective defendant; second, there was concern that settlement discussions prior to Commission approval would give the staff the leverage to threaten prospective defendants into submission.[83] Therefore, the procedure described in the 1970 internal directive of requiring the staff to seek Commission approval to bring an action prior to negotiating settlement of it remained in effect.

In 1979, the Commission, under Chairman Harold Williams,[84] formally adopted in the SEC procedural rules the requirement that the enforcement staff must have Commission authorization before engaging in settlement discussions.[85] The Commission reasoned that its involvement in settlement discussions was critical to ensuring a fair process and to protecting the rights of defendants.[86]

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79. *Id.*

80. *See* SEC Release No. 5310, *supra* note 74, at 2.

81. WELLS COMMITTEE ADVISORY REPORT, *supra* note 39, at 34.

82. *Id.* at 35.

83. Glasser, *supra* note 76.

84. Harold M. Williams—Biography, http://skadden.com/index.cfm?contentID=45&bioID=848 (last visited May 8, 2008). During his tenure, Chairman Williams increased the Office of the General Counsel from approximately a dozen attorneys to more than forty attorneys as an alternative source of advice to the Commission on issues such as enforcement matters.

85. *See* 17 C.F.R. § 202.5(f) (2006).

86. John M. Fedders, Dir., Div. of Enforcement, U.S. Sec. & Exch. Comm'n, Remarks to the 1981 SEC Accounting Conference Foundation for Accounting

Although the Commission did not adopt all of the forty-three specific recommendations, the most obvious legacy of the Wells Committee was the adoption of the "Wells Process," a process whereby prospective defendants or respondents are afforded an opportunity to submit a writing—essentially a brief—to the Commission and its staff after the staff's investigation is completed, but before the staff has made a recommendation to the Commission. Under this procedure, a prospective defendant or respondent enjoys due process—a hallmark of our Anglo-American judicial system.

THE EVOLUTION OF THE ENFORCEMENT PROGRAM AND ITS PHILOSOPHY

Prior to 1990, the SEC's statutory purpose for enforcing the securities laws was to provide remedial relief for aggrieved investors and to deter future violations.[87] The enforcement program began by serving primarily a remedial purpose, through the Commission's injunctive powers and the disgorgement remedies that the Commission fashioned.[88] In the decades following the Wells Committee, the Commission's enforcement actions began to shift from remedial to punitive in nature. This shift of emphasis arose from the new powers that Congress gave the SEC, such as the authority to impose officer and director bars, penalties against individuals and registered entities, and censures in administrative actions.

In 1984, the SEC staff, in response to a congressional request, prepared a review of the adequacy of enforcement sanctions and remedies.[89] The resulting report stated that "[t]he federal securities laws are presently viewed by the courts as remedial rather than punitive" and

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Education: New York State Society of Certified Public Accountants 3-6 (Nov. 16, 1981).

87. *See, e.g.*, Memorandum from John S.R. Shad, Chairman, U.S. Sec. & Exch. Comm'n, to Rep. Timothy E. Wirth, Chairman, Subcomm. Telecomms., Consumer Prot., & Fin. of the H. Energy and Commerce Comm. 350 (Feb. 22, 1984) [hereinafter Memorandum to Chairman Wirth].

88. *See, e.g.*, *SEC v. Manor Nursing Ctrs., Inc.*, 458 F.2d 1082, 1104 (2d Cir. 1972) ("The deterrent effect of an SEC enforcement action would be greatly undermined if securities law violators were not required to disgorge illegal profits."); *SEC v. Commonwealth Chem. Sec., Inc.*, 574 F.2d 90, 102 (2d Cir. 1978) ("[T]he primary purpose of disgorgement is not to compensate investors. . . . [I]t is a method of forcing a defendant to give up the amount by which he was unjustly enriched.").

89. *See* Memorandum to Chairman Wirth, *supra* note 87 (transmitting "Results of the Review of the Adequacy of Enforcement Remedies and Sanctions").

that the SEC's non-monetary remedies were "effective in most cases" in providing that remedial relief.[90] The staff reported that, aside from the area of insider trading, which Congress was addressing at the time,[91] "the Commission has been unable to identify a serious need for additional remedies to deter a specific type of conduct."[92]

The report asserted that "the advantages of seeking additional civil penalties appear to be marginal" and "must be balanced against a number of potentially serious disadvantages."[93] Chief among those identified disadvantages was the concern that giving the SEC the authority to seek or impose civil monetary penalties for violations of the federal securities laws would "change the character of the enforcement program from remedial to punitive, [and] might lead the judiciary to be less receptive to the SEC's injunctive actions."[94] Traditionally, the Commission relied on the Department of Justice to exercise these remedies through its criminal authority.[95]

By the late 1980s, these philosophical views substantially changed. In a memorandum in support of the Securities Enforcement Act of 1989, the Commission stated that "variable-penalty provisions are appropriate to *penalize and deter the broad range of conduct* for which these penalties will be assessed."[96] The Commission conceded that moving to remedies that were more punitive in nature could result in one of two things: increased difficulty in obtaining settlements as a result of defendants' unwillingness to settle cases involving large civil penalties, thereby potentially harming aggrieved investors, or a greater likelihood of settlement by defendants hoping to avoid much larger civil monetary penalties after litigation.[97] The Commission's asserted need in 1990 to penalize a broad range of conduct was a significant departure from its

90. *Id.*

91. Congress was considering proposed legislation that eventually became the Insider Trading Sanctions Act of 1984. *See* Insider Trading Sanctions Act of 1984, Pub. L. No. 98-376, § 1, 98 Stat. 1264 (codified as amended in scattered sections of 15 U.S.C.).

92. Memorandum to Chairman Wirth, *supra* note 87, at 350.

93. *Id.*

94. *Id.*

95. *Id.*

96. U.S. Sec. & Exch. Comm'n, Memorandum of the Securities and Exchange Commission in Support of the Securities Law Enforcement Remedies Act of 1989, *reprinted in* H.R. No. 975, 101st Cong., at 7 (emphasis added) [hereinafter SEC Memorandum in Support of Remedies Act].

97. Memorandum to Chairman Wirth, *supra* note 87, at 350-51.

representation to Congress only six years earlier that its existing remedies were effective.[98]

In 1990, former Director of Enforcement Gary Lynch, who had recently left the SEC, testified before the Senate Subcommittee on Securities. Although he testified in favor of providing additional penalty powers to the Commission, he cautioned:

> I think it is important for the Commission to maintain its historical focus on achieving remedial relief, rather than taking punitive action in every case, and that the Commission should still continue to judge the effectiveness of the Commission's enforcement program based on what it actually accomplishes, as opposed to what the dollar amount is that is ordered in a particular case.[99]

Congress provided the SEC with enhanced enforcement remedies, including expanded remedial powers and new penalty authority. These powers were included in the Insider Trading Sanctions Act of 1984,[100] the Insider Trading and Securities Fraud Enforcement Act of 1988,[101] and the Securities and Enforcement Remedies and Penny Stock Reform Act of 1990.[102]

As a result of these laws, the SEC gained three significant new sets of powers: (1) the ability to seek civil monetary penalties against persons and entities that may have violated federal securities laws; (2) the authority to bar directors and officers of public companies from serving in those capacities if they violated federal antifraud provisions; and (3) the authority to issue administrative cease-and-desist orders, temporary restraining orders, and orders for disgorgement of ill-gotten profits to violators of federal securities laws. These significant powers and laws enabling them are discussed in more detail below.

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98. *Id.* at 350.

99. *The Securities Enforcement Remedies Act of 1989: Hearing Before the Sec. Subcomm. of the S. Banking, Hous., & Urban Affairs Comm.* (Feb. 1, 1990) (statement of Gary G. Lynch, Fmr. Dir., Div. of Enforcement, U.S. Sec. & Exch. Comm'n).

100. Insider Trading Sanctions Act of 1984, Pub. L. No. 98-376, § 1, 98 Stat. 1264 (codified as amended in scattered sections of 15 U.S.C.).

101. Insider Trading and Securities Fraud Enforcement Act of 1988, Pub. L. No. 100-704, § 1, 102 Stat. 4677 (codified as amended in scattered sections of 15 U.S.C.).

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

The Insider Trading Sanctions Act of 1984

In connection with its enhanced enforcement efforts with respect to insider trading,[103] the SEC submitted proposed legislation to Congress on September 27, 1982, that would authorize the SEC to seek (and a United States District Court to impose) civil monetary penalties of up to three times the profit realized or loss avoided in insider trading cases.[104] At the time of the proposal, the SEC's primary weapons "against insider trading [were] injunction[s] requiring a defendant to comply with the law in the future, and ancillary equitable relief in the form of disgorgement of illegal profits."[105] Previously, the power to seek "penalties" in the form of prison sentences, criminal fines and restitution resided solely in the Department of Justice ("DOJ") and state authorities.

As a result of the growing number of insider trading cases, the Commission believed that its existing tools of injunctions and disgorgement were inadequate to deter persons from trading on material, nonpublic information. Injunctions, the Commission explained, merely order a defendant prospectively to comply with existing law, and do "not penalize the defendant for the illegal conduct for which the injunction was imposed."[106] The Commission viewed the remedy of disgorgement as likewise inadequate because it merely "strips the defendant of the fruits of his unlawful trading and returns him to the position he was in before he broke the law."[107] Apparently discounting the possible criminal sanctions and the reputational harm associated with injunctive and ancillary relief, the Commission explained to Congress, "[A]n insider who is caught improperly profiting from the use of material information is placed in no worse a position than the honest man who refuses to act."[108]

103. U.S. Sec. & Exch. Comm'n, Memorandum of the Securities and Exchange Commission in Support of the Insider Trading Sanctions Act of 1982, *reprinted in* H.R. REP. No. 98-355, 98th Cong., at 18 (1984), *and in* 1984 U.S.C.C.A.N. 2274, 2293 [hereinafter SEC Memorandum in Support of Insider Trading Sanction Act].

104. Letter from John Shad, Chairman, U.S. Sec. & Exch. Comm'n, to Hon. Thomas P. O'Neill, Jr., with accompanying memorandum (Sept. 27, 1982), *reprinted in* H.R. REP. No. 98-355, 98th Cong., at 18 (1984), *and in* 1984 U.S.C.C.A.N. 2274, 2292.

105. SEC Memorandum in Support of Insider Trading Sanction Act, *supra* note 103, at 24.

106. *Id.*

107. *Id.*

108. *Id.* (quoting HARVEY J. GOLDSCHMID, REPORT FOR THE U.S. ADMINISTRATIVE CONFERENCE: AN EVALUATION OF THE PRESIDENT AND POTENTIAL USE OF CIVIL

In response, Congress passed the Insider Trading Sanctions Act of 1984 ("ITSA"), which was signed into law on August 10, 1984. ITSA authorized treble damages in insider trading cases[109] and increased the maximum criminal fine for Exchange Act violations to $100,000.[110] ITSA was the first significant legislation that provided the SEC with the authority to penalize, and it was premised on the Commission's limited belief that penalties in the form of monetary sanctions were necessary to deter the specific securities law violation of insider trading.[111] At that time, the Commission believed that existing remedies were effective against other securities law violations.

Insider Trading and Securities Fraud Enforcement Act of 1988

After the passage of ITSA, Congress continued to evaluate whether the legislation was sufficient to deter insider trading.[112] In the mid-1980s, insider-trading scandals dominated the financial news and involved such high-profile Wall Street traders as Ivan Boesky, Michael Milken, and Dennis Levine.[113] Insider trading became the focus of Congressional hearings in June and July 1986 and continued to be the focus of hearings for the next several years.[114]

In 1988, members of the House Committee on Energy and Commerce introduced additional legislation "[a]fter learning of an increasing number of serious insider trading cases."[115] The new

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MONEY PENALTIES AS A SANCTION BY THE FEDERAL ADMINISTRATIVE AGENCIES 36 (1972)).

109. *See* Insider Trading Sanctions Act of 1984, Pub. L. No. 98-376, § 2, 98 Stat. 1264 (codified as amended in scattered sections of 15 U.S.C.).

110. *See id.* § 3. Previously, the maximum criminal fine for Exchange Act violations was $10,000. *Id.*

111. *See* Memorandum to Chairman Wirth, *supra* note 87 (transmitting "Results of the Review of the Adequacy of Enforcement Remedies and Sanctions").

112. *See* Thomas J. Woo, *Legislation and Legitimation: Congress and Insider Trading in the 1980s* (The Berkeley Electronic Press, Working Paper No. 941, 2006), *available at* http://law.bepress.com/cgi/viewcontent.cgi?article=4566&context=expresso.

113. *Id.* at 7.

114. *Id.*

115. Stuart J. Kaswell, *An Insider's View of the Insider Trading and Securities Fraud Enforcement Act of 1988*, 45 BUS. LAW. 145 (1989); *see also* H.R. REP. No. 100-910, 100th Cong., at 7 (1988), *reprinted in* 1988 U.S.C.C.A.N. 6043, 6044 ("The Insider Trading and Securities Fraud Enforcement Act of 1988 represents the response of [the House Committee on Energy and Commerce] to a series of revelations over the

legislation, the Insider Trading and Securities Fraud Enforcement Act of 1988 ("ITSFEA"), was prompted by an "unstated premise that broker-dealers in particular, and others in general, were not doing enough to detect and deter insider trading."[116]

Congress passed ITSFEA and President Reagan signed it into law in November 1988. The new law extended the SEC's authority to impose penalties on persons who control a person who trades on material nonpublic information in violation of the law,[117] and it required broker-dealers and investment advisers to "establish, maintain, and enforce written policies and procedures reasonably designed . . . to prevent the misuse . . . of material, nonpublic information."[118] ITSFEA extended the DOJ's criminal authority by: (1) increasing maximum criminal fines for Exchange Act violations to $1,000,000 for individuals and $2,500,000 for non-natural persons;[119] (2) increasing the maximum duration of imprisonment to ten years;[120] and (3) authorizing the payment of a reward to those "persons who provide information leading to the imposition of [a] penalty."[121] ITSFEA also vested private plaintiffs with authority to assist in the deterrence effort by creating an express private right of action against insiders who trade on material nonpublic information.[122]

The Securities Enforcement Remedies and Penny Stock Reform Act of 1990

In October 1987, prior to the passage of the ITSFEA, the National Commission on Fraudulent Financial Reporting—dubbed the "Treadway Commission" after its chairman, former SEC Commissioner James C. Treadway, Jr.—published a comprehensive report that identified causes of financial reporting fraud and issued recommendations for their

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last two years concerning serious episodes of abusive and illegal practices on Wall Street.").

116. Kaswell, *supra* note 115, at 156.

117. Insider Trading and Securities Fraud Enforcement Act of 1988, Pub. L. No. 100-704, § 3, 102 Stat. 4677 (codified as amended in scattered sections of 15 U.S.C). The penalty authorized for such control persons could not exceed the greater of three times the profit realized or loss avoided or $1,000,000. *Id.*

118. *Id.*

119. *Id.* § 4.

120. *Id.*

121. *Id.* § 3.

122. *Id.* § 5.

reduction.[123] The Treadway Commission Report recommended the creation of additional SEC enforcement remedies, namely the imposition of fines outside the limited context of insider trading cases, cease-and-desist orders and corporate officer and director bars or suspensions.[124] The stated purpose of these proposals was to afford the Commission "[t]he ability to tailor enforcement actions more precisely to particular facts[,] [thereby] enabl[ing] the SEC to maximize its enforcement effectiveness."[125] In response to the Treadway Commission Report, the chairman directed the staff to develop legislative recommendations in response to the conclusions of the Treadway Commission.[126]

Although the House Committee on Energy and Commerce anticipated taking up the SEC's legislative proposals in response to the Treadway Commission at the same time the House Committee considered ITSFEA,[127] the SEC was unable to complete its proposals in time for inclusion in that legislation.[128] To prompt the SEC to submit additional legislative proposals, Congress added section 3(c) to ITSFEA, which directed the Commission to submit to Congress "any recommendations the Commission considers appropriate with respect to the extension of the Commission's authority to seek civil penalties or impose administrative fines."[129]

After ITSFEA was passed, but before it was signed into law, the Commission submitted to Congress its first recommended legislative response to the recommendations of the Treadway Commission.[130] The Commission initially asked for the authority to seek civil penalties in all administrative proceedings, including in proceedings against issuers under explicit, limited circumstances.

In a memorandum to Congress, the Commission, under Chairman David Ruder, set forth the factors that should be considered in determining whether to seek a civil penalty against an issuer in an

123. *See* NAT'L COMM'N ON FRAUDULENT FIN. REPORTING, REPORT OF THE NATIONAL COMMISSION ON FRAUDULENT FINANCIAL REPORTING (1987), *available at* http://www.coso.org/Publications/NCFFR.pdf.

124. *See id.* at 64-67.

125. *Id.* at 64.

126. Kaswell, *supra* note 115, at 171.

127. *Id.*

128. *Id.*

129. Insider Trading and Securities Fraud Enforcement Act § 3.

130. *See* H.R. REP. No. 101-616, 101th Cong., at 15 (1990), *reprinted in* 1990 U.S.C.C.A.N. 1379.

administrative proceeding.[131] First, the SEC underscored that the proposed law would not "dictate" that the Commission must seek or impose a civil penalty against an issuer.[132] Instead, as the Commission explained, the Commission could proceed against culpable individuals and exercise discretion in *not* seeking an issuer penalty.[133] Second, the Commission stressed that it "may properly take into account its concern that civil penalties assessed against corporate issuers will ultimately be paid by shareholders who were themselves victimized by the violations."[134] The Commission explained that penalties should be assessed against issuers only in the rare situation where the issuer received a "direct economic benefit" from the fraud:

> In a typical case of financial fraud in which a[n] issuer overstates it[s] earnings and revenues, for example, the only shareholders who reap *a direct economic benefit* are those who sell their shares at an inflated price before the fraud is exposed. By the time that an enforcement action is brought, a large percentage of the shareholders may consist of persons who purchased shares at a price that was artificially inflated as a result of the fraud. *To assess a civil penalty in such a case against the issuer, as opposed to the individual officers who were responsible for the fraud, would appear to be inequitable.*[135]

The Commission further elaborated in a footnote on the limited instances where shareholders of a company might have received a direct economic benefit from fraud:

> The lack of a direct economic benefit to shareholders differentiates financial fraud from other types of violations for which public companies may be fined under other statutes. For example, if a corporation violates environmental standards relating to emissions control, it generally realizes a cost saving that is ultimately realized by shareholders.[136]

Third, the Commission stated that a civil penalty should be imposed on an issuer "only where the violation resulted in an improper benefit to

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131. SEC Memorandum in Support of Insider Trading Sanction Act, *supra* note 103, at 4.

132. *Id.*

133. *Id.*

134. *Id.*

135. *Id.* (emphasis added).

136. *Id.* at 4 n.5

shareholders," but that, even under those circumstances, the passage of time and resulting shareholder turnover may weigh against imposing a penalty.[137]

Central to the Commission's analysis of the propriety of seeking a penalty against an individual or an issuer was whether the penalty would serve a "public interest."[138] To that point, the Commission outlined several additional factors it would consider to determine if the penalty was in the public interest:

- whether the act or omission for which such penalty is assessed involved fraud, deceit, manipulation, or deliberate or reckless disregard of a regulatory requirement;
- the harm to other persons resulting either directly or indirectly from such act or omission;
- the extent to which any person was unjustly enriched, *taking into account any restitution made to persons injured by such behavior*;[139]
- whether such person previously has been found by the Commission, other appropriate regulatory agency, or self-regulatory organization to have violated the federal securities laws, state securities laws, or the rules of a self-regulatory organization, or has been enjoined by a court of competent jurisdiction from violations of such laws or rules;
- the need to deter such person and other persons from committing such acts or omissions; and
- such other matters as justice may require.[140]

In its February 1, 1990, "modified proposal" to Congress, the Commission removed its request for the authority to seek civil monetary

137. *Id.* at 5.

138. *Id.* at 9.

139. *Id.* (emphasis added); *compare* Press Release, U.S. Sec. & Exch. Comm'n, Statement of the Securities and Exchange Commission Concerning Financial Penalties (Jan. 4, 2006) (omitting this clause), *available at* http://www.sec.gov/news/press/2006-4.htm.

140. SEC Memorandum in Support of Insider Trading Sanction Act, *supra* note 103, at 9.

penalties against issuers in administrative proceedings.[141] The Commission also removed its prior request for authority to impose officer and director bars in administrative proceedings.[142] The modified proposal added provisions that expressly authorized the SEC to issue cease-and-desist orders and to order disgorgement in administrative proceedings, and allowed federal courts to bar persons from serving as directors or officers.[143] The Commission's "modified proposal" eventually became law through the "the Securities Enforcement Remedies and Penny Stock Reform Act of 1990," commonly referred to as "The Remedies Act."

As enacted, the Remedies Act significantly expanded the permissible enforcement remedies the Commission may seek in civil proceedings or impose in administrative proceedings.[144] The Remedies Act formulated a three-tiered penalty framework, which sets forth the amount of a fine based on the number and nature of violations.[145] At each tier, the fine may not exceed the higher of the gross pecuniary gain or the maximum statutory amount.[146] This variable penalty framework was not in the original draft of the Remedies Act but was later included to reflect the Commission's belief that variable penalties would aid in

141. *See The Securities Law Enforcement Act of 1990: Hearings on S. 647 Before the S. Subcomm. on Sec.*, 101st Cong. 31 (1990) (statement by Richard C. Breeden, Chairman, U.S. Sec. & Exch. Comm'n).

142. *Id.*

143. *Id.*

144. For a general discussion of each class of remedies created by the Remedies Act, *see* Richard A. Spehr & Michelle J. Annunziata, *The Remedies Act Turns Fifteen: What is its Relevance Today?*, 1 N.Y.U J. L. & BUS. 587, 589-95 (2005).

145. *See* The Securities Law Enforcement Remedies Act of 1990, S. REP. No. 101-337, 101st Cong. (1990). Originally, there were three tiers of maximum penalty amounts separated according to the gravity and extent of harm caused by the violation, and each penalty is per violation. For SEC administrative proceedings, the first tier penalty was $5,000 for natural citizens and $50,000 for any other person. The second tier maximum penalty was $50,000 for natural persons and $250,000 for any other person and applies to violations involving fraud, deceit, manipulation or deliberate or reckless disregard of a regulatory requirement. The third-tier penalty for natural persons was $100,000 and $500,000 for any other person and applies to violations that either resulted in substantial losses to other persons or created the risk of such losses. These amounts have been increased by subsequent regulation. *See* 17 C.F.R. 201.1001, *et seq.* (citing the Debt Collection Improvement Act of 1996).

146. *See id.*

tailoring the size of the penalty to fit the circumstances of individual cases.[147]

The Remedies Act further gave the SEC the power to seek (and an administrative law judge to impose) civil penalties through administrative proceedings against specified persons and entities directly regulated by the Commission, such as broker-dealers and investment advisors, when a penalty would be in the "public interest."[148] The Remedies Act also gave the SEC the power to seek civil monetary penalties against issuers, but only in federal court proceedings. Although Congress understood that imposing civil monetary penalties on issuers would harm shareholders,[149] Congress expected that the SEC would exercise discretion and seek civil monetary penalties against issuers *only* when a violation resulted in improper benefits to shareholders.[150]

Congress took comfort in the fact that federal judges would operate as an independent check to the Commission's decision to seek an issuer penalty and the amount sought to be recovered. The concern among members of Congress and internally at the SEC was that if the same remedies were available to the SEC under both judicial and administrative proceedings, then the SEC might be perceived to have an incentive to conduct more enforcement actions through its own

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147. *See* SEC Memorandum in Support of Insider Trading Sanction Act, *supra* note 103, at 49; *see also* S. REP. No. 101-337, 101st Cong. (1990)

148. *See* Securities Enforcement Remedies and Penny Stock Reform Act of 1990, Pub. L. No. 101-429, § 202, 104 Stat. 931 (1990) (for certain Exchange Act violations); *id.* § 301 (for certain Investment Company Act violations); *id.* § 402 (for certain Advisers Act violations).

149. *See The Securities Law Enforcement Remedies Act of 1990: Hearings on S. 647 Before the S. Subcomm. on Sec.*, 101st Cong. 85 (1990) (statement by Sen. John Heinz) ("Doesn't the imposition of a fine against a publicly held company penalize the shareholder?").

150. *See* S. REP No. 101-337, 101st Cong. 16-17 (1990). Echoing the Commission's intent, the Senate Committee on Banking, Housing, and Urban Affairs stated that it

> intends that a penalty be sought when the violation results in an improper benefit to shareholders. In cases in which shareholders are the principal victims of the violations, the Committee expects that the SEC, when appropriate, will seek penalties from the individual offenders acting for a corporate issuer. Moreover, in deciding whether and to what extent to assess a penalty against the issuer, the court may properly take into account whether civil penalties assessed against corporate issue[r]s will ultimately be paid by shareholders who were themselves victimized by the violations.

Id. at 17.

administrative proceedings, rather than before a federal district court judge. The final legislation did not include penalty authority in administrative proceedings precisely because there would be no oversight by Article III judges as there would be in civil proceedings. In practice, however, public companies seldom choose to litigate with the SEC, and *settled* injunctive actions rarely receive any detailed judicial scrutiny. To guarantee the safeguards that normally accompany a judicial determination of a penalty, commissioners must exercise sufficient, policy-level scrutiny, such as the "public interest" analysis described above, in evaluating a penalty recommendation.[151]

After the Remedies Act was signed into law in 1990 and before the SEC's April 2002 Xerox case,[152] the Commission brought only four issuer-penalty cases, totaling less than $5 million.[153] The Xerox case, in which the company paid a $10 million penalty, is viewed by many as the beginning of the "corporate penalty era" at the Commission. Between the Xerox case and the date this Article was written, the Commission has imposed penalties against approximately sixty issuers, totaling billions of dollars.

THE CORPORATE SCANDALS AT THE BEGINNING OF THE 21ST CENTURY

In the first years of this century, the investing public was scarred by major corporate scandals leading to the demise of several large companies such as Enron Corp.[154] and WorldCom Inc.[155] that were

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151. In January 2006, the Commission issued a statement outlining the parameters under which it would consider seeking penalties against issuers. *See infra*, text accompanying notes 178-181.

152. Xerox Corp., Litigation Release No. 17465, 77 SEC Docket 971, 2002 WL 535379 (Apr. 11, 2002).

153. There were large penalties against registered entities during this period. *See, e.g.*, Press Release, Department of Justice and SEC Enter $290 Million Settlement with Solomon Brothers in Treasury Securities Case, *available at* http://www.usdoj.gov/atr/public/press_releases/1992/211182.htm. These penalties are not discussed in this Article because they were levied against registered entities for defrauding their customers or the market, as opposed to defrauding their shareholders.

154. At the time that it declared bankruptcy in 2001, Enron was the seventh largest company on the Fortune 500 list by revenues. *See* Matt Moore, *Bankrupt Enron No. 5 in Fortune 500 List*, HOUSTON CHRONICLE, Apr. 4, 2002, *available at* http://www.chron.com/disp/story.mpl/special/enron/1327642.html.

155. Until the financial problems of WorldCom became acute in spring 2002, the bills under consideration in the Senate and House were not given much chance of passage. *See* Peter J. Wallison, *Sarbanes-Oxley as an Inside-the-Beltway Phenomenon*,

viewed previously as paragons of industry. Congress reacted to the new spate of corporate scandals in the same way that it did in response to the insider trading scandals of the 1980s—it provided the SEC with significant authority to enforce new and existing laws.[156] The Sarbanes-Oxley Act of 2002 imposed significant, additional requirements on corporations and their officers and directors.[157] The Sarbanes-Oxley Act greatly expanded the Commission's enforcement powers and the criminal penalties for violating the federal securities laws.[158]

Section 1105 of the Sarbanes-Oxley Act permits the SEC to obtain officer and director bars in administrative proceedings, and section 305(a) amended 15 U.S.C. § 78u(d)(2) and 15 U.S.C. § 77t(e) by lowering the standard for obtaining a bar from "substantially unfit" to "unfit." Prior to the adoption of the Sarbanes-Oxley Act, an officer and director bar was available only in civil injunctive actions after a showing that the officer or director was "substantially unfit" to serve in the position.[159]

Section 308(a) of the Sarbanes-Oxley Act contained a novel "Fair Funds" provision that allows the Commission to disperse the penalties obtained from wrongdoers to compensate harmed shareholders.[160] Section 308 had no counterpart in the Senate bill, because it was added

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AMERICAN ENTER. INST. FOR PUB. POLICY RESEARCH, June 2004, at 2, *available at* http://www.aei.org/publications/pubID.20582/pub_detail.asp. The collapse of WorldCom, relatively close to the 2002 congressional election, which both political parties acknowledged as a rematch of the very close presidential election of 2000, led to the eventual enactment of the Sarbanes-Oxley Act, with only three votes against it in the entire Congress. Some in Washington dubbed the Sarbanes-Oxley Act the "Bernie Ebbers Memorial Act" after the then-CEO of WorldCom.

156. In the intervening years following the Remedies Act, Congress did not adjust the SEC's enforcement authority to any great extent. The principal exception was the Private Securities Litigation Reform Act of 1995 §104, Pub. L. No. 104-67, 109 Stat. 737 (1995) (codified at 15 U.S.C. 78t(e)). The PSLRA amended the securities laws to allow the SEC to bring actions against secondary violators that aid and abet securities law violations. Congress wisely declined to extend that right to private parties, out of concern over abusive securities litigation.

157. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (codified in scattered sections of 11, 15, 18, 28, and 29 U.S.C.).

158. The changes relevant to this Article are discussed below. The Sarbanes-Oxley Act included other provisions that are not discussed here.

159. Sarbanes-Oxley Act § 1105, 15 U.S.C. 7246 (2006).

160. *Id.* § 308(a).

during the conference process.[161] Accordingly, the Senate Banking Committee report does not discuss this provision.

Prior to Section 308(a), the Commission was permitted to remit amounts obtained in actions as *disgorgement* to injured investors, but was required to remit any *penalties* it received to the U.S. Treasury. Section 308(a) provided flexibility to the Commission to distribute both disgorgement and penalties through a Fair Fund, but the penalties cannot be dispersed absent disgorgement of ill-gotten gains.[162] Congress, joined by the Justice Department, wanted to avoid having penalties become a substitute for disgorgement. Disgorgement is the forfeiture of the ill-gotten gains received by the defendant; it is not inherently a mechanism to recompense aggrieved investors. By making disgorgement a prerequisite for adding penalties to the Fair Fund, Congress focused on depriving the defendant of its ill-gotten gains, not necessarily punishing wrongdoers.[163] Congress also may have been concerned with a possible windfall to investors if the defendant did not receive any ill-gotten gain from the wrongdoing.

Congress also required the SEC to study ways to improve the Fair Funds process. Section 308(c) of Sarbanes-Oxley instructed the SEC to review and analyze enforcement actions over the course of the five years prior to enactment "to identify areas where such proceedings may be utilized to efficiently, effectively, and fairly provide restitution for injured investors . . . including methods to improve the collection rates

161. *See* Press Release, Baker Proposes New Federal Investor Restitution Fund (July 17, 2002), *available at* http://web.archive.org/web/20031108035021/www.baker.house.gov/News/fair_fund.htm [hereinafter Baker I].

162. *See* Sarbanes-Oxley Act § 308(a). Within the first six months of having the authority, the Commission sought federal court approval of Fair Fund distributions on at least 12 occasions. Stephen Cutler, Dir. of Enforcement, U.S. Sec. & Exch. Comm'n, Testimony Concerning Returning Funds to Defrauded Investors Before the H. Subcomm. on Capital Mkts., Ins., & Gov't Sponsored Enters., Comm. on Fin. Servs. 10 (Feb. 26, 2003) *available at* http://www.sec.gov/news/testimony/022603tssmc.htm [hereinafter Cutler Testimony].

163. *See* Press Release, Baker Statement to Open House-Senate Conference on Corporate Reform (July 19, 2002), *available at* http://web.archive.org/web/20030906035258/www.baker.house.gov/News/conf_corprfm.htm.

> How is it possible for anyone to sit idly by while watching a corporate official move into his $20 million mansion, with hundreds of millions of dollars in retirement benefits, having generated this lifestyle by manipulating the books and defrauding shareholders? With the adoption of the FAIR plan, we will make this much less likely to occur and offer the hope to investors for a small reduction in their loss.

Id.; *see also* Baker I, *supra* note 161.

for civil penalties and disgorgements."[164] Section 308(c) instructed the SEC to provide a report to Congress within 180 days of the enactment of the Act that included "a discussion of regulatory or legislative actions" that the SEC recommended or "that may be necessary to address concerns identified in the study."[165]

In response to Section 308(c), the Commission submitted a report to Congress on January 23, 2003.[166] In its report, the Commission described the limitations of the requirement in Section 308(a) for the SEC to obtain disgorgement before adding the penalty amount to the Fair Fund:

> Currently, the Fair Fund provision permits the Commission to add penalty money to distribution funds in limited circumstances. If a defendant is ordered only to pay a penalty, then that defendant's penalty amount cannot be added to the disgorgement fund. Moreover, if no defendants in a case are ordered to pay disgorgement, then no penalties may be distributed to injured investors. Some issuer financial fraud and reporting cases do not result in any disgorgement orders because no defendant received a tangible profit causally connected to the fraud.[167]

To alleviate these restrictions, the Commission recommended that Congress amend Section 308 to permit the penalties to be added to the Fair Funds even when no disgorgement is obtained. The Commission's report stated:

> By amending the Fair Fund provision to allow defendants' penalties to be distributed to investors irrespective of whether the defendant has been ordered to disgorge money, Congress could allow more monies to be returned to harmed investors.[168]

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164. Sarbanes-Oxley Act § 308(c).

165. *Id.*

166. *See* U.S. SEC. & EXCH. COMM'N, REPORT PURSUANT TO SECTION 308(C) OF THE SARBANES OXLEY ACT OF 2002, *available at* http://www.sec.gov/news/studies/sox308c report.pdf.

167. *Id.* at 34.

168. *Id.*; *see also* Cutler Testimony, *supra* note 162.

> [I]t would be beneficial if the Commission could distribute penalties collected from these defendants (as well as from defendants who are paying disgorgement) to harmed investors in that case . . . . We recommend making technical amendments to the Fair Fund provision to permit the Commission to use penalty moneys for distribution funds in these additional circumstances.

Id.

In response to the Commission's request, Chairman Richard Baker of the Subcommittee on Capital Markets, Insurance, and Government-Sponsored Enterprises of the House Financial Services Committee introduced legislation in 2003 and 2006 to permit any penalty monies obtaining by the Commission to be added to a Fair Fund for the benefit of victims of the securities law violation.[169] Neither bill passed Congress.[170]

Proponents of corporate penalties argue that the Fair Funds provision of the Section 308 of the Sarbanes-Oxley Act alleviates the earlier concerns raised by the Commission in 1989 and Congress in 1990 about harm to shareholders, because any penalties collected are distributed to shareholders. This argument is premised on flawed, circular reasoning. When the Commission obtains penalties from a corporation, there is always one group of shareholders that must pay. The Commission is taking from one group of shareholders to recompense another.[171] Whatever its characterization, ultimately the costs of making this circular distribution are borne by shareholders.

There is no doubt that Section 308 was rooted in good intentions of attempting to help defrauded shareholders. Unfortunately, it has injected an element of uncertainty because penalties are inherently subjective, while disgorgement is rooted in the notion of illicit gain, which generally is quantifiable. In many instances, the SEC has avoided—some argue circumvented—the requirements of Section 308 by assessing a "nominal" disgorgement amount of $1 in order to obtain the "hook" to justify seeking a large corporate penalty to put into a Fair Fund for distribution.[172] As a result, the Fair Fund provision, which was

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169. *See* Fair Fund Improvement Act, H.R. 5956, 109th Cong. (2006); Securities Fraud Deterrence and Investor Restitution Act of 2004, H.R. 2179, 108th Cong. (2004); Dissenting Views to Accompany H.R. 2179, H.R. REP. No. 108-475 (Apr. 27, 2004); *see also* Press Release, Baker, Oxley Introduce Bill To Strengthen SEC Powers Against Securities Fraud, Return Funds To Defrauded Investors (May 21, 2003), *available at* http://web.archive.org/web/20030602 192406/www.baker.house.gov/News/fair_bill.htm.

170. The bills did not advance in Congress because of the general unwillingness to re-open the Sarbanes-Oxley Act of 2002.

171. The Fair Fund distribution thus creates a circular situation: the Commission penalizes a corporation to put the money into a fund to reimburse the shareholders who were themselves just indirectly penalized.

172. *See, e.g.*, Bruce Carton, *When a Dollar (of Disgorgement) Is Worth Millions*, SEC. CLASS ACTION SERV., (Institutional S'holder Servs.), Dec. 3, 2004, *available at* http://scas.issproxy.com/Newsletter/issscasDecember2004.html#POVEditorial (discus-

designed to *protect* shareholders, has been used as a justification for obtaining large corporate penalties, which may *harm* shareholders. Therein lies the paradox: Fair Funds used to compensate injured shareholders are often funded largely through corporate penalties, which are paid by the corporation's current shareholders and result in additional adverse consequences for the company through depletion of its assets.

AN ERA OF INCREASING PENALTIES AGAINST SHAREHOLDERS

The size of the penalties imposed by the Commission has increased markedly in recent years.[173] For example, in 2002, the SEC obtained its first $10 million penalty against a public corporation in its settlement with Xerox Corporation.[174] Since then, the Commission has levied many civil penalties in that amount or larger. In 2003, the Commission obtained twenty penalties in that range or greater, while in 2004, it

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sing recent settlements such as Symbol Technologies ($1 disgorgement; $37,000,000 civil penalty), i2 Technologies ($1 disgorgement; $10,000,000 civil penalty), Royal Dutch Petroleum ($1 disgorgement; $120,000,000 civil penalty), Bristol-Myers Squibb Co. ($1 disgorgement; $150,000,000 civil penalty), and Qwest ($1 disgorgement; $250,000,000 civil penalty)). Disgorgement is a remedy that, if available, is supposed to be exhausted before the SEC seeks a penalty. Therefore, only in the rarest of circumstances should the SEC seek a penalty that accomplishes the goal of stripping away an ill-gotten benefit. Unfortunately, that has not been the case in many SEC penalty actions. Many of those actions have blurred the distinction between "benefit" and "restitution."

173. Not only have civil monetary penalties increased, the number of officer and director bars has also increased drastically over the last several years as has the involvement of criminal authorities, such as the Department of Justice, in securities law violations. In 2004, 170 director and officer bars were entered—more than three times as many as entered in 2001—and the DOJ brought criminal proceedings against 302 entities and individuals in SEC related matters. U.S. CHAMBER OF COMMERCE, REPORT ON THE CURRENT ENFORCEMENT PROGRAM OF THE SECURITIES AND EXCHANGE COMMISSION 25 (2006), *available at* http://www.uschamber.com/NR/rdonlyres/eodmud jqljq2lvttjhn56rn4uubva3yoyzeijj2sh4ugkxlo6xyrpu3cqismvuckpgea3o4gpn4utyo7uzs7 ueqydmc/0603SECEnforcementStudy.pdf.

174. Xerox Corp., Litigation Release No. 17465, 77 SEC Docket 971, 2002 WL 535379 (Apr. 11, 2002); *see* U.S. SEC. & EXCH. COMM'N, 2004 ANNUAL PERFORMANCE PLAN AND 2002 ANNUAL PERFORMANCE REPORT (2003), *available at* http://www.sec.gov/about/gpra2004_2002.pdf.

obtained forty such penalties.[175] The total amount of issuer penalties in 2003 and 2004 was greater than the total amount of *all* penalties imposed by the SEC for the prior fifteen years combined. From 2003 through 2007, approximately $13.8 billion in disgorgement and civil penalties were ordered to be paid to the SEC, courts, or other appointed trustees.[176]

An essential consideration in deciding the appropriateness of any corporate penalty is determining who has profited from the illegal conduct. Sometimes, shareholders have benefited, as in cases of price fixing or bribery of foreign officials; without the bribe, the corporation would not have received a benefit. Regulated entities, such as broker-dealers or registered investment advisors, might increase profits or revenues, which in turn benefit shareholders, by failing to comply with regulatory requirements.[177] In the rare instances where disgorgement may be difficult to calculate, corporate penalties may be appropriate to reverse the ill-gotten benefit.

On the other hand, there are situations where the shareholders did not benefit from the securities law violation. In a typical financial fraud case, management misrepresented the corporation's financial performance to the owners of the corporation. In the typical case, the shareholders have suffered from management's deception and received no ill-gotten gain. When the fraud becomes public, often the market reacts by depressing the value of the stock. In addition, an investigation and ensuing litigation distracts management from the business, drains corporate resources, and harms the corporation's reputation. A penalty would add further to shareholder injury.

In the majority of SEC corporate penalty cases, the corporation has also been sued for the same transgressions in civil class action suits seeking restitution for allegedly harmed shareholders. Settlement proceeds from such private actions should be recognized by the Commission as an offset when determining whether to penalize a corporation in a financial fraud case. Indeed, by statute, the Commission must consider such restitution in its own administrative proceedings when a penalty is under consideration.

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175. *See* U.S. SEC. & EXCH. COMM'N, 2004 ANNUAL PERFORMANCE REPORT (2005), *available at* http://www.sec.gov/about/secpar/secpar04.pdf; U.S. SEC. & EXCH. COMM'N, ANNUAL REPORT 2003 (2004), *available at* http://www.sec.gov/pdf/annrep03/ar03full.pdf.

176. 2007 REPORT, *supra* note 9, at 26.

177. Penalty figures in this Article do not include regulated entities.

Another essential consideration in seeking and imposing a penalty is the effectiveness of the sanction. There is an inherent conflict of interest between management and shareholders of a corporation. If senior managers are faced with the threat of enforcement actions against them or their former colleagues, the senior managers might be motivated by their self-interest to settle the action against the corporation for a large corporate penalty. The penalty obtained in settlement with the corporation may satisfy the SEC's desire to garner public awareness (and thus enhance the "deterrent" effect), causing the SEC to forgo seeking large penalties against individual managers. This willingness to forgo seeking penalties against individuals increases when the evidence against the individuals is relatively weak (indicating a greater risk of losing at trial), or when the individuals have negligible assets or name recognition (diminished publicity and deterrence value).

Other potential conflicts of interest exist between management and shareholders that may interfere with the effectiveness of the sanction. New senior managers, who may have started after the departure of former employees tainted by the fraud, may feel compelled to settle the matter to minimize negative publicity from their being associated with the fraud. In addition, corporate boards, while exercising business judgment, may approve a settlement to avoid the costs and other negative effects of prolonged litigation with the SEC.

As both a philosophical and practical matter, the effectiveness of a corporate penalty as a means for deterrence is questionable. Corporations do not act; individuals do. Senior managers who commit fraud undoubtedly do so with the knowledge that their actions, if exposed, will cause reputational and economic harm to their corporation, such as a depressed stock price, loss of customers and business partners, shareholder litigation, and legal and investigative costs. Often, what motivates the wrongdoer to commit the fraud is the potential personal pecuniary gain of increased stock price, personal advancement within the corporation, or masking the negative effects of strategic or tactical management decisions on the performance of the company. If wrongdoers have little concern for their company and shareholders when they commit the fraud, it is doubtful that the behavior of potential wrongdoers will be altered by the threat of a corporate penalty on the company and shareholders that they are seeking to victimize. Are would-be fraudsters more likely to be deterred by headlines trumpeting a multimillion dollar corporate fine, or by hearing that a senior executive was fired, lost his savings, became barred from serving as an officer or a

director, suffered irreparable harm to his reputation, and perhaps faces incarceration?

Each of these considerations continues to be important when the Commission evaluates whether to seek a penalty against a corporation. In providing the SEC with the power to seek penalties against corporations, Congress recognized the need for the SEC to have the authority in limited and rare circumstances, and it trusted the SEC with the discretion to use that authority in accordance with the SEC's mission of protecting investors. In order to provide some transparency to the process, the Commission has issued guidance to the public concerning what factors the Commission considers and what prospective defendants may do to avoid a penalty or reduce the amount.

THE 2006 STATEMENT OF THE SECURITIES AND EXCHANGE COMMISSION CONCERNING FINANCIAL PENALTIES

Under a new chairman, the Commission on January 4, 2006, released a statement concerning the factors that the SEC would evaluate in assessing a monetary penalty.[178] In formulating the penalty statement, the Commission returned to first principles: it discussed the 1989 and 1990 Commission and Congressional statements regarding penalties and attempted to set up a hierarchy of balancing considerations to guide future deliberations. It stated unequivocally that penalties against corporations can harm shareholders, a point that previously had been in dispute within the Commission.

The Commission explained that the two most significant factors 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 shareholders.[179] The first key factor focused on unjust enrichment to the corporation, and thus to the shareholders. Any improper benefit would have to be balanced against the losses incurred by the shareholders as a result of the fraud.

The second key factor balances the possibility that the penalty will "recompense" investors with the injury that the penalty would do to them. In this factor, the Commission, unfortunately, was rather

178. Press Release, U.S. Sec. & Exch. Comm'n, Statement of the Securities and Exchange Commission Concerning Financial Penalties (Jan. 4, 2006), *available at* http://www.sec.gov/news/press/2006-4.htm [hereinafter 2006 Penalty Statement].

179. *Id.*

imprecise with its terms. In every case, current stockholders pay for the penalty. The purpose of this language was to cover the cases in which other classes of investors may have been harmed for the benefit of the stockholders—for example, fraudulently enhanced financial statements may have resulted in lower coupon interest rates or yields to bondholders, to the benefit of the corporation and its common stockholders.

The Commission also announced secondary factors for consideration. Those factors are: (1) "The need to deter the particular type of offense;" (2) "The extent of the injury to innocent parties;" (3) "Whether complicity in the violation is widespread throughout the corporation;" (4) "The level of intent on the part of the perpetrators;" (5) "The degree of difficulty in detecting the particular type of offense;" (6) "Presence or lack of remedial steps by the corporation;" and (7) "Extent of cooperation with Commission and other law enforcement."[180]

The penalty statement has served as a reminder of the fact that corporate penalties harm shareholders. Nevertheless, it has had some unintended consequences. In particular, the last factor—the extent of cooperation with the Commission and law enforcement—has been used along with other Commission guidance as a means to *credit* prospective defendants, particularly corporations, for waiving their attorney-client privilege and work-product protections.[181]

THE SEABOARD REPORT

The SEC's explicit willingness to credit cooperation, even if it involves the waiver of the attorney-client privilege and work-product protection, predates the 2006 Statement on Penalties and the Sarbanes-

180. *Id.*

181. The New York Stock Exchange lists waiver of the attorney-client privilege as a factor in evaluating whether a Member has exhibited "extraordinary cooperation." *See* New York Stock Exchange, Information Memorandum No. 05-65 to All Members, Member Organizations and Chief Operating Officers 5 (Sept. 14, 2005). Members of the New York Stock Exchange are required as a condition for listing to cooperate and produce documents upon request by the Exchange, but that required cooperation does not include a mandatory requirement to produce attorney-client privileged information. FINRA (formerly NASD) Rule 8210 requires members and persons associated with members to produce non-privileged documents and provide testimony upon request by FINRA. *See* FINRA Rule 8210, *available at* http://finra.complinet.com. As a general matter, the SEC does not impose any similar mandatory requirements to cooperate in its investigations.

Oxley Act. On October 23, 2001, the Commission released an investigative report pursuant to section 21(a) of the Exchange Act, addressing the relationship of cooperation and agency enforcement decisions.[182] That report, called the "Seaboard Report" based on the name of the defendant at issue, marked the first time that the Commission announced the factors that it would evaluate in measuring cooperation and assessing whether to bring an enforcement action.

The Commission intended this report to encourage companies to cooperate with the SEC in investigations. In that respect, the report was a major improvement in the transparency of the SEC in its enforcement investigations. Lacking a public manual of policies and procedures, the SEC in effect encouraged an informal body of knowledge to develop among long-time SEC enforcement practitioners as to what was expected of potential defendants in dealing with the Commission.[183] The Seaboard report was a long-overdue attempt to open up the process.

Among other issues, the Seaboard Report discussed disclosures to staff of confidential information protected by the attorney-client privilege or work-product doctrine. In a footnote, the Seaboard Report stated:

> The Commission recognizes that these privileges, protections and exemptions serve important social interests. In this regard, the Commission does not view a company's waiver of a privilege as an end in itself, but only as a means (where necessary) to provide relevant and sometimes critical information to the Commission staff.[184]

Waiver is not itself listed as one of the Seaboard criteria for determining whether, and how much, to credit self-policing, self-reporting, remediation, and cooperation. Nonetheless, the Enforcement Division and the Commission in the ensuing years often have misinterpreted the Seaboard Report as a basis for rewarding companies for waiving privilege. As a practical matter, rewarding companies for

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182. Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934 and Commission Statement on the Relationship of Cooperation to Agency Enforcement Decisions, Exchange Act Release No. 44,969 (Oct. 23, 2001), *available at* http://www.sec.gov/litigation/investreport/34-44969.htm#P54_10935.

183. The Wells Committee had the same concern with inexperienced practitioners being unaware of a prospective defendant's ability to provide written submissions that raised factual and legal defenses. *See supra*, text accompanying note 58.

184. *Id.* at n.3.

cooperating by waiving privilege has the same effect as punishing them for not waiving privilege—both effectively strip the attorney-client privilege, which is a fundamental component of our legal system.[185]

Another problem with a permissive approach to waiver is that waiver becomes mandatory in practice. Faced with concerns over their fiduciary duties and the expense and risk of litigation to the corporation, a corporation's board of directors may feel compelled to take full advantage of any cooperation credit available to it by waiving the attorney-client privilege and work-product protection. Indeed, shareholders likely would be unable to establish that the board of directors breached its fiduciary duty by waiving the corporation's privilege in exchange for cooperation credit if the corporation faced the threat of a large penalty.[186]

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185. *See, e.g.*, The Thompson Memorandum's Effect on the Right to Counsel in Corporate Investigations: Hearing Before the S. Comm. on the Judiciary (2006) (statement of Edwin Meese III, former Att'y Gen. of the United States and Chairman, Ctr. for Legal and Judicial Studies, Heritage Foundation), *available at* http://judiciary.senate.gov/testimony.cfm?id=2054&wit_id=5741.

> [E]xperience has shown that the [Thompson] Memorandum has resulted in the dilution of essential rights encompassed by the attorney-client relationship. . . . [T]he Thompson Memorandum itself pressures companies to fulfill its nine factors, including by waiving their attorney-client privilege and cutting off their employees' attorney fees. Even if no prosecutor ever mentions either factor to a company, the fact that the Thompson Memorandum requires federal prosecutors to take all nine of its factors into consideration when deciding whether to indict a business organization necessarily places great pressure on the company to take these two steps.

Id. For a discussion of the Thompson Memorandum and other Justice Department memoranda regarding waiver of attorney-client privilege and work-product protection, *see infra* note 187.

186. Just as with any individual, corporations must not obstruct government investigations and must comply with duly issued subpoenas and court orders. Individuals and corporations, however, owe no duty to abandon all potential defenses and privileges in the face of government investigations. In fact, under state law, the directors of a corporation owe fiduciary duties to their shareholders. *See, e.g.*, *Smith v. Van Gorkom*, 488 A.2d 858 (Del. 1985) (discussing the duties of directors). Under most state laws, including Delaware General Corporate Law, the board of directors of a corporation owes to its *shareholders* a duty of care and loyalty. *See id.* In some instances, cooperating with the SEC or another regulator may be contrary to the fiduciary duties of the directors because cooperation may lead to the corporation's being susceptible to meritless governmental actions and frivolous shareholder litigation. In those circumstances, it may be appropriate for the board of directors, in fully evaluating the situation and exercising business judgment, to decline to waive their attorney-client privilege with respect to a government investigation.

The idea of crediting the waiving of the attorney-client privilege or work-product protection originated with the Department of Justice. Two years prior to the Seaboard Report, the DOJ published the first memorandum—of what would ultimately be several memoranda—illuminating on the meaning of cooperation and the general principles that the Department of Justice follows when investigating business organizations.[187] These DOJ memoranda stated explicitly that a corporation's willingness to waive the attorney-client privilege and work-product protection should be considered in determining whether a corporation has cooperated adequately with the government. Given the number of parallel investigations by the DOJ and SEC, the policies of one agency affect the conduct of the other's investigations and limit the possible range of choices available to a defendant.[188]

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187. The first memorandum was sent by Deputy Attorney General Eric Holder to all Department Component Heads and U.S. Attorneys on June 16, 1999 (the "Holder Memorandum"). The Holder Memorandum focused on the prosecution of corporate criminal activity and included a document called "Federal Prosecution of Corporations," which outlined factors and considerations to be taken into account when charging corporations. Memorandum from Eric Holder, Deputy Att'y Gen., to Heads of Department Components and United States Attorneys (June 16, 1999) (on file with the Department of Justice). The second memorandum, which was a response to the substantial controversy that arose over the Holder Memorandum, was sent by Deputy Attorney General Larry Thompson in January 2003 and included much of the same text from the Holder memo, with some changes to reflect findings of the Corporate Fraud Task Force. Memorandum from Larry D. Thompson, Deputy Att'y Gen., to Heads of Department Components and United States Attorneys (Jan. 20, 2003), *available at* http://www.usdoj.gov/dag/cftf/corporate_guidelines.htm. Mounting criticism regarding lack of policies and procedures in this regard led acting Deputy Attorney General Robert McCallum in 2005 to amend the U.S. Attorney's manual to require that U.S. Attorneys establish a written waiver review process for their respective districts. See Memorandum from Robert D. McCallum, Jr., Acting Deputy Att'y Gen., to Heads of Department Components and United States Attorneys (Oct. 21, 2005), *available at* http://www.usdoj.gov/usao/eousa/foia_reading_room/usam/title9/crm00163.htm.
Finally, the Justice Department, under the direction of Deputy Attorney General Paul J. McNulty, released a memorandum that attempted to draw distinctions on categories of privileged material. *See* Memorandum from Paul J. McNulty, Deputy Attorney General, to Heads of Department Components and United States Attorneys (Dec. 12, 2006), *available at* http://www.usdoj.gov/dag/speeches/2006/mcnulty_memo.pdf. The McNulty memorandum still gives entities credit for turning over attorney-client privileged material and attorney work product.

188. The implications extend to individuals as well. DOJ allows prosecutors to consider a company's willingness to punish employees who assert their constitutional rights and whether the company entered into joint-defense or information-sharing agreements with employees. This policy could cause an employee to face the difficult choice of losing his job or cooperating in an internal investigation without counsel and without constitutional protections. *See, e.g.*, *Proposed Amendment of Commentary on*

The practices of the SEC and DOJ to credit cooperation for waiving the attorney-client privilege or work-product protection have met with significant criticism. On February 5, 2007, the American Bar Association ("ABA") submitted to the SEC a proposed "Revised Commission Statement on the Relationship of Cooperation to Agency Enforcement Decisions," which seeks to have the SEC revise the Seaboard Report with respect to the waiver of the attorney-client privilege and work-product protection.[189] The proposal amends the section of the Seaboard Report describing the factors by which cooperation may be measured to read: "provided, however, that a company shall not be required to take any of the foregoing actions to the extent that it would result in a waiver of the attorney-client privilege or work product doctrine."[190] The proposal also seeks to remove the ambiguous footnote 3 of the Seaboard Report that describes waiver as "a means (where necessary) to provide relevant and sometimes critical information to the Commission staff." The proposal adds a new paragraph and related footnote describing the importance of attorney-client privilege and work-product protection and the adverse consequences when staff seeks the waiver.[191] The new paragraph states in part:

> Commission staff shall not take any action or assert any position that directly or indirectly demands, requests or encourages a company or its attorneys to waive its attorney-client privilege or the protections of the work product doctrine. Also, in assessing a company's cooperation, Commission staff shall not draw any inference from the company's preservation of its attorney-client privilege and the protections of the work product doctrine. At the same time, the voluntary decision by a company to waive the attorney-client

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Section 8c2.5 of the Federal Sentencing Guidelines Regarding Waiver of Attorney-Client Privilege and Work Product Doctrine Before the United States Sentencing Commission (2006) (statement of Kent Wicker, Nat'l Ass'n of Criminal Def. Lawyers).

> This compelled waiver of the attorney-client privilege forced my client to give up the protection at the heart of our criminal justice system: The privilege under the Fifth Amendment against self-incrimination. It is not enough to say he could have just given up his job and retained his Fifth Amendment rights. This is a real person, with a real family to support.

Id.

189. Letter from Karen J. Mathis, President, American Bar Ass'n, to Christopher Cox, Chairman, U.S. Sec. & Exch. Comm'n (Feb. 5, 2007), *available at* http://www.abanet.org/poladv/letters/attyclient/2007feb05_privwaivsec_l.pdf.

190. *Id.* at 2.

191. *Id.* at 2-3.

> privilege and/or the work product doctrine shall not be considered when assessing whether the company provided effective cooperation. The Commission may consider, however, in assessing whether a company has provided effective cooperation, the degree to which the company has provided factual information to the Commission staff in a manner, to be worked out by the company and the Commission staff, that preserves the protections of the attorney-client privilege and work product doctrine to the extent possible.[192]

Similar criticisms by other groups have been, and continue to be, levied against using the Seaboard Report to encourage waiver of the attorney-client privilege or work-product protection.[193]

As the SEC and other Federal agencies press to have the attorney-client privilege waived as they undertake investigations, the entire privilege is gradually weakened. As knowledge of its weakening spreads, corporate employees may become less candid and forthcoming, corporate internal investigations will be less trustworthy, and shareholders and government investigators will be frustrated in their efforts to prevent misdeeds. Given those outcomes, revisiting Seaboard and the SEC's approach to the attorney-client privilege and work-product protection is long overdue.

A CALL FOR A NEW ADVISORY COMMITTEE

The SEC Enforcement Division is viewed with pride by Commissioners, staff, alumni, and many outsiders. The Division has a long history of stellar achievements and dedicated attorneys, accountants, and other staff. Thirty-six years after its creation, the Division is larger, stronger, and more visible than any member of the Wells Committee could have imagined. Thus, it makes sense that the

192. *Id.* at 3. The proposal recognizes that there are limited, specific exceptions where the staff, after obtaining advance approval from the Director of Enforcement or his/her designee, may seek privileged or work-product materials. Those exceptions arise when the company asserts the advice of counsel defense or the SEC staff establishes the elements for the crime/fraud exception. *Id.*

193. *See, e.g.*, McLucas, Shapiro & Song, *The Decline of the Attorney-Client Privilege in the Corporate Setting*, 96 J. CRIM. L. & CRIMINOLOGY 621 (2006); Posting of Thomas O. Gorman, The Rolling Stones Test: SEC And DOJ Cooperation Standards, SEC Actions Blog, http://www.secactions.com/?p=190 (May 22, 2007, 01:07 EST) ("Conversely no cooperation credit should be given for what the government says it does not usually need –privileged material and waivers.").

Commission should consider whether it is time to convene a Wells-like committee to "bring to date" the best thinking on enforcement practices.

The new advisory committee's mission would be to conduct an independent review of the Commission's enforcement program from multiple, diverse perspectives, and to recommend to the Commission, if warranted, any needed changes. We propose that the new advisory committee adopt the same mandate as that of the Wells Committee in 1972. The tasks assigned to the Wells Committee are as important today as they were in 1972. If the same mandate is adopted, the new advisory committee would be charged with virtually the same tasks as the original Wells Committee, only slightly adapted to developments in the last three decades:

> (1) reviewing and evaluating the Commission's enforcement policies and practices in light of its statutory responsibilities and mission to protect investors; to maintain fair, orderly, and efficient markets; and to facilitate capital formation;
> (2) advising how the SEC's enforcement objectives and strategies may be made more effective;
> (3) examining the Commission's enforcement practices and procedures from the point of view of due process,[194] respect for the prospective defendants' attorney-client privilege and work-product protection,[195] the relationship of enforcement action to notice of legal requirements, the attribution of responsibility for violations, and the

194. The Committee should consider the Commission's current procedure regarding authorization of cases implicating potential corporate penalties, under which the Commission authorizes the staff to negotiate a settlement, before the staff engages in any settlement discussions with the prospective defendant. At issue is whether the Commission, at the time of authorization of negotiations, should also authorize the staff to litigate if the settlement negotiations prove unfruitful, or whether the staff should return to the Commission to seek litigation authorization. The issues hearken back to those that animated the debate around the original Wells Committee Recommendation 20, namely whether authorizing staff to litigate before commencing settlement negotiations skews the negotiations through the implicit threat to litigate if no settlement is reached. *See supra* notes 61-72 and accompanying text.

195. Included in this task would be the need to re-evaluate the 2006 Statement Regarding Penalties and the 2001 Seaboard Report, particularly with respect to the expectation of waiver of attorney-client privilege and work-product protection as a determinant of cooperation.

> protection of reputation and rights of privacy of those with whom the Commission interacts;[196]
> (4) making recommendations on the appropriate blend of regulation, publicity, and formal enforcement action and on methods of furthering voluntary compliance with securities laws;
> (5) making recommendations on criteria for the selection and disposition of enforcement actions, in particular, providing timely notice to parties of the closing of an investigation; and
> (6) advising on the appropriate uses of penalties against corporations in light of the SEC's mission of protecting investors.

Among the many issues that would fall under this broad mandate would be the implementation of mechanisms to provide more efficacy, predictability and transparency to the enforcement program. The overall philosophy and management of the enforcement program should be examined to determine how best it can fulfill the SEC's mission, in light of resources and statutory authority.

Predictability and transparency provide for a fair process that respects the rights of all parties involved and ensures adherence to the rule of law.[197] Of course, the Commission's discretion should not be eliminated in favor of rote application of a mathematical formula for calculating penalties. Discretion plays an important role in forgoing certain theories of liability or not bringing an action at all. For example, a company and its shareholders may have been punished enough through

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196. Beyond the scope of this Article is the ancillary issue of disclosure by issuers of the various stages of an SEC investigation. Although in large part a facts-and-circumstances determination as to materiality, guidance would be helpful to issuers and practitioners.

197. With the increasing emphasis on a more punitive enforcement approach, are sufficient safeguards in place to protect the rights of prospective individual defendants? At the time of the Wells Committee, the SEC lacked the power to seek punitive damages against individuals, so the potential costs to the individual defendant were not as pronounced as they are today. Individual defendants are faced with high costs of defending an SEC action and severe consequences if they lose. These consequences at times can be tantamount to criminal sanctions, including large monetary payments and loss of livelihood. Often, the only option is a pro-se defense. Will a Commission one day decide that it should establish a system to provide representation to individual defendants who cannot afford to hire private counsel?

other avenues or the securities law violation may have been merely an honest mistake. Indeed, the Wells Committee's Recommendation 14 discussed this type of discretion:

> The Commission should give due consideration in cases which appear to involve honest mistake or good faith efforts at compliance to exercising its discretion against bringing a formal enforcement proceeding notwithstanding the appearance of a violation.[198]

The ability of the Enforcement Division to recommend to the Commission that no action be taken in a particular matter should be encouraged and institutionalized. This will require, among other things, a re-evaluation of the incentives for bringing actions and obtaining large penalties (such as through promotions, awards, and public recognition). Statistics, such as the number of cases brought and the penalties recovered, should play only a minimal role in assessing individual performance. Instead, an evaluation system should focus on rewarding high quality efforts and professionalism regardless of the outcome of particular actions. A decision to forgo bringing an enforcement action should not be treated automatically as a loss, but it should be evaluated qualitatively alongside other enforcement decisions.

In some instances, exercising discretion may not be appropriate. There should not be institutional encouragement for using discretion to formulate theories of liability that overstep the boundaries of existing law. Law making is reserved for legislative process in Congress and the SEC rulemaking process under the strict requirements of the Administrative Procedure Act; it is not a function of the Enforcement Division.

Another aspect that could be considered by the advisory committee is the implementation of a written and uniform "full-disclosure" policy for enforcement matters.[199] In criminal procedure, this is often referred to as an "open jacket" policy. Operating under such a policy, the enforcement staff would show defense counsel the evidence it has against the prospective defendant, which is the essence of due process. Some practicing lawyers have criticized the SEC Enforcement Division for failing to explain to defendants the allegations of wrongdoing and failing to share critical incriminating—and most importantly,

198. WELLS COMMITTEE ADVISORY REPORT, *supra* note 39, at iv.

199. The Wells Committee proposed the institutionalization of a similar policy. *See supra* note 71 and accompanying text. Currently, there is not a uniform practice among the various units in the Enforcement Division.

exculpatory—evidence that the SEC has gathered.[200] Because no such policy is in place today, arguments in Wells Submissions often are based on defense counsel's best guess as to the conduct that enforcement staff has identified as violating federal securities laws. The sharing of information would promote the goal of fact-finding, which is paramount to due process and to the administration of justice.

With the advent of additional remedies in the SEC's arsenal in the decades after the Wells Committee and a shift in approach towards a more punitive focus, the idea of a full-disclosure policy is even more important than it was when the Wells Committee made its recommendations. The SEC staff should inform fully individuals and companies about the allegations and the evidence at the time of a Wells call or, at the very latest, before entering into settlement discussions. Corporate boards, in particular, must be sufficiently informed so that they can apprise their shareholders and exercise good business judgment in determining whether to settle a matter with the SEC.

Another aspect of the enforcement program that the new advisory committee should consider is the process for closing investigations. In a report to Congress by the General Accountability Office ("GAO"), the GAO harshly criticized the Enforcement Division for not closing investigations promptly and observed that the Division had a "potentially large backlog of investigations that are not likely to result in enforcement actions and for which closing packages have not been completed."[201] As a result, the GAO concluded that "the subjects of many aged and inactive investigations may continue to suffer adverse consequences until closing actions are completed."[202]

Enforcement Division officials told the GAO that their attorneys may believe that pursuing potential securities violations is a higher

200. *See, e.g.*, Kevin J. Harnishch & Natasha Colton, *When the SEC Comes Knocking*, 15 A.B.A. SEC. BUS. L. 1 (2005), *available at* http://www.abanet.org/buslaw/blt/2005-09-10/colton.shtml.

201. U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-07-830, SEC: ADDITIONAL ACTIONS NEEDED TO ENSURE PLANNED IMPROVEMENTS ADDRESS LIMITATIONS IN ENFORCEMENT DIVISION OPERATIONS 22 (2007), *available at* http://www.gao.gov/new.items/d07830.pdf. For example, according to the GAO Report, one SEC regional office reported that as of March 2007 about 35% of its open investigations were "more than 2 years old, had not resulted in an enforcement action, and were no longer being actively pursued." *Id.* at 21. In response, the Enforcement Division has undertaken to review the backlog and streamline the closing process. *Id.* at 46.

202. *Id.*

priority than closing investigations.[203] Officials also cited a scarcity of time, administrative support, and incentives to comply with established procedures for closing investigations.[204] Although the GAO recognized that resolving the potentially large backlog of investigations would impose resource challenges for Enforcement Division,[205] the GAO recommended that the SEC chairman direct the Enforcement Division to "consider developing expedited procedures for closing investigations."[206]

When the Commission or its staff determines that an investigation should be closed or action is not warranted, the agency promptly should send a closing letter.[207] Closing letters should be sent not only to those who have made a Wells Submission, but also to any significant non-party that has provided documents, information, or testimony to the SEC. Similarly, if the enforcement staff views a person only as a witness or source of information in an investigation, staff should make that clear to the person.

In its proposed mandate to examine enforcement practices and procedures from the point of view of due process, the new advisory committee should consider ways to improve the cherished Wells process. One way in which the Wells process should be bolstered is through a mechanism to allow a proposed defendant to appear before the Commission to oppose a proposed enforcement proceeding. Although it would likely be both unnecessary and unmanageable to allow such an "oral Wells submission" in every situation, it may be beneficial to both the Commission and proposed defendants for the Commission to have a discretionary avenue to hear from proposed defendants prior to taking action. Matters that might be appropriate for this procedure would include complex factual cases, such as those necessitating expert witnesses, disputes concerning the level of cooperation, or cases in which character assessment and credibility is particularly important.[208]

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203. *Id.*

204. *Id.*

205. *Id.*

206. *Id.* at 7.

207. The Wells Committee in Recommendation 8 proposed that the "Commission adopt in the usual case the practice of notifying an investigatee against whom no further action is contemplated that the staff has concluded its investigation . . . ." and will not recommend an enforcement action. WELLS COMMITTEE ADVISORY REPORT, *supra* note 39, at 20.

208. For example, at both the Federal Trade Commission and the Federal Communications Commission, in-person presentations to commissioners and staff of

A review of the enforcement process would not be complete without a review of the costs to parties responding to an investigation. Responding to an SEC investigation is costly, particularly in the age of e-mails and electronic data. The SEC must ensure that its investigations and enforcement actions do not impose unnecessary costs. Overly broad subpoenas or document or interview requests add to a responding entity's costs, and not every responding entity becomes a defendant. Innocent parties pay the price of overly broad requests. Notices to preserve—and subsequent requests to produce—electronic data, including e-mails, voicemails, and server back-up tapes are particularly burdensome and costly to a company. While it is undoubtedly critical for the SEC to have certain electronic data to conduct an investigation and litigate a matter, preservation notices and requests for production are often generic and extend well beyond the boundaries of the existing investigation. It is difficult to justify imposing unnecessary costs on a company, particularly when the investigation may last many years and result in no action taken.

The new advisory committee should recommend ways to minimize costs through the formulation of detailed procedures to address preservation notices and production requests for electronic data. In recommending the procedures, the advisory committee should take into account the burden and expense of preserving certain kinds of records, such as electronic voicemail, and producing data stored in long-term media such as back-up tapes. Preservation notices should be reasonably related to the matters under investigation, and prospective preservation of information should be invoked only if misconduct is suspected or ongoing.[209] The use of generic preservation notices, covering data that the company might not otherwise preserve in the normal course of its operations, should be prohibited.

Production requests should be narrowly tailored and should first seek information that is readily accessible. Requests should not demand the production of data stored on back-up tapes unless unavailable through other sources. As a measure to guard against overbroad requests, the advisory committee should consider ways to incorporate in enforcement procedures pre-approval of document requests by a senior member of the Enforcement Division.

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evidence and advocacy positions in advance of potential enforcement actions are routine.

209. Subjects of investigation already have other legal obligations to preserve documents. *See, e.g.*, 18 U.S.C. § 1512 (2006).

The advisory committee also should explore the establishment of an ombudsman to review and evaluate complaints about the enforcement process and behavior of the Enforcement staff. An ombudsman would provide an avenue for persons to convey their grievances to the Commission without fear of reprisal. People should be able to make these complaints anonymously through a hotline.[210]

The new advisory committee should examine the usage, effects, amount, and appropriateness of issuer penalties in financial fraud cases. The committee should consider whether these issuer penalties are consistent with the SEC's mission of investor protection; maintaining fair, orderly, and efficient markets; and facilitating capital formation. For example, do penalties protect investors? Do they harm or benefit shareholders? Is the circularity of Fair Fund penalty distributions consistent with ensuring fair, orderly, and efficient capital markets? Is capital formation impeded by the threat of large, unpredictable issuer penalties?

The advisory committee also should evaluate the moral hazards associated with issuer penalties. One moral hazard is the possibility that managers of companies might agree to a large corporate penalty in order to avoid or soften actions against culpable individuals.[211] Are individuals deterred from wrongdoing if they expect that shareholders will pay the penalties for the misconduct?

The SEC also faces it own moral hazards when contemplating the assessment of issuer penalties. Does the prospect of large issuer penalties and the inevitable press coverage cause the SEC to misallocate

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210. The SEC's Office of Compliance Inspections and Examinations already has such a hotline. *See* U.S. Sec. & Exch. Comm'n, Office of Compliance Inspections & Examinations, Examination Hotline, http://www.sec.gov/about/offices/ocie/ocie_hotline.shtml (last visited May 9, 2008).

211. *See generally* Donald C. Langevoort, *On Leaving Corporate Executives "Naked, Homeless and Without Wheels": Corporate Fraud, Equitable Remedies, and the Debate over Entity versus Individual Liability*, 42 WAKE FOREST L. REV. 627 (2007). As Professor Langevoort explains:

> The corporate sanction avoids the need to attribute fault to any particular individual under circumstances where there is likely mutual finger pointing about who is to blame. For all these reasons, company sanctions are the path of least resistance; the SEC can claim its victory and move its resources to new matters that deserve attention. There is probably a publicity-related reason as well: sanctions against companies can be large enough to grab headlines, which is less likely to occur with respect to individual sanctions, even in the aggregate.

Id. at 654.

resources to build these cases to the detriment of other types of enforcement actions?

The Commission's 2006 penalty statement was a significant first step in setting forth a principled foundation for examination of many of these concerns.[212] In applying the penalty statement, the Commission has encountered areas not addressed by the statement, such as the determination of the amount of penalty and the appropriateness of imposing penalties on new shareholders.[213] Taking the Commission's experience into consideration, the new advisory committee should re-examine these issues with the input of economists, legal scholars, and practitioners.

These and any additional recommendations from the advisory committee that ultimately are approved by the Commission should be set forth in a publicly available Enforcement Manual. In 2007, the minority members of the Senate Finance Committee recommended that the SEC create such a manual, which would be similar to the U.S. Attorney Manual, "to address situations or issues likely to recur."[214] The public accessibility of the manual would ensure transparency and uniform application. The manual itself, and any later changes to it, should be reviewed and approved by the Commission. Deviations from the manual, while necessary in some instances, should be discouraged. The manual will serve as the governing guidelines for the Enforcement staff at headquarters and in the regional offices. An Enforcement Manual that reflects the recommendations of an advisory committee, as adopted by the Commission, could serve as a useful framework for the Commission's enforcement program in the years to come.

CONCLUSION

The SEC's enforcement program serves a critical function in ensuring proper compliance with the U.S. securities laws. Throughout

212. *See* 2006 Penalty Statement, *supra* note 178.

213. Many of these same concerns were raised by the Commission during the legislative debate over the Remedies Act of 1990. *See, e.g.*, SEC Memorandum in Support of Remedies Act, *supra* note 96.

214. *See* Staff of S. Fin. Comm., 110th Cong., Report on the Firing of an SEC Attorney and the Investigation of Pequot Capital Management 7 (Comm. Print 2007), *available at* http://finance.senate.gov/sitepages/leg/LEG%202007/Leg%20110%20080307%20SEC.pdf.

its history, the SEC has protected investors and the general public from a wide array of fraudulent conduct. Given the importance of enforcement to the SEC's mission, a critical review of the enforcement program—similar to that done by the Wells Committee in 1972—is long overdue. This article is intended to start a list of items for consideration, but does not purport to identify all the areas that should be evaluated by a new Wells-like advisory committee. The members of the advisory committee undoubtedly will draw from their own experiences and expertise to develop a full agenda. The Commission should be receptive to considering any new ideas for improving the enforcement program and furthering the SEC's mission. We are confident that the result will be an enforcement program that is more transparent, better embodies principles of due process, and more effectively combats violations of the federal securities laws.

WRITTEN TESTIMONY OF JOSEPH P. BORG

PRESIDENT, NORTH AMERICAN SECURITIES ADMINISTRATORS ASSOCIATION, INC.

AND

DIRECTOR, ALABAMA SECURITIES COMMISSION

BEFORE THE

U.S. HOUSE COMMITTEE ON FINANCIAL SERVICES

SUBCOMMITTEE ON CAPITAL MARKETS, SECURITIES, AND INVESTMENT

"Ensuring Effectiveness, Fairness, and Transparency in Securities Law Enforcement"

June 13, 2018

WASHINGTON, DC

I. Introduction

Good Morning, Chairman Huizenga, Ranking Member Maloney, and members of the Subcommittee. I'm Joseph Borg, Director of the Alabama Securities Commission and President of the North American Securities Administrators Association ("NASAA").[1] It's been a privilege for me to serve as Director of the Alabama Securities Commission since 1994, and to have been elected as NASAA's President three times, most recently for a term spanning 2017-2018. I am honored to testify before the Subcommittee today about effectiveness, fairness, and transparency in the enforcement of federal and state securities laws.

In the United States, state securities regulators have protected Main Street investors for the past 100 years, longer than any other securities regulator.[2] We are sometimes referred to as the "cops on the beat" as we are the securities regulators closest in proximity to your constituents. State securities regulators are responsible for administering state securities laws that both serve to protect your constituents from fraud while also providing regulatory frameworks through which businesses can raise capital. My colleagues and I are responsible for enforcing state securities laws including investigating complaints, examining broker-dealers and investment advisers, registering certain securities offerings, and providing investor education programs to your constituents. Ten of my colleagues are appointed by Secretaries of State, five serve in the state Attorney General's office or under the direction thereof, and others are appointed by their Governors and other senior state officials. Some, like me, work for independent commissions or boards. We are proud to work alongside our colleagues at the U.S. Securities and Exchange Commission ("SEC"), Commodities Futures Trading Commission ("CFTC"), and the Financial Industry Regulatory Authority ("FINRA") to police the securities markets and enforce our nation's securities laws.

States are leaders in civil and administrative enforcement actions, as well as criminal prosecutions of securities violators. Our most recently compiled enforcement statistics reflect that in 2016 alone, state securities regulators conducted nearly 4,300 investigations, leading to more than 2,000 enforcement actions, including 241 criminal actions. Moreover, in 2016, among licensed financial professionals, NASAA members reported 186 enforcement actions involving broker-dealer agents, 133 actions involving investment adviser representatives, 144 involving broker-dealer firms, and 157 involving investment adviser firms.

States also continue to serve a vital gatekeeper function by screening out bad actors before they have a chance to conduct business with unsuspecting investors. A total of 2,843 securities license applications were withdrawn in 2016 as a result of state action; and an additional 537 licenses were either denied, revoked, suspended or conditioned. State securities

[1] The oldest international organization devoted to investor protection, NASAA was organized in 1919. Its membership consists of the securities administrators in the 50 states, the District of Columbia, Canada, Mexico, Puerto Rico and the U.S. Virgin Islands. NASAA is the voice of securities agencies responsible for grass-roots investor protection and efficient capital formation.

[2] Currently, 43 states have adopted a uniform securities act. The uniform securities acts were developed by the Uniform Law Commission for adoption by the states.

regulators continue to focus on protecting retail investors, especially those of your constituents who lack the expertise, experience, or resources to protect their own interests.

In addition to serving as "cops on the beat," state securities regulators serve as the primary regulators of many small and local securities offerings. As such, state securities regulators often work with and assist local businesses that seek capital investment. Moreover, state securities regulators, acting within NASAA, have a long history of working closely with the SEC, FINRA, and other regulators to effect greater uniformity in federal-state securities matters.

Finally, given the focus of today's hearing, it should be noted that state securities regulators are often first to discover and investigate our nation's largest frauds. In thinking about the role of state and federal enforcement authorities, it is instructive to look back at the regulatory responses to the major financial scandals over the past decade. From the investigation into the role of investment banks in the Enron fraud, to exposing securities analyst conflicts, "market timing" in mutual funds, and to uncovering problems in the auction rate securities market, state securities regulators have consistently been in the lead.

II. State Securities Regulators & Enforcement

The State Role in Securities Law Enforcement

Our capital markets function and grow in large part due to the trust investors place in market participants and the regulators. Maintaining that trust is essential to the continued primacy of our markets in an ever-competitive global marketplace. And integral to maintaining that trust is the work of state securities regulators in investigating suspected investment fraud, and, where warranted, pursuing enforcement actions. Keeping the bad actors out of the markets serves not only the interests of investors, but the businesses that rely on markets to raise capital.[3]

The enforcement role of state securities regulators differs in some ways from the SEC and self-regulatory organizations ("SROs") such as FINRA. Because our local offices are often the first to receive complaints from investors, state securities regulators serve as an early warning system, working on the front lines, investigating potentially fraudulent activity, and alerting the public to the latest scams.

States take aggressive enforcement actions against a wide variety of actors. From the fraudsters engaged in Ponzi or pyramid schemes to companies who mislead investors our

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[3] For example, a report of the Group of 20 countries (G-20) issued in response to the financial crisis of 2008 concluded that "[n]o matter how sound the rules are for regulating the conduct of market participants, if the system of enforcement is ineffective – or is perceived to be ineffective – the ability of the system to achieve the desired outcome is undermined. It is thus essential that participants are appropriately monitored, that offenders are vigorously prosecuted and that adequate penalties are imposed when rules are broken. A regulatory framework with strong monitoring, prosecution, and application of penalties provides the incentives for firms to follow the rules. This, in the end, adds to the framework's credibility and enhances investor confidence in the financial system." *See:* G-20 Working Group 1, *G20 Working Group on Enhancing Sound Regulation and Strengthening Transparency – Final Report* (Mar. 25, 2009), accessible at http://www.gfintegrity.org/storage/gfip/documents/g20%20working%20group%201%20report.pdf.

message is simple – if you rip off or defraud investors we will take action. Whether acting independently or collaboratively, such as through the NASAA enforcement framework or in conjunction with our federal regulatory partners, state securities agencies have a long history of pursuing enforcement actions that affect not only the residents of our individual states, but also the citizens of our nation as a whole.

State securities agencies are less bureaucratic and usually nimbler than our federal counterparts. Upon identifying a problem, states can move quickly to halt ongoing investment frauds using a range of civil and administrative remedies.

For example, states led the charge in exposing conflicts of interest and disclosure failures in the market for auction rate securities. These efforts led to the return of billions of dollars to retail investors.[4] For example, in Alabama the repurchase of auction rate securities totaled $1.3 billion, saving Alabamians from defaulting on home loans, ruining their credit, and allowing them to pay their bills. States were similarly in the vanguard in exposing sell-side research analysts' conflicts of interest and abusive market timing practices by mutual fund investment advisers, which gave an unfair and illegal advantage to hedge funds and other large entities at the expense of retail investors. Working alongside the SEC, these matters resulted in significant settlements and, no less significantly, long-term changes in securities industry practices to prevent this conduct from recurring.[5]

In addition, state securities regulators recently have been acting at the intersections of law and technology. Last month, we announced preliminary results from "Operation Cryptosweep," a coordinated investigative effort of 40 NASAA members to target fraud and other securities law violations in the sale of initial coin offerings ("ICOs") and cryptocurrencies.[6] State securities regulators have already brought dozens of enforcement actions involving ICOs and other new and unique financial products. These actions are supportive of similar initiatives by federal regulators, and SEC Chairman Clayton applauded NASAA's efforts, saying they send a "strong warning to would-be fraudsters in this space that many sets of eyes are watching, and that regulators are coordinating on an international level to take strong actions to deter and stop fraud."[7]

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4 *See:* NASAA Auction Rate Securities Information Center, http://www.nasaa.org/regulatory-activity/enforcement-legal-activity/auction-rate-securities-information-center/.

5 *See:* Press Release No. 2003-54, U.S. Securities and Exchange Commission, *Ten of Nation's Top Investment Firms Settle Enforcement Actions Involving Conflicts of Interest Between Research and Investment Banking* (Apr. 28, 2003), accessible at https://www.sec.gov/news/press/2003-54.htm. *See also:* Press Release, North American Securities Administrators Association, *State, Federal Investigations Demonstrate 'Fundamental Unfairness' in Mutual Fund Industry* (Nov. 4, 2003), accessible at http://www.nasaa.org/7961/state-federal-investigations-demonstrate-%E2%80%98fundamental-unfairness%E2%80%99-in-mutual-fund-industry/.

6 *See:* Press Release, North American Securities Administrators Association, *State and Provincial Securities Regulators Conduct Coordinated International Crypto Crackdown* (May 21, 2018), available at http://www.nasaa.org/45121/state-and-provincial-securities-regulators-conduct-coordinated-international-crypto-crackdown-2/.

7 *See:* Public Statement of SEC Chairman Jay Clayton (May 22, 2018), available at https://www.sec.gov/news/public-statement/statement-nasaas-announcement-enforcement-sweep-targeting-fraudulent-icos-and.

In addition to investigating cases and bringing enforcement actions, states work with federal regulators on market-wide solutions when needed. Such collaborations have repeatedly demonstrated their value to investors and markets. In fact, it has been shown that in cases where state and federal regulators work cooperatively and leverage resources, the involvement of state securities regulators can produce significant increases in the penalty and restitution components of the federal regulator's enforcement efforts.[8]

Finally, although states do not engage in rulemaking for the national markets – that is the purview of the SEC and the SROs under federal law – state regulators are active participants in the SEC's rulemaking process and work to align federal and state securities regulations.

Securities Enforcement Coordination: Federal and State

State and federal securities regulators collaborate on a voluntary basis, usually at the regional level, with common goals of sharing information and leveraging resources efficiently. Collaboration includes ongoing informal quarterly or monthly meetings at the state or regional levels; regulators working on investigations and enforcement cases when the nature of the case warrants collaboration; and other initiatives, such as memorandums of understanding ("MOUs").

Recently, to facilitate federal-state coordination, NASAA entered into important information sharing MOUs with federal regulators. In 2017, the SEC and NASAA signed an MOU to facilitate sharing information about intrastate crowdfunding offerings and regional securities offerings. This should help small businesses raise needed capital. More recently, in May 2018, NASAA signed an MOU with the CFTC to foster a closer working relationship between the CFTC and state securities agencies.[9] This MOU will facilitate information sharing about violations of the Commodity Exchange Act. In recent Congressional testimony, CFTC Chairman Christopher Giancarlo described the MOU as "marking a milestone in the area of U.S. federal and state financial fraud detection and prosecution."[10]

Securities Enforcement Coordination: State to State

NASAA serves as a forum to facilitate collaboration among its members in multijurisdictional enforcement matters. State regulators who are members of NASAA's Enforcement Section routinely assist in coordinating these cases by sharing information and leveraging state resources in the most efficient way.[11] Each year the section compiles data from

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8 *See:* Eric Zitzewitz, *An Eliot Effect? Prosecutorial Discretion in Mutual Fund Settlement Negotiations*, 2003-7, accessible at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1091035.

9 *See:* Press Release, North American Securities Administrators Association, *CFTC, NASAA Sign Agreement for Greater Information Sharing Between Federal Commodities and State Securities Regulators* (May 21, 2018), accessible at http://www.nasaa.org/45123/cftc-nasaa-sign-agreement-for-greater-information-sharing-between-federal-commodities-and-state-securities-regulators/.

10 *See:* Testimony of CFTC Chairman J. Christopher Giancarlo Before the Senate Committee on Appropriations Subcommittee on Financial Services and Government Affairs, p.9. (Jun. 5, 2018), accessible at https://www.appropriations.senate.gov/imo/media/doc/060518%20-%20CFTC%20Giancarlo%20Testimony.pdf.

11 There are numerous examples of collaboration among state securities regulators in multijurisdictional enforcement matters. *See: e.g.*, Press Release, North American Securities Administrators Association, *State*

participating NASAA jurisdictions and publishes this information in an annual enforcement report.

III. NASAA's Perspective on H.R. 5037 and H.R. 2128

The Committee has requested NASAA's views on the two bills pending before the Committee, H.R. 5037 and H.R. 2128. I will discuss each in turn.

H.R. 5037: "The Securities Fraud Act of 2018"

If enacted, H.R. 5037 will harm the investors that state regulators are charged with protecting by preempting state securities regulators' civil enforcement authority and by impeding – if not outright preempting – state criminal securities fraud prosecutions. The bill should be understood as nothing less than an attempt to tie the hands of state regulators, the "cops on the beat" closest to Main Street investors, in favor of large companies engaged in or suspected of securities fraud. H.R. 5037 represents a dramatic encroachment by the federal government on state police powers and is bad for investors and bad for our capital markets.

As a threshold matter, the putative findings in Section 2 of the bill are inaccurate. State securities regulatory authority was entirely unrestricted for most of the 20th century, until passage of the National Securities Market Improvement Act of 1996.[12] In 1996 Congress realigned state and federal regulatory authority over the offer and sale of nationally traded securities and of the broker-dealer and investment advisory industries. What Congress did not do was preempt any aspect of state antifraud authority. In fact, Congress deliberately left this authority fully intact.[13] In a colloquy on the floor of the House, Representatives Moran and Bliley discussed this precise point:

Congressman Moran:	"Mr. Speaker, . . . our State Corporation Commission in Virginia . . . [is afraid] they will not have sufficient enforcement authority [after NSMIA] . . . ."

Securities Regulators File Action Against Morgan Keegan (Apr. 7, 2010), accessible at http://www.asc.state.al.us/News/2010%20News/4-7-10%20Morgan%20Keegan%20show%20cause.pdf; Press Release, North American Securities Administrators Association, *State Securities Regulators Announce $26 Million Settlement with LPL Financial LLC Involving Sales of Unregistered, Non-Exempt Securities* (May 2, 2018), accessible at http://www.nasaa.org/44990/state-securities-regulators-announce-26-million-settlement-with-lpl-financial-llc-involving-sales-of-unregistered-non-exempt-securities/; Press Release, North American Securities Administrators Association, *State Securities Regulators Announce Settlement with Bankers Life and Casualty Company* (Apr. 4, 2012), accessible at http://www.nasaa.org/11996/state-securities-regulators-announce-settlement-with-bankers-life-and-casualty-company/. *See also: e.g.*, In the Matter of Prudential Securities, Inc., 51 SEC 726 (1993); SEC v. Prudential Securities Inc., No. 93-2164 (EGS) (D.D.C. Jan. 21, 1993); and SEC v. Prudential Securities Inc., 171 F.R.D. 1, 2 (D.D.C. 1997), *aff'd*, 136 F.3d 153 (D.C. Cir. 1998).

[12] Pub. Law 104-290, 110 Stat. 3416 (1996).

[13] "The Managers have preserved the authority of the states to protect investors through application of state antifraud laws." *See:* H.R. Rep. No. 104-864, 1996 WL 559878 (1996).

Congressman Bliley:	"Mr. Speaker, reclaiming my time, they have all of that enforcement authority and they retain their fees."
Congressman Moran:	"They retain their fees and enforcement authority."
Congressman Bliley:	"That is correct."[14]

This was not the first time Congress did so. In 1995, when Congress was considering the Securities Litigation Uniform Standards Act of 1998, it included a *statutory* preservation of state antifraud authority.[15] Another example of Congress's recognition of the importance of state antifraud authority came in the form of the rejection in 2003 of an amendment to the Securities Fraud Deterrence and Investor Restitution Act that would have placed limits on state antifraud authority.[16] The state-federal balance struck by Congress in the regulation and enforcement of securities laws has been debated and settled. The attempt to upend this balance in H.R. 5037 in favor of firms and individuals suspected of securities fraud should be rejected yet again.

Furthermore, H.R. 5037 is premised on the specious assertion that state securities enforcement is detrimental to the public interest and somehow disincentivizes capital raising. Such a premise is unsupported by either logic or fact.[17] As the U.S. Treasury Department recently reported, America's capital markets are "the largest, deepest, and most vibrant in the world," and U.S. businesses "successfully derive a larger portion of business financing from [America's] capital markets, rather than the banking system, than most other advanced economies."[18] The Financial Services Committee has, for the past five-and-a-half years, conducted rigorous oversight of the U.S. capital markets holding at least twenty hearings with dozens of witnesses and as a result passed numerous measures designed to facilitate capital formation. All of these bills have left untouched state antifraud authority in recognition of the

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[14] 142 Cong. Rec. H6436-05, 1996 WL 332161 (1996).

[15] 15 U.S.C. §77p(e).

[16] *See:* Cheryl Nichols, *H.R. 2179, The Securities Fraud Deterrence and Investor Restitution Act of 2004: A Testament to Selective Federal Preemption*, 31 Suffolk Transnat'l L. Rev. 533 (2008).

[17] A recent analysis, by EY, of trends in the U.S. capital markets identified the following four factors as the basis for a challenging IPO climate: (1.) economic or geopolitical uncertainty; (2.) market declines; (3.) a risk averse investor mindset; and (4.) poor recent IPO performance. Notably absent from this list of factors is state enforcement activity. *See:* EY, *Looking Behind the Declining Number of Public Companies – An Analysis of Trends in US Capital Markets* (May 2017), available at https://www.ey.com/Publication/vwLUAssets/an-analysis-of-trends-in-the-us-capital-markets/$FILE/ey-an-analysis-of-trends-in-the-us-capital-markets.pdf. Furthermore, an exhaustive list of recommendations by the U.S. Department of the Treasury to bolster the capital markets does not include a recommendation to weaken state enforcement authority. *See:* U.S. Department of the Treasury, *A Financial System That Creates Economic Opportunities - Capital Markets* (Oct. 2, 2017), available at http://www.treasury.gov/press-center/press-releases/Documents/A-Financial-System-Capital-Markets-FINAL-FINAL.pdf. Finally, a recent report by a coalition of organizations including the U.S. Chamber of Congress Center for Capital Markets Competitiveness explored a number of recommendations to address the decline in the number of public companies, none of which advocate for the preemption of state enforcement authority. See: U.S. Chamber of Commerce, *Expanding the On-Ramp: Recommendations to Help More Companies Go and Stay Public* (Apr. 26, 2018), accessible at https://www.uschamber.com/sites/default/files/ipo_report_expanding_the_on-ramp.pdf.

[18] *Ibid.*

important role this authority plays in maintaining confidence in U.S. markets.[19] In short, the evidence simply does not support the assertion that state enforcement is detrimental to capital formation.

More tangibly, though, H.R. 5037 is problematic because of the negative impact it would have on the ability of states to protect investors and punish those who commit securities fraud.

Analysis of H.R. 5037

First, H.R. 5037 would preempt state civil antifraud authority for certain violations of state securities laws, putting Main Street investors at risk.

H.R. 5037 would amend the Securities Exchange Act by adding new state law preemption provisions whereby states would be prohibited from pursuing certain civil securities fraud cases. The relevant provisions are drafted in such a way that they are ambiguous as to scope. At a minimum, states would be prohibited from pursuing civil fraud cases against the issuers of publicly traded securities. However, the preemption provisions are drafted such that a defendant could argue and a court could find that states are preempted from pursuing civil fraud violations in connection with any transaction involving publicly traded securities. Under such an interpretation, for example, the bill would preempt state enforcement actions against a broker-dealer and/or its associated person(s) for defrauding customers so long as the fraud involved a covered security. I have had enough experience trying securities fraud cases that I know defendants will make the argument that the ambiguous preemption provisions should be construed broadly in order to shield their violative conduct from state enforcement action.

Second, H.R. 5037 would hamper or prevent state prosecutions of criminal securities fraud.

Section 3(a) of H.R. 5037 would amend the Securities Exchange Act to add new Section 21G(c)(2), which would require that state criminal securities fraud prosecutions "comply in all respects" with federal legal requirements. This provision is also inherently ambiguous and poorly drafted and as a result has the potential to be extremely problematic for all state criminal authorities.[20] Depending on how the provision is interpreted by the courts, it could hamper – if not outright preempt – state criminal securities fraud prosecutions. (For example, I am aware of no state judge or judiciary panel in Alabama that will agree to suspend all state criminal laws and procedures in favor of federal requirements.)

H.R. 5037 does not provide any direction or clarification regarding how states could satisfy the requirements of Section 21G(c)(2) or what it means to "comply in all respects" with

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[19] In addition to various hearings held pursuant to its mandate to oversee the Securities and Exchange Commission, the House Financial Services Committee and its Subcommittee on Capital Markets have held at least twenty hearings intended to examine capital formation in the U.S. equity markets under Chairman Hensarling. This includes at least eight hearings in the 113th Congress, seven in the 114th Congress, and six in the current 115th Congress, to date.

[20] The adverse effect of this provision would apply to district, county and all other non-federal prosecutions.

federal law.[21] Defendants in state criminal prosecutions would of course vigorously advocate for the broadest possible reading of this language. Thus, for practical purposes, Section 21G(c)(2) will be preemptive in its effect to the extent that no state judge or judiciary panel will agree to suspend all state criminal law and procedure. In essence, Section 21G(c)(2) functions as a directive to state prosecutors and courts that state criminal cases must be referred to federal prosecutors, to be tried in federal courts.

At a minimum, by forcing state regulators, state courts, and state prosecutors to comply with federal legal requirements applicable to securities fraud cases, Section 3(a) would have a chilling effect on the willingness and ability of states to bring criminal securities fraud prosecutions if not halt all such actions altogether.

I imagine that the fraudsters, including the ones my office has prosecuted, would be pleased with such a result.

Third, H.R. 5037 will deprive defrauded investors of a choice in forum in seeking recourse for their claims.

Section 3(a) of H.R. 5037 would amend the Securities Exchange Act by adding Section 21G(b), which states that all civil (*i.e.*, private) securities fraud claims involving covered securities shall proceed in federal district courts under federal law. There are no exceptions. This would prevent all private litigants from seeking relief in state court for securities fraud claims arising in connection with covered securities (to the extent such claims are not already foreclosed by the Private Securities Litigation Reform Act of 1995 ("PSLRA") and the Securities Litigation Uniform Standards Act of 1998 ("SLUSA")). Under the bill, defrauded investors pursuing private securities fraud claims outside of the class action context would no longer have a choice of forum in which to pursue their claims. Section 3(a) thus represents a direct threat to state pension funds that would require them to litigate in federal courts, and other investors who seek to "opt-out" of shareholder class action litigation and instead advocate on their own behalf in pursuing claims against an issuer.

Views Regarding H.R. 5037

Based on the significant harm H.R. 5037 poses for investors NASAA opposes this legislation in the strongest possible terms. Enacting policies that would make it more difficult, and in some cases impossible, for state regulators – the regulators closest to Main Street investors – to hold accountable the most powerful companies on Wall Street serves no valid interest. State antifraud provisions serve as a deterrent to improper conduct by companies and the potential consequences of violating these laws serves as an incentive to these companies to provide investors with complete and accurate information.[22] Moreover, while state regulators are judicious in exercising their enforcement authority against publicly traded companies, states' authority to pursue enforcement activity against issuers of securities, and to do so independently

[21] For example, it is an open question under H.R. 5037 whether litigation in state courts would have to apply federal rules of civil or criminal procedure and federal rules of evidence.

[22] State antifraud provisions can both raise the amount of any potential penalty and, even more importantly, raise the probability of detection and prosecution of those companies that commit securities fraud.

when appropriate, is a major deterrent to fraud and one of many reasons investors have confidence in America's capital markets.[23]

Beyond the overarching backwardness of the policies prescribed by H.R. 5037, the enactment of which would be inadvisable at any juncture, NASAA questions the basis for Congress's interest in curtailing state enforcement authorities at the present time. Indeed, given the recent and marked decline in enforcement actions by the SEC against public companies, this would appear to be the most inopportune time for Congress to tie the hands of states in policing fraud by publicly traded companies.[24] The proposed legislation would also shift policies in a direction diametrically opposed to those encouraged by the current Administration, which favors states' rights, and encourages the exercise of state authority with regard to enforcement activity.[25]

In sum, H.R. 5037 is a misguided and dangerous bill. It is premised on a flawed understanding of the importance of state securities enforcement functions in protecting "mom and pop" investors and deterring fraudulent conduct in our securities markets. In every instance, the bill places the interests of big companies above those of the hardworking Americans who look to our capital markets to help build a secure retirement. For all the foregoing reasons, NASAA opposes the bill, and strongly encourages the Committee to reject it.

H.R. 2128: "The Due Process Restoration Act of 2018"

The Due Process Restoration Act seeks to benefit respondents in SEC enforcement actions by providing them with a broad right of removal to federal district courts. The bill also would raise the burden of proof in SEC administrative proceedings from preponderance of the evidence to clear and convincing evidence. While we understand that there are due process concerns evidently underlying the bill, the bill would have deleterious downstream consequences for the public interest and, ultimately, for respondents in SEC enforcement actions. The bill would likely cause most SEC enforcement actions to proceed in federal district courts, burdening the courts and limiting the opportunities for administrative resolution of SEC actions.

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23 According to legal research on the role of enforcement in promoting market integrity, a "growing body of academic research has found that foreign corporations that do cross-list on a U.S. exchange seem to reap extraordinary benefits," including "a valuation premium compared to otherwise similar firms that do not cross-list in the United States, which at least one study has found to average 37% for foreign firms cross-listing on a major U.S. exchange." *See:* John C. Coffee, Jr., *Law and the Market: The Impact of Enforcement*, 156 U. Pa. L. Rev. 229, 235 (2007).

24 According to an analysis published by New York University's Pollack Center, new SEC enforcement actions against public companies decreased by 33% from FY 2016 to FY 2017. Likewise, SEC settlements declined by more than 80% over 2017, from $1 billion in the first half of FY 2017 to $196 million in the second half, and penalties during the second half of FY 2017 accounted for only 16% of total settlements for the fiscal year – the lowest percentage and dollar amount for any half year since FY 2010. *See:* Cornerstone Research, *SEC Enforcement Activity: Public Companies and Subsidiaries – Fiscal Year 2017 Update* (2017), available at http://www.cornerstone.com/Publications/Reports/SEC-Enforcement-Activity-2017-Update.

25 *See:* Office of Management and Budget Director and Consumer Financial Protection Bureau Acting Director Mick Mulvaney remarks to the National Association of Attorneys General winter meeting, "We're going to be looking to the state regulators and the states' attorneys general for a lot more leadership when it comes to enforcement" (Feb. 20, 2018), available at https://www.c-span.org/video/?441853-4/consumer-financial-protection-bureau-acting-director-mick-mulvaney.

Analysis of H.R 2128

Sections 40(a) and 40(b) of the bill would give respondents in SEC administrative enforcement actions where penalties could be imposed the right to remove the action to federal district court. More importantly, Section 40(c) would raise the burden of proof in administrative proceedings from a "preponderance of the evidence standard" to a "clear and convincing standard." This would incentivize respondents not to remove the action to federal court – and also disincline the SEC to ever bring enforcement actions administratively in the first place.

Views Regarding H.R. 2128

NASAA sees no good reason for Congress to enact the changes contemplated by H.R. 2128 – and several reasons why these changes would disrupt our securities markets and the efficient functioning of the federal judiciary.

First, the SEC has broad statutory authority to seek penalties administratively.[26] Given this, the removal power conferred by H.R. 2128 would allow respondents – all respondents, including SEC-registered broker-dealers, investment advisers and their respective registered and associated persons – to remove nearly all SEC administrative actions to federal court. Administrative proceedings generally proceed faster than federal court cases and affording respondents a right of removal would invariably slow the SEC enforcement process, delaying justice. It would also add to the caseload of our already overburdened federal judiciary.

Further, the downsides of Sections 40(a) and 40(b) pale in comparison to the potential negative consequences of Section 40(c). Section 40(c) represents a potential death knell for SEC administrative practice. By raising the standard of proof in SEC administrative proceedings to clear and convincing evidence, the bill would disincline the SEC from bringing any cases administratively. This would slow justice and clog the courts and, when taken with the other sections of the bill, give respondents an opportunity for regulatory arbitrage. If the SEC brought an action administratively, the respondent could choose to proceed in that forum or remove the case to federal district court (and proceed under a lesser preponderance of the evidence burden of proof). H.R. 2128 thus represents a significant change in SEC enforcement jurisprudence and likely would substantially increase the number of SEC enforcement cases filed in federal court.

NASAA urges the Committee to reject this legislation.

IV. NASAA's Views on Certain Federal Securities Enforcement Matters

SEC Regulation D, Rule 506 and the Private Placement Market

Private securities once comprised just a fraction of the overall marketplace, but today they serve as a major source of investment capital for certain businesses, exceeding public

[26] *See: e.g.*, Section 21B of the Securities Exchange Act of 1934.

markets.[27] Unfortunately, these markets are inherently inefficient and risky. Because private placement offerings are exempt from registration at both the state and federal levels, no state or federal regulator reviews these offerings before they are sold to investors.[28] It should not be surprising that these offerings routinely rank among the most common products or schemes leading to enforcement actions in surveys of state securities regulators.[29]

Securities sold in compliance with Regulation D, Rule 506 are "covered securities," which results in preemption of state-level registration requirements. However, the states retain antifraud jurisdiction and, for all practical purposes, are responsible for policing this market, only after the losses have been inflicted on America's Main Street investors. As the regulators closest to hardworking Americans, state securities regulators frequently receive complaints from those who are victimized in offerings conducted under Rule 506, and private placements are commonly listed on NASAA's annual list of top investor traps. As a result, the states have a very large stake in the SEC's rulemaking in this area, as well as in any legislative changes that would affect the private securities market.

NASAA is not wholly opposed to efforts to modernize the accredited investor standard, including in a manner that would increase the size of this marketplace. However, if Congress or the SEC wish to grow these markets, that should occur only in tandem with reforms that provide regulators with the tools necessary to address fraud and misconduct and improve transparency in this growing segment of the U.S. markets. NASAA believes that modest changes can be made to Rule 506 and Form D that will enhance the ability of the Commission and NASAA members to protect investors while minimizing the burdens to the small businesses who utilize the rule to raise capital.[30] We have also offered suggestions to the SEC and Congress as to how to revise the current accredited investor definition such that it more accurately measures investor sophistication and at the same time improves regulatory oversight of this important segment of our markets.[31] In the absence of such concrete improvements in the oversight of these offerings,

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27 *See:* SEC Division of Economic and Risk Analysis, *Access to Capital and Market Liquidity* (Aug. 8, 2017), available at https://www.sec.gov/files/access-to-capital-and-market-liquidity-study-dera-2017.pdf. *See also:* Scott W. Bauguess, Deputy Director, SEC Division of Economic Risk and Analysis, *Private Securities Offerings post-JOBS Act*. Presentation to Accounting Standards Executive Committee (Feb. 25, 2016), available at https://www.sec.gov/info/smallbus/acsec/private-securities-offerings-post-jobs-act-bauguess-022516.pdf.

28 As described in SEC Inspector General Report No. 459, "Regulation D Exemption Process" (March 31, 2009), the Commission conducts no substantive review of Form D filings to determine whether an issuer actually complies with Rule 506. Accessible at http://www.sec-oig.gov/Reports/AuditsInspections/2009/459.pdf.

29 *See:* NASAA Enforcement Report – 2015 Report on 2014 Data, p.7 (Sep. 2015), available at http://nasaa.cdn.s3.amazonaws.com/wp-content/uploads/2011/08/2015-Enforcement-Report-on-2014-Data_FINAL.pdf.

30 NASAA has repeatedly expressed support for amendments the SEC proposed in July 2013 that would make modest changes to Rule 506 and Form D that will significantly enhance the ability of the SEC and NASAA members to protect investors while minimizing the burdens to the small businesses who utilize the rule to raise capital. *See:* http://www.nasaa.org/wpcontent/uploads/2011/07/NASAA-Comment-Letter-re-Form-D.pdf.

31 The current income and net worth standards were established by the SEC in 1982 and have not been adjusted to reflect the impact of inflation. Had the thresholds been adjusted for inflation when they were put in place by the SEC in 1982, the income threshold today would be approximately $500,000 and the net worth threshold would be approximately $2.5 million. However, if Congress wishes to maintain the current income and net worth standards, other investor protection tools, such as investment limits, could be put into place to account for the effects of not adjusting the standards for 35 years.

NASAA remains opposed to legislation that would further expand the size of the marketplace for private securities by increasing the number of persons who qualify as "accredited investors."

Finally, as the Subcommittee is undoubtedly aware, the unprecedented expansion of the private placement market in recent years is a primary driver of the decline in initial public offerings ("IPOs") during the same period. There are a variety of factors contributing to the decline in IPOs. Some examples would include expanded use of Regulation D, Rule 506, business development companies, venture capital and private equity funds, and the federal crowdfunding laws. The simple fact is that it is easier now to raise capital through private securities offerings than at any other time in our history.[32] Given Congress's ongoing, bipartisan interest in taking steps to increase the number of IPOs – efforts which have recently been the focus of hearings by the Subcommittee – Congress should be very cautious about taking any steps that would further expand the private markets at the expense of public markets.

SEC Penalty Authority

When it comes to protecting investors from bad actors, aggressive enforcement actions that penalize violators, disgorge ill-gotten gains, and provide damages and restitution for aggrieved investors, are the best deterrent and the only proven remedy. In order for enforcement to be effective as a deterrent, the costs to violators must be meaningful as a punishment. Hearings in the wake of the financial crisis established that the present statutory limit on the SEC's authority to pursue civil penalties significantly ties the hands of the SEC in performing its enforcement duties.[33]

Federal securities laws currently limit the amount of civil penalties that the SEC can impose on an institution or individual. Specifically, under existing law, the SEC can only penalize individual violators a maximum of $150,000 per offense, and institutions $725,000 per offense.[34]

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[32] As Healthy Markets Association Executive Director, Tyler Gellasch, noted in his testimony to this Subcommittee last month, "It's not a great mystery why in the last few years the trend has developed whereby there are more private offerings in the U.S. today than public ones. In the past, the law and SEC rules simply didn't permit all these private offerings. Over the past two decades, however, Congress and the SEC have spent years constructing ad hoc exemptions and exceptions designed to allow firms, their executives, and their early investors to sell securities without incurring the costs or burdens typically associated with public offerings. While some of these exemptions and exceptions may have been well-intended, the undeniable result has been that they have grown so dramatically that they have undermined the public markets." *See:* Testimony of Tyler Gellasch before the House Financial Services Committee, Subcommittee on Capital Markets, Securities and Investment (May 23, 2018), accessible at https://financialservices.house.gov/uploadedfiles/hhrg-115-ba16-wstate-tgellasch-20180523.pdf.

[33] *See:* Senate Committee on Banking, Subcommittee on Securities, Insurance and Investment. Hearing entitled "Strengthening the S.E.C.'s Vital Enforcement Responsibilities." May 7, 2009.

[34] In some cases, the SEC may calculate penalties to equal the gross amount of ill-gotten gain, but only if the matter goes to federal court, not when the SEC handles a case administratively.

NASAA supports legislation that has been proposed in Congress that would increase the per violation cap applicable to the most serious securities laws violations.[35] NASAA also supports proposals to provide the SEC with the discretion to increase the amount of the penalty in cases where the size of the penalty is tied to the amount of money gained by the bad action.[36]

SEC Enforcement Resources

The SEC's Division of Enforcement polices approximately 8,000 public companies and more than 26,000 registered market participants. While highly skilled and dedicated to their mission, the fact remains that the SEC Enforcement Staff of approximately 1,400 is less than 4 percent of the number of companies the SEC oversees, and easily less than 0.1 percent of the employees of those companies. As Ranking Member Maloney noted at a recent hearing of the Subcommittee on Capital Markets, Securities, and Investment, "given this huge disparity, there's simply no way that the enforcement division can catch and punish every single violation of the securities laws."[37]

Earlier this year the SEC announced a $1.658 billion budget request for fiscal year 2019 to support its "core mission" and expand "oversight and enforcement in emerging areas such as financial innovation, market structure and cybersecurity." Of note, this would reflect a modest increase in funding and allow the SEC to lift a hiring freeze that has been in place for several years.[38] NASAA strongly urges Congress to fully fund the SEC's fiscal year 2019 budget request.

SEC Disgorgement Authority (*Kokesh v. SEC*)

The American people need Congress to enact legislation granting the SEC statutory authority to bring federal court claims for disgorgement and restitution. The SEC has authority to seek disgorgement through its own administrative courts.[39] But the SEC lacks explicit authority to do so in federal court. Traditionally this has not been a problem, and the SEC has for decades relied on federal courts' own inherent equitable powers to obtain disgorgement from wrongdoers.[40] The SEC often returns these monies to harmed investors. But the necessity for Congress to enshrine the SEC's disgorgement and restitution authority in federal law has been brought to the fore by the Supreme Court's decision last year in *Kokesh v. SEC*.[41]

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35 For example, S.779 – The Stronger Enforcement of Civil Penalties Act of 2017. (Similar provisions are also included in H.R. 10, the Financial CHOICE Act of 2017.)

36 *Ibid.*

37 *See:* U.S. House Financial Services Committee, Subcommittee on Capital Markets, Securities and Investments. Hearing entitled "Oversight of the SEC's Division of Enforcement." (May 16, 2018).

38 *See:* Testimony by Chairman Jay Clayton Before the Senate Committee on Appropriations Subcommittee on Financial Services and Government Affairs. (Jun. 5, 2018). Accessible at https://www.sec.gov/news/testimony/testimony-financial-services-and-general-government-subcommittee-senate-committee.

39 *See:* Section 21C(e) of the Securities Exchange Act, 15 U.S.C. § 78u-3(e).

40 *See:* SEC v. Texas Gulf Sulphur, 312 F. Supp. 77, 91 (S.D.N.Y. 1970), *aff'd in part* 446 F.2d 1301 (2d Cir. 1971).

41 Kokesh v. SEC, 137 S. Ct. 1635 (2017).

In *Kokesh*, the Supreme Court reversed decades of established jurisprudence by holding that SEC disgorgement is a "penalty" subject to the five-year statute of limitations in 28 U.S.C. § 2462. The Court furthermore in a footnote questioned the SEC's ability even to obtain disgorgement in federal court.[42] *Kokesh* followed on the heels of another problematic Supreme Court decision, *Gabelli v. SEC*.[43] In *Gabelli*, the Court held the SEC cannot benefit from the so-called "discovery rule" to toll the beginning of the statute of limitations period when it seeks penalties. The Supreme Court no doubt thought it was doing what federal law commanded when it issued the *Kokesh* and *Gabelli* decisions. But these two decisions have only negative implications for the American people.

Kokesh and *Gabelli* will severely limit the SEC's ability to recover from wrongdoers in the future. Fraudsters will use these decisions to avoid returning ill-gotten gains to harmed investors. Imagine the American people's outrage if a future Ponzi schemer is able to retain the proceeds from his fraud simply because he evaded detection long enough. (The American people are fortunate that *Kokesh* and *Gabelli* were not the law of the land when the Bernie Madoff and Allen Stanford schemes finally came to light.)

The SEC is stuck with *Kokesh* and *Gabelli* and the agency is adjusting its enforcement activities in response. But the American public should not have to be stuck with these bad decisions. Congress can – and should – legislatively override these rulings by revising the federal securities laws to make clear that the SEC has authority to seek disgorgement and restitution in federal court and that no statute of limitations applies to these remedies. In Alabama, we took such a step in 2014 when we revised our state laws to provide prosecutors in Alabama (such as myself) the ability to pursue felony securities fraud or theft by deception charges for five years from our *discovery* of the fraud.[44]

V. CONCLUSION

I will close my testimony by reiterating my opposition to H.R. 5037. In more than 24 years as a securities regulator, I don't believe that I've ever seen a legislative proposal that so alarms me, offends me, and worries me. Should Congress pass this bill, my office's efforts, as well as those of my colleagues, to protect investors from serious violations of the securities laws would be eviscerated. Real investors in your districts – you can call them "Mom and Pop" investors, call them "Mr. and Mrs. 401K" – but real investors, and real people, will suffer as a result of this misguided and irresponsible legislation.

Thank you, Mr. Chairman and Ranking Member Maloney, for the opportunity to appear before the subcommittee today. I will be pleased to answer any questions you may have.

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[42] *Id.* n.3.

[43] Gabelli v. SEC, 133 S. Ct. 1216 (2013).

[44] *See:* Press Release, Alabama Securities Commission, *Alabama Statute of Limitations Bill Signed by Governor Bentley* (Apr. 9, 2014), http://asc.alabama.gov/News/2014%20News/4-9-14%20HB325%20Signed%20and%20now%20law%20FNL.pdf.

Statement of the U.S. Chamber of Commerce

ON: Ensuring Effectiveness, Fairness, and Transparency in Securities Law Enforcement

TO: House Committee on Financial Services, Subcommittee on Capital Markets, Securities and Investment

BY: Thomas Quaadman, Executive Vice President, Center for Capital Markets Competitiveness, U.S. Chamber of Commerce

DATE: June 13, 2018

1615 H Street NW | Washington, DC | 20062

The Chamber's mission is to advance human progress through an economic, political and social system based on individual freedom, incentive, initiative, opportunity and responsibility.

The U.S. Chamber of Commerce is the world's largest business federation, representing the interests of more than three million businesses of all sizes, sectors, and regions, as well as state and local chambers and industry associations. The Chamber is dedicated to promoting, protecting, and defending America's free enterprise system.

More than 96% of Chamber member companies have fewer than 100 employees, and many of the nation's largest companies are also active members. We are therefore cognizant not only of the challenges facing smaller businesses, but also those facing the business community at large.

Besides representing a cross-section of the American business community with respect to the number of employees, major classifications of American business—e.g., manufacturing, retailing, services, construction, wholesalers, and finance—are represented. The Chamber has membership in all 50 states.

The Chamber's international reach is substantial as well. We believe that global interdependence provides opportunities, not threats. In addition to the American Chambers of Commerce abroad, an increasing number of our members engage in the export and import of both goods and services and have ongoing investment activities. The Chamber favors strengthened international competitiveness and opposes artificial U.S. and foreign barriers to international business.

Chairman Huizenga, Ranking Member Maloney, and members of the Subcommittee on Capital Markets, Securities, and Investment: my name is Tom Quaadman, executive vice president of the Center for Capital Markets Competitiveness ("CCMC") at the U.S. Chamber of Commerce ("Chamber").

The Chamber views a strong and fair Securities and Exchange Commission ("SEC") as a critical and essential element needed for efficient capital markets. Having a strong securities regulator is necessary for investors and businesses to have the certainty needed to transfer capital for its best use with an expectation of return. This allows market participants to engage in reasonable risk taking on a fair playing field. A rigorous enforcement regime ensures efficient markets by rooting out fraudsters and other bad actors, but if not properly calibrated, it will also serve to discourage legitimate businesses that may be seeking growth capital. This is an especially acute issue in light of the declining number of public companies—in the past twenty years, the number of U.S. public companies has been cut in half.

The Chamber has become increasingly focused on ensuring that the SEC remains the premier securities regulator and is well-positioned for the challenges of a twenty-first century economy. As members of this Subcommittee know, capital markets have fundamentally changed since the SEC was created during the Great Depression of the 1930s. Additionally, managerial challenges within the agency have at times created obstacles that have prevented the SEC from acquiring the appropriate expertise and deploying its resources for the best use, undercutting its ability to evolve with changing markets and oversee them. Of particular importance to today's hearing, changes in enforcement practices have created fundamental issues of due process and fairness that are at the heart of any legal proceeding under our constitutional form of government. Relatedly, it has sometimes been difficult for the SEC to focus on all of the elements of its tripartite mission—promoting investor protection, facilitating capital formation, and maintaining fair, orderly, and efficient markets. We believe SEC Chairman Jay Clayton is aware of these issues and we commend him for his efforts to overcome them.

Over the years, the Chamber has identified shortcomings in our financial regulatory structure that make it harder for businesses to acquire the capital needed to grow and prosper. As far back as 2007, the Chamber released a report, the *Report and Recommendations of the Commission on the Regulation of U.S. Capital Markets in the 21st Century*, and a report in 2011, the *U.S. Capital Markets Competitiveness, the Unfinished Agenda*, to identify problems and the shortfalls of our financial regulatory system and the difficulty this puts on the United States to compete in a global economy.

The Chamber has also offered solutions. For example, in 2009, we issued a report, *Examining the Efficiency and Effectiveness of the U.S. Securities and Exchange Commission*, and in 2011, the *U.S. Securities and Exchange Commission: a Roadmap for Transformational Reform*, that contained 51 recommendations for managerial reforms and regulatory enhancements to help the SEC acquire the knowledge and expertise needed to better understand and oversee the markets and products it regulates.

Of particular relevance to today's hearing, in July 2015 the Chamber issued a report, *Examining U.S. Securities and Exchange Commission Enforcement: Recommendations on Current Processes and Practices* ("Chamber SEC enforcement report"), which made 28 specific recommendations to improve SEC enforcement and due process.

The Chamber's 2015 SEC enforcement report reviewed the practices of the SEC Enforcement Division, changes in strategy and practice by the SEC, the evolving use of administrative proceedings, and the adequacy of rules of practice. This paper was the culmination of almost two years of effort that included a survey of more than 75 companies to identify areas where there was a perceived ambiguity or lack of clarity in the process. We conducted extensive interviews with a wide range of more than 30 former SEC officials, legal experts, and corporate counsels to develop specific recommendations. We included the ideas that have broad support from those who generously participated in this process.

The Chamber's 2015 enforcement report recommended a wide variety of structural and procedural changes to the SEC's enforcement process. At a high level, our recommendations focused on:

- Providing a structure for the choice of forum decision that incorporates due process protection;
- Strengthening the "Wells Process" so that defendants in SEC investigations have a more robust ability to marshal a defense before the SEC commences litigation;
- Clarifying the SEC policy on admissions of liability in settled cases;
- Reducing duplication in regulatory enforcement;
- Rationalizing the "broken windows" enforcement policy and the need for alternative methods of resolving matters;
- Improving oversight by the SEC commissioners over the SEC enforcement staff; and
- Streamlining and improving the efficiency of the SEC investigation process, including with respect to document requests, production, and preservation.

To describe a few of these recommendations in greater detail, oversight of the SEC Enforcement program by the five presidentially-appointed commissioners remains an area that we believe is critical. Macro-level Commission oversight of the overall enforcement program, in terms of priorities and areas of emphasis, allocation of resources, and periodic assessment of effectiveness has traditionally been extremely limited. Given the importance of the SEC's enforcement program, a macro-level oversight process is required. First, there must be systematic collection of quantitative and qualitative information on the program operations. Second, there must be a regular periodic process for presenting this information to the Commission in a manner that provides them with a meaningful, not a pro forma, opportunity to provide input and direction.

To this end, we recommended that the Division of Enforcement should submit a quarterly management report to the five commissioners containing productivity and efficiency metrics developed by the agency's Division of Economic and Risk Analysis. The commissioners should receive quarterly oversight briefings on the enforcement program, with an emphasis on "national priority" investigations, investigations raising novel or complex legal questions, oldest active investigations, post-mortem analysis of litigated cases decided not in favor of the SEC, and new or emerging areas warranting investigation. We also recommended that the SEC improve transparency of its enforcement regime to place the public and regulated entities on notice as to emerging regulatory issues and enforcement priorities. For example, we recommended that the SEC should publish annually a report on its enforcement program, provide a public comment period on relevant issues, and conduct an annual public roundtable to discuss the report and the operations of its enforcement program.

We also offered several recommendations in the 2015 report to improve the efficiency and effectiveness of the SEC investigation process. The agency's investigation process is the largest program at the SEC. It is also the most opaque. The Commission provides very limited information on the process, except when a formal enforcement action is filed. The process is often long and costly, both to the SEC and to persons and entities that are the subjects of the investigation. Because the great majority of SEC investigations are closed without any action taken, these substantial costs are incurred by significant numbers of persons and entities that are never charged with committing violations. For public companies that are unable to raise capital because of the uncertainties associated with an open SEC investigation or that suffer large share-price decreases upon the announcement of an investigation, the consequences can be significant. By improving the efficiency of the investigation process, the SEC would make more effective use of its limited resources and, at the same time, reduce the substantial costs incurred by persons and entities that are subjected to the process. There, our recommendations focused on the importance of

better internal management of the process and on ways to streamline the document production process.

In the 2015 report, we also advocated for improving the efficiency of the investigative process. Improving management of the investigative process requires greater internal controls over the duration of investigations, the metrics that are used to evaluate and incentivize the staff, the problems resulting from staff turnover, and the case closing process. Additionally, the report recommended a review and changes in the rules of practice to make due process enhancements, creating a right of removal to district court under appropriate circumstances and strengthening the Wells process by which defendants mount a defense to the staff and commissioners before the commissioners vote to commence litigation.

Reducing duplication in regulatory enforcement was another theme of the Chamber's 2015 enforcement report. As we noted in the report, regulation of the financial markets in the United States has historically involved multiple entities, including multiple agencies at the federal level (the SEC, U.S. Commodity Futures Trading Commission, and the Department of Justice), multiple self-regulatory organizations (SRO), and at the state level, a state securities regulator and a state attorney general. For businesses engaged across the financial sector, prudential supervision can mean multiple examinations by more than one SEC regional office in addition to a designated SRO, and the multiple federal banking regulators. Globalization of the securities markets has added one more layer of foreign regulation for multinational companies.

When companies respond to allegations of improper activities, management's focus is necessarily diverted from the day-to-day running of its business. That is a consequence of doing business in a regulated society. But, we believe there should be some understanding on government's part that, in the current era, firms are frequently subject to multiple domestic and foreign regulators. Responding to multiple regulators with respect to the same conduct or transaction is not, and should not be allowed to become, a regular attribute of doing business. It is counterproductive—and damaging to shareholders—to subject firms and individuals serially to multiple SEC inquiries or multiple regulators and self-regulators for the same alleged misconduct.

Regulatory duplication occurs on three different levels—duplicative or overlapping investigations and exams by different offices of the SEC; duplicative or overlapping efforts within the United States at the federal and state levels; and most recently, duplicative or overlapping efforts internationally. Of course, there is a limit to what the SEC can accomplish with regard to duplication at the federal level, the federal and state levels, or the international level, given the sovereignty or

independence of other enforcement authorities that can pursue the same (or similar) conduct that the SEC can pursue. There are limits to the agency's ability to cabin all duplicative proceedings.

However, in preparing the 2015 report, it became clear the scope of the problem appears to be increasing. For example, during the preparation of our 2015 enforcement report, we learned from multiple interviewees of firms that were regulated by the SEC, FINRA, the Office of the Comptroller of the Currency, the Federal Reserve Board, and the Consumer Financial Protection Bureau, that they frequently experienced upward of 60 regulatory examinations each year. We have also observed a growing trend of state enforcement agencies bringing state charges that are substantially the same as those brought against the same defendant by their federal enforcement counterparts.

To remedy this situation, the 2015 report recommended the SEC take steps to eliminate duplicative and overlapping enforcement responses within the Commission and by multiple enforcement authorities against the same individuals or entities for effectively the same misconduct. In this respect, we believe the SEC should take a leadership role among regulatory bodies at the federal, state, and international levels to reduce or eliminate duplicative and overlapping investigations and enforcement actions for the same conduct.

To this end, the 2015 Chamber enforcement report recommends that, within the United States, the SEC should:

- Consider greater use of memoranda of understanding with one or more other enforcement authorities to avoid "duplication of efforts, unnecessary burdens on businesses, and ensuring consistent enforcement" of securities-related requirements;
- Seek to proceed jointly with other enforcement authorities at the early stages of an investigation;
- Coordinate non-cause examinations with other regulatory agencies and self-regulatory organizations;
- Before commencing an enforcement action, contact other agencies to try to file a single action reflecting the common interest of multiple regulators;
- Consider standing down, or utilizing a deferred prosecution agreement, where effective action already has been taken (or commenced) by another enforcement authority;

- Develop mutual coordination agreements with domestic enforcement authorities, and jointly pledge to eliminate, where appropriate, duplicative enforcement actions; and
- Pursue special efforts to eliminate or diminish the extensive duplication of efforts that occurs on the part of state and local enforcement authorities.

As we noted in the 2015 report, it would be a mistake to misinterpret any of these recommendations as calling for changes that would either weaken enforcement or erect any process barriers that would impede vigorous action by the SEC. This 2015 report proposed changes that would both further maintain a tough-as-nails efforts to punish and deter fraud while ensuring that honest market participants benefit from a clear and predictable process. The Chamber firmly believes that investors, market participants, and the SEC all benefit from this approach.

We are encouraged that the SEC has been moving forward on some of the Chamber's recommendations. The SEC continues to integrate trial lawyers into the investigative process at an early stage. Similarly, the SEC has also adopted incremental changes to its rules of practice for administrative proceedings. This responds to a specific recommendation in our 2015 report. And the SEC appears to have begun focusing on programmatically more important cases in lieu of pursuing so-called "broken windows," a strategy that has previously strained agency resources and sent a mixed message to the markets.

To his credit, Chairman Clayton has also begun to put his own mark on enforcement priorities at the SEC. We applaud his efforts to focus on "Mr. and Mrs. 401(k)" by launching a Retail Strategy Task Force. As Chairman Clayton has noted, retail investors are more vulnerable to fraud schemes than institutional or other sophisticated investors. And we commend the agency's efforts to focus on cybersecurity. Indeed, the Enforcement Division's new Cyber Unit has already taken important strides to combat cyber-fraud in our capital markets.

Our discussion regarding relevant legislation being considered at today's hearing is discussed in further detail below.

H.R. 5037, the Securities Fraud Act of 2018

As noted above, reducing duplicative enforcement was a major theme of the Examining U.S. Securities and Exchange Commission Enforcement: Recommendations on Current Processes and Practices. Responding to multiple regulators with respect to the same conduct or transaction is not, and should not be allowed to become, a regular attribute of doing business. It is counterproductive—and

damaging to shareholders—to subject firms and individuals serially to multiple SEC inquiries, self-regulatory organizations, or multiple state regulators or attorneys general, for the same alleged misconduct.

But a more pernicious problem exists within the scope of securities enforcement, and that is state authorities acting as *de facto* national regulators for companies who list their shares on a national securities exchange. It is worth remembering that the SEC itself was created to establish a system of *national* securities regulation and enforcement for entities engaged in interstate commerce. States should not be able to substitute their powers for those that are rightfully reserved for a federal regulator. State attorneys general in particular certainly have a right to protect their residents from all types of criminal conduct, frauds, and scams – but that does not mean that a single state elected official should be allowed to impact all aspects of a national economy.

Emblematic of this problem is New York State's Martin Act, a law enacted in 1921 to facilitate the prosecution of "bucket shops" and other scams directed at small investors. For 80 years, the law was used responsibly by New York attorneys general to protect residents from stock scams or other frauds.

However, in the last decade, the Martin Act was weaponized by New York attorneys general. This was largely due to the fact that the Martin Act does not require the attorney general to prove fraudulent intent, and does not even require prosecutors to show that anyone has been injured or that any securities transaction actually took place.

Because New York is home to thousands of U.S.-listed public companies, the Martin Act effectively anoints the state attorney general a national regulator for these businesses engaged in interstate commerce. In the Constitution, the Federal Government has sole domain over issues involved in interstate commerce. The Martin Act harms certainty by allowing one state to set policies that compete with the SEC.

Introduction of the Securities Fraud Act of 2018 is an important step towards rebalancing securities enforcement as it relates to nationally listed public companies. The legislation clarifies and reaffirms federal law's supremacy and Congress's authority over interstate commerce (including our national securities markets). It limits the authority of state officials to establish national regulations, while ensuring that they can continue to protect the residents of their state. This bill would preserve the ability of the New York Attorney General to bring cases under the Martin Act. However, civil cases would be required to be heard in federal court and the intent to

defraud proved. These requirements are wholly consistent with the history of the federal securities laws, and would also help prosecutors prioritize important enforcement cases against bad actors. We believe that efforts in this area should not harm the ability of state securities administrators to prosecute crimes such as boiler rooms or pump and dump schemes.

The Chamber appreciates Rep. MacArthur's work on this important legislation, and we look forward to working with all members of the Financial Services Committee as it advances through the legislative process.

H.R. 2128, the Due Process Restoration Act of 2017

The Chamber supports the Due Process Restoration Act of 2017, with a suggested amendment described in more detail below. This legislation would provide respondents in SEC administrative proceedings the right to have their case removed to federal district court if the SEC is seeking both a cease and desist order and a monetary penalty.

As noted above, a major concern identified during the development of the Examining U.S. Securities and Exchange Commission Enforcement: Recommendations on Current Processes and Practices was the increased and wide-spread use of administrative proceedings for enforcement cases. Since enactment of the 2010 Dodd-Frank Wall Street Reform and Consumer Protection Act – which expanded the SEC's authority to use administrative proceedings – we began to see such proceedings used as the primary means of the SEC prosecuting enforcement cases under its non-criminal powers. This has created an imbalance within the system that endangers the rights of defendants and undermines the use of appropriate enforcement tools, while raising important questions regarding the separation of powers between the executive and judicial branches of government.

In 2016, the SEC adopted a series of amendments to its rules of practice that were intended to address many of the concerns raised over the agency's increased use of administrative forums.[1] While these amendments were a small step in the right direction, the protections afforded defendants in administrative proceedings still fall well short of those provided in an Article III court, and the due process standards provided by the Federal Rules of Evidence and the Federal Rules of Civil Procedure.[2] For example, the number of depositions allowed to be taken by respondents in

[1] https://www.sec.gov/rules/final/2016/34-78319.pdf

[2] See e.g. U.S. Chamber comment letter on proposed amendments to rules of practice, available at: https://www.sec.gov/comments/s7-18-15/s71815-12.pdf

administrative proceedings and the amount of time respondents has to build a defense still pale in comparison to what is provided for in federal district court.

We believe that the Due Process Restoration Act of 2015 is an important step forward in restoring the balance between the appropriate uses of administrative proceedings and preserving the due process rights of defendants. This bill, if passed, would allow defendants, within parameters, to have the option to take a case to district court. We believe this bill would allow for the SEC to use administrative proceedings as they have been used historically, while allowing defendants all available options. If the SEC rules of practice are amended to allow for a fair process of discovery, administrative proceedings would be a fair and level playing field. The right of removal would not, in our opinion, burden court dockets.

Nevertheless there is one amendment we would suggest making to H.R. 2128 as it moves through the legislative process. The legislation changes the burden of proof that the SEC must use in an administrative proceeding to a "clear and convincing" standard. We believe the burden of proof should be the same in an administrative proceeding or a district court case. While we understand the thought behind the use of a clear and convincing standard, this can have unforeseen consequences that may not help defendants or appropriate enforcement activities.

The Chamber believes that the passage of the Due Process Restoration Act of 2017, with our suggested amendment, as well as further changes to the SEC's rules of practice, would allow for both fair due process and strong enforcement policies.

We ask that the Subcommittee and House consider both of these bills expeditiously in order to provide American businesses with greater enforcement certainty that encourages them to compete, thrive, and create jobs.

I am happy to take any questions that you may have at this time.

HEARING BEFORE THE SUBCOMMITTEE ON CAPITAL MARKETS, SECURITIES, AND INVESTMENT

OF THE COMMITTEE ON FINANCIAL SERVICES

OF THE HOUSE OF REPRESENTATIVES

Ensuring Effectiveness, Fairness, and Transparency in Securities Law Enforcement

Testimony of Andrew N. Vollmer

June 13, 2018

Chairman Huizenga, Ranking Member Maloney, and Members of the Subcommittee:

I am pleased to have an opportunity to comment on several timely and important issues about the approach of the Securities and Exchange Commission to enforcing the federal securities laws. I will address (1) general problems with SEC enforcement, (2) disgorgement, limitations periods, and the length of investigations, (3) the role of administrative proceedings in enforcement of the federal securities laws, and (4) the role of civil enforcement of securities laws by states.

I have extensive experience with the SEC enforcement process and have written about various aspects of it. A summary of my background and a list of enforcement articles are at the end of these written remarks. The views I express in this written statement and in my oral testimony are solely my own and are not on behalf of and do not necessarily reflect the views of any other person. For convenience, I will refer to a person involved in an SEC investigation or charged with a violation of the securities laws as a defendant.

Enforcement of the federal securities laws should be vigorous but fair. Fair treatment of defendants increases accuracy of results, promotes the legitimacy and acceptability of the enforcement process, fosters respect for the law, and therefore advances the statutory goals of encouraging capital formation while protecting investors and markets. The SEC enforcement process should be based on the rule of law and should provide each defendant with adequate advance notice of specific and identifiable standards of conduct, a meaningful opportunity to prepare and present a defense, and an ability to bring cases that lack merit to a rapid close. Fairness to

defendants should be one of the highest values protected by the process used to enforce the federal securities laws.

General

In an article a few years ago, I suggested several ways to improve the SEC enforcement process. Four Ways To Improve SEC Enforcement, 43 Sec. Reg. L.J. 333 (2015). The article said that the SEC could extend more fairness and consideration to defendants without any damage to tough enforcement by:

- using established and accepted legal theories and not basing claims on new, untested liability theories,
- creating an objective and balanced investigative record that considers both potential wrongdoing and innocent explanations,
- applying rigorous, neutral standards before opening investigations and initiating cases. The Commissioners should not authorize a proceeding unless they believe a reasonable person would conclude that the SEC is more likely than not to prevail on the facts and the law and believe that a proceeding would serve broad and legitimate enforcement goals, and
- substantially shortening investigations. Each member of the staff should make an effort to limit the number of documents requested and the number of individuals called for testimony.

Many of these areas can be addressed internally at the Commission with better procedures, controls, and management and do not require action by

Congress. The Commissioners and staff at the SEC periodically pay attention to ways to improve the internal systems, but the problems addressed in the article largely remain relevant today.

Disgorgement, limitations periods, and the length of investigations

One of my concerns about the SEC enforcement process is with the length of investigations. This is an area in which attention from Congress could be helpful.

In my experience, the length of SEC investigations is strongly correlated to the five-year limitations period for fines, penalties, and forfeitures in 28 U.S.C. § 2462. The Supreme Court decisions in Gabelli v. SEC, 568 U.S. 442 (2013), and Kokesh v. SEC, 137 S. Ct. 1635 (2017), addressed the application of section 2462 to SEC enforcement cases. The Commission and the staff have an incentive to complete investigations in time to commence enforcement proceedings before the five-year statute of limitations for monetary penalties and disgorgement expires.

Too frequently, however, the Commission does not complete an investigation within five years and initiates an enforcement action based on alleged misconduct many years old. The staff of the Division of Enforcement often avoids the effect of the limitations period by entering into one or more tolling agreements. In a tolling agreement, the person being investigated agrees with the staff to suspend the running of time for purposes of calculating any limitations period. See SEC Division of Enforcement, Enforcement Manual 3.1.2 (November 28, 2017).

Long investigations and the use of tolling agreements signal a need for stricter application of limitations periods. "Statutes of limitation are vital to the

welfare of society and are favored in the law. They are found and approved in all systems of enlightened jurisprudence. They promote repose by giving security and stability to human affairs." Wood v. Carpenter, 101 U.S. 135, 139 (1879). Important public policies lie at their foundation: "repose, elimination of stale claims, and certainty about a plaintiff's opportunity for recovery and a defendant's potential liabilities." Rotella v. Wood, 528 U.S. 549, 555 (2000). "A federal cause of action "brought at any distance of time" would be "utterly repugnant to the genius of our laws." Adams v. Woods, 2 Cranch 336, 342 (1805). As time goes by, evidence becomes less reliable, and the results of investigations and litigation become less accurate. "Just determinations of fact cannot be made when, because of the passage of time, the memories of witnesses have faded or evidence is lost. In compelling circumstances, even wrongdoers are entitled to assume that their sins may be forgotten." Wilson v. Garcia, 471 U.S. 261, 271 (1985).

Long investigations cause other social harms. They create uncertainty, which can lead businesses to fail or postpone research and investment in potentially beneficial goods and services. Individuals suffer. They can be fired or put on administrative leave during investigations even when no misconduct occurred. The existence of an investigation can become public, injuring reputations and causing investors to withdraw money and customers to abandon a company. The longer an investigation, the worse these problems are.

For these reasons, Congress should be reluctant to lengthen limitations periods for SEC cases. It should lengthen the limitations period for the SEC only if it receives convincing data that a substantial problem with the current five-year

period exists and that five years is not sufficient for an effective enforcement program. Has the SEC been unable to obtain adequate relief in a large number of cases because of the limitations period? Even if some such cases exist, does that justify extending the limitations period for all SEC cases? A longer limitations period is likely to lead to longer and longer investigations. A ten-year period seems inordinately long given the catalogue of ills from lengthy investigations and litigation based on old conduct.

If Congress is convinced that the five-year period prevents obtaining effective relief in a sufficient number of cases, the better approach would be to define specific exceptions from the five-year period. Exceptions should be few. The SEC should be obliged to prove that a case involved serious and widespread misconduct and that the SEC could not reasonably have commenced an action within a five-year period for an alleged violation occurring more than five years ago.

Congress also should address additional matters if it is inclined to reconsider the limitations period for SEC cases. First, a limitations period should apply to the power of the SEC to commence an enforcement case and should not apply to any particular form of relief. The statute of limitations should not be tied to fines, disgorgement, injunctions, or other relief. That is how section 2462 operates now, but that statute presents a variety of interpretive difficulties and is not the best approach. The expiration of a limitations period should stop the SEC from suing.

Second, a limitations period should apply to SEC enforcement cases brought in district court or as administrative proceedings. The litany of social harms from

long investigations and ancient misconduct exists no matter what forum the SEC uses.

Third, a limitations period should not be connected to compensation for investor losses. The Kokesh opinion did that for purposes of analyzing the language in section 2462, but Congress has no reason to connect the two. It has authority to set a limitations period of reasonable length and reasonable terms without linking the period to the return of funds to harmed investors.

Congress has never given the SEC power to calculate a monetary recovery based on investor loss or damage. Congress has given the SEC many different forms of relief, but they have all related to prevention and deterrence, such as injunctions, civil penalties, and revocation of a person's registration as a broker-dealer or investment adviser. Private actions recover loss, but private actions provide a defendant with a variety of procedural protections not available in SEC enforcement cases. Those protections include the plaintiff's need to prove reliance, loss, and loss causation and to meet higher pleading standards. Granting the SEC the power to sue for compensation for investor damage would be a sharp break from precedent with unpredictable consequences.

Fourth, a new statute of limitations should restrict and control tolling agreements. The staff currently uses them to prolong the five-year limitations period. Congress might not want to prohibit all tolling agreements, but they should be rare.

The role of SEC administrative proceedings in enforcement of the federal securities laws

SEC administrative enforcement proceedings have been the subject of serious criticism and complaint for decades. Congress should take action to address the concerns and has several different approaches it could take.

The basic problem with SEC administrative proceedings (APs) is that they are either inherently unfair to defendants or appear to be unfair. Defendants caught up in the process emerge with a sense that they did not receive the same even-handed and impartial consideration from an AP that they would have received in district court. The first level of adjudication is before an administrative law judge (ALJ) who has or appears to have reasons to favor the SEC. The second level of adjudication is before the Commission itself, which is the same body that voted to charge the defendant. A defendant could be forgiven for questioning whether the body – sometimes the very same Commissioners -- that sued him is entirely open-minded on the ultimate question of whether he committed the violation.

In addition, the procedures used at the ALJ level hamper a defendant's ability to prepare and present a full defense. The SEC staff spends years investigating potential violations. They have subpoena power and often amass an enormous investigative record. Only part of that record is available to a defendant before the SEC sues. After the SEC sues, APs are on a short time schedule. That short schedule can have advantages over district court litigation but generally favors the SEC because the staff is already more familiar with the facts and evidence than the

defendant. The SEC must disclose most (but not all) of the record to the defendant, but the shortness of time seriously impairs considered review of the record, especially in large or complicated matters.

A defendant's ability to obtain information during an AP is severely restricted. A defendant must request a subpoena for depositions or documents and is not assured of obtaining it. When several persons are defendants in a single case, they may notice no more than five depositions and must move for additional depositions. SEC rules do not offer all forms of discovery available pursuant to the Federal Rules of Civil Procedure.

Restrictions on a defendant's ability to obtain information is consequential because the investigative record reflects the efforts of the SEC staff to obtain information to charge and support a violation. The staff has little incentive to develop facts that could support exoneration. The result is that the investigative record in many cases is incomplete from the defendant's point of view, and a defendant is not provided the time or tools to prepare an adequate defense.

The SEC rules of practice also do not provide a defendant with an early mechanism to test the legal validity of a claim. In district court, the motion to dismiss is a common first step.

A jury is not available in an SEC AP. Some would argue that the unavailability of a jury is a disadvantage of APs.

Empirical research has only a limited ability to sort through a comparison of the fairness of APs and district court cases. The results in district court cases cannot

just be compared to the results of APs because the allocation of enforcement cases between court and APs is not random. The SEC staff and the Commissioners decide on the allocation. They are human and make decisions for many different reasons. They could be sending easier or more difficult cases to APs, or the likelihood of success in the two categories of cases could be the same. An amicus brief in the Supreme Court in Lucia v. SEC filed by Professors Velikonja and Grundfest discuss the research issues (page 6).

If Congress concludes that reasonable questions about the impartiality and legitimacy of APs exist, it could take one of several different actions. Congress could give serious consideration to abolishing SEC APs and could collect more information on whether the benefits of retaining APs outweigh their costs, particularly the cost of the actual or perceived unfairness. The general assumption is that APs are faster and more expert than district court proceedings, but those assumptions could be tested. Are ALJs and Commissioners actually more expert and more accurate than district courts on the issues raised by standard enforcement cases involving a fraud, misstatement, or the mistreatment of a customer by a broker-dealer or investment adviser? Do the short periods of time for proceedings before ALJs actually serve the interests of justice and fairness to defendants in a case of factual complexity? A further question is whether elimination of APs would impose an unacceptable burden on district courts.

A second approach would be to make APs as fair to defendants as district court cases. Whether that could be accomplished is not clear. The SEC Rules of Practice would need to be overhauled to give defendants an adequate opportunity

to obtain information and to prepare and present a complete defense. Congress could require SEC APs to use the Federal Rules of Civil Procedure and the Federal Rules of Evidence after having a group of experts modify the Rules specifically for use before ALJs. The Federal Rules are highly regarded, treat all parties equally, and have held up well over time. ALJs would need to be independent from the Commission, but constitutional problems with appointment and removal would need to be resolved. More thought should be given to the triple role of SEC Commissioners. They adopt substantive rules of conduct, initiate enforcement cases, and then make final determinations of violations when reviewing ALJ decisions. Concentrating that much power and discretion in the same small group of individuals cannot be healthy or appropriate in our system of government. I discussed the due process issues from the combination of charging and adjudicating functions in a recent paper: Accusers as Adjudicators in Agency Enforcement Proceedings, http://ssrn.com/abstract=3171674 and forthcoming in 52 U. Mich. J.L. Reform.

A third approach would be to give defendants in APs the right to move the case to district court. This is the removal concept. The idea has several variations, including the one in H.R. 2128, which gives a defendant in an AP an absolute right to require the SEC to proceed in court but only if the AP seeks a cease-and-desist order and a penalty. Other variations create complicated removal procedures that rely on vague and subjective standards to be applied by the district court. The more complicated versions could add cost, delay, and uncertainty to the enforcement process.

My preference is to let the SEC make the initial forum selection, as it does now, but then give a defendant in any type of AP a right to transfer the case to district court. The right would be unqualified and unreviewable. The approval of the district court would not be needed. This approach would be simple and fast and would allow each defendant to consider the specifics of the particular case and decide whether an AP or a district court would produce a more accurate and fairer result. Under this approach, the number of cases each year that would be entitled to use a removal right would not be too large and should not burden the federal courts. The right would matter only when a defendant intended to contest the SEC charges and would not be used when a defendant settled at the time of initiation or very soon after initiation.

Some have proposed requiring the use of APs for certain types of cases. In these proposals, a defendant could not remove certain cases or the SEC could have a district court remand certain cases back to the SEC for continuation as an AP. My concern with these proposals is that APs do not necessarily offer a clear comparative advantage for any particular category of case. ALJs are not necessarily more expert than federal court judges in all areas of the federal securities laws, and the time limit for APs are not necessarily a benefit for a defendant who needs time to prepare a defense. Statutory language attempting to define a category of cases more suitable to be litigated as APs is likely to be over and under inclusive and inflexible.

The role for civil enforcement of securities laws by states

The final topic concerns the extent to which federal law should pre-empt civil enforcement of securities laws by states. Currently, federal law has a complicated arrangement with state law in the securities area, but federal law generally preserves the power of state securities authorities to investigate and bring enforcement actions (section 18(c)(1) of the Securities Act and section 28(f)(4) of the Exchange Act).

State enforcement of securities laws can be valuable, especially when a problem is limited to one or a small number of states and involves local activities, such as the actions of a few local securities sellers or employees of a broker-dealer or investment adviser. Many times, however, state enforcement targets a perceived problem that exists nationwide and might be the subject of an SEC or FINRA investigation. In those cases, state enforcement can lead to novel theories of liability and standards of conduct or to piling on to the efforts of other regulators.

H.R. 5037 is on the right track. It properly concentrates on the need for national uniformity of legal standards and the need to reduce and minimize the costly overlap and duplication of the federal and state systems of regulating the securities area. The bill is limited to securities fraud, broadly defined, and to securities listed on major national stock exchanges. That would be an important first step, but the principles underlying the bill usefully could be extended to all regulatory obligations in addition to the anti-fraud provisions and to all securities transactions other than those having a distinctly local nature.

Background

I am Professor of Law, General Faculty, and Director of the John W. Glynn, Jr. Law & Business Program at the University of Virginia School of Law. I teach Securities Regulation, Advanced Topics in Securities Regulation, and Securities Litigation and Enforcement. I was Deputy General Counsel of the Securities and Exchange Commission from mid-2006 to March 2009 and was a partner in the securities litigation and enforcement practice of Wilmer Cutler Pickering Hale and Dorr LLP before and after my time at the SEC. While at the Commission, one of my main areas of responsibility was to advise the Commissioners and the Division of Enforcement on legal aspects of contemplated enforcement proceedings. While in private law practice, I represented many individuals and companies that were in SEC investigations and private securities litigation or that discovered potential misconduct before an investigation or private litigation began.

I have written on various aspects of the SEC enforcement process:

Accusers as Adjudicators in Agency Enforcement Proceedings, http://ssrn.com/abstract=3171674 and forthcoming in 52 U. Mich. J.L. Reform.

A Rule of Construction for the Personal Benefit Requirement in Tipping Cases, 11 N.Y.U. J.L. & Lib. 331 (2017).

SEC Revanchism and the Expansion of Primary Liability Under Section 17(a) and Rule 10b-5, 10 Va. L. & Bus. Rev. 273 (2016).

Computer Hacking and Securities Fraud, 47 Sec. Reg. & L. Rep. (Bloomberg BNA) 1985 (October 19, 2015).

Four Ways To Improve SEC Enforcement, 43 Sec. Reg. L.J. 333 (2015).

Need for Narrower Subpoenas in SEC Investigations, New York Law Journal 4 (October 9, 2014).

A Chance to Rein in Securities Class Actions, Wall Street Journal A17 (March 4, 2014).

Should Class Actions To Enforce Rule 10b-5 Be Expanded or Curtailed?, 44 Sec. Reg. & L. Rep. (Bloomberg BNA) 325 (2012).

How hedge fund advisers can reduce insider trading risk, 3 Journal of Securities Law, Regulation & Compliance 106 (2010).

COMMUNITY BANCORP OF SANTA MARIA
2739 Santa Maria Way, Santa Maria, California 93455
(805) 922 - 2900

May18, 2018

The Honorable Jeb Hensarling, Chairman
Committee on Financial Services
U.S. House of Representatives
Washington, D.C. 20515

The Honorable Maxine Waters, Ranking Member
Committee on Financial Services
U.S. House of Representatives
Washington, D.C. 20515

The Honorable Bill Huizenga, Chairman
Subcommittee on Capital Markets and Government Sponsored Enterprises
Committee on Financial Services
U.S. House of Representatives
Washington, D.C. 20515

The Honorable Carolyn Maloney, Ranking Member
Subcommittee on Capital Markets and Government Sponsored Enterprises
Committee on Financial Services
U.S. House of Representatives
Washington, D.C. 20515

Re: Main Street Growth Act

Dear Chairman Hensarling, Ranking Member Waters, Chairman Huizenga and Ranking Member Maloney,

I am the President and Chief Executive Officer of Community Bancorp of Santa Maria (OTCQX: CYSM), a community bank located in Santa Maria, California that is publicly-traded on OTC Markets Group's OTCQX Best Market.

I am writing to share Community Bancorp of Santa Maria's experience as a small, public company and describe why we do not support the "Main Street Growth Act."

The Main Street Growth Act would allow the creation of "Venture Exchanges" that are intended to have trading and listing rules tailored for smaller companies like ours. However, these regulatory privileges would not be available to non-exchange markets such as OTCQX.[1]

[1] OTC Markets Group Inc. operates the OTCQX Best and OTCQB Venture markets, where over 1,200 companies meeting financial standards and providing current disclosure to investors, including many innovative and entrepreneurial 'venture' companies, trade via an SEC registered alternative trading system ("ATS").

Community Bancorp of Santa Maria joined the OTCQX market on January 1, 2016. Under the OTCQX Rules, Community Bancorp of Santa Maria is required to meet high financial standards (OTCQX does not accept Penny Stocks or Shell Companies) and provide current disclosure to investors (including PCAOB audited annual financials). Since joining OTCQX we have experienced improvement in the liquidity of our shares, and recognized a 75% increase in the market value of our stock.

There are many reasons why the OTCQX market works well for small, growing companies like ours:

- **Lower Cost & Complexity**: OTCQX costs less, and our compliance obligations, while challenging, are less burdensome than listing on an exchange, giving us more time and money to spend growing our business.
- **Small Company Liquidity**: OTC Markets Group's ATS dealer model supports the liquidity needs of smaller, less-actively traded securities. Unlike large, exchange-listed companies, we do not have large amounts of natural liquidity and high trading volumes. Rather, our liquidity needs are focused on making sure our shareholders have the ability to buy and sell on an as-needed basis.
- **Investor Engagement & Capital Formation**: Through OTC Markets' disclosure services, we are able to easily communicate with our shareholders, publish financial reports and share company updates to broaden our visibility in the marketplace. The OTCQX market is also exempt from Blue Sky secondary trading regulations in 30 states, which allows broker dealers to reach a wider audience of potential investors, raise capital and grow our shareholder base.

The OTCQX market has helped Community Bancorp of Santa Maria grow and mature by providing all of the benefits of a public market – scaled to fit the needs of small companies.

The Main Street Growth Act does not work for companies like us because it focuses solely on national securities exchanges and excludes other models, such as OTCQX where we have established a thriving secondary market. The Main Street Growth Act instead would restrict trading to one, single exchange.

While we welcome legislation aimed at supporting small public companies and the venture markets that serve them, the Main Street Growth Act does not achieve these goals. We urge the Committee to consider the value of alternative secondary market models, such as ATSs, because companies should be able to choose the venue that best suits their needs. A "Venture Company" should be afforded the same regulatory treatment, regardless of whether it trades on an exchange or an ATS market like OTCQX.

We remain hopeful that Congress, the SEC, and market participants can work together to provide venture companies with all of the tools necessary to foster their growth and development. Please let me know if we can provide any additional information or insight in furtherance of that shared goal.

Sincerely,

JSilveria

Janet Silveria
President
Chief Executive Officer

FREEDOM BANK

May 22, 2018

The Honorable Jeb Hensarling, Chairman
Committee on Financial Services
U.S. House of Representatives
Washington, D.C. 20515

The Honorable Maxine Waters, Ranking Member
Committee on Financial Services
U.S. House of Representatives
Washington, D.C. 20515

The Honorable Bill Huizenga, Chairman
Subcommittee on Capital Markets and Government Sponsored Enterprises
Committee on Financial Services
U.S. House of Representatives
Washington, D.C. 20515

The Honorable Carolyn Maloney, Ranking Member
Subcommittee on Capital Markets and Government Sponsored Enterprises
Committee on Financial Services
U.S. House of Representatives
Washington, D.C. 20515

Re: Main Street Growth Act

Dear Chairman Hensarling, Ranking Member Waters, Chairman Huizenga and Ranking Member Maloney,

I am the President of The Freedom bank of Virginia (OTCQX: FDVA), a community bank located in Fairfax, Virginia that is publicly-traded on OTC Markets Group's OTCQX Best Market.

I am writing to share Freedom Bank's experience as a small, public company and describe why we do not support the "Main Street Growth Act."

The Main Street Growth Act would allow the creation of "Venture Exchanges" that are intended to have trading and listing rules tailored for smaller companies like ours. However, these regulatory privileges would not be available to non-exchange markets such as OTCQX.[1]

Freedom Bank joined the OTCQX market in March 2015. Under the OTCQX Rules, Freedom Bank is required to meet high financial standards (OTCQX does not accept Penny Stocks or Shell Companies) and provide current disclosure to investors (including PCAOB audited annual financials). Since joining the OTXQX, we have seen our market capitalization increase from $45

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502 Maple Avenue West
Vienna, Virginia 22180
703.667.4170

11700 Plaza America Drive
Reston, Virginia 20190
703.663.2300

10555 Main Street
Fairfax, Virginia 22030
703.242.5300

freedombankva.com

million to $85 million, partially due to a successful stock offering we were able to undertake as a OTCQX bank. Our daily trading volume has increased from 1,000 shares daily to up 5,000 shares daily on average.

There are many reasons why the OTCQX market works well for small, growing companies like ours:

- **Lower Cost & Complexity**: OTCQX costs less, and our compliance obligations, while challenging, are less burdensome than listing on an exchange, giving us more time and money to spend growing our business.
- **Small Company Liquidity**: OTC Markets Group's ATS dealer model supports the liquidity needs of smaller, less-actively traded securities. Unlike large, exchange-listed companies, we do not have large amounts of natural liquidity and high trading volumes. Rather, our liquidity needs are focused on making sure our shareholders have the ability to buy and sell on an as-needed basis.
- **Investor Engagement & Capital Formation**: Through OTC Markets' disclosure services, we are able to easily communicate with our shareholders, publish financial reports and share company updates to broaden our visibility in the marketplace. The OTCQX market is also exempt from Blue Sky secondary trading regulations in 30 states, which allows broker dealers to reach a wider audience of potential investors, raise capital and grow our shareholder base.

The OTCQX market has helped Freedom Bank grow and mature by providing all of the benefits of a public market – scaled to fit the needs of small companies.

The Main Street Growth Act does not work for companies like us because it focuses solely on national securities exchanges and excludes other models, such as OTCQX where we have established a thriving secondary market. The Main Street Growth Act instead would restrict trading to one, single exchange.

While we welcome legislation aimed at supporting small public companies and the venture markets that serve them, the Main Street Growth Act does not achieve these goals. We urge the Committee to consider the value of alternative secondary market models, such as ATSs, because companies should be able to choose the venue that best suits their needs. A "Venture Company" should be afforded the same regulatory treatment, regardless of whether it trades on an exchange or an ATS market like OTCQX.

We remain hopeful that Congress, the SEC and market participants can work together to provide venture companies with all of the tools necessary to foster their growth and development. Please let me know if we can provide any additional information or insight in furtherance of that shared goal.

Sincerely,

Craig S. Underhill

Craig S. Underhill
President & CEO
The Freedom Bank of Virginia

First Resource Bank

May 21, 2018

The Honorable Jeb Hensarling, Chairman
Committee on Financial Services
U.S. House of Representatives
Washington, D.C. 20515

The Honorable Maxine Waters, Ranking Member
Committee on Financial Services
U.S. House of Representatives
Washington, D.C. 20515

The Honorable Bill Huizenga, Chairman
Subcommittee on Capital Markets and Government Sponsored Enterprises
Committee on Financial Services
U.S. House of Representatives
Washington, D.C. 20515

The Honorable Carolyn Maloney, Ranking Member
Subcommittee on Capital Markets and Government Sponsored Enterprises
Committee on Financial Services
U.S. House of Representatives
Washington, D.C. 20515

Re: Main Street Growth Act

Dear Chairman Hensarling, Ranking Member Waters, Chairman Huizenga and Ranking Member Maloney,

I am the Executive Vice President & Chief Financial Officer of First Resource Bank (OTCQX: FRSB), a community bank providing loan and deposit services to businesses and consumers located in Exton, Pennsylvania that is publicly-traded on OTC Markets Group's OTCQX Best Market.

I am writing to share First Resource Bank's experience as a small, public company and describe why we do not support the "Main Street Growth Act."

The Main Street Growth Act would allow the creation of "Venture Exchanges" that are intended to have trading and listing rules tailored for smaller companies like ours. However, these regulatory privileges would not be available to non-exchange markets such as OTCQX.[1]

[1] OTC Markets Group Inc. operates the OTCQX Best and OTCQB Venture markets, where over 1,200 companies meeting financial standards and providing current disclosure to investors, including many innovative and entrepreneurial 'venture' companies, trade via an SEC registered alternative trading system ("ATS").

First Resource Bank joined the OTCQX market in November 2014. Under the OTCQX Rules, First Resource Bank is required to meet high financial standards (OTCQX does not accept Penny Stocks or Shell Companies) and provide current disclosure to investors (including PCAOB audited annual financials). Since joining OTCQX First Resource Bank has grown 51% from $175 million in assets at October 31, 2014 to over $265 million today, with over $275 million in new loans generated in our local market during that timeframe. In addition to the jobs created and supported by this significant loan growth, we have grown our own staff from 25 employees in October 2014 to 43 employees today, with plans to hire 16 more over the next three years. Our growth was supported by capital growth of $5.8 million since joining OTCQX and our market capitalization has increased from $10.6 million in October 2014 to approximately $30 million today. Our growth has allowed us to achieve not only record profitability for our shareholders, but it has also allowed us to donate over $575,000 to schools and charitable organizations in our local market of Chester County, Pennsylvania since we joined OTCQX. Since opening First Resource Bank in 2005, we have donated well over $1 million to local schools and charities.

There are many reasons why the OTCQX market works well for small, growing companies like ours:

- **Lower Cost & Complexity**: OTCQX costs less, and our compliance obligations, while challenging, are less burdensome than listing on an exchange, giving us more time and money to spend growing our business.
- **Small Company Liquidity**: OTC Markets Group's ATS dealer model supports the liquidity needs of smaller, less-actively traded securities. Unlike large, exchange-listed companies, we do not have large amounts of natural liquidity and high trading volumes. Rather, our liquidity needs are focused on making sure our shareholders have the ability to buy and sell on an as-needed basis.
- **Investor Engagement & Capital Formation**: Through OTC Markets' disclosure services, we are able to easily communicate with our shareholders, publish financial reports and share company updates to broaden our visibility in the marketplace. The OTCQX market is also exempt from Blue Sky secondary trading regulations in 30 states, which allows broker dealers to reach a wider audience of potential investors, raise capital and grow our shareholder base.

The OTCQX market has helped First Resource Bank grow and mature by providing all of the benefits of a public market – scaled to fit the needs of small companies.

The Main Street Growth Act does not work for companies like us because it focuses solely on national securities exchanges and excludes other models, such as OTCQX where we have established a thriving secondary market. The Main Street Growth Act instead would restrict trading to one, single exchange.

While we welcome legislation aimed at supporting small public companies and the venture markets that serve them, the Main Street Growth Act does not achieve these goals. We urge the Committee to consider the value of alternative secondary market models, such as ATSs, because companies should be able to choose the venue that best suits their needs. A "Venture Company" should be afforded the same regulatory treatment, regardless of whether it trades on an exchange or an ATS market like OTCQX.

We remain hopeful that Congress, the SEC and market participants can work together to provide venture companies with all of the tools necessary to foster their growth and development. Please let me know if we can provide any additional information or insight in furtherance of that shared goal.

Sincerely,
Lauren C. Ranalli

Lauren C. Ranalli
EVP & CFO
First Resource Bank

meritage
HOSPITALITY GROUP

May 21, 2018

The Honorable Bill Huizenga, Chairman
Subcommittee on Capital Markets and Government Sponsored Enterprises
Committee on Financial Services
U.S. House of Representatives
Washington, D.C. 20515

Re: Main Street Growth Act

Dear Bill,

As you may be aware I am the CEO of Grand Rapids based Meritage Hospitality Group (OTCQX:MHGU), a restaurant company employing 10,000 people, that is publicly-traded on OTC Markets Group's OTCQX Best Market.

I am writing to share Meritage's experience as a small, public company and describe why we do not support the "Main Street Growth Act."

The Main Street Growth Act would allow the creation of "Venture Exchanges" that are intended to have trading and listing rules tailored for smaller companies like ours. However, these regulatory privileges would not be available to non-exchange markets such as OTCQX.[1]

Meritage joined the OTCQX market in 2007. Under the OTCQX Rules, Meritage is required to meet high financial standards, (OTCQX does not accept Penny Stocks or Shell Companies) and provide current disclosure to investors (including PCAOB audited annual financials and sworn certifications). Over the past 11 years, we have seen our market capitalization increase 270% to $112 million and expanded our business into 16 states with 10,000 employees.

There are many reasons why the OTCQX market works well for small, growing companies like ours:

- **Lower Cost & Complexity**: OTCQX costs less, and our compliance obligations, while challenging, are less burdensome than listing on an exchange, giving us more time and money to spend growing our business.
- **Small Company Liquidity**: OTC Markets Group's ATS dealer model supports the liquidity needs of smaller, less-actively traded securities. Unlike large, exchange-listed companies, we do not have large amounts of natural liquidity and high trading volumes.

[1] OTC Markets Group Inc. operates the OTCQX Best and OTCQB Venture markets, where over 1,200 companies meeting financial standards and providing current disclosure to investors, including many innovative and entrepreneurial 'venture' companies, trade via an SEC registered alternative trading system ("ATS").

Rather, our liquidity needs are focused on making sure our shareholders have the ability to buy and sell on an as-needed basis.

- **Investor Engagement & Capital Formation**: Through OTC Markets' disclosure services, we are able to easily communicate with our shareholders, publish financial reports and share company updates to broaden our visibility in the marketplace. The OTCQX market is also exempt from Blue Sky secondary trading regulations in 30 states, which allows broker dealers to reach a wider audience of potential investors, raise capital and grow our shareholder base.

The OTCQX market has helped Meritage grow and mature by providing all of the benefits of a public market – scaled to fit the needs of small companies.

The Main Street Growth Act does not work for companies like us because it focuses solely on national securities exchanges and excludes other models, such as OTCQX where we have established a thriving secondary market. The Main Street Growth Act instead would restrict trading to one, single exchange.

While we welcome legislation aimed at supporting small public companies and the venture markets that serve them, the Main Street Growth Act does not achieve these goals. We urge the Committee to consider the value of alternative secondary market models, such as ATSs, because companies should be able to choose the venue that best suits their needs. A "Venture Company" should be afforded the same regulatory treatment, regardless of whether it trades on an exchange or an ATS market like OTCQX.

We remain hopeful that Congress, the SEC and market participants can work together to provide venture companies with all of the tools necessary to foster their growth and development. Please let me know if we can provide any additional information or insight in furtherance of that shared goal.

Sincerely,

Robert E. Schermer, Jr

CEO

Meritage Hospitality Group Inc.
45 Ottawa Ave
6th Floor
Grand Rapids, MI 49503

May 21, 2018

The Honorable Jeb Hensarling, Chairman
Committee on Financial Services
U.S. House of Representatives
Washington, D.C. 20515

The Honorable Maxine Waters, Ranking Member
Committee on Financial Services
U.S. House of Representatives
Washington, D.C. 20515

The Honorable Bill Huizenga, Chairman
Subcommittee on Capital Markets and Government Sponsored Enterprises
Committee on Financial Services
U.S. House of Representatives
Washington, D.C. 20515

The Honorable Carolyn Maloney, Ranking Member
Subcommittee on Capital Markets and Government Sponsored Enterprises
Committee on Financial Services
U.S. House of Representatives
Washington, D.C. 20515

Re: Main Street Growth Act

Dear Chairman Hensarling, Ranking Member Waters, Chairman Huizenga and Ranking Member Maloney,

I am the President and CEO of Mission Valley Bank (OTCQX: [**MVLY**]), a $326 million community focused small business bank located in the San Fernando Valley, California that is publicly-traded on OTC Markets Group's OTCQX Best Market. The exposure the OTCQX has afforded MVLY has allowed for greater liquidity in our stock and enhanced market value.

I am writing to share Mission Valley Bank's experience as a small, public company and describe why we do not support the "Main Street Growth Act."

The Main Street Growth Act would allow the creation of "Venture Exchanges" that are intended to have trading and listing rules tailored for smaller companies like ours. However, these regulatory privileges would not be available to non-exchange markets such as OTCQX.[1]

Mission Valley Bank joined the OTCQX market in 2014. Under the OTCQX Rules, Mission Valley Bank is required to meet high financial standards (OTCQX does not accept Penny Stocks

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or Shell Companies) and provide current disclosure to investors (including PCAOB audited annual financials). **We have seen our market cap grow over the past 4 years from $16.8 million to $49.4 million.**

There are many reasons why the OTCQX market works well for small, growing companies like ours:

- **Lower Cost & Complexity**: OTCQX costs less, and our compliance obligations, while challenging, are less burdensome than listing on an exchange, giving us more time and money to spend growing our business.
- **Small Company Liquidity**: OTC Markets Group's ATS dealer model supports the liquidity needs of smaller, less-actively traded securities. Unlike large, exchange-listed companies, we do not have large amounts of natural liquidity and high trading volumes. Rather, our liquidity needs are focused on making sure our shareholders have the ability to buy and sell on an as-needed basis.
- **Investor Engagement & Capital Formation**: Through OTC Markets' disclosure services, we are able to easily communicate with our shareholders, publish financial reports and share company updates to broaden our visibility in the marketplace. The OTCQX market is also exempt from Blue Sky secondary trading regulations in 30 states, which allows broker dealers to reach a wider audience of potential investors, raise capital and grow our shareholder base.

The OTCQX market has helped Mission Valley Bank grow and mature by providing all of the benefits of a public market – scaled to fit the needs of small companies.

The Main Street Growth Act does not work for companies like us because it focuses solely on national securities exchanges and excludes other models, such as OTCQX where we have established a thriving secondary market. The Main Street Growth Act instead would restrict trading to one, single exchange.

While we welcome legislation aimed at supporting small public companies and the venture markets that serve them, the Main Street Growth Act does not achieve these goals. We urge the Committee to consider the value of alternative secondary market models, such as ATSs, because companies should be able to choose the venue that best suits their needs. A "Venture Company" should be afforded the same regulatory treatment, regardless of whether it trades on an exchange or an ATS market like OTCQX.

We remain hopeful that Congress, the SEC and market participants can work together to provide venture companies with all of the tools necessary to foster their growth and development. Please let me know if we can provide any additional information or insight in furtherance of that shared goal.

Sincerely,

Tamara Gurney

Tamara Gurney
President & CEO
Mission Valley Bank

The OurPet's Co.
Unleashing great ideas in pet care.

May 21, 2018

Re: Main Street Growth Act

Dear Chairman Hensarling, Ranking Member Waters, Chairman Huizenga and Ranking Member Maloney,

I am the Chairman/CEO of OurPet's Company (OTCQX: **OPCO**), a leading company in the rapidly growing pet market, located in Cleveland, OH that is publicly-traded on OTC Markets Group's OTCQX Best Market.

I am writing to share OPCO's experience as a small, public company and describe why we do not support the "Main Street Growth Act."

The Main Street Growth Act would allow the creation of "Venture Exchanges" that are intended to have trading and listing rules tailored for smaller companies like ours. However, these regulatory privileges would not be available to non-exchange markets such as OTCQX.[1]

OPCO joined the OTCQX market in 2015. Under the OTCQX Rules, OPCO is required to meet high financial standards (OTCQX does not accept Penny Stocks or Shell Companies) and provide current disclosure to investors (including PCAOB audited annual financials). Our experience since joining OTCQX has been very positive in terms of stock price appreciation, revenue and employee growth and credibility.

There are many reasons why the OTCQX market works well for small, growing companies like ours:

- **Lower Cost & Complexity**: OTCQX costs less, and our compliance obligations, while challenging, are less burdensome than listing on an exchange, giving us more time and money to spend growing our business.
- **Small Company Liquidity**: OTC Markets Group's ATS dealer model supports the liquidity needs of smaller, less-actively traded securities. Unlike large, exchange-listed companies, we do not have large amounts of natural liquidity and high trading volumes. Rather, our liquidity needs are focused on making sure our shareholders have the ability to buy and sell on an as-needed basis.
- **Investor Engagement & Capital Formation**: Through OTC Markets' disclosure services, we are able to easily communicate with our shareholders, publish financial reports and share company updates to broaden our visibility in the marketplace. The OTCQX market is also exempt from Blue Sky secondary trading regulations in 30 states, which allows broker dealers to reach a wider audience of potential investors, raise capital and grow our shareholder base.

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[1] OTC Markets Group Inc. operates the OTCQX Best and OTCQB Venture markets, where over 1,200 companies meeting financial standards and providing current disclosure to investors, including many innovative and entrepreneurial 'venture' companies, trade via an SEC registered alternative trading system ("ATS").

1300 East Street, Fairport Harbor, OH 44077 • 1-800-565-2695 • 440-354-6500 • fax 440-354-9129 • www.ourpets.com

OurPet's Co.
Unleashing great ideas in pet care.

The OTCQX market has helped grow and mature by providing all of the benefits of a public market – scaled to fit the needs of small companies.

The Main Street Growth Act does not work for companies like us because it focuses solely on national securities exchanges and excludes other models, such as OTCQX where we have established a thriving secondary market. The Main Street Growth Act instead would restrict trading to one, single exchange.

While we welcome legislation aimed at supporting small public companies and the venture markets that serve them, the Main Street Growth Act does not achieve these goals. We urge the Committee to consider the value of alternative secondary market models, such as ATSs, because companies should be able to choose the venue that best suits their needs. A "Venture Company" should be afforded the same regulatory treatment, regardless of whether it trades on an exchange or an ATS market like OTCQX.

We remain hopeful that Congress, the SEC and market participants can work together to provide venture companies with all the tools necessary to foster their growth and development. Please let me know if we can provide any additional information or insight in furtherance of that shared goal.

Since

Dr. Steven Tsengas
Chairman/CEO
OurPet's Company (OTCQX: OPCO)

1300 East Street, Fairport Harbor, OH 44077 • 1-800-565-2695 • 440-354-6500 • fax 440-354-9129 • www.ourpets.com

OTC Markets

May 22, 2018

The Honorable Jeb Hensarling, Chairman
Committee on Financial Services
U.S. House of Representatives
Washington, D.C. 20515

The Honorable Maxine Waters, Ranking Member
Committee on Financial Services
U.S. House of Representatives
Washington, D.C. 20515

The Honorable Bill Huizenga, Chairman
Subcommittee on Capital Markets and Government Sponsored Enterprises
Committee on Financial Services
U.S. House of Representatives
Washington, D.C. 20515

The Honorable Carolyn Maloney, Ranking Member
Subcommittee on Capital Markets and Government Sponsored Enterprises
Committee on Financial Services
U.S. House of Representatives
Washington, D.C. 20515

Re: Main Street Growth Act (H.R. 5877)

Dear Chairman Hensarling, Ranking Member Waters, Chairman Huizenga and Ranking Member Maloney,

OTC Markets Group Inc. operates the OTCQX Best and OTCQB Venture markets with over 1,200 companies meeting financial standards and providing current disclosure to investors, including many innovative and entrepreneurial 'venture' companies, trading via our SEC registered alternative trading system ("ATS").[1] In advance of the House Financial Services Committee's Subcommittee on Capital Markets, Securities, and Investment hearing on Legislative Proposals to Help Fuel Capital and Growth on Main Street, we want to share our concerns about the Main Street Growth Act (H.R. 5877) and the approach it takes towards regulating the U.S. venture markets.

We thank the Committee, Committee staff and Congressman Emmer for eliciting our feedback and communicating with us as they worked on the Main Street Growth Act. While we are disappointed with the bill as currently drafted, we appreciate the opportunity to be heard and look forward to working with the Committee on the important issues of small company trading and capital raising going forward.

[1] The U.S. based companies on these markets have an aggregate market capitalization of over $17 billion and employ over 45,000 people.

The Main Street Growth Act would allow the creation of "Venture Exchanges" that are intended to have trading and listing rules tailored for smaller companies and regulatory privileges that are unavailable to non-exchange markets. The bill focuses soley on national securities exchanges and excludes ATSs like ours and other innovative market models. We oppose the bill's mandate of a single business model for the trading of all venture securities. Prescribing an exchange-only solution for venture-stage companies stifles the type of innovative, tailored market structure that has seen more than 300 companies graduate from our markets to the NYSE or Nasdaq exchanges over the past 5 years. Many small companies on our OTCQX market do not seek to graduate, and have established thriving secondary markets on our ATS platform without the cost and complexity of listing on an exchange.[2]

OTC Markets Group and the ATS Model

Successes on our markets are attributable in part to the structure of our ATS as a dealer market, allowing competing broker-dealers to directly interact with one another, as opposed to an auction (exchange model) market where broker-dealers interact only with the exchange as the centralized trading facility. Dealer markets have been shown to work better for smaller company trading, and ***all market participants should be permitted to choose the type of trading venue that best suits their needs. Companies should be free to choose their listing or designation based on value and cost, broker-dealers should be free to seek best execution from the market or broker-dealer of their choice, and investors should benefit from competition between multiple market options for buying and selling company stock.***

In an attempt to consolidate liquidity, H.R. 5877 would not permit Venture Exchanges to offer Unlisted Trading Privileges (UTP) to the securities traded there. Unlisted Trading Privileges allow securities to trade across multiple venues and were adopted, in large part, to facilitate competition between markets and deter monopolistic practices by the exchanges. Removing these privileges incentivizes anti-competitive behavior and far outweighs the potential benefits of consolidated liquidity. Forcing these participants to use a venue type prescribed by regulators is not in the best interest of any market, particularly one intended to support smaller companies and their investors.

For example, our markets cost significantly less than exchange listings, and offer streamlined compliance processes while requiring that companies meet high financial standards and produce audited financial statements among other ongoing, current public disclosure.[3] We work closely with state regulators, and thus far 30 states have recognized our OTCQX market as exempt from state "Blue Sky" restrictions on

[2] Nine OTCQX companies submitted letters to the Committee expressing their concern over the Main Street Growth Act.

[3] All OTCQX and OTCQB company disclosure is made publicly available for free on the OTC Markets Group website at www.otcmarkets.com. The website also features transparent real-time pricing information for these companies, including the inside bid and offer as well as the full depth-of-book market data for each OTCQX and OTCQB security.

secondary trading. That allows broker-dealers to reach a wide audience of potential investors, which improves liquidity and capital raising opportunities.

Liquidity and Competition

High-speed exchange matching engines can capture the substantial existing liquidity in the largest public companies, but they cannot create liquidity for smaller companies. Only market makers using dealer-based markets like our ATS can provide additional liquidty as a service, which is an important reason why OTCQX and OTCQB have been successful for smaller company securities without large amounts of natural liquidity. Academic research also indicates that the competing broker-dealer model used by OTC Markets Group compares favorably to other successful smaller company trading markets. [4]

Market makers today can compete with the exchange markets for online broker orders based on quality of executions, costs and providing greater liquidity than is displayed on the exchanges. This structure requires a competive, low-cost trading ecosystem that ATSs like ours can provide while exchanges cannot. We should seek to foster forward-thinking markets structure models, rather than restricting trading to a single, exchange license only model.

Conclusion

For the reasons outlined above, OTC Markets Group does not support the Main Street Growth Act in its current form. Our OTCQX and OTCQB markets provide secondary trading platforms for the companies that drive the Main Street economy. We have a history of providing a long-term home for these companies and their investors, and acting as a launching pad for the 60+ companies a year that grow with us and ultimately graduate from our markets to a national securities exchange listing.

We remain hopeful that Congress, the SEC and market participants can work together to provide smaller, venture companies with all of the tools necessary to foster their growth and development. Please let me know if we can provide any additional information or insight in furtherance of that shared goal.

Sincerely,

Daniel Zinn
General Counsel
OTC Markets Group Inc.

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[4] The study, attached as Exhibit A, is titled: *The rise and fall of the Amex Emerging Company Marketplace*, Journal of Financial Economics 52 (1999), 257-289.

EXHIBIT A

ELSEVIER Journal of Financial Economics 52 (1999) 257–289

JOURNAL OF Financial ECONOMICS

The rise and fall of the Amex Emerging Company Marketplace[☆]

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Abstract

In 1992, the Amex launched the Emerging Company Marketplace (ECM) to trade the stocks of small but growing companies. Bid–ask spreads decreased dramatically for listing firms, and news coverage increased. Executives of listing firms were quite satisfied. Yet few firms chose to list on the ECM, and it closed in 1995. What went wrong? Most Amex stakeholders had little to gain from the success of the ECM, and a series of scandals damaged the reputation of the exchange. Similar small-firm markets have also failed, largely because successful firms quickly depart for traditional markets, leaving only unsuccessful firms behind.

JEL classification: G10; G15

Keywords: Amex; Nasdaq; Listings; Stock market failure; Market structure

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1. Introduction

On March 18, 1992, the American Stock Exchange (Amex) launched the Emerging Company Marketplace (ECM) with great fanfare. The ECM was designed to trade the stocks of small but growing firms until they grew large enough to qualify for a regular Amex listing. Bid–ask spreads fell substantially for the firms that listed on the ECM, and media coverage of the ECM firms increased. However, relatively few companies followed the initial 22 firms, and the Amex closed the market on May 11, 1995.

What went wrong? How could a market produce a substantial reduction in transaction costs, yet fail to succeed? The ECM is one of many failed attempts to launch public equity markets for small stocks in the US and Europe. Why do such markets have so much trouble? This paper analyzes several factors that possibly contributed to the demise of the ECM and that shed light on the factors affecting the development of equity markets for smaller firms.

The governance structure of the Amex is one such factor. Like most traditional exchanges, the Amex is organized as a membership organization rather than a private firm. This cooperative structure means that most Amex stakeholders had little to gain if the ECM succeeded. In fact, some members of the Amex board represented firms that also owned Nasdaq market makers who were in direct competition with the Amex.

So-called 'junior' markets like the ECM also suffer from an adverse selection problem. The successful firms graduate to a listing on the senior market, leaving behind the unsuccessful ones. The junior market thus develops a reputation as a place for unsuccessful firms. As part of the Amex, the ECM had no incentive to keep firms from graduating to a regular Amex listing. This problem was made worse for the ECM because poor screening of firms led to some embarrassing scandals that hurt the ability of the ECM to attract new listings.

The market mechanism chosen for the ECM, which was the same as the regular Amex auction market, is another possible problem. Although auction markets like the Amex generally have lower bid–ask spreads than dealer markets such as Nasdaq, the wider bid–ask spreads of a dealer market can possibly motivate broker–dealers to promote a stock, increasing liquidity by widening the pool of potential shareholders. However, the ECM-listed firms enjoyed both a decrease in bid–ask spreads and an increase in their media visibility, implying that the market mechanism alone did not lead to the failure.

The experience of the ECM provides a natural opportunity to investigate these questions and to take a closer look at the competition between markets for listings. The next section presents the history of the ECM. Section 3 examines in more detail the hypotheses regarding the failure of the ECM, and presents the empirical results. Section 4 documents the failures of other markets in the US

and elsewhere that have attempted to trade very small company stocks. Section 5 concludes and summarizes.

2. The Amex emerging company marketplace

By 1992, the Amex was in a difficult competitive position. Traditionally, new firms first traded on the over-the-counter (OTC) market, then moved to the Amex as they grew larger, and eventually attaining a listing on the NYSE. However, the evolution of the OTC market into the Nasdaq market, with substantially improved quotation and trade dissemination compared to the old OTC market, significantly reduced the relative benefits of an Amex listing. The Amex lost significant market share in its core equity business. As a fraction of the total share volume on the traditional exchanges (NYSE, Amex, and the regionals), Amex market share fell from a peak of 29.6% in 1968 to 6.1% in 1991. The number of issuing firms fell from a level of 1215 in 1975 to 860 by the end of 1991. (These facts are derived from the 1992 fact books published by the Amex, NASD, and the NYSE.)

The Amex had tried a number of ways to increase its business in the 1970s and 1980s, including a successful entry into the options business, a failed entry into futures trading and an unsuccessful effort to trade NYSE-listed stocks. Bruchey (1991) provides more details about this and the Amex's entries into options and futures trading. The Amex also scored a series of successes by listing innovative derivative securities that the NYSE would not. Thus, it was in character with the history of the Amex that it would contemplate starting a new market in 1992.

Following the resignation of Amex Chairman Arthur Levitt, Jr. in 1989, the Amex chose former congressman James Jones as its chairman. Although he had been a public member of the Amex's board since 1987, Jones had no work experience in financial services. Jones, when first asked about the job, remarked, 'I don't really know enough about the industry (Investment Dealers' Digest, Nov. 18, 1991, p. 12)'. In addition to launching the ECM, Jones explored plans for a number of potential new ventures, including after-hours trading, a satellite trading floor in Hawaii, and a merger with the Philadelphia Stock Exchange.

The ECM was similar in concept to many of the junior or 'incubator' markets that had been started by the major stock exchanges in Europe to provide an exchange market for firms too small for the senior market. The Amex also intended to compete with Nasdaq for the listings of stocks that were too small to qualify for the regular Amex. By listing such companies early in their development, the Amex hoped to retain them as they grew bigger.

The Amex had three potential competitive advantages in this market segment. First, its auction market usually produced narrower bid–ask spreads than did

Nasdaq's dealer market. The lower transaction costs were expected to attract firms and investors. Second, at that time there was no last-trade reporting for Nasdaq stocks that were not part of the Nasdaq National Market, so investors had substantially less information about prices and volumes for such stocks. Since the Amex reported trade prices and volumes almost immediately over the consolidated tape, this improved information should also have attracted both listing companies and investors. Third, because of its traditional listing standards, the Amex had a reputation for listing firms of higher quality than many of those found in the *Pink Sheets* or the Nasdaq stocks outside the Nasdaq National Market.

The Amex adopted listing requirement for the ECM that were much less stringent than for a regular Amex listing. These are illustrated in Table 1. Not only were ECM requirements smaller in terms of stockholders' equity than were regular Amex requirements, ECM firms did not have to show positive earnings. Furthermore, there was no requirement for outside directors or audit committees. Concerns about the quality of the ECM firms were raised by the SEC and others even before the market started. Mary Schapiro, then SEC Commissioner, observed that 'Investors should understand that these companies are subject to much lower standards than companies traditionally associated with the American Exchange' (The New York Times, March 5, 1992, p. 01). The Amex sought to allay these concerns by promising to screen the companies very carefully. In addition, the Amex priced the listing fees for the ECM just slightly lower than Nasdaq's listing fees, as seen in Table 2.

2.1. The ECM companies

The ECM began trading on March 18, 1992 with 22 companies. The original ECM companies were relatively small, having a median market capitalization of $18 million and a median market price of $3.00 per share. Many of them were high-tech firms. The companies were reportedly picked by a 'blue ribbon' committee of Amex members and money managers. Most of the original companies had previously traded on what is now known as the Nasdaq Small Cap market, a lower tier of Nasdaq than the Nasdaq National Market. Six of the firms had previously traded on the *Pink Sheets*, meaning that they were even smaller and there was less trading activity in them. *Pink Sheets*' quotations are not firm; rather, they are primarily indications of interest, not commitments by dealers to trade at a given price. One of the stocks (Intertel Communications) had previously traded on the Vancouver Stock Exchange, an automated exchange known primarily for trading speculative mining stocks. Table 3 provides summary statistics about the firms that listed on the ECM and where their stocks traded prior to listing on the ECM. Table 10 of Appendix A contains more details about the firms.

Table 1
Amex, Nasdaq, and NYSE initial and continuing fees

The Amex, NYSE, and NASD charge listing firms a fee for initial listing in addition to an annual maintenace fee. The fees are usually based on the number of shares outstanding. This table demonstrates the listing and maintainence fees for selected firm sizes when the Amex ECM was launched in 1992.

Share outstanding (millions)	Original listing fees					Annual maintenance fees		
	Nasdaq	Nasdaq national market	Amex ECM	Amex	NYSE	Nasdaq	Amex	NYSE
1	$6000	$10,000	$5000	$10,000	$51,550	$5250	$5500	$15,700
5	$10,000	$30,000	$5000	$25,000	$84,600	$7250	$7500	$15,700
10	$10,000	$42,500	$5000	$37,500	$102,100	$9750	$10,000	$15,700
25	$10,000	$50,000	$5000	$52,500	$154,600	$13,250	$13,000	$31,400
50	$10,000	$50,000	$5000	$77,500	$242,100	$20,000	$13,500	$41,840
100	$10,000	$50,000	$5000	$127,500	$417,400	$20,000	$13,500	$82,090
200	$10,000	$50,000	$5000	$227,500	$767,100	$20,000	$13,500	$162,590
Maximum	$10,000	$50,000	$5000	$227,500 + $0.001*shares over 100 millions	$1,467,100 + $0.0009*shares over 300 millions	$20,000	$13,500	$500,000

Source: Amex listing fee data published in 1993.

Table 2
Amex, NYSE, and Nasdaq comparative listing requirements in 1992

This table contains representative initial listing standards for the Nasdaq, Amex, and NYSE at the time of the inauguration of the Amex ECM in 1992, obtained from the individual markets. All markets also have lower standards for continued inclusion on their lists. Some alternative standards exist.

	Nasdaq	Nasdaq national market system	Amex ECM (Companies presently not trading on Nasdaq)	Amex ECM (Companies presently trading on Nasdaq)	Amex	NYSE
Total assets	$4 million	—	$4 million	$2 million	—	—
Stockholder's equity	$2 million	—	$2 million	$1 million	$4 million	—
Net tangible assets	—	$4 million	—	—	—	$18 million
Net income	—	$400,000[a]	—	—	—	—
Pretax income	—	$750,000[a]	—	—	$750,000[a]	$2.5 million[c]
Public float (shares)	100,000	500,000	250,000	250,000	500,000	1,100,000
Market value of public float	$1 million	$3 million	—	—	—	$18 million
Market value	—	—	$2.5 million	$2.5 million	$3.0 million	—
Market makers	2	2	—	—	—	—
Minimum price	$3	$5	$1	$1	$3	—
Public Shareholders	300	400–800[b]	300	300	400–800[b]	2000[d]

[a] In last fiscal year or two of last three fiscal years.
[b] Based on number of shares publicly held and average daily trading volume.
[c] In addition, the firm is required to have $2.0 million in pretax income for each of the preceding two years or a total of $6.5 million for the sum of the last three years with $4.5 million in the preceding fiscal year. All three years must be profitable. The alternative is an aggregate of $6.5 million in pretax income for the last three years and a minimum of $4.5 million in the preceding year, with all three years profitable.
[d] Round lot holders. Alternatively, a firm can have 2200 total shareholders together with average monthly trading volume of 100,000 shares.

Table 3
Summary statistics on ECM firms

Panel A contains summary statistics for the 65 firms that listed on the Amex ECM between March 18, 1992 and May 11, 1995. The number of market makers in each stock before lisitng was obtained from the NASD, Amex, or the *Pink Sheets*. Panel B contains information on the source of listings for the ECM. The original firms are the firms that listed on the ECM when it commenced operations on March 18, 1992, and the additional firms are those firms that listed later.

Panel A: Summary statistics on the listed firms

	Market capitalization (millions)	Stock price	Number of pre-ECM market makers
Mean	$28.8	$4.34	9.61
Median	$15.1	$3.38	8.00
Standard deviation	$38.8	$3.17	6.57
Minimum	$3.0	$0.69	1
Maximum	$253.7	$15.19	30
Numbers of firms	65	65	46

Panel B: Sources of ECM listings

Prior market	Original firms	Additional firms	Total firms
Nasdaq – not national market	15 (68.2%)	11 (25.6%)	26 (40.0%)
Pink sheets/Nasdaq Bulletin Board	6 (27.3%)	15 (34.9%)	21 (32.3%)
No previous market	0 (0.0%)	5 (11.6%)	5 (7.7%)
Vancouver stock exchange	1 (4.5%)	3 (7.0%)	4 (6.2%)
Initial public offering	0 (0.0%)	3 (7.0%)	3 (4.6%)
Spinoff	0 (0.0%)	3 (7.0%)	3 (4.6%)
London stock exchange	0 (0.0%)	1 (2.3%)	1 (1.5%)
Pacific stock exchange	0 (0.0%)	1 (2.3%)	1 (1.5%)
Toronto stock exchange	0 (0.0%)	1 (2.3%)	1 (1.5%)
Total	22 (100%)	43 (100%)	65 (100%)

As time progressed, the ECM listed smaller firms and firms that had been delisted from Nasdaq. Few of the additional listings came from the Nasdaq Small Cap market. Most came from the *Pink Sheets* or elsewhere. Five of the firms were private firms that had no public market for their stocks, not even in the *Pink Sheets*.

The Amex used the same market mechanism for the ECM stocks as for the regular Amex stocks. Eleven different specialist firms handled the trading in the original ECM stocks along with their regular stocks at various posts on the Amex trading floor. Although in general the ECM stocks traded like regular

Amex stocks, there were a few differences. The ticker symbols for ECM stocks carried the suffix 'EC', which made it difficult for some brokers to access information about the firms on their computer systems. Furthermore, ECM-listed stocks were not automatically marginable like regular Amex-listed stocks.

Another difference between the regular Amex and the ECM was that, unlike regular Amex-listed firms, ECM firms were not automatically exempt from the SEC's penny stock disclosure rules. SEC Rules 15g1–15g6, which generally require that brokers selling unlisted stocks with a price less than $5.00 per share must provide additional written disclosures to customers about the risks of such stocks. This meant that brokerage firms would incur additional compliance costs and paperwork in determining which ECM firms were covered by the penny stock disclosure rules, making it less likely that the firms would want to bother promoting ECM-listed firms. Seguin and Smoller (1997) address the trading and risks involved in penny stocks.

2.2. Scandals and embarrassments

Almost immediately after the ECM started, questions arose about the care with which the Amex had screened the ECM firms. *Business Week* (April 13, 1992, p. 78) and *The Wall Street Journal* (July 2, 1992, p. A1) reported that the controlling shareholder of one ECM-listed firm, PNF, a maker of flame retardants, had previously been barred for life by the Amex and was a convicted arsonist. Other scandals also beset the market. In May 1993, the SEC temporarily suspended trading in Digitran, the first ECM firm to graduate to the regular Amex, in May 1993 pending an investigation of the firm's accounting methods. Later, *Business Week* (Sept. 12, 1994, p. 80) reported that the CEO of Printron had been sued twice by the SEC for securities violations – once as a man and once as a woman – and had not revealed this information to the Amex.

Perhaps even more embarrassing than the scandals, two of the original ECM firms, North Coast Energy and Ocean Optique, voluntarily returned to trading on Nasdaq. Ken Gordon, the CFO of Ocean Optique, stated, 'We were almost illiquid on the Amex, and would sometimes go an entire week without trading' (Securities Week, Nov. 23, 1992, p. 4).

This U.S. General Accounting Office delivered more bad news in 1994, finding 'weaknesses in Amex's practices of assessing companies' qualifications for Marketplace listings' (Report # GAO/GGD 94-72). Specifically, the Amex had not screened the early firms thoroughly, although it later improved its screening process. The report also found that the Amex's reliance on qualitative listing factors, such as the companies' prospects, was potentially misleading to investors who were expecting tougher listing standards.

2.3. Closure

Throughout the life of the ECM, new listings replaced some of the firms that left, so the total number of ECM listings stayed relatively stable. Nonetheless, by the end of 1992, there were only 28 companies on the ECM, far below the 50 that Amex officials had envisioned. The number fell to 22 by the end of 1993. Some smaller firms joined the ECM in 1994, bringing the number of listings to 35 and the median market capitalization from its original \$18.4 million down to \$6.8 million. Several of the later listings on the ECM were 'fallen angels', companies that had been delisted from Nasdaq and then traded in the *Pink Sheets*. In August 1993, Jones, who had personally championed the ECM, resigned as chairman of the Amex to become the US ambassador to Mexico. He was replaced in 1994 by Richard Syron, who had been president of the Federal Reserve Bank of Boston. Syron stopped actively marketing the ECM pending a review, and the Amex announced the closure of the market on May 11, 1995. After the closure, the remaining ECM firms were permitted to continue trading on the ECM. Many of them moved up to the regular Amex list as soon as they met the listing standards, although as of this writing several of them are still trading as ECM stocks.

During its life, the ECM listed a total of 65 firms. Table 4 contains information about the status of the firms after the ECM closed. As of June 1997, 29 of those 65 firms had graduated to a primary Amex listing, and 15 were still on the ECM. Eight of the firms had voluntarily switched to Nasdaq, and 11 were delisted by the Amex for failing to meet listing requirements. One stock was listed in Toronto and one other on the NYSE.

Table 4
Primary listing status of ECM-listed firms, May 1995 and June 1997

This table presents the primary listing status of the 65 firms that listed on the ECM as of the May 1995 announcement of the closure of the market and also as of June 1997. 'Delisted' refers to firms that were removed from the Amex for failure to meet Amex listing requirements or whose trading was suspended by the Amex. Nasdaq refers to firms that switched voluntarily to Nasdaq.

Primary listing of firm	Status as of May 1995 number of firms	Status as of June 1997 number of firms
Amex ECM	32 (49.2%)	15 (23.1%)
Amex (regular)	19 (29.2%)	29 (44.6%)
Delisted	7 (10.8%)	11 (16.9%)
Nasdaq	5 (7.7%)	8 (12.3%)
NYSE	1 (1.5%)	1 (1.5%)
Toronto	1 (1.5%)	1 (1.5%)
Total	65 (100%)	65 (100%)

3. Hypotheses regarding the failure of the ECM

3.1. Governance structure of the Amex and the ECM

The governance structure of the Amex might have contributed to the failure of the ECM because important Amex constituencies had little to gain from the ECM. Like most traditional stock exchanges, the Amex is organized as a not-for-profit membership organization. As Hart and Moore (1995) eloquently point out, this cooperative organization can lead to serious inefficiencies. Whereas an investor-owned firm has the clear objective of maximizing shareholder value, the members of a cooperative have divergent interests. Members buy seats on the Amex in order to make money by executing trades for themselves or for their customers on the Amex. The members are more concerned with earnings from their trading operations than they are with maximizing the value of an Amex membership.

It is interesting to note that none of the successful entrants into the U.S. equity market in recent years have been organized as cooperatives. Electronic trading networks such as POSIT and Instinet are for-profit ventures. Furthermore, several exchanges, including Amsterdam, Australia, Milan, and Stockholm, have converted or are in the process of converting from cooperative ownership to limited liability companies.

Euroquote, an earlier attempt to start a pan-European trading system, highlights some of the problems cooperative organizations face when attempting to launch new ventures (see Clarkson, 1990; Financial Times, Mar 13, 1991, p. 34 and Sept. 24, 1991, p. 25). The Federation of European Stock Exchanges sought to make it possible for its member stock exchanges to share prices and quotations. In its first phase, Euroquote would have provided only price information, but the long-term goal was to become an integrated European trading mechanism. Euroquote would have allowed the member markets to compete with one another in a manner similar to the competition between market makers on Nasdaq. However, the system was scuttled prior to launching because several member exchanges felt their individual interests were threatened by it.

Apparently few, if any, Amex stakeholders had a stake in the ECM. As the CEO of one ECM-listed firm (who requested anonymity) bluntly put it, 'There was no constituency inside the exchange [for the ECM]'. Clearly, the Amex officials who had championed the ECM, such as its chairman, James Jones, had a reputational stake in its success. However, the other constituencies had little to gain from the ECM. Some of the existing Amex-listed companies were concerned that the new segment with its lower listing standards would damage the reputation of Amex-listed firms (Investment Dealer's Digest, Nov. 18, 1991, p. 12). Even if the ECM had succeeded, it would not have benefited the options traders, because the Amex trades options mostly on non-Amex stocks.

Although the Amex specialists would have benefited had the ECM resulted in more high-volume regular Amex listings, conversations with some Amex specialists indicate that they were not too interested in the ECM firms themselves. The low potential trading volumes of the tiny ECM firms meant that they had little immediate profit potential (Hasbrouck and Sofianos (1993) report that NYSE specialists earn substantially lower profits per trade on less frequently traded stocks). Because the specialists were already trading the regular Amex stocks, they did not give the ECM firms much attention. However, some specialists strongly supported the ECM because they viewed it as providing the listings of the future.

The retail brokerage firms that route orders to the Amex should not have been particularly concerned over whether a stock traded on the ECM, the regular Amex, or the NYSE. They would have earned the same commission regardless of where a trade executed. However, Amex member firms that also owned Nasdaq broker–dealers stood to gain from the failure of the ECM, because their affiliated market makers could earn more money from Nasdaq's traditionally wider bid–ask spreads.

The composition of the Amex's 25-member Board of Governors in 1992 reflects the diverse interests of the membership. The Amex, like the NYSE and the NASD, is required to have public board members. There were 12 board members who represented the public, including former Federal Reserve Chairman Paul Volcker and Princeton University Professor Burton Malkiel. Several of these public board members were affiliated with the larger Amex-listed firms. The remainder of the board positions were split between specialist firms, floor brokers, and brokerage firms. Six of the Amex governors represented firms that were also affiliated with Nasdaq market makers, including Merrill Lynch, Smith Barney, Prudential, and Nomura. Thus, the potential supporters of the ECM among the floor traders and specialists were in a minority on the board and unable to save the ECM when the board was deciding its fate.

One example of how this cooperative governance hurt the ECM was in the screening of ECM firms. Some of the poor quality firms that hurt the ECM's reputation were introduced by members of the exchange, and thus received less than appropriate scrutiny. Another example is the response of the Amex to the concerns of the larger listed firms, represented by 'public' members of the board, that the ECM would hurt the reputation of the larger firms. Thus, the Amex took several steps to differentiate the ECM firms from the regular Amex-listed firms, such as adding the problematic 'EC' suffix to the ticker symbol of ECM firms.

In addition, because the Amex had designed the ECM to generate more listings for the regular Amex, there was no incentive for the ECM to discourage firms from moving up to the main list. Indeed, conversations with executives of ECM-listed firms indicate that the Amex encouraged the firms to move to the

main list as soon as they qualified. An independent market like Nasdaq competes aggressively to keep its listed firms from moving to another market. This accentuated the adverse selection problem described below.

3.2. *Adverse selection*

The ECM, like other junior markets, suffered from an adverse selection problem. By definition, such markets target firms that are too small for the senior market. Some of the firms do well and graduate to the senior market. The firms that do not do well remain behind in the junior market. Thus, the junior market must constantly list new firms or face a drop in listings. For example, of the 28 firms on the ECM at the end of 1992, 16 (57.1%) were gone by the end of 1993.

If anything such as an economic recession, a market downturn, or a scandal disrupts the flow of new listings, the junior market will comprise only the less successful firms, damaging its reputation. The declining number of listings and an unsuccessful reputation further deters new firms from listing in the junior market, setting up a vicious circle of decline. The poor screening by the Amex made this problem even worse. The scandals created a reputation for the ECM as a collection of poorly screened firms, further deterring other firms from considering a listing.

3.2.1. *Stock market performance of ECM firms*

The adverse selection hypothesis implies that successful firms would quickly move on to the regular Amex and that the less successful firms would spend more time on the ECM. This was indeed the case. To investigate this, we examine the stock market performance of the ECM firms during the time they were listed on the ECM. Overall, many of the ECM-listed stocks performed poorly, as indicated by the 11 delistings out of the 65 stocks. To examine aggregate performance of the ECM stocks, we calculate returns on a value-weighted portfolio of firms that listed on the ECM during the time period that they were on the ECM. We compare the performance of this ECM portfolio with the Nasdaq Composite Index and with a control portfolio made up of 65 size- and industry-matched firms. We use a group of control firms as a benchmark in light of Barber and Lyon's (1997) finding that control firms generally provide less biased estimates of long-term abnormal returns. (Results for a variety of different benchmarks were quite similar and are omitted for brevity.) The control firms are selected from the Center for Research in Security Prices database by matching each ECM firm with the Nasdaq-listed firm in the same two-digit SIC code that was closest in market capitalization to the ECM firm. A firm is included in the control firm portfolio only during the time its matching ECM firm is in the ECM. For comparison, we set each portfolio only during the time its matching ECM firm is in the ECM. For comparison, we set each

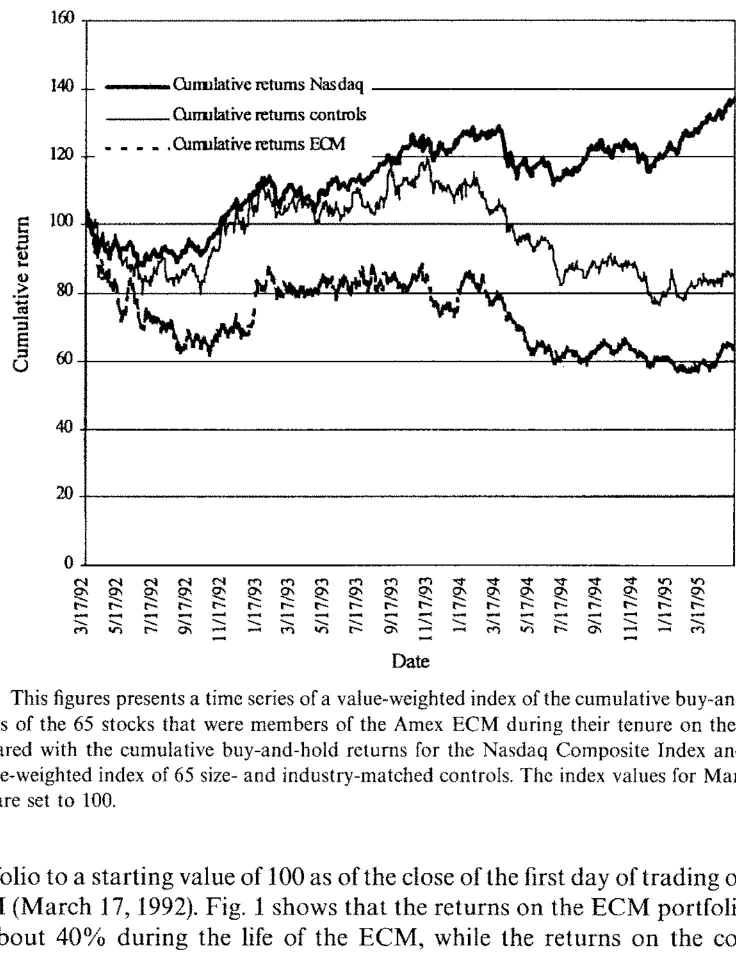

Fig. 1. This figures presents a time series of a value-weighted index of the cumulative buy-and-hold returns of the 65 stocks that were members of the Amex ECM during their tenure on the ECM compared with the cumulative buy-and-hold returns for the Nasdaq Composite Index and with a value-weighted index of 65 size- and industry-matched controls. The index values for March 17, 1992 are set to 100.

portfolio to a starting value of 100 as of the close of the first day of trading on the ECM (March 17, 1992). Fig. 1 shows that the returns on the ECM portfolio fall by about 40% during the life of the ECM, while the returns on the control portfolio fall about 20% and the Nasdaq Composite Index increases almost 40%. Of the 65 ECM firms, 39 decline in value during their tenure on the ECM, 25 increase in value, and one is unchanged.

In Table 5, we compare the cumulative buy-and-hold returns of the individual firms during the periods that they were listed on the ECM with the returns on the two different benchmark portfolios, the Nasdaq Composite Index and the control firms benchmark. In the spirit of Barber and Lyon (1997), we examine the buy-and-hold-abnormal return ($\mathrm{BHAR}_{i\tau}$) for stock i over the period τ for which it was listed on the ECM, which we compute as follows:

$$\mathrm{BHAR}_{i\tau} = \prod_{t=1}^{\tau} [1 + R_{it}] - \prod_{t=1}^{\tau} [1 + \mathrm{E}(R_{it})] - 1, \tag{1}$$

Table 5
Stock market performance of ECM listed firms

This table presents the stock market performance of the 65 firms that listed on the Amex ECM from the time that the firms listed on the ECM until the earlier of the time that the firms left the ECM or the ECM closed in May 1995. Performance is presented for the cumulative buy-and-hold return, and also for cumulative buy-and-hold abnormal returns relative to the size- and industry-matched control firms described in the text, as well as for market model adjusted returns using the Nasdaq Composite Index as a benchmark. The p-value is for the hypothesis that the probability of a negative return is greater than the null hypothesis of a 50% probability.

	Time listed on ECM			Overall
	Less than 200 days	200–300 days	More than 300 days	
Number of firms	16	23	26	65
Mean	21.5%	10.0%	− 23.9%	0.7%
(t-stat)	(1.24)	(0.52)	(− 1.80)	(− 0.08)
Median	12.8%	− 10.6%	− 38.1%	− 16.8%
% negative	31.3%	60.9%	76.9%	60.0%
(p-value)	(0.993)	(0.149)	(0.003)	(0.053)
Cumulative buy-and-hold abnormal return (Control firms benchmark)				
Mean	22.5%	2.6%	− 19.5%	− 1.4%
(t-stat)	(1.15)	(0.16)	(− 1.44)	(− 0.15)
Median	11.0%	− 14.2%	− 39.5%	− 19.3%
% negative	37.5%	65.2%	76.9%	63.1%
(p-value)	(0.934)	(0.072)	(0.003)	(0.018)
Cumulative buy-and-hold abnormal return (Nasdaq Composite Index benchmark)				
Mean	20.4%	6.0%	− 27.0%	− 3.6%
(t-stat)	(1.07)	(0.34)	(− 2.19)	(− 0.39)
Median	10.0%	− 14.2%	− 35.4%	− 21.1%
% negative	31.3%	60.9%	80.8%	61.5%
(p-value)	(0.934)	(0.149)	(0.001)	(0.031)

where R_{it} is the return for stock i during period t and $E(R_{it})$ it given by the benchmark return. The mean BHAR is not significantly different from zero for both benchmarks. However, the median firm's BHAR is significantly negative for both benchmarks; the median ECM firm suffers a decline of 19.3% compared with the control firms.

Furthermore, the adverse selection effect is apparent in Table 5, which also displays the results by length of tenure on the ECM. Firms that remain on the ECM for under 200 days perform better than the control firm portfolio, with

a mean and median BHAR of 22.5% and 11.0%, respectively. The mean returns are not significant. Only 37.5% of these firms have negative cumulative abnormal buy-and-hold-returns relative to the control firms benchmark. The firms that stay on the ECM longer than 300 days suffer a median BHAR of − 39.5%, and 76.9% of them have negative BHARs. Once again, the mean returns were generally insignificant.[1]

This poor stock price performance is indicative of the low quality of the ECM firms and of the adverse selection problem faced by the ECM, in which the good firms graduate as soon as they can, leaving only the weaker firms behind. The ECM itself it not responsible for the price performance of the firms; such firms would have suffered price drops on whatever market they traded.

Although many of the ECM-listed stocks perform poorly, a few do quite well. Spectrum Signal Processing, Media Logic, and Colonial Data Technologies all tripled in value while they were listed on the ECM. Yet two of these winners, Colonial Data Technologies and Spectrum Signal Processing, voluntarily switched to Nasdaq, further damaging the image of the ECM.

3.3. *Market mechanism*

The auction market mechanism of the ECM is another possible factor in its failure, because small firms in the United States have traditionally chosen to be traded in a dealer market. For example, the majority of the small firms that meet the listing requirements of the Amex and the regional exchanges have to choose a dealer market. For example, as of July 1997, 1328 firms with a market capitalization of less than $100 million in the Compustat PC-Plus database meet the Amex listing requirements for stockholders' equity, pretax income, shares outstanding, market capitalization, and price. Of these firms, 1066 (80.3%) are listed on Nasdaq, 77 (5.8%) on the NYSE, and 185 (13.9%) are listed on the Amex. This preference for dealer markets potentially did not help attract listings to the ECM, because the Amex used the same auction market mechanism for the ECM as it did for its main stocks.

An auction market like the Amex generally produces narrower bid–ask spreads than dealer markets by consolidating trading activity in one location

[1] One potential problem that could bias these tests would be a high degree of correlation (e.g., an 'ECM factor') among the ECM stocks. To check for this, we calculate the Pearson correlation coefficient among all possible pairs of ECM stock returns during the time they were listed on the ECM, as well as the correlations among all possible pairs of controls. The mean correlation among the ECM stocks is only 0.008 with a median of 0.003, compared with a mean correlation among the pairs of controls of 0.004 with a median of 0.005. The 10th and 90th percentiles for the ECM firms are − 0.10 and 0.12, and the 10th and 90th percentiles for the controls are − 0.10 and 0.11. We thus do not think that there is a serious correlation bias affecting the stock returns of the ECM firms.

under the oversight of a single specialist who also acts as a dealer.[2] The wider Nasdaq bid–ask spreads have led to much criticism of Nasdaq, including allegations of oligopolistic behavior and price fixing (Forbes, Aug. 16, 1993, pp. 74–79; Christie and Schultz, 1994).[3] But differences in spreads are not necessarily evidence that one type of market mechanism is inherently better than another. In addition to the bid–ask spread, there is also the issue of 'sponsorship', or the marketing efforts of some broker–dealers on behalf of the stocks they cover. Many Nasdaq market makers publish security research about the stocks in which they make markets. This increases the information available to investors. Furthermore, Nasdaq broker–dealer firms have a double incentive to promote trading activity in the stocks in which they make markets, because they earn both commission revenue and dealer trading profits on orders that they generate. Some broker–dealers pass this incentive on to their registered representatives by allowing them to keep a higher fraction of the gross commissions on such stocks (Morgenson, 1993). In contrast, Amex Rule 190 prohibits its specialists from promoting their stocks.

It is not clear a priori which type of market mechanism should provide the lowest cost of capital for a firm. Recent theoretical work by Lipson (1997) and Aggarwal and Angel (1998) supports the notion that the smallest firms would prefer a dealer market and the larger firms an auction market. A dealer market generally has higher bid–ask spreads, which would be expected to increase the cost of capital in the spirit of Amihud and Mendelson (1986). Yet the higher spreads give dealers more incentive to make a market in a given stock. Multiple dealers may devote more capital to the market-making process than a monopolist specialist, which should help make the stock more liquid.[4] Furthermore, the higher spreads give dealers more incentive to provide security research and inform investors about a stock. This effect increases the number of investors who 'know about' the stock in the sense of Merton (1987), which leads to a lower cost of capital. Thus, a small firm might rationally choose a higher-transaction-cost

[2] Numerous studies investigate differences between dealer and auction markets. See Ule (1937), Van Horne (1970), Ying et al. (1977), Sanger and McConnell (1986), McConnell and Sanger (1987), Christie and Huang (1993), Kadlec and McConnell (1994), Dharan and Ikenberry (1995), Huang and Stoll (1996), and Clyde et al. (1998) for a sample of the work on differences across exchanges.

[3] For more on the alleged Nasdaq collulsion, see Barclay (1997), Bessembinder (1997), Demsetz (1997), Harris and Schultz (1997), LaPlante and Muscarella (1997), and Kandel and Marx (1997).

[4] However, to the extent that net capital requirements have any relation to the capital employed, an exchange can require its specialists to maintain higher capital levels, although it cannot compel them to use the additional capital to take larger positions. For example, NYSE Rule 104.20 requires a specialist to be able to assume a position of 150 round lots of a given stock, and to maintain sufficient net capital equal to 25% of this position requirement. Thus, a $30 stock adds $112,500 to the NYSE specialist's net capital requirement. Under SEC Rule 15c3-1, each stock over $5 adds only $2,500 to a Nasdaq market maker's net capital requirements, up to a total requirement $1,000,000.

market if that market provides additional marketing services for its stock. This is similar to a manufacturer who chooses a high-cost boutique as a channel of distribution because it provides marketing support that a low-cost mass merchandiser might too.

Even though some small firms might prefer a dealer market, it does not follow that this is the preference for all small firms. Whether the potential for increased investor interest provided by a dealer market is offset by its higher transaction costs is likely to differ from company to company. For some firms, the added marketing from Nasdaq broker–dealers might not be worth the higher transaction costs. Other firms might believe that the reputation effect of an Amex listing would increase the pool of potential investors more than would the marketing efforts of Nasdaq broker–dealers. Thus, it is likely that some small firms would be interested in an auction market. Indeed, choosing a different market mechanism from Nasdaq could have been a viable way to differentiate the ECM product and reach a niche of small firms that did not necessarily prefer a dealer market.

The hypothesis that the market mechanism contributed to the failure of the ECM contains several empirical implications. As discussed above, there are two dimensions of market quality that affect the decision regarding where to list. One dimension is that of transaction costs, which we measure with the bid–ask spread.[5] The ECM resulted in significant reductions in bid–ask spreads. The other dimension is the number of investors familiar with the firm, which we measure indirectly by looking at total trading volume and media visibility. Results on average daily trading volume are mixed, but showed a trend toward an increase in trading volume. Media visibility generally increases for the ECM-listed firms compared with a set of size- and industry-matched controls. Thus, the ECM seems to improve market quality on both dimensions, casting doubt on the hypothesis that the market mechanism alone caused the failure. The following subsections present these empirical results.

3.3.1. Effect of ECM listing on bid–ask spreads

We obtain data on price, volume, and bid–ask spreads from the Amex, the NASD, the Vancouver Stock Exchange, Dow Jones News Retrieval, and the *Pink Sheets* for 1992 published by the National Quotation Bureau. Bid–ask spread and volume data are not available for firms that were not publicly traded before they joined the ECM (such as initial public offerings and spinoffs). Volume data also are generally not available for firms that traded in the *Pink Sheets*. Consistent with the findings of Christie and Huang (1993) and Huang and Stoll (1996), our sample shows a significant drop in the average bid–ask

[5] See Ule (1937), Van Horne (1970), Ying et al. (1977), Sanger and McConnell (1986), and McConnell and Sanger (1987) for a sample of the work on exchange listings.

Table 6
Effect of ECM listing on bid–ask spreads

This table presents the effect of ECM listing on the quoted closing bid–ask spreads for a sample of 49 ECM firms for which bid–ask spread data are available both before and after listing. Bid–ask spreads before listing are calculated for those firms that were traded on the Nasdaq Small Cap for the month prior to listing. For stocks that traded in the *Pink Sheets*, the week prior to the ECM listing date is used. Bid–ask spreads after listing are calculated for the month following the listing date. Data are obtained from the NASD, Amex, Vancouver Stock Exchange, and the *Pink Sheets*.

	ECM firms					
	Dollar bid–ask spreads			Percentage bid–ask spreads		
	Before listing	After listing	Difference	Before listing	After listing	Difference
Median	0.375	0.160	– 0.210	14.1%	4.9%	– 7.9%
Mean	0.411	0.168	– 0.244	15.2%	6.2%	– 8.9%
Standard error of the mean	0.039	0.008	0.035	1.5%	0.8%	1.3%
Minimum	0.034	0.082	– 1.068	1.9%	1.6%	– 49.7%
Maximum	1.30	0.344	0.078	54.6%	32.0%	4.5%
Number of increases			5			5
Number of decreases			44			43
Number unchanged			0			0
t-statistic of mean difference			– 6.90			– 6.63
Sign test p-value			0.000			0.000
Wilcoxon signed rank test p-value			0.000			0.000

spread for the 49 ECM firms for which before and after bid–ask spread data are available. As seen in Table 6, the percentage bid–ask spread falls for 43 of the 49 firms, from an average of 15.2% before listing to 6.2% after listing, a decline of 59%.

Intertel Communications, which had previously traded on the Vancouver Stock Exchange, saw its spread rise from 1.9% to 3.9%. Part of this increase might be attributable to the tick size used in Vancouver, where the minimum price variation is one Canadian cent. On the Amex, the minimum tick size for a stock in this price range is 1/16, or \$0.0625. The five other firms whose spreads increase generally have a larger number of market makers prior to listing than do the other ECM firms. The mean number of market makers for this group is 18.8 with a median of 18, compared with a mean of 8.5 and a median of eight for the other ECM firms.

3.3.2. *Effect of ECM listing on average daily trading volume*

Another natural measure of liquidity, average daily trading volume, shows mixed results. Table 7 shows the results on average daily trading volume for the

Table 7
Effect of ECM listing on average daily trading volume

This table presents information on the trading volume for the 35 firms that listed on the Amex ECM for which before and after trading volume are available. Trading volume data prior to listing are unavailable for firms that were IPOs, spinoffs, had no public market, or were traded on the *Pink Sheets*. Statistics are also presented for 35 Nasdaq control firms that were matched to teh ECM firms by two-digit SIC code and market capitalization at time of listing. Data are from the Amex, Bloomberg, FactSet Research Systems, and the NASD.

	ECM firms		Industry-and size-matched controls	
	Benchmark		Benchmark	
	Prior year	Year to date	Prior year	Year to date
	Average daily volume before listing date			
Median	4577	10,894	14,737	14,678
Mean	15,873	22,829	44,362	56,726
(Standard deviation)	(22,686)	(27,768)	(82,659)	(135,327)
	Average daily volume after listing date			
Median	7411		11,838	
Mean	14,465		(37,704	
(Standar deviation)	(18,030)		(73,440)	
Median percentage increase	101.64%	− 22.14%	− 9.26%	− 23.91%
Number of firms with higher volume	21	14	13	2
Number of firms with lower volume	14	21	22	33
Difference in mean before and after listing (t-statistic)	− 1372 (− 0.36)	− 8364 (− 2.00)	− 6658 (− 1.26)	− 63,384 (− 2.56)
Sign test (Median percentage increase > 0) p-value	0.1553	− 0.9123	0.9552	1.00
Wilcoxon signed-rank test (Median percentage increase > 0) p-value	0.003	0.810	0.725	0.948

35 ECM firms for which before and after volume data are available, along with the results for their controls. We compare the average daily volume for the firms during their life on the ECM with their average daily volume in the calendar year prior to listing and the year-to-date volume prior to listing. Compared with the full calender year prior to listing, average daily volume after listing on the ECM increases for 21 firms and decreases for 14 firms. Median average daily trading volume increases significantly from 4577 to 7411 shares per day

although the mean decreases insignificantly. The median firm's volume increases by 101.6%.

However, if we use the year-to-date period just prior to listing as the benchmark, then volume increases for only 14 firms and declines for 21 firms, and the median falls from 10,894 to 7411 shares per day. Volume for the median firm decreases by 22.1%. Table 7 shows that the average daily trading volume generally declines for the control firms for both benchmarks. Caution should be used in interpreting these trading volume numbers because the double counting of trades by Nasdaq creates an upward bias in reported Nasdaq volume compared with the Amex.[6]

3.3.3. Effect of ECM listing on media coverage

Because exchange membership can provide additional visibility for a firm, it can lead to more media coverage. This media coverage can in turn increase the pool of investors who 'know about' a firm in the sense of Merton (1987), and thus increase its liquidity. To investigate this, we examine the number of media reports, including news wires and newspaper stories, disseminated about these firms. We collect media reports on the firms for one year before and after their ECM listing date from the ALLNWS file on Lexis/Nexis to determine whether ECM listing is followed by an increase in media coverage. We exclude stories about the ECM listing itself, duplicate records, and PR wires that are issued by the firm. If ECM listing increases the visibility of the firms, then we would expect an increase in news stories. On the other hand, with less of a dealer network to promote the stock, we would expect a decrease in news stories. Because the changes in visibility could be gradual, we examine three-month, six-month, nine-month, and one year windows around the listing date. We also examine changes in news coverage for the industry and size-matched Nasdaq-traded control firms as described above.

Table 8 shows that the number of news stories increases slightly but insignificantly when comparing the three months prior to listing with the three months after. The same is true in comparing the six months before with the six months after listing. However, news coverage is significantly higher in the nine-month and one-year windows. For the 12 months before and after ECM listing, the

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[6] On a quote-driven market such as the Amex, a large number of transactions are directly between the buyer and the seller; such trades and their attendant volume will be reported only once. The Amex reports in its 1992 Fact Book that in 1991 its specialists participated in only 11.2% of the total transactions in the market. In a dealer market such as Nasdaq, the dealers act as intermediaries, and can buy shares from a dealer, who later sells the shares to the natural counterparty. Such a trade would be reported as two trades on Nasdaq; if the buyer had purchased directly from the natural couterparty on the Amex, only one trade would have been reported. Amex volume is, however, increased for trades in which the specialist participates. See Gould and Kleidon (1994) for an analysis of Nasdaq trading volume.

Table 8
Media coverage before and after ECM listing

This table presents the number of news stories in the ALLNWS file on Nexis/Lexis measured relative to each firm's listing date for the 65 firms that listed on the Amex ECM. News stories that were about the ECM itself and PR news wires issued by the firm itself are not included. Statistics are also presented for 65 Nasdaq control firms that were matched to the ECM firms by two-digit SIC code and market capitalization at time of listing.

	65 ECM firms				65 industry and size-matched controls			
	0–3 months	0–6 months	0–9 months	0–12 months	0–3 months	0–6 months	0–9 months	0–12 months
	Before listing date							
Median number of stories	5	8	11	15	9	18	23	32
Mean number of stories	7.5	13.3	16.8	20.2	11.3	22.0	30.7	40.0
	After listing date							
Median number of stories	6	13	21	28	6	12	19	24
Mean number of stories	7.3	14.3	23.3	31.8	10.8	21.5	33.0	43.2
Number of firms with higher number of stories	34	41	44	51	19	29	26	28
Number of firms with same number of stories	5	1	2	1	8	3	8	2
Number of firms with fewer stories	26	23	19	13	38	33	31	35
Difference in mean before and after listing (t-statistic)	− 0.26	1.08	6.49	11.55	− 0.51	− 0.49	2.23	3.18
	(− 0.21)	(0.59)	(3.31)	(4.84)	(− 0.46)	(− 0.29)	(1.02)	(1.26)
Sign test (Median difference > 0) p-value	0.1831	0.0168	0.0012	0.0000	0.9960	0.7373	0.7866	0.8432
Wilcoxon signed rank test (Median difference > 0) p-value	0.087	0.047	0.000	0.000	0.984	0.906	0.426	0.375

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median number of stories about the ECM-listed firms increased from 15 to 28; 51 of the 65 firms have increases in the number of stories. In contrast, the control firms do not see significant increases in news coverage, and in fact the majority (35) of the controls actually have fewer news stories in the year after listing. Thus, listing on the ECM is associated with an increase in media coverage for the ECM-listed firms.

3.4. Opinions of senior management of ECM-listed firms

We also undertook field research to learn more about the ECM from the perspective of the ECM-listed firms themselves. We interviewed senior officials from ECM-listed firms who were personally involved with or highly knowledgeable about the original decision to list on the ECM, most of whom were CEOs or CFOs. Because of personnel turnover and the disappearance of some ECM firms, we were unable to locate such officials at all the ECM firms. Table 9 provides summary information about the interviews with 37 of the 65 firms.

In general, the officials indicate that they were satisfied with their experiences on the Amex, and most (88.6%) of them would have made the same decision if they had it to do it over again. This is strong evidence against the notion that the Amex alienated its listed companies. Indeed, many of the officials report that their firms had unsatisfactory experiences with Nasdaq before they listed on the Amex ECM.

One very important finding from the survey is that the majority (71.4%) state that they would have sought an Amex listing anyway once they qualified, even if the Amex had not started the ECM. This response indicates that the ECM was attracting few firms to the Amex that would not have eventually chosen the Amex anyway. Indeed, several of the firms joined the ECM after the Amex stopped actively marketing it because those firms wanted to be on the Amex. Thus, the ECM was reductant in that it did not attract many listings beyond the firms that would eventually have come to the Amex anyway.

During the interviews, the officials freely volunteered many insights into why they listed on the Amex and on the strengths and weaknesses of the ECM. They mentioned repeatedly that lower spreads and more visibility on the ECM were important reasons for listing. Some firms were very pleased with the various investor relations programs offered by the Amex to introduce them to potential investors. For some a contributing factor was to have a listing in the newspaper every day, because many newspapers do not carry quotes for Nasdaq Small Cap stocks. One CEO felt that an Amex listing had more visibility to Europeans than a Nasdaq Small Cap listing, and this visibility was important for raising additional financing.

Many of the officials express a strong belief in the auction market. They think that the auction market is the 'right' way to conduct a stock market. Several

Table 9

Opinions of senior management of ECM-listed firms

This table summarizes the results of personal interviews with senior officials of 37 ECM-listed firms regarding their experiences with the ECM. We attempted to interview officials who were personally involved with, or highly knowledgeable about, the decision to list on the ECM. During the interviews, the officials were asked the questions listed here. The officials also provided additional unstructured comments and insights discussed elsewhere in the paper.

Title	Number of firms responding
Chairman, President, EOC, COO	11 (29.7%)
CFO	21 (56.8%)
Investor Relations	2 (5.4%)
Corporate Secretary or EVP	3 (8.1%)
Total	37 (100%)
Firm listing status as of June 1997	
Amex (regular)	19 (51.4%)
ECM	13 (35.1%)
Delisted	3 (8.1%)
Nasdaq	1 (2.7%)
NYSE	1 (2.7%)
Total	37 (100%)

"Were you personally involved with the listing decision?"

Yes	No	Total
30 (81.1%)	7 (18.9%)	37 (100%)

"Did you think that the ECM would provide more visibility for the firm than Nasdaq?"

Yes	No	Not sure	Total
21 (67.7%)	7 (22.6%)	3 (9.7%)	31 (100%)

"If the Amex did not have the ECM, did you think that the firm would have eventually listed anyway on the Amex?"

Yes	No	Not sure	Total
25 (71.4%)	3 (8.6%)	7 (20.0%)	35 (100%)

"If you had it to do over again, do you think you would make the same decision?"

Yes	No	Not sure	Total
31 (88.6%)	2 (5.7%)	2 (5.7%)	35 (100%)

"Were you satisfied with the experience of your stock on the Amex?"

Yes	No	Not sure	Total
32 (88.9%)	3 (8.3%)	1 (2.8%)	36 (100%)

firms heard presentations from both the Nasdaq and the Amex and liked the Amex presentation better. They found that 'Amex did a better job at selling'. Other executives believe that the Amex provides better protection against short sellers because at that time there was no uptick rule on Nasdaq. This is

consistent with the notion that the Amex is attractive to firms that prefer an auction market but are too small for the NYSE.

Some firms felt that they had 'no choice' but to list on the ECM. They had been delisted from the Nasdaq National Market due to financial difficulties, yet they wanted a national marketplace for their stock. Because they were too small to qualify for a regular Amex listing, the ECM was the only national marketplace open to them other than the *Pink Sheets*.

However, not all of the executives were totally satisfied. As one official put it, '...the ECM was a good idea that was poorly executed. The two main problems with the execution were the poor screening and that it was oversold as a market'. One executive felt that 'Amex specialists move the stock price too far sometimes on small volume' but was overall very satisfied with the ECM.

Some of the firms that were no longer on the Amex report that they were unhappy with the loss of support from retail brokers when they moved to the Amex. One CEO states that he was 'dumfounded' by the reaction of the retail brokerage firms: 'As soon as we did that [switched to the ECM], we lost the interest of a lot of retail brokers. They all felt they needed the extra spread to make some money on the stock. They lost interest in us because they couldn't make the hidden commission'. Another official indicates that his firm switched back to Nasdaq for three reasons: they wanted more research coverage, the firm's peer companies were on Nasdaq, and there was a 'negative prestige' about Amex.

4. Other markets for small company stocks

The failure of the Amex ECM is not surprising when viewed in the historical context of the failures of other stock markets for very small companies. This section discusses attempts in the US and elsewhere to start public equity markets for small stocks.

4.1. The U.S. experience

In the 19th century there were literally dozens of stock exchanges in the U.S. Virtually every major city had a stock exchange of one kind or another. These local exchanges executed orders for local residents in national stocks, and also provided a secondary market for the stocks of local companies. As communications improved, the secondary market for large companies gradually consolidated at the NYSE. This left smaller companies that did not meet the listing requirements of the NYSE or the Amex with a choice between the OTC market or the regional exchanges, most of which operated specialist auction markets similar to the NYSE. Walter (1957) notes that, by the 1950s most small

companies that met the listing standards of the regional exchanges chose to be traded in the OTC market. Most of the local exchanges died.

The surviving regionals continue to list small stocks that do not meet Amex or NYSE listing requirements. However, most of their trading volume is in NYSE- and Amex-listed stocks. According to the Securities and Exchange Commission (1994), the surviving regionals now do 97% of their business in NYSE and Amex listed stocks, rather than in their exclusive listings.

In 1962 the New York Mercantile Exchange launched the National Stock Exchange in an attempt to diversify by trading equities as well as commodities. SEC Release No. 11744 (File No. 10–53) provides some details on the National Stock Exchange. Many of the stocks previously traded on the National Stock Exchange moved to the Boston Stock Exchange, where a few of them are still listed. The National Stock Exchange, like the ECM, was an attempt to provide an exchange market for stocks too small for the Amex. At that time, such tiny stocks could trade only on the pre-Nasdaq over-the-counter market. However, the National Stock Exchange suffered almost exactly the same fate as later befell the ECM. Few stocks listed on the National, and it had a hard time gaining visibility. Newspapers would not publish its stock quotes, so it had to buy advertisements in *The Wall Street Journal* to disseminate its prices. The National also suffered from reputation effects. Its president was a former Amex president who had been forced to resign amidst a scandal at the Amex. After languishing for several years, the National finally ceased trading in 1968, ironically in the middle of one of the biggest bull markets in U.S. history.

4.2. *The European experience*

The European experience demonstrates that problems with small stock markets are not limited to auction markets. During the 1980s, virtually every stock market in Europe established a special section for companies that were too small to meet the normal listing requirements. These junior, or 'incubator', markets used a variety of market mechanisms, usually ones similar to their parent markets. For example, London's Unlisted Securities Market was designed as a continuous dealer market, and Amsterdam's Official Parallel Market as an auction market with a specialists-like *hoekman*. Other markets used mechanisms for their small market segments that differed from those used in their primary markets: Milan's Mercato Ristretto and Paris' Marché Hors Cote used daily call auctions.

Many of these markets appeared to prosper for a short time, but ultimately they all suffered from severe illiquidity and attracted few companies or investors, as chronicled by Rasch (1994) and Bannock (1994). Amsterdam's Official Parallel Market, which used an auction mechanism similar to the Amex, closed in 1993. London closed its Unlisted Securities Market, which was a dealer market, in 1996.

Bannock (1994) notes that all of the second-tier European markets for small stocks were started by the major European exchanges, similar to the Amex ECM. The adverse selection problem has also been a serious problem with the European junior markets. Because most of the business on the major exchanges comes from trading larger stocks, the small company tiers are seen as inferior cousins of the main market. Companies move up to the main tier as soon as they qualify, just as with the ECM.

4.3. Successful small capitalization stock markets

In contrast to the dismal record of failure for many small capitalization stock markets, there have been some that have survived. In the U.S., Nasdaq now reports a higher trading volume than that of the NYSE, and over 900 Nasdaq-listed firms that could list on the NYSE choose not to. This number was estimated by using Compustat PC-Plus to search for Nasdaq-listed companies that meet NYSE listing requirements for net tangible assets, pretax income, and number of shares outstanding). Japan has created Jasdaq, a Nasdaq-like market that now lists almost twice as many stocks as the second section of the Tokyo Stock Exchange. These markets have three things in common. First, both markets grew out of pre existing over-the-counter markets. They were not just mechanisms created in the search for listings. Second, both are dealer markets. Finally, both are separate entities from the other national exchanges. By being independent, they can specialize in doing the best possible job of serving their target clientele, which might otherwise be overlooked in a market for large companies. They also have a strong financial incentive to compete to retain listings and prevent their successful firms from switching to the other markets. Thus, many of the more successful firms remain in these markets for significant periods of time, bolstering the markets' reputation.

4.4. Other new initiatives for small capitalization stock markets

Other attempts are also underway to create special markets for smaller stocks. London's Alternative Investment Market (AIM) has attracted over 260 stocks with a market capitalization over six billion pounds since its inception in 1995. The AIM operates a hybrid market that contains elements of both an auction and a dealer market. The AIM system allows for the electronic matching of orders in addition to displaying competing quotes.

European stock exchanges have launched new markets for smaller stocks in Germany (Neuer Markt, 1997), France (Le Nouveau Marché, 1996), Brussels (Le Nouveau Marché, 1997), and Amsterdam (NMAX, 1997). These markets generally combine features of both auction and dealer markets. They are also linking up in a project called Euro-NM, which will allow members of each exchange to trade the small stocks listed on the other exchanges. This linkage is

a direct response to the 1996 launch of Nasdaq, a Nasdaq-like system that is independent of the national exchanges. It is still too early to tell how these markets will do in the long term. As of October 1997, there were only 15 stocks on Easdaq, 30 on France's Nouveau Marché, and ten on Neuer Markt.

5. Summary and conclusions

The Amex Emerging Company Marketplace appeared to start successfully. Bid–ask spreads fell for most of the listed firms. Volume results were mixed, with reported trading volume rising substantially for some stocks but falling for others. The visibility of most of the ECM firms increased, as evidenced by more media coverage in the year after listing on the ECM. Interviews with officials of ECM-listed firms indicate that they were satisfied with the trading of their stocks on the ECM and with the services provided by Amex.

Nevertheless, the ECM failed. Several factors contributed to this failure. The organizational structure of the Amex as a membership organization meant that most Amex stakeholders had little to gain from the success of the ECM. Firms affiliated with Nasdaq market makers held almost one-fourth of the Amex board seats, and these firms could have had a vested interest in seeing the venture fail.

The ECM also suffered from the same adverse selection problem that has affected other junior markets. The successful firms graduated to the main Amex as soon as they could, leaving the unsuccessful firms on the ECM. Scandals affecting three of the original stocks damaged the ECM's reputation for monitoring the quality of its listings, one of its initial selling points. Indeed, the poor quality of the firms earned the ECM the nickname 'the submerging company marketplace'. This poor reputation contributed to the reluctance of other firms to list on the ECM, leading to a vicious circle of decline.

Because the ECM was owned by the Amex, there was no incentive for the ECM to try to prevent its listings from moving onto the Amex, which exacerbated the adverse selection problem. One thing that the Amex could have done differently would have been to encourage the successful ECM firms to stay on the ECM longer in order to build up the reputation of the ECM market. It could also have structured the ECM as a separate entity that would have had an incentive to try to retain its listings.

Even though many small firms traditionally choose a dealer market, the auction market mechanism of the ECM could have been a viable way to differentiate the ECM from Nasdaq. Indeed, interviews with senior officials of ECM-listed firms indicate that the ECM attracted firms that wanted an auction market. Perhaps modifications to its auction market similar to the new hybrid markets such as the AIM and Euro-NM would have broadened the appeal of the market.

Ultimately, the ECM was closed because it was redundant. It did not attract firms beyond those that would eventually have sought an Amex listing anyway, and thus it was not worth the direct and reputational costs of operation. This redundancy is what one would expect if firms are well informed and choose their listing rationally.

For the designers and regulators of financial markets, especially in countries that are developing new markets, the lessons are clear. Exchanges must properly screen firms to prevent scandals from destroying confidence in the market. This is especially important for a new market with a small number of stocks. Markets should seriously consider the limited liability form of ownership instead of the traditional membership organization. Policy makers seeking to establish and promote capital markets in their countries should nurture competition among markets for listings. A firm in the process of deciding its listing policy should consider, in addition to transaction costs, how a market mechanism affects the visibility of its stock.

One interesting issue for further research is to explore the reason that Nasdaq has managed to avoid the adverse selection problem common to junior markets and to retain the listings of many large companies that qualify for listing on the Amex and the NYSE.

Appendix A

Amex Emerging Company Marketplace Companies (see Table 10).

Table 10
This table lists the companies that listed on the Amex Emerging Company Marketplace (ECM). Data are obtained from the Amex, the National Association of Securities Dealers, and Lexis Nexis. Original firms are those that listed when the market commenced operations on March 18, 1992. Additional firms are those that listed later. The prior market indicates where the stock traded prior to its listing on the ECM. SC indicates Nasdaq-traded firms that were not part of the Nasdaq National Market System. Market makers before ECM refers to the number of Nasdaq dealers providing quotes in the stock. NA = Not Available or Not Applicable.

Original firms	Listing date	ECM ticker	Prior market	Market capitalization (millions)	Market makers before ECM	Status in May 1995
Advanced Photonix	3/18/92	API	SC	$10.2	6	Amex
Alta Energy	3/18/92	ALE	SC	$17.7	9	Amex
American Pacific mint	3/18/92	DLS	SC	$16.9	4	ECM
Audre Recognition Systems	3/18/92	ARS	SC	$253.7	26	Amex
Cancer Treatment Holdings	3/18/92	CTH	SC	$12.5	12	ECM
Colonial Data Technologies	3/18/92	CDT	SC	$22.1	5	Amex
Digitran Systems	3/18/92	DGT	*Pink Sheets*	$23.8	11	Amex
Epigen	3/18/92	EPN	SC	$13.4	10	Delisted
Intertel Communications	3/18/92	ITR	Vancouver	$77.3	NA	Amex
Ion Laser Technology	3/18/92	ILT	SC	$8.7	16	Amex
Media Logic	3/18/92	TST	SC	$11.9	10	Amex
Medphone	3/18/92	MPO	SC	$16.3	26	Delisted
North Coast Energy	3/18/92	NCE	SC	$13.7	6	Nasdaq
Ocean Optique Distributors	3/18/92	OPQ	SC	$8.3	1	Nasdaq
PNF Industries	3/18/92	PNI	*Pink Sheets*	$28.3	1	Delisted
Printron	3/18/92	PNT	*Pink Sheets*	$51.3	10	Delisted
Professional Dental Technology	3/18/92	PRO	*Pink Sheets*	$52.5	8	ECM
Randers Group	3/18/92	RGI	SC	$21.0	13	ECM
Three-Five Systems	3/18/92	TFS	SC	$5.0	4	NYSE
Top Source	3/18/92	TPS	SC	$70.2	30	Amex
Topox	3/18/92	TPO	*Pink Sheets*	$106.9	6	Delisted
Unique Mobility	3/18/92	UQM	*Pink Sheets*	$18.4	8	Amex

Table 10. Continued.

Additional firms	Listing date	ECM ticker	Prior market	Market capitalization (millions)	Number of market makers	Status in May 1995
ACOI Inc	8/4/92	CCS	SC	10.1	15	ECM
Air Methods Corporation	6/2/92	ARF	SC	15.1	15	Nasdaq
Aviva Petroleum	11/14/94	AVV	London	149.5	NA	ECM
Banker's Note, Inc.	3/31/94	TBN	SC	3.6	5	ECM
Bema Gold Corporation	3/4/94	BGO	Toronto	68.7	NA	ECM
Besicorp Group Inc.	11/22/93	BGI	*Pink Sheets*	21.6	8	ECM
CEC Resources	4/24/95	CGS	Spinoff	6.6	NA	ECM
Chad Therapeutics, Inc.	8/4/93	CTU	*Pink Sheets*	37.8	9	Amex
Chesapeake Biological Laboratories, Inc.	2/10/94	PHD	*Pink Sheets*	13.4	6	ECM
Columbus Energy Crop.	7/30/92	EGY	Pacific	15.1	NA	Amex
Cornerstone Bank	3/20/95	CBN	No market	8.8	NA	ECM
Creative Comp. Appl., Inc.	8/23/94	CAP	SC	3.6	13	ECM
Crown Laboratories, Inc.	3/30/94	CLL	*Pink Sheets*	49.7	1	ECM
Encore Marketing International Inc.	4/29/93	EMI	No market	9.0	NA	ECM
Environmental Diagnostics	9/16/92	EDI	*Pink Sheets*	35.4	12	Amex
ETS International, Inc.	7/23/92	ETS	Vancouver	24.6	NA	ECM
First West Virginia Bancorp	3/8/95	FWV	*Pink Sheets*	11.4	NA	ECM
Grove Real Estate Asset Trust	6/16/94	GRE	IPO	5.6	NA	ECM
InnoVet, Inc	7/15/93	IVT	SC	24.2	13	Delisted
Intelligent Controls	2/15/95	ITC	No market	12.3	NA	ECM
Interline Resources Corp.	7/12/94	IRC	SC	68.2	18	ECM
Intl. Remote Imaging Systems, Inc.	6/23/92	IRI	SC	9.2	20	Amex
Leather Factory, Inc. (The)	9/27/93	TLF	*Pink Sheets*	67.5	2	Amex
Luxtec Corporation	4/20/94	LXU	SC	3.0	8	ECM
Magnum Pertroleum, Inc.	11/15/93	MPM	*Pink Sheets*	12.2	6	ECM
Measurement Specialities, Inc.	4/23/93	MSS	*Pink Sheets*	15.2	11	ECM

MidSouth Bancorp, Inc.	4/19/93	MSL	No market	6.8	NA	Amex
Northern Instrument Corp	3/27/92	NIZ	*Pink Sheets*	12.3	6	Amex
NuMED Home Health Care	5/2/94	NHH	*Pink Sheets*	10.9	2	Nasdaq
OMNI Multimedia Group Inc	4/20/95	OMG	IPO	7.3	NA	ECM
PC Quote, Inc.	4/23/92	PQT	SC	6.0	6	ECM
Pyrocap International Corporation	1/10/94	PYR	*Pink Sheets*	21.2	4	ECM
Reliv International, Inc.	3/8/93	RLV	No market	59.9	NA	Amex
RF Power Products, Inc.	4/29/94	RFP	Spinoff	20.5	NA	ECM
Saba Petroleum Company	9/15/93	SAP	*Pink Sheets*	11.0	8	ECM
Scott Instruments Corp.	7/16/92	SIC	SC	8.1	12	Nasdaq
Sheffield Exploration Co., Inc.	12/14/93	SHE	*Pink Sheets*	25.8	2	ECM
Soligen Technologies, Inc.	3/10/94	SGT	Vancouver	39.1	NA	ECM
SouthFirst Bancshares	2/14/95	SZB	IPO	8.9	NA	ECM
Spectrum Signal Processing Inc.	7/29/92	SNL	Vancouver	13.4	NA	Toronto
Statordyne Corporation	6/25/93	STY	Spinoff	30.8	NA	Delisted
Surety Capital Corporation	2/23/94	SRY	SC	14.5	12	Amex
WIZ Technology, Inc.	2/2/94	WIZ	*Pink Sheets*	17.4	6	ECM

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May 22, 2018

The Honorable Jeb Hensarling, Chairman
Committee on Financial Services
U.S. House of Representatives
Washington, D.C. 20515

The Honorable Maxine Waters, Ranking Member
Committee on Financial Services
U.S. House of Representatives
Washington, D.C. 20515

The Honorable Bill Huizenga, Chairman
Subcommittee on Capital Markets and Government Sponsored Enterprises
Committee on Financial Services
U.S. House of Representatives
Washington, D.C. 20515

The Honorable Carolyn Maloney, Ranking Member
Subcommittee on Capital Markets and Government Sponsored Enterprises
Committee on Financial Services
U.S. House of Representatives
Washington, D.C. 20515

Re: Main Street Growth Act

Dear Chairman Hensarling, Ranking Member Waters, Chairman Huizenga and Ranking Member Maloney,

I am the CFO of Repro Med Systems, Inc. (OTCQX: REPR), a medical device manufacturer located in Chester, New York that is publicly-traded on OTC Markets Group's OTCQX Best Market.

I am writing to share Repro Med System's experience as a small, public company and describe why we do not support the "Main Street Growth Act."

The Main Street Growth Act would allow the creation of "Venture Exchanges" that are intended to have trading and listing rules tailored for smaller companies like ours. However, these regulatory privileges would not be available to non-exchange markets such as OTCQX.[1]

Repro Med Systems joined the OTCQX market in September 2015. Under the OTCQX Rules, Repro Med Systems is required to meet high financial standards (OTCQX does not accept Penny Stocks or Shell Companies) and provide current disclosure to investors (including PCAOB audited annual financials). "We have seen our market cap grow over the past 2.5 years from $14.4 million to $52.1 million." "We have grown to 75 employees with sales expanding globally."

There are many reasons why the OTCQX market works well for small, growing companies like ours:

- **Lower Cost & Complexity**: OTCQX costs less, and our compliance obligations, while challenging, are less burdensome than listing on an exchange, giving us more time and money to spend growing our business.
- **Small Company Liquidity**: OTC Markets Group's ATS dealer model supports the liquidity needs of smaller, less-actively traded securities. Unlike large, exchange-listed companies, we do not have large amounts of natural liquidity and high trading volumes. Rather, our liquidity needs are focused on making sure our shareholders have the ability to buy and sell on an as-needed basis.
- **Investor Engagement & Capital Formation**: Through OTC Markets' disclosure services, we are able to easily communicate with our shareholders, publish financial reports and share company updates to broaden our visibility in the marketplace. The OTCQX market is also exempt from Blue Sky secondary trading regulations in 30 states, which allows broker dealers to reach a wider audience of potential investors, raise capital and grow our shareholder base.

The OTCQX market has helped Repro Med Systems grow and mature by providing all of the benefits of a public market – scaled to fit the needs of small companies.

The Main Street Growth Act does not work for companies like us because it focuses solely on national securities exchanges and excludes other models, such as OTCQX where we have established a thriving secondary market. The Main Street Growth Act instead would restrict trading to one, single exchange.

While we welcome legislation aimed at supporting small public companies and the venture markets that serve them, the Main Street Growth Act does not achieve these goals. We urge the Committee to consider the value of alternative secondary market models, such as ATSs, because companies should be able to choose the venue that best suits their needs. A "Venture Company" should be afforded the same regulatory treatment, regardless of whether it trades on an exchange or an ATS market like OTCQX.

[1] OTC Markets Group Inc. operates the OTCQX Best and OTCQB Venture markets, where over 1,200 companies meeting financial standards and providing current disclosure to investors, including many innovative and entrepreneurial 'venture' companies, trade via an SEC registered alternative trading system ("ATS").

We remain hopeful that Congress, the SEC and market participants can work together to provide venture companies with all of the tools necessary to foster their growth and development. Please let me know if we can provide any additional information or insight in furtherance of that shared goal.

Sincerely,

Karen Fisher
Chief Financial Officer
Repro Med Systems, Inc.

Royal Financial, Inc. 9226 S. Commercial Avenue | Chicago, Illinois 60617 | Phone: 773-768-4800

May 21, 2018

The Honorable Jeb Hensarling, Chairman
Committee on Financial Services
U.S. House of Representatives
Washington, D.C. 20515

The Honorable Maxine Waters, Ranking Member
Committee on Financial Services
U.S. House of Representatives
Washington, D.C. 20515

The Honorable Bill Huizenga, Chairman
Subcommittee on Capital Markets and Government Sponsored Enterprises
Committee on Financial Services
U.S. House of Representatives
Washington, D.C. 20515

The Honorable Carolyn Maloney, Ranking Member
Subcommittee on Capital Markets and Government Sponsored Enterprises
Committee on Financial Services
U.S. House of Representatives
Washington, D.C. 20515

Re: Main Street Growth Act

Dear Chairman Hensarling, Ranking Member Waters, Chairman Huizenga and Ranking Member Maloney,

I am the President and CEO of Royal Financial, Inc. (OTCQX: RYFL), a Holding Company for a $430 million bank located in Chicago, IL that is publicly-traded on OTC Markets Group's OTCQX Best Market.

I am writing to share Royal Financials experience as a small, public company and describe why we do not support the "Main Street Growth Act."

The Main Street Growth Act would allow the creation of "Venture Exchanges" that are intended to have trading and listing rules tailored for smaller companies like ours. However, these regulatory privileges would not be available to non-exchange markets such as OTCQX.[1]

Royal Financial joined the OTCQX market in 2015. Under the OTCQX Rules, Royal Financial is required to meet high financial standards (OTCQX does not accept Penny Stocks or Shell Companies) and provide current disclosure to investors (including PCAOB audited annual financials).

It is important to say we have enjoyed great transparency of our publicly traded stock and have seen large increases in our market cap because of the rigidity of OTC QX Best Markets and the integrity behind and the support of the system. We have gone from a two bank branch serving Chicagoland to nine full banking centers and two loan production offices, supporting the economy in the Midwest.

There are many reasons why the OTCQX market works well for small, growing companies like ours:

- **Lower Cost & Complexity**: OTCQX costs less, and our compliance obligations, while challenging, are less burdensome than listing on an exchange, giving us more time and money to spend growing our business.
- **Small Company Liquidity**: OTC Markets Group's ATS dealer model supports the liquidity needs of smaller, less-actively traded securities. Unlike large, exchange-listed companies, we do not have large amounts of natural liquidity and high trading volumes. Rather, our liquidity needs are focused on making sure our shareholders have the ability to buy and sell on an as-needed basis.
- **Investor Engagement & Capital Formation**: Through OTC Markets' disclosure services, we are able to easily communicate with our shareholders, publish financial reports and share company updates to broaden our visibility in the marketplace. The OTCQX market is also exempt from Blue Sky secondary trading regulations in 30 states, which allows broker dealers to reach a wider audience of potential investors, raise capital and grow our shareholder base.

The OTCQX market has helped Royal Financial grow and mature by providing all of the benefits of a public market – scaled to fit the needs of small companies.

The Main Street Growth Act does not work for companies like us because it focuses solely on national securities exchanges and excludes other models, such as OTCQX where we have established a thriving secondary market. The Main Street Growth Act instead would restrict trading to one, single exchange.

While we welcome legislation aimed at supporting small public companies and the venture markets that serve them, the Main Street Growth Act does not achieve these goals. We urge the Committee to consider the value of alternative secondary market models, such as ATSs, because companies should be able to choose the venue that best suits their needs. A "Venture

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Company" should be afforded the same regulatory treatment, regardless of whether it trades on an exchange or an ATS market like OTCQX.

We remain hopeful that Congress, the SEC and market participants can work together to provide venture companies with all of the tools necessary to foster their growth and development. Please let me know if we can provide any additional information or insight in furtherance of that shared goal.

Sincerely,

Leonard Szwajkowski
Royal Financial, Inc.
President and CEO

singing machine
creating Joy through music

May 21, 2018

The Honorable Jeb Hensarling, Chairman
Committee on Financial Services
U.S. House of Representatives
Washington, D.C. 20515

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Washington, D.C. 20515

The Honorable Carolyn Maloney, Ranking Member
Subcommittee on Capital Markets and Government Sponsored Enterprises
Committee on Financial Services
U.S. House of Representatives
Washington, D.C. 20515

Re: Main Street Growth Act

Dear Chairman Hensarling, Ranking Member Waters, Chairman Huizenga and Ranking Member Maloney,

I am the CEO of The Singing Machine Company, Inc. (OTCQX: SMDM), the world-wide leader in consumer karaoke products, located in Fort Lauderdale, FL that is publicly-traded on OTC Markets Group's OTCQX Best Market.

I am writing to share my experience operating as a small, public company and describe why we do not support the "Main Street Growth Act."

The Main Street Growth Act would allow the creation of "Venture Exchanges" that are intended to have trading and listing rules tailored for smaller companies like ours. However, these regulatory privileges would not be available to non-exchange markets such as OTCQX.[1]

Singing Machine joined the OTCQX market in 2016. Under the OTCQX Rules, Singing Machine is required to meet high financial standards (OTCQX does not accept Penny Stocks or

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Shell Companies) and provide current disclosure to investors (including PCAOB audited annual financials). Since joining OTCQX, we have experienced increased visibility as a public company and have grown to 40 employees with two offices throughout the country.

There are many reasons why the OTCQX market works well for small, growing companies like ours:

- **Lower Cost & Complexity**: OTCQX costs less, and our compliance obligations, while challenging, are less burdensome than listing on an exchange, giving us more time and money to spend growing our business.
- **Small Company Liquidity**: OTC Markets Group's ATS dealer model supports the liquidity needs of smaller, less-actively traded securities. Unlike large, exchange-listed companies, we do not have large amounts of natural liquidity and high trading volumes. Rather, our liquidity needs are focused on making sure our shareholders have the ability to buy and sell on an as-needed basis.
- **Investor Engagement & Capital Formation**: Through OTC Markets' disclosure services, we are able to easily communicate with our shareholders, publish financial reports and share company updates to broaden our visibility in the marketplace. The OTCQX market is also exempt from Blue Sky secondary trading regulations in 30 states, which allows broker dealers to reach a wider audience of potential investors, raise capital and grow our shareholder base.

The OTCQX market has helped Singing Machine grow and mature by providing all of the benefits of a public market – scaled to fit the needs of small companies.

The Main Street Growth Act does not work for companies like us because it focuses solely on national securities exchanges and excludes other models, such as OTCQX where we have established a thriving secondary market. The Main Street Growth Act instead would restrict trading to one, single exchange.

While we welcome legislation aimed at supporting small public companies and the venture markets that serve them, the Main Street Growth Act does not achieve these goals. We urge the Committee to consider the value of alternative secondary market models, such as ATSs, because companies should be able to choose the venue that best suits their needs. A "Venture Company" should be afforded the same regulatory treatment, regardless of whether it trades on an exchange or an ATS market like OTCQX.

We remain hopeful that Congress, the SEC and market participants can work together to provide venture companies with all of the tools necessary to foster their growth and development. Please let me know if we can provide any additional information or insight in furtherance of that shared goal.

Sincerely,

Gary Atkinson
CEO
The Singing Machine Company, Inc.

TIX corporation 12711 VENTURA BLVD, SUITE 340, STUDIO CITY, CA 91604 • PHONE: 818-761-1002 • FAX: 818-761-1072

May 18, 2018

The Honorable Jeb Hensarling, Chairman
Committee on Financial Services
U.S. House of Representatives
Washington, D.C. 20515

The Honorable Maxine Waters, Ranking Member
Committee on Financial Services
U.S. House of Representatives
Washington, D.C. 20515

The Honorable Bill Huizenga, Chairman
Subcommittee on Capital Markets and Government Sponsored Enterprises
Committee on Financial Services
U.S. House of Representatives
Washington, D.C. 20515

The Honorable Carolyn Maloney, Ranking Member
Subcommittee on Capital Markets and Government Sponsored Enterprises
Committee on Financial Services
U.S. House of Representatives
Washington, D.C. 20515

Re: Main Street Growth Act

Dear Chairman Hensarling, Ranking Member Waters, Chairman Huizenga and Ranking Member Maloney,

I am the Chief Financial Officer of Tix Corporation (OTCQX: TIXC), a leading provider of discount ticketing services that currently operates nine discount ticket stores in Las Vegas under its Tix4Tonight marquee and two online properties www.tix4tonight.com and www.tix4.com. Tix Corporation offers up to a 50 percent discount for shows, concerts, attractions, and tours, as well as discount dining and shopping offers. Tix Corporation is publicly-traded on OTC Markets Group's OTCQX Best Market.

I am writing to share Tix Corporation's experience as a small, public company and describe why we do not support the "Main Street Growth Act."

The Main Street Growth Act would allow the creation of "Venture Exchanges" that are intended to have trading and listing rules tailored for smaller companies like ours. However, these regulatory privileges would not be available to non-exchange markets such as OTCQX.[1]

Tix Corporation joined the OTCQX market in November 2010. Under the OTCQX Rules, Tix Corporation is required to meet high financial standards (OTCQX does not accept Penny Stocks or Shell Companies) and provide current disclosure to investors (including PCAOB audited annual financials). Since joining the OTCQX, Tix Corporation's investor base has increased significantly, saved money on regulatory efficiencies, increased the number of locations, and increased employee headcount.

There are many reasons why the OTCQX market works well for small, growing companies like ours:

- **Lower Cost & Complexity**: OTCQX costs less, and our compliance obligations, while challenging, are less burdensome than listing on an exchange, giving us more time and money to spend growing our business.
- **Small Company Liquidity**: OTC Markets Group's ATS dealer model supports the liquidity needs of smaller, less-actively traded securities. Unlike large, exchange-listed companies, we do not have large amounts of natural liquidity and high trading volumes. Rather, our liquidity needs are focused on making sure our shareholders have the ability to buy and sell on an as-needed basis.
- **Investor Engagement & Capital Formation**: Through OTC Markets' disclosure services, we are able to easily communicate with our shareholders, publish financial reports and share company updates to broaden our visibility in the marketplace. The OTCQX market is also exempt from Blue Sky secondary trading regulations in 30 states, which allows broker dealers to reach a wider audience of potential investors, raise capital and grow our shareholder base.

The OTCQX market has helped Tix Corporation grow and mature by providing all of the benefits of a public market – scaled to fit the needs of small companies.

The Main Street Growth Act does not work for companies like us because it focuses solely on national securities exchanges and excludes other models, such as OTCQX where we have established a thriving secondary market. The Main Street Growth Act instead would restrict trading to one, single exchange.

While we welcome legislation aimed at supporting small public companies and the venture markets that serve them, the Main Street Growth Act does not achieve these goals. We urge the Committee to consider the value of alternative secondary market models, such as ATSs, because companies should be able to choose the venue that best suits their needs. A "Venture Company" should be afforded the same regulatory treatment, regardless of whether it trades on an exchange or an ATS market like OTCQX.

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[1] OTC Markets Group Inc. operates the OTCQX Best and OTCQB Venture markets, where over 1,200 companies meeting financial standards and providing current disclosure to investors, including many innovative and entrepreneurial 'venture' companies, trade via an SEC registered alternative trading system ("ATS").

We remain hopeful that Congress, the SEC and market participants can work together to provide venture companies with all of the tools necessary to foster their growth and development. Please let me know if we can provide any additional information or insight in furtherance of that shared goal.

Sincerely,

Steve Handy
Chief Financial Officer
Tix Corporation

Stephen F. Lynch
Questions for the Record
Capital Markets Subcommittee hearing entitled, "Ensuring Effectiveness, Fairness, and Transparency in Securities Law Enforcement" at 2 p.m. on June 13, 2018

Questions for the Dem Witness: Mr. Joseph Borg, Director, Alabama Securities Commission, President, North American Securities Administrators Association ("NASAA"):

1. To me, H.R. 5037 is the narrowest kind of special interest legislation. An April 15, 2018 article in the *New York Times, Wall Street Titan Takes Aim at Law that Tripped Him Up,* makes it clear that H.R. 5037 was filed at the request of former AIG CEO and Chairman Hank Greenberg. In the article, Mr. Greenberg states that he is "at war," and that H.R. 5037 is a direct response to securities fraud cases brought by the New York attorney general against him and against AIG. AIG is the last company we should be helping. I clearly remember how, in the aftermath of the 2008 financial crisis, AIG received a massive taxpayer funded bailout to keep it from going bankrupt. According to the Congressional Research Service report, *Government Assistance for AIG: Summary and Cost*, "at the maximum, the Federal Reserve and the Treasury committed approximately $182.3 billion in specific extraordinary assistance for AIG and another $15.2 billion through a more widely available lending facility. The amount actually disbursed to assist AIG reached a maximum of $141.8 billion in April 2009."

    a. Under the language of H.R. 5037, would a state be barred from taking civil enforcement action against a company listed on a national exchange if that company generates false financial reports and claims fictitiously high earnings?

    Response:

    You're exactly correct, Congressman.

    If the bill was to become law, my office, my colleagues in Massachusetts, and my colleagues in every other state, would be prohibited by federal law from taking on the types of cases highlighted in your question and perhaps many more. Investors who have lost money in these cases due to fraud will instead have to solely depend on the federal government to pursue the wrongdoers.

    At a minimum, under the bill, states would be prohibited from pursuing civil fraud cases against the issuers of publicly traded securities. However, the preemption provisions are drafted such that a defendant could argue, and a court could find that states are preempted from pursuing civil fraud violations in connection with any transaction involving publicly traded securities. Thus, the scope of preemption enacted by H.R. 5037 would unquestionably extend to civil cases such as those you identify – frauds such as filing false financial reports, false earnings reports – but could be applied by courts much more broadly. And defendants would certainly push courts towards the broadest possible interpretation, especially given the language of the very first line as introduced … "to provide for exclusive Federal jurisdiction over securities fraud actions, and for other purposes."

    If H.R. 5037 were to become law, more work would fall to the federal government, specifically, the SEC and the federal courts. That's bad news for the SEC as the agency is currently

underfunded and its bad news for a federal court system that has a backlog of cases that is going to get worse under this bill. Further, as I described in my written testimony, the bill includes provisions that affect state criminal enforcement authority. These criminal provisions would, at a minimum, have a chilling effect on the ability of state authorities to pursue criminal cases in connection with these same types of frauds.

Taken collectively, the overarching effect of the bill's preemption and other requirements would be to eliminate an important deterrent against securities fraud at the direct expense of Alabama investors – and investors in Massachusetts and every other state – and strike a blow to the integrity of the U.S. securities markets. And it would leave your constituents with nowhere to turn should federal investigators be unable to pursue a case.

2. Under H.R. 5037, states would be prohibited from bringing actions against an issuer. However, the bill does not define "issuer" anywhere. Massachusetts has brought cases against issuers who are located within the state and selling securities into the state. One example is the case against Woodbridge Mortgage Investment Funds, where the fund offered and sold unregistered securities in the form of interests in commercial loans ostensibly secured by real property. Another example is the case against Lending Club, where individual lenders could pool their money with other individual lenders to make a larger loan evidenced by a payment note that were securities and were not registered or exempt from registration. In these cases, issuers were selling unregistered securities to Massachusetts residents.

    a. Does the language of H.R. 5037 reduce any existing uncertainty or lack of clarity relating to state and federal securities enforcement, or does it increase those results?

    b. Under this bill, would Massachusetts still be able to bring these sorts of cases where issuers are accused of selling unregistered securities to Massachusetts residents?

Response:

Congressman, one of the most striking features of H.R. 5037 is its *lack of clarity* – both in regard to what it seeks to achieve, what it would actually achieve, and how or why the envisioned policy changes would be necessary or appropriate. H.R. 5037 would, if enacted, be a source of considerable litigation in federal and state courts as defendants and regulators battle over what the bill means. I thus cannot ultimately answer either of these two questions with precision.

At a minimum, under H.R. 5037 states would be prohibited from pursuing civil fraud cases against the issuers of publicly traded securities. However, the preemption provisions are drafted such that a defendant could argue, and a court could find, that states are preempted from pursuing civil fraud violations in connection with *any* transaction involving publicly traded securities.[1] Under such an interpretation, for example, the bill would preempt state enforcement actions against a broker-dealer, or any other entity, so long as the fraud was limited to, or involved, or connected to "covered securities" under the bill.[2] The bill does not define relevant

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1 Please note the term, "or transactions of a covered security" appears in several places throughout the bill.

2 Any "transaction" in a listed company or a company involved in interstate commerce would, in essence, cover the entire market – including such smaller actions as broker churning accounts, selling unsuitable products, in addition to general

terms, including its use of the word "issuer." Furthermore, the bill would require state criminal securities fraud prosecutions to "comply in all respects" with federal legal requirements. The scope of this obligation is never made clear. Does this, for example, require state courts to apply federal rules of evidence or criminal procedure? I am confident in stating that in my home state many state courts would dismiss and suggest the case be brought in Federal Court (and therefore prosecuted by federal prosecutors). The likelihood of a federal prosecutor bringing cases on behalf of "mom & pop" investors is slim, at best.

H.R. 5037's many inherent ambiguities would impel defendants to test its boundaries and it is impossible to predict with any confidence what courts would do with it. I am certain of one thing about the bill, though. If H.R. 5037 becomes law, it will be a source of significant litigation in federal courts, as regulators and defendants battle over its scope and meaning. This needless litigation will drain regulators' already limited enforcement resources.

I would also note that the proffered rationale for the bill is specious. The claims that underlie the bill simply do not add up.

As I discuss extensively in my written testimony, H.R. 5037 is premised on a completely unsupported assertion that state securities enforcement is detrimental to the public interest and somehow disincentivizes capital raising.[3] [4] This is wholly unsupported by fact or logic. Reports just issued in July (after H.R. 5037 was filed) show significant increases in the number of companies now conducting IPOs. The Wall Street Journal recently reported (July 2, 2018) that more than 120 companies have conducted IPOs in U.S. markets in the first half of 2018, the highest volume in four years. This trend demonstrates that the IPO market can thrive without the need to pass laws that handcuff regulators and expose investors to greater harm.

For your benefit and the benefit of the Committee, I have enclosed a copy of the relevant Wall Street Journal article.

3. Past bills that would have preempted state regulatory authority have specifically left state enforcement authority intact. This has been based on a widespread view that the states have acted quickly and effectively to shut down a variety of large-scale and small-scale frauds. Massachusetts, for example, has brought a number of cases where they moved quickly and were followed by larger federal actions. The 2003 analyst cases, for example, involved sell side research analysts who had material conflicts of interest that led to fraudulent activity. This activity included payments made to analysts based upon continued favorable stock coverage, making research recommendations solely to win or maintain investment banking relationships, and making research recommendations without a reasonable basis to do so. Some cases would

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fraud, microcap, insider trading, market manipulation and other rip-offs for which the state may be the only regulator who would handle.

[3] *See:* The Securities Fraud Act of 2018, H.R. 5037, 115th Cong. § 2 (2017) (*The lack of a uniform standard for public companies is a contributing factor to the declining interest in the United States public market, harming the United States economy and reducing investment opportunities for the U.S. public.*). The preemption would apply to .... securities transactions .... in connection with a covered security or transactions of a covered security (emphasis added).

[4] Currently, 41 of 50 states have adopted a version of the Uniform Securities Act. Accordingly, there does not exist as much disparity as premised by H.R. 5037.

appear to be precluded by the prohibition from bringing cases that involve a covered security and other cases would appear to be precluded by the prohibition against bringing actions against an issuer.

a. In light of this, could you address the consequences that would flow from the preemption of state enforcement authority that is outlined H.R. 5037?

Response:

Congressman, I think it is important to note that Congress has never passed legislation to restrict the ability of states to take enforcement action to punish and deter securities fraud. This bill is a clear encroachment by the federal government on the authority of states to protect their citizens and only benefits those companies and individuals suspected of committing fraud.

States play a critical role in keeping bad actors out of our markets by enforcing securities laws and our work has a long history of bipartisan support. Policy makers have long understood that federal agencies simply do not have the resources to police misconduct in the capital markets. Working with the SEC and other regulators, state securities regulators help to keep the bad guys from ripping off your constituents.[5]

In my office alone, hundreds of millions of dollars have been returned to hard-working Alabamians and many fraudsters have been barred from the securities industry or even jailed for committing securities fraud. My colleague in Massachusetts, Secretary of the Commonwealth William Galvin, and his team of securities regulators are also fierce advocates for investors in that state. My office in Alabama worked alongside many States, including Massachusetts, in the Analyst cases, the mutual fund timing cases, the subprime cases, and others.

As for the consequences of H.R. 5037, for all of the reasons I've explained, I believe the bill represents a serious threat to investor protection. It would needlessly tie the hands of state regulators in a way that would expose everyday investors on Main Street to more financial fraud and abuse and leave your constituents without recourse should the federal authorities decline or be unable to pursue any case. The bill is bad for our investors, bad for our markets and bad for our small businesses. I hope that you and the rest of the members of Congress will see this legislation for what it is – an attempt by those suspected of wrongdoing to make it easier to get away with their misconduct.

[5] The combination of state and federal antifraud enforcement authority, along with that of the Financial Industry Regulatory Authority ("FINRA"), ensures that U.S. capital markets remain the deepest and most liquid in the world.

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