Testimony Concerning

Strengthening the SEC's Vital Enforcement Responsibilities

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

Bruce Hiler
Partner
Cadwalader, Wickersham & Taft LLP

May 7, 2009

Chairman Reed, Ranking Member Bunning, and Members of the Subcommittee:

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

Although recently the Commission, and particularly its enforcement efforts, have come under fire for reported lapses in detecting or in quickly reacting to the activities of some individuals in the marketplace, the Commission has long been viewed as a premier regulatory agency and, through its Division of Enforcement, a premier civil enforcement agency. If there have been lapses, I am confident that the Commission will evaluate those situations and develop new policies and procedures to avoid them in the future. In this regard, I think it is important to understand the effects that the vagaries of funding and resource allocation, the exponential

expansion both of market activity and of sophisticated instruments and investment strategies, and the day-to-day pressure of operating in the glare of public scrutiny can have on any organization.

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

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

Currently, in the Commission's D.C. headquarters offices, the Division has two deputy directors and five associate directors. Through assistant directors and branch chiefs, the associate directors indirectly supervise hundreds of investigative attorneys, and they may be supervising dozens, if not scores, of investigations and active litigations, in addition to fulfilling other management responsibilities. The associate and the deputy directors typically are among

the most experienced professionals in the Division, and they are looked upon internally as having the judgment and expertise to make appropriate case recommendations. Yet, these are also the individuals who have the least amount of time to spend on any one matter, and who are relatively infrequently involved in any one particular matter on the day-to-day decision-making or day-to-day review of facts, as they are discovered or analyzed by those directly involved in the investigations.

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

Second, efficiency must not be achieved at the expense of fairness or thorough evaluation. The SEC has a long history of careful evaluation of important and complex issues and constantly must guard against public pressure to act too quickly or to be rushed to enforcement resolutions which may have significant policy implications. The matters which the SEC investigates can be extremely complex, and some conduct may easily be made to appear nefarious to the public and in media reports because of its novel or complex nature. SEC investigations can involve sophisticated instruments and trading strategies, as well as complex issues, such as accounting, risk analysis and economic modeling, that fall outside of the normal expertise of attorneys. Although there are individuals at the SEC with expertise in some of these

areas, their numbers should be increased and the Commission should organize these individuals by expertise outside of the Division of Enforcement. These experts should be available to consult and to work day-to-day on enforcement investigations. I believe that the addition of a cadre of experts in a variety of fields to assist in enforcement inquiries could lead to more efficient and better informed decision-making, and may assist in determining when issues are better resolved by way of considered regulatory or policy judgments.

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

I believe that the causes of this mutual suspicion are varied. However, I believe that increased scrutiny by criminal authorities of securities law matters and public pressure on the SEC to hold anyone and everyone responsible for the stock market crash in 1999, for corporate bankruptcies and defalcations, and, more recently, for the current economic turmoil have

contributed to this atmosphere. Increased attention to securities cases by criminal prosecutors is not in and of itself a cause for concern, but I believe that the line between civil securities cases and criminal securities-based fraud cases has been blurred, and that there has been a shift to an inappropriately low level in what authorities view as conduct that demonstrates sufficient *scienter* or "state of mind" to make even a civil securities case.

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

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