Strengthening the SEC's Vital Enforcement Responsibilities

Testimony of Mercer E. Bullard

Associate Professor of Law
University of Mississippi School of Law

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

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

INTRODUCTION

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

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

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

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

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

GAO REPORT

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

Consensus Management. The most striking aspect of the GAO's Report is the picture it presents of the apparent subversion of the SEC's enforcement program through the efforts of individual Commissioners. The GAO reported that individual Commissioners blamed "the quality of management" in the enforcement division for declining amounts of penalties and disgorgement, even while the same Commissioners apparently spearheaded efforts to require pre-approval of penalties. Individual Commissioners claimed that "the staff elect[ed] on its own to retreat from penalties," although the GAO found that staff consistently interpreted Commission positions to been intended to have this effect. In a very revealing admission, an individual Commissioner emphasized that it was "important to understand that the division worked at the direction of the Commission, not as an independent entity." This apparent desire by individual Commissioners to "remind the staff who's boss," coupled with Chairman Cox's publicly expressed preference for consensus on the Commission, was a recipe for disaster and explains much about the recent

deterioration in the Commission's enforcement program. The GAO reports that penalty pre-approval policy was developed without input from the enforcement division when it should have been the division that produced the first draft of such a policy. The GAO reports that controversial cases were frequently re-calendered. The seriatim approval of investigations was suspended. As a whole, these findings paint a troubling picture of a concerted effort to impede the enforcement of the securities laws from within the Commission itself.[1]

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

The Commission appears to be well on its way to correcting this situation. Chairman Schapiro has wasted no time in suspending the "penalty pilot" program and ordering a review of the 2006 corporate penalty statement; reinstating seriatim or individual approval of formal orders of investigation; and ending the re-calendaring process. These are important steps, but misguided, subversive interference by individual Commissioners will not cease unless the Chairman is willing to prosecute cases without reaching a consensus. Chairman Schapiro's

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

March 25, 2009 letter to the GAO, in which she specifically noted that the re-calendaring resulted from a perceived need for "consensus," seems to signal that she will not tolerate the undermining of the Commission's enforcement program from within.

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

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

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

Second, if the term "issues" is a euphemism for misconduct that the law does not clearly prohibit, then *no enforcement actions should be brought*. This the "gotcha" problem about which defense lawyers often complain. A small number of industry participants may seek a competitive advantage by engaging in questionable practices, and, when the Commission does nothing in response, an industrywide issue is created when the practices become widespread. Enforcement cases should not be used to correct such misconduct. In this case, good enforcement practice is to ensure that the SEC's operating divisions act promptly to provide public clarification of industry members' legal obligations, including rulemaking as necessary.

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

Internal Review. Another example of internally created resource constraints is what the Report describes as "the burden of the division's internal review."[4] As

[3] *See* GAO Report at 29.

[4] GAO Report at 28.

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

OTHER ISSUES

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

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

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

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

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

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

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

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

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

There are no definitive answers to these questions. The following discussion provides two analyses of the SEC's enforcement program that are intended to foster debate and prompt action. The first analysis posits that a misapplication of the

principle of deregulation has caused a kind of regulatory paralysis at the Commission that has resulted in the delegation of the SEC's enforcement responsibilities to less efficient, state and private legal mechanisms. The second analysis posits that the dominant metrics used to measure the SEC's enforcement success has resulted in an inefficient and ineffective allocation of resources.

The Myth of Deregulation

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

Effective deregulation does not mean non-regulation or inaction in the face of change. Deregulation refers to a kind of affirmative regulation. When the SEC's position on the law regarding an area of legal duties is unclear, deregulation does not always mean it should leave it to "free markets" to resolve the uncertainty. The idea that the markets in this sense are the "markets" of privately contracted arrangements is an illusion. In the absence of clear SEC guidance, the "markets" that guide the conduct of private actors are the panoply of alternative policymaking and dispute resolution structures that naturally fill in the void created by SEC inaction. They are the fifty state attorneys general; hundreds of state securities enforcement staff; thousands of state courts; hundreds of federal bankruptcy courts, district courts, and courts of appeal; state and federal banking regulators; the Department

of Labor; the Department of Justice; and others. The list is a long one, but no one on it has the expertise – the *capital markets* expertise – and the ability to establish efficient, uniform capital markets standards as the SEC. When the Commission fails to establish standards of conduct, the standards will be established by other *regulatory* means. The result of this populist version of "deregulation" actually leads to more costly, less efficient regulation. This kind of "deregulation" leads to regulatory anarchy, not regulatory efficiency. It should be kept caged in the academic zoo where it was conceived and can do no real harm.

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

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

positions handcuffs its own enforcement efforts,[6] creates legal uncertainty and increases private and state litigation.

The SEC's failure to correct stale pricing by mutual funds, commission overcharges by brokers, options backdating by executives, conflicted recommendations by analysts and similar misconduct early on in its evolution, and its continuing failure to establish standards for the disclosure of revenue sharing and excessive mutual fund fees, for example, impose costs not only on investors, but also on the financial services industry. When known misconduct becomes widespread, it becomes difficult for compliance officers and legal counsel to persuade their clients that the misconduct is illegal. Firms that seek to compete in a free enterprise market are undercut by those who compete by breaking the rules. In some cases, the internal tension created by the misconduct escalates until it reaches crisis levels and public pressure forces the Commission to act. The inefficiencies and competitive distortions created by ignored misconduct are resolved in an expensive, time-consuming spasm of litigation and over-regulation. In cases that never escalate to this level, the regulatory void created by SEC inaction operates as a permanent tax on financial services. Mutual funds are left defending revenue sharing and excessive fee cases brought by states and private litigants largely because the Commission has not established clear *regulatory* guidance.

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

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

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

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

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

testimony, Chairman Schapiro made remarks indicating that the Commission was reconsidering a disclosure-only approach to the issue of target-date funds.[7])

The Metrics of SEC Enforcement

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

For example, consider the most recent settlement in the never-ending mutual fund trading scandal. The most recent of these cases was settled just two weeks ago. The alleged misconduct took place between 2000 and 2003, it was very similar to misconduct alleged in dozens of previous cases, and the charge was mere negligence. If this prosecution was typical, it involved numerous, often redundant and expansive document requests demanding immediate compliance followed by extended periods of SEC inactivity and silence. The individuals remained under the cloud of the investigation throughout this period with no indication as to the SEC's position on their culpability. At the end of the investigation, the settlement broke no new ground, provided no additional general deterrence, and did not even finalize

[7] *See supra* note 5.

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

the amount to be disgorged, that process having been left to a distribution consultant to be retained well into the next decade. Remarkably, most of the rulemaking initiatives arising out of the mutual fund scandal were developed, proposed and adopted long before many cases were closed. Most lawyers who defend SEC investigations probably would agree that the process leading to a settlement is usually far more costly and burdensome than the penalties ultimately imposed.

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

The BISYS case provides a current illustration of the likely overcommitment of resources to stale matters. In September 2006, the Commission reached a settlement with BISYS Fund Services, Inc. that was based on BISYS's payments to 27 unnamed fund managers in return for their recommending that their funds use BISYS as the fund's administrator. The arrangements were in place from June 1999 and July 2004, which means that more than two years already had passed before the Commission settled with BISYS. Since then, the Commission has settled with only one of the 27 fund managers, and that occurred another two years after the BISYS

settlement, in September 2008.[9] The fund managers' arrangements with BISYS had already been terminated for over four years. Many of the funds have reached private settlements with the fund managers who were involved in the scandal. But the fate of the other 26 fund managers appears to remain unresolved. The investigations regarding the unlucky 26 are probably ongoing, with some inching toward a resolution and others floating motionless in an investigation purgatory awaiting a final decision on their fate. [10]

In lieu of the staff time invested in settling cases based on ancient misconduct, the Commission could have been looking for developing problems in other areas. This approach to the allocation of staff resources would result in a smaller number of settlements, however, and current indications are that the Commission is committed to keeping its numbers up. The SEC Chairman recently stated, for example, that the Commission has "150 active hedge fund investigations," "two dozen active municipal securities investigations," and "50 current investigations involving Credit Default Swaps, [CDOs] and other derivatives-related investments."[11] That totals 224 investigations, all of which are, not surprisingly, in areas that have recently received a great deal of public attention. While these matters should be investigated, is it prudent to commit the resources necessary to investigate 150 hedge funds? Why not only 20, or 50, or even 100? Are these investigations triggered primarily by allegations of alleged misconduct or by simply being a large hedge fund? Hedge funds and credit default swaps are generally

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

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

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

purchased by sophisticated investors. What about investigations of the losses suffered in 529 plans by investors who will not be able to afford to send their children to college? Or in target-date 2010 funds by 65-year-old investors who will not be able to retire? Like the dozens of mutual fund trading, options backdating, and other massive investigations, the current slew of topical matters will take years to resolve.

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

Once these potential enforcement targets have been identified, the Commission should establish real-time enforcement guidelines that are designed to produce a settlement or a complaint within 18 months. This will often mean winnowing out the less egregious or more complex cases, even where there is known misconduct. But it is not the SEC's role to bring enforcement actions against

every wrongdoer. It is the SEC's duty to use its unique position to deter misconduct, communicate and set uniform standards, and inspire confidence in the rules governing the financial markets. A small number of targeted enforcement actions brought (and section 21(a) reports issued) on a real-time basis will allow the Commission to invest resources in identifying abuses before they become systemic while sending strong signals to compliance officers about what kinds of conduct will not be tolerated.

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