THE FIX IS IN: CAN THE ASYMMETRIC CONDITION OF REGULATORY OVERSIGHT IN THE U.S. CAPITAL MARKETS BE CORRECTED?

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INTRODUCTION

As the United States financial markets approach the end of the first decade of the 21st century, financial compliance as implemented by the regulated enterprise remains as varied as the businesses subject to regulatory oversight. Indeed, regulators have only just begun the grueling process of promulgating new rules under the 848 page Dodd-Frank Wall Street Reform and Consumer Protection Act, signed into law by President Obama on July 21, 2010.[1] When Dodd-Frank becomes fully implemented by financial regu-

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lators, nearly every segment of the financial services industry will be subsumed by this enhanced regulatory scrutiny. Hedge funds and private equity firms will now be required to join the ranks of broker-dealers, investment companies, and investment advisers as registrants of the U.S. Securities and Exchange Commission (SEC) and be subject to its examination, inspection and enforcement policy protocol.

Although many hedge funds have voluntarily registered with the SEC in the recent past, broker-dealers, mutual funds and investment advisers have heard the Commission knocking for years. For broker-dealers, this oversight has been complemented by self-regulatory organizations (SROs), including the various national exchanges, the Depository Trust and Clearing Corporation and the Financial Industry Regulatory Authority (FINRA). The primary function of an SRO is to promote, implement and enforce rules of fair practice and ethics in a given marketplace. The SRO originated in the brokerage industry under the Exchange Act of 1934 (as amended by the 1938 Maloney Act)[2], thus providing a rather lengthy and storied pedigree of regulator oversight.

This begs the question as to why, after decades of regulatory oversight, the responsible development and ongoing implementation of compliance programs remains highly variable in the investment services industry today. There are a number of valid assumptions that may explain this condition; however one in particular comes to mind. It is widely accepted that the SEC, as the primary functional regulator for mutual funds, investment advisers, hedge funds and soon, private equity firms, currently enjoys only modest credibility among its regulated constituents. Even the U.S. Congress, which retains budgetary and appointment oversight of the SEC, cast a skeptical eye towards this "top cop" of the capital markets during hearings held in early 2009 while performing a bureaucratic autopsy of the U.S. economy in the wake of the financial crisis.

This pervasive cynicism manifest among SEC registrants impels the following hypothesis: *The incentive for regulated entities to responsibly develop, implement and manage compliance programs in the financial services sector directly correlates to the collective credibility bestowed upon the regulator by the regulated.* The immediate reaction to this observation might very well be, "no kidding, you really think so?" Many are of the opinion that after 150 years of federal and state regulation of the securities industry, regulators remain unable to keep pace with the markets and product in-

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1. Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, Pub. L. No. 111-203, 124 Stat. 1376 (codified as amended in scattered sections of 12 U.S.C.).

2. 17 U.S.C. § 78(a). The National Association of Securities Dealers and New York Stock Exchange merged in 2006 and the successor SRO is the Financial Industry Regulatory Authority (FINRA).

novation they are tasked to regulate.[3] After decades of boom and bust cycles and recurrent financial fraud, the maxim that rules were meant to be broken remains a salient feature of the financial services industry.[4] The significant question therefore is not, "do you really think so?" but rather, "why is this the case and how can this scenario be corrected?"

This article will examine the asymmetric challenges which continue to threaten the SEC as a viable federal bureaucracy, and the change management process that is currently underway at the Commission as it seeks to address the numerical and intellectual disadvantage of the financial regulatory dynamic in the U.S. capital markets. This article will examine the implications of the Commission's recent bureaucratic rebirth and the timeline leading up to and immediately following the financial crisis and its aftermath. By dint of bureaucratic persuasion and no small amount of political finesse, the SEC has managed to retain its independence and even increase its Congressional mandate to regulate the securities and investment industry in this country. Finally, the article will explore what this portends not only for regulated entities, but for our country as well. Spoiler alert - the risks of failure have never been greater.

I. *A Familiar Headline*

One need only overlay the savings & loan debacle of the late 1980's with the economic crisis of 2010 to highlight their similarities. Once again, excess leverage and enabling deregulation has been coupled with ineffectual oversight, and the prominent feature of real estate is the underlying catalyst. Several scandals, most of them brewed in the cauldron of lax corporate governance, span the modern financial regulatory era which has been characterized by massive investor losses and severe erosion of investor confidence. Indeed, the U.S. financial regulatory regime was perceived to be so dysfunctional in the immediate aftermath of the Lehman Brothers implosion in 2008 that our hypothesis may have been easily extrapolated to virtually every financial regulator in the country as regulated entities, Congress, and the public collectively discounted the financial regulators as ineffectual bureaucrats.

All primary federal financial regulators came under suspicion of incompetence and/or mission creep by both the executive and legislative branch, especially when the crisis reached its apex in early 2009. Virtually all were compelled to rationalize the continuance of their respective congressional

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3. *Financial Regulation: Recent Crisis Reaffirms the Need to Overhaul the U.S. Regulatory System,* U.S. GOV'T ACCOUNTABILITY OFFICE, 2 (Sept. 29, 2009), http://www.gao.gov/new.items/d091049t.pdf.

4. Roberty Khuzami, director of SEC's Enforcement Division stated, "I'm not naïve enough to think that even the most aggressive enforcement program will stop people from engaging in improper behavior." Jean Eaglesham and Brooke Masters, *SEC: No Longer a Doormat*, FINANCIAL TIMES (Aug. 26, 2009, 10:00 PM), http://www.ft.com/cms/s/0/1d2fd850-b14d-11df-b899-00144feabdc0.html?ftcamp=rss.

mandate and concomitant funding. Even the Federal Reserve Bank (Fed), the first federal financial regulator (conceived by Congress in 1913 in part to obviate the cyclic boom/bust phenomena) and veteran of many subsequent trips to the Congressional woodshed, found its continued independence in serious jeopardy during the market mayhem of 2009.

In the end, if indeed things have now come to that, the Office of Thrift Supervision (the former regulator of such mega enterprises as Indy Mac, AIG International Group[5], and Washington Mutual) was the sole regulatory bureaucracy that failed to make its case for independence and will soon be absorbed by the Office of the Comptroller of the Currency. Up to and during the financial crisis, the dysfunctional condition apparent within regulatory circles was so acute as to lead to the scenario whereby the regulators themselves were being played by the regulated as business models and balance sheets were maneuvered to obtain the most favorable tax and regulatory environment. This "regulatory arbitrage" has been cited as a primary contributor to the systemic risk introduced by the financial crisis.[6]

II. *The Asymmetric Condition*

The mismatch between regulated entities and regulatory manpower is staggering. There are over 35,000 registrants under the regulatory oversight of the SEC which includes 10,000 publicly held companies, 11,500 investment advisers, 7,800 mutual funds, 5,400 broker-dealers, 600 transfer agents, 12 national exchanges, and various SROs.[7] These entities are subject to assorted inspection and examination regimens correlating to the underlying statutory authority to ensure compliance with federal laws and when necessary, enforcement actions for noncompliant registrants.

As noted, a significant degree of oversight and enforcement for broker-dealers is administered by FINRA which has been delegated limited regulatory authority from the SEC pursuant to the Securities Exchange Act of 1934[8]. However for investment advisers, investment companies, hedge funds, and newly initiated private equity firms, regulatory oversight is implemented solely by the SEC's Office of Compliance Inspections and Examinations (OCIE) while enforcement actions are referred to and executed

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5. The former Chairman of the OTS contests this as a matter of degree, i.e., the regulator only had oversight of the holding company which allegedly did not reach to the financial services division. Congress saw differently. Chana Joffe-Walt., Regulating AIG: Who Fell Asleep on the Job.. NATIONAL PUBLIC RADIO (June 5, 2009), http://www.npr.org/templates/story/story.php?storyId=104979546.

6. Tim Geithner, *Treasury Secretary Tim Geithner Written Testimony House Financial Services Committee Hearing*, U.S. DEP'T OF THE TREASURY (April 20, 2010), http://www.treasury.gov/ press/releases/tg71.htm.

7. *In Brief FY 2001 Congressional Justification*, U.S. SEC. & EXCH. COMM'N, 2 (Feb. 2010), http://www.sec.gov/about/secfy11congbudgjust.pdf.

8. *See* Securities Exchange Act of 1934, 15 U.S.C. § 78a (2006).

by the SEC Division of Enforcement or the U.S. Department of Justice in the event of a criminal referral.

This mathematical asymmetry, particularly as it relates to the OCIE inspection and examination protocol, has handicapped the Commission for years. Up until 2009, the deck was heavily stacked against the SEC and its approximately eight-hundred field auditors manning eleven regional branches. This condition became even more apparent in light of public statements by the Commission in the pre-crisis era affirming "the mission of the SEC . . . to protect investors, maintain fair, orderly and efficient markets and facilitate capital formation."[9]

Nowhere in this mission statement does the word *risk* appear. Indeed there is little if any public reference to risk either in terms of the markets subject to regulation by the Commission or the regulatory model employed by the Commission to regulate. The SEC does however employ the term and expounds upon it conceptually quite often in regulatory guidance to firms who must implement their own risk management apparatus. The Commission appropriately directs investment companies, advisers and hedge funds to develop and maintain "risk based" compliance policy and procedures whereby the regulated firm is advised to ensure that its policy and procedures reflect sound management of the myriad regulatory risks arrayed against the enterprise by virtue of its business model.

In many respects the actual examination and inspection process has been rather linear in its approach. Though the Commission resources allocated to an examination of Goldman Sachs would be significantly more than those delegated to XYZ Advisors with $2 billion in assets under management, the general protocol has historically been the same: ascertain the registrant's compliance with the 1940 Investment Advisers Act[10], note deficiencies, and require appropriate remediation. The Commission strives to examine all registrants over time (initially every five years beginning in 2004 and subsequently evolving to a ten-year cycle by 2008) while seeking to achieve its stated mission. With the proliferation of new registrants, the likelihood of the SEC performing multiple on-site inspections or examinations of a $200 million or even $1 billion firm was relatively remote as long as the firm did not grow too fast and the compliance program did not intersect with one of the Commission's regulatory sweeps. Even multiple inspections over several years did not always ferret out non-compliance, as the Madoff Securities fraud amply illustrated.

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9. *Strategic Plan 2004 - 2009*, U.S. SEC. & EXCH. COMM'N, 4, http://www.sec.gov/about/secstratplan0409.pdf.

10. Investment Advisers Act of 1940 § 201, 15 U.S.C. § 80b-6 (2006).

III. *The Cyclical Examination Process – Standard Fare*

The blueprint for a routine SEC "cycle" examination for an investment adviser began with a notice of pending examination from one of the eleven regional offices accompanied by a rather lengthy document request list delineating the books and records of the firm to be produced on-site for perusal by SEC staff. In some cases, a preliminary request letter required that certain documents be forwarded to the Commission in advance of the on-site exam. Following the SEC's visit, it was not unusual for examiners to contact the registrant to clarify information already submitted, or request additional documentation to drill deeper on certain matters.

Upon the completion of the examination, the registrant generally received either (a) a letter expressing SEC appreciation of the firm's cooperation with the examination with no further action required (generally less than 10% of examined firms); (b) a deficiency letter delineating the various compliance violations detected by the Commission which require the registrant to submit a written response within thirty days outlining proposed remediation of said violations; or (c) in the most extreme cases, correspondence requesting additional information, perhaps accompanied with a subpoena, whereby an imminent civil enforcement action or even more rarely, a criminal enforcement action, was likely.

In the case of the first two outcome scenarios, the probability of further interaction with the regulator within several years was slim unless the registrant's form filings or a preponderance of investor complaints triggered a red flag. To provide further contrast with the current environment, in the early years of investment adviser registration dating back to 2004, it was not unusual for the registrant to undergo an "examination lite" experience wherein the SEC audit staff would, upon determining a good faith effort by the firm's Chief Compliance Officer (CCO), provide more time to get the newly implemented compliance program up to speed. This inspection protocol clearly exacerbated the preexisting mathematical asymmetry which grew more acute as the registrant population exploded and the ratio of incremental federal funding of the SEC to new registrants declined.

Further compounding the regulatory asymmetry has been the professional bifurcation evident in many adviser compliance programs wherein thousands of CCOs assume management responsibilities in addition to their compliance duties. The bifurcated CCO is neither condoned nor prohibited by the SEC under Rule 206(4)-7 of the Advisers Act[11], the primary guidance being that the CCO retain the necessary influence and independence to implement and enforce compliance policy and procedures.

Nonetheless, to the extent that an ineffectual regulator diminished compliance with the promulgated regimen as stated in our hypothesis, the emergent

11. Investment Advisers Act of 1940 § 206(4)-7, 15 U.S.C. § 80b-6 (2006).

corporate definition of the CCO as a "part-time" managerial responsibility inherently diluted the mandate and influence of the office, certainly for the midsized firms with hybrid business models. Ironically, the very person who by statute has been required to independently design, implement and manage the compliance program has been in certain cases limited by competing professional responsibilities and the attendant conflicts of interest.

Indeed, one can observe highly capable CCOs who very effectively co-manage their professional duties and who aver that it is the very division of duty that provides a much needed operational element to the compliance risk management capability. The competent CCO surely must insinuate needed operational expertise into the compliance regimen utilizing human and technical resources without diluting or marginalizing the independent capability necessary to ensure that the compliance program remains robust and relevant. This balance can be achieved with something less than dual professional delegation, e.g., utilizing an organic approach to compliance[12] wherein the CCO proactively solicits input from line of business managers to identify and manage material risk.

In recent years, the Commission has not been entirely unaware of the growing mismatch between its oversight capabilities and the scope of risk presented by the regulated. Between 2002 and early 2009, the SEC settled with over 300 defendants in alleged Ponzi schemes involving impaired investor assets[13] (not including the $50 billion associated with Madoff and another $8 billion with the unsettled Sanford Investments case expected to go to trial in 2011).

It appears that the SEC certainly failed to deploy a risk-based regulatory model to regulate firms that were themselves required by the SEC to install risk-based compliance programs. It is now clear that this failure resulted in catastrophic damage to the U.S. capital markets system as iconic brokerage firms like Merrill Lynch and Morgan Stanley were sold off or substantially reorganized and the U.S. investment banking business model, an essential participant in the capital formation function (a key component referenced in the SEC mission statement)[14], literally became obsolete overnight as investment banks like Goldman Sachs became Federal Reserve chartered commercial banks. Perhaps most importantly though was the loss inflicted on the collective confidence of household investors which has yet to recover any semblance of pre-crisis levels.

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12. *See* Elizabeth Horrigan Rathz, *Organic Compliance…Doing More with Less*, 12 DUQ. BUS. L.J. 1 (2009).

13. Jan Larsen & Paul Hinton, *SEC Settlements in PonziScheme Cases: Putting Madoff and Stanford in Context,* NERA ECON. CONSULTING, (Mar. 13, 2009), http://www.securitieslitigation trends.com/PUB_Ponzi_Schemes_0309.pdf.

14. The Investor's Advocate: How the SEC Protects Investors, Maintains Market Integrity, and Facilitates Capital Formation, U.S. SEC. & EXCH. COMM'N, (October 20, 2010), http://www.sec.gov/about/whatwedo.shtml

According to the Investment Company Institute (ICI) 2009 Fact Book and the ICI 2009 Annual Report to Members, U.S. households experienced a $13 trillion drop in their financial and housing assets since the onset of the crisis in late 2007. The ICI tracks data trends associated with mutual funds which are a prime indicator for macro investor trends in the United States. As of year-end 2009, 88.5 million Americans owned funds which represented over 51% of all households.[15]

IV. *The SEC's New Mission*

Despite its blemished track record, the SEC has vowed to move ahead. In addition to protecting investors, regulating markets, and facilitating capital formation, the Commission is on a mission: to change its image and thereby ensure that its survival as an independent and relevant regulator remains intact. While the recent passage of financial reform assured the SEC of its continued congressional mandate, another near-death experience like Stanford Financial Group or Madoff Investment Securities wherein over $70 billion of investor assets are smoked would quickly change that.

Indeed, *Change Management* is afoot at the SEC. One need only peruse professional postings on the Commission's website to see the term repeatedly referenced as qualified candidate material. As a management discipline, *Change Management* posits that standing still is not an option. The attendant environment, either naturally occurring or intentionally manufactured, will ultimately spell doom for the entity in question unless thoughtful change is appropriately conceived and implemented.

When in 1988 the oil rig Piper Alpha caught fire in the North Sea, a worker trapped on the burning platform 100 feet above the freezing water decided to jump. He was required to make an immediate decision: certain death by fire or likely death by jumping, hence the reference to the burning platform. [16] The key subtext in change management theory is the ability to identify the "burning platform," i.e., that particular item or event which is the catalyst to impel change or allow the changing condition itself to determine one's fate.

The SEC's burning platform was most certainly the Madoff and Stanford cases wherein the Commission's own internal controls were marginalized by acutely indifferent staff and regulatory negligence in the face of investigative red flags. As Warren Buffett once said about financial crisis, "you only find

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15. Investment Company Institute, *A Review of Trends and Activity in the Investment Company Industry*, 2009 INVESTMENT COMPANY FACT BOOK, 49 ED. (2009), http://www.ici.org/pdf/2009_factbook.pdf.

16. *Buring Platform*, CHANGINGMINDS.ORG, http://changingminds.org/disciplines/changemanagement/creating_change/burning_platform.htm.

out who is swimming naked when the tide goes out,"[17] referring to the remarkable capability of an acute bear market to reveal managerial and strategic shortcomings (in both the public and private sector) left unchecked during a bull market. Madoff, Stanford and the SEC would most certainly not be where they are now (prison, jail without bail pending trial, and undergoing intensive change management, respectively) were it not for the unprecedented risk taking and assumption of leverage by unrelated entities. The inevitable rolling out of the tide and subsequent waves of client liquidations revealed in many instances that swimmers were in fact experiencing a rather serious wardrobe malfunction.

One might argue that change management is lurking for regulated entities as well. Although the days of *examination lite* are over, in many respects the reform underway at the SEC has become a question of bureaucratic survival for a not-so-small federal bureaucracy. Anyone with a modicum of insight into congressional funding and the attendant bounding of mandate will note that bureaucracy and survival are two dynamics that will require change management not only by the agency in question but also by its regulated constituents. In other words, either the bureaucracy succeeds in its change endeavor to become more effective and politically relevant (thus changing the regulatory dynamic for the regulated) or it does not and is ultimately replaced by a more politically agile entity.

V. *Reform - Act I*

The likelihood that the SEC can meaningfully turn on a dime the prevailing negative perception of its regulated and Congressional constituents is doubtful. Nonetheless, the Commission continues to undertake a number of initiatives to implement needed change. Indeed, in what may only be perceived as a most bitter irony, preceding the onset of the financial crisis and the emergent tsunami of financial fraud that would subsequently be referred to as the *Madoff era*, the SEC had already embarked upon notable changes in internal information management processes and capital expenditures to remediate the imbalance represented in the capital markets/regulatory match-up.

For years the Commission had intoned the need for regulated firms to adopt a *risk-based* compliance program designed to identify and mitigate both macro and inherent compliance risk sets. While not prohibited, the SEC certainly did not endorse "off the shelf" compliance programs. One size fits all was anathema to the "culture of compliance" concept originated in 2004 and still publicly referenced by the Commission today.[18] However,

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17. *Top 25 Warren Buffett Quotes*, MARKET FOLLY (Sept. 3, 2009), http://www.marketfolly.com/2009/09/top-25-warren-buffett-quotes.html.

18. *Strategic Plan 2010-2015*, U.S. SEC. & EXCH. COMM'N, 10, http://www.sec.gov/about/secstratplan1015.pdf.

as noted previously, it is clear that in many respects the SEC did not in fact practice what it preached in failing to deploy a risk-based examination and enforcement protocol which in concert with underlying statutes was to be the basis of the U.S. regulatory regimen. The SEC had come to the realization that mathematical asymmetry notwithstanding, decades of "financial engineering" of new services and products, e.g., the evolution of electronic clearing networks, the proliferation of derivative and structured financial products, and the stunning growth in the participation of U.S. households in the equity markets, had radically altered the business models of firms swimming in traditional capital markets channels.

This innovation and evolution resulted in registrant risk profiles which varied quite substantially from one to the other, thus further marginalizing the Commission's linear process of cyclical examinations. This was especially the case in the investment adviser space where business models varied substantially. For example, assets under management dispersion has been bounded by $25 million on the low side to hundreds of billions on the high end, with employee ranks ranging from one or two in smaller firms to several thousand within large, multi-faceted firms. To complicate matters further, the hedge fund and private equity industry also experienced significant growth in the decade preceding the financial crisis and likewise deployed highly varied business models that also included prodigious use of levered derivative products which further marginalized the linear inspection and examination protocol utilized by the SEC (if the entity was regulated at all).

VI. *Practice What You Preach*

After decades of the private sector outgunning the regulators, in 2003 the Commission under Chairman Harvey Pitt began to develop and implement proprietary risk analysis tools (compliance analytics) and related audit protocol changes to "better identify and focus its resources on those activities representing the highest risk to investors."[19] The nascent *risk-based* inspection and examination protocol at the SEC thus came into being. Objective watchdogs of the federal bureaucracy (most especially the Government Accounting Office) loudly echoed the need for change and now it was being delivered with the full effect of a newly invigorated and better funded SEC.[20]

Throughout the period immediately preceding the financial crisis, change was also underway in the OCIE whereby the examination protocol for regulated firms shifted to a risk-based paradigm from the routine examination and inspection cycle (remember the theoretical examination cycle was now ten years). The SEC acknowledged that the success of this approach would

19. *Securities and Exchange Commission: Steps Being Taken to Make Examination Program More Risk-Based and Transparent*, U.S. GOV'T ACCOUNTABILITY OFFICE, 2 (Aug. 2007) http://www.gao.gov/new.items/d071053.pdf.

20. *Id.*

largely depend on its ability to accurately assess the risk level of firms, i.e., what risk did the firm's business model pose to investors and markets, what did they sell, who did they sell it to, how did they sell it, and what was the likelihood of that model contributing to incremental systemic risk.

An inherent weakness in the emergent OCIE protocol was the "reliance on proxy indicators of compliance risks without incorporating information about the relative strength of a firm's compliance controls." In effect, the SEC was not delving deeply enough into compliance programs due to the shortage of field auditors, i.e., intellectual asymmetry was biting again. According to SEC records, the budgeted authority of the Commission rose by 40% in the full fiscal year following enactment of the Sarbanes–Oxley Act of 2002.[21] Ultimately, by 2010 the budget rose 100% vs. the 2002 baseline.[22] Clearly the hiring was only the beginning of regulatory overhaul wherein the newly hired had to be trained and provided with relevant field experience to provide a much needed boost to those already in the field.

In 2008, the SEC implemented the Risk Assessment Database for Analysis and Reporting (RADAR) as part of its ongoing effort to evolve as a risk-based regulator utilizing state of the art compliance analytics. There were other initiatives in this genre as well, including the Self Regulatory Organization Investigation Referral System, the "Hub" case management system, and the Risk Assessment Documentation and Inspection Umbrella System (RADIUS) among others. Collectively these tools provided enhanced risk triage capabilities to the OCIE and Division of Enforcement as the Commission endeavored to remedy the regulatory asymmetry. Whether the Commission at this time actually perceived that extraordinary systemic risk had been insinuated into the U.S. capital markets is unclear but there is evidence that at least one regulator was beginning to take action.

VII. *A Prescient Fed*

In 2005, the New York Federal Reserve spearheaded efforts to improve the clearing infrastructure of the over-the-counter derivatives market which had grown so fast so as to outpace the capabilities of dealers' processing systems leading to backlogs of unconfirmed trades. These unconfirmed trades had potentially unknown legal status and limited the ability of dealers to ascertain counterparty exposure, a concern that also increased systemic risk. Circa 2005, for every 100 derivative trades confirmed there were 1,000

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21. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (codified as amended in scattered sections of 28 U.S.C.).

22. *Frequently Requested FOIA Document: Budget History — BA vs. Actual Obligations*, U.S. SEC. & EXCH. COMM'N, http://www.sec.gov/foia/docs/budgetact.htm.

aged unconfirmed trades; under the leadership of the Fed this ratio actually inverted from 100:1000 to 100:10.[23]

This was a remarkable achievement given the fact that over $270 trillion of over-the-counter derivative contracts were outstanding as of June, 2005.[24] After the cataclysm of 2008-2009 became fully manifest in its gut wrenching market sell-off and the unfolding "ifs and buts" panorama played out in Congressional testimony, "when the dust settled, Congress realized that Bernanke and the Fed knew what they were doing."[25] The SEC took a page out of the Fed's examination book and initiated a pilot program by physically placing a sizeable contingent of staff within the walls of larger hedge funds and advisers. This approach had been utilized by the Fed for years whereby the regulator embeds personnel with the objective of absorbing the culture of the enterprise to effectively gauge the emergent compliance risk sets of the enterprise.

VIII. *Clawback*

In a recent article written for this publication, *Compliance as a Competitive Differentiator*, the events of 2008-2009 were described as an *Event Horizon* wherein institutions or individuals that approached the bounds of the crisis (excessive financial leverage, opaque financial communication or most egregiously, subprime residential real estate) were apt to be obliterated without further ado.[26] What occurred two years ago in the global markets continues to profoundly rock the U.S. socio-political and economic strata today as media headlines, mid-term elections, and government policy primarily reflect and respond to the conditions produced as a consequence of the crisis. More specifically, the financial crisis put in stark view the unassailable fact that despite all efforts undertaken by the SEC to remedy the numerical and intellectual asymmetry extant between the regulator and the regulated, the Commission had failed to achieve its primary mission to provide investors with protection from fraudulent and unethical business practices as advisers and hedge fund managers cooked up more than the local produce and Ponzi schemes abounded. Once again only now circa 2008, a few years after the

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23. Darrell Duffie, Ada Li, & Theo Lubke, *Policy Perspectives on OTC Derivatives Market Infrastructure*, FEDERAL RESERVE BANK OF NEW YORK STAFF REPORTS, 2 (Mar. 2010), http://www.newyorkfed.org/research/staff_reports/sr424.pdf.

24. *The Bank for International Settlements: OTC Derivatives Market Activity in the First Half of 2005*, BANK FOR INTERNATIONAL SETTLEMENTS, 1 (1Nov. 2005), http://www.bis.org/publ/otc_hy0511.pdf.

25. Steve Matthews & Joshua Zumbrun, *Bernanke Meets Buffet in Role Conceived to Protect Markets,* BLOOMBERG, (Sept. 2, 2010), http://noir.bloomberg.com/apps/news?pid=newsarchive&sid =aXYQ6nb6WFNw.

26. James Rathz, *Compliance as the Competitive Differentiator*, 12 DUQ. BUS. L.J. 13 (2009).

last regulatory crisis (Enron, Worldcom, the dot.com bubble, etc), the SEC was intent on restoring its squandered credibility.

The term "clawback" is actually a legal remedy associated with personal liability often utilized in times of financial scandal or crisis, and indeed it figures prominently in the current SEC game plan. However, clawback is also an appropriate metaphor epitomizing the current mindset of the SEC relative to reclaiming squandered credibility with its regulated constituents. The SEC by this time had "vowed to bring more high enforcement actions against Wall Street (firms) over the financial crisis" and publicly stated its intent to focus on those parties it deems to have contributed to that unfortunate event.[27]

Once it became apparent that the SEC would retain its independence as a federal regulator, it was a short hop to the realization that the Commission would be required to carry some of the regulatory water divined from the Dodd- Frank bill. The implementing rules would cover a vast new swath of investment service business models to be regulated under an amended 1940 Investment Advisers Act, piling on the more than 11,000 registered advisers already regulated under its purview. The mathematical asymmetry was about to get far worse.

Something had to be done to reverse not only the current condition, but perhaps more ominously, the troubling scenario of newly regulated entities utilizing sophisticated models which further skewed the regulatory mismatch. The SEC in particular had taken a beating in the press regarding its collective intellectual capacity to regulate entities which provided very significant incentives to attract very smart people to develop and execute sophisticated business models that were designed to generate enormous profits. As the economy teetered towards depression, money market funds "broke the buck" and the President sought Congressional funding for the largest spending bill in history to get the "economy out of the ditch." Markets and households that comprise the largest economy in the world were near collective cardiac arrest, and the question remained, "Could the newly sworn in President and the federal bureaucracy be tasked to swiftly implement appropriate policy and reform?" In the parlance of a television medical drama, the patient was about to code and many informed observers of the financial crisis, as well as more than a few of the President's men attempting to put the teetering economy back together again, sincerely believed that the defibrillator (federal financial regulators) had no juice.

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27. Jean Eaglesham and Brooke Masters, *SEC Vows More Action Over Crisis*, FINANCIAL TIMES (Aug. 26, 2010, 10:00 PM), http://www.ft.com/cms/s/0/7d6da03e-b13f-11df-b899-00144feabdc0.html.

IX. *The Big Bet*

The presence of acute regulatory asymmetry now assumed greater urgency for the newly elected President, Congress, and of course, the recently installed Chairman of the SEC, Mary Shapiro. Unlike her predecessors, Shapiro spent her entire professional career in the financial regulatory bureaucracy. Appointed as a Commissioner to the SEC by President Reagan in 1988, Shapiro subsequently served as the Chief Executive Officer of the National Association of Securities Dealers and it successor entity, FINRA prior to her appointment as SEC Chairman.[28] Over the prior three decades, Shapiro's predecessors had been former politicians (Cox, Shad), lawyers (Longstreth, Ruder, Pitt) or Wall Street executives (Levitt, Donaldson).[29] At the very nadir of the most devastating financial crisis the U.S. had experienced in seventy-five years, Shapiro would in effect become the first SEC Chairman born, bred, and buttered as a professional federal regulator in the modern financial era. While many opposed her appointment due to her lineage as a sitting senior regulator during the financial crisis, her appointment was ultimately confirmed by Congress on January 26, 2009.

In her testimony to Congress in early 2009, Shapiro provided an embellishment to the mission wherein the SEC would "facilitate a *risk-based* oversight methodology and better allow the staff to identify and focus on those firms presenting the most risk."[30] In successive speeches and testimony, the Chairman referred to the critical need for the Commission to become a risk-based regulator. However, the demographics of the newly regulated market compelled the cynics to again raise the specter of that other mismatch, as there would now be over 28,000 registrants requiring examinations and inspections by roughly 1,000 members of the OCIE staff (once the new hires were trained up). Chairman Shapiro's recent testimony notwithstanding, many of the registrants would be deploying rather sophisticated business models—did Congress and the SEC really think $139 million in additional budget authority would be the answer?[31] Was this what months of Congressional testimony and aggressive financial reporting fashioned? The same arguments that surfaced in 2008 were again floated; informed cynics not only believed that the SEC did not have the numbers to field a credible team as the SEC itself had acknowledged in Congressional testimony,[32] they (the

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28. *SEC Biography: Chairman Mary L. Schapiro*, U.S. SEC. & EXCH. COMM'N, (Feb. 23, 2009), http://www.sec.gov/about/commissioner/schapiro.htm.

29. *SEC Historical Summary of Chairman and Commissioners*, U.S. SEC. & EXCH. COMM'N, (Feb. 23, 2009), http://www.sec.gov/about/sechistoricalsummary.htm.

30. Chairman Mary L. Shapiro, *Testimony before House Committee on Financial Services and General Government*, U.S. SEC. & EXCH. COMM'N, (Mar. 11, 2009), http://www.sec.gov/news/testimony/2009/ts031109mls.htm.

31. *In Brief FY 2001 Congressional Justification*, *supra* note 7, at 2.

32. Shapiro, *supra* note 26.

SEC) remained perched in their ivory tower and did not even know how to play the game.

The firms that created collateralized debt obligations, off-balance sheet structured investment vehicles, and special purpose entity derivative structures were now to be regulated by the SEC.[33] The SEC performed three routine examinations and two inspections of Bernie Madoff Investment Securities and "… received ample information in the form of detailed and substantive complaints over the years to warrant a thorough examination (of Madoff) which was never performed."[34] In many cases, the regulated firms were entrepreneurs who were engineering products and services that were unimaginable even a few short years ago. Furthermore, regulated entities were compensated and incented in a manner that could not begin to compare to a GS-9 pay grade[35] allotted to a midlevel bureaucrat in the SEC regional office who were now resident in the very hedge funds and private equity firms that the Commission was about to fold into their regulatory purview via Dodd-Frank. In essence, the reregulation of this era could have had the singular effect of putting more traffic on the one-way street where "chicken" was the name of the game.

The President knew, Shapiro knew, Dodd and Frank knew; everyone knew. A very large double down had just occurred wherein the SEC was perceived to be bent but not broken. The President and Congress essentially told the American taxpayer that the SEC was up to the task of adequately regulating the securities markets and furthermore, it would be a reliable partner with a seat at the table to implement the newly architected federal financial regulatory regimen. However, Shapiro's first job was to address its credibility problem.

X. *Reform Act II*

One of Shapiro's first new hires was Robert Khuzami as the agency's new Director of Enforcement. A former U.S. Attorney, he was recruited from Deutche Bank in early 2009.[36] Khuzami shared Shapiro's belief that the

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33. Investigation of Failure of the SEC to Uncover Bernard Madoff's Ponzi Scheme, U.S. Sec. & Exch. Comm'n, 20 (Aug. 31, 2009) http://sec.gov/news/studies/2009/oig-509.pdf.

34. *Id*.

35. The federal government pay scale is laid out in the GS (General Schedule). *Federal Pay*, IT'S NOT JUST MAKING A LIVING, IT'S MAKING A DIFFERENCE (2008), http://www.makingthedifference.org/federalbenefits/federalpay.shtml. The GS was designed to keep Federal government salaries on a par for all federal jobs throughout the various Federal agencies. *Id.* The GS is divided into fifteen grades and each grade has ten levels. *Id.*

36. An interesting irony is that as the top legal professional at Deutche during the financial crisis, Khuzami was likely integral to approving the legal contracts which defined the highly profitable OTC short subprime trades that his banking colleague Gregg Lippman orchestrated on behalf of the bank and others. *US SEC Enforcement Chief Oversaw Deutsche DCOs-WSJ*, REUTERS (Apr. 23, 2010 10:01 PM), http://www.reuters.com/article/idUSN233751220100424.

Commission had to become far more nimble than in years past were it to reassert its regulatory relevance and effectiveness. Integral in this evolution was the intent to shrink the management bureaucracy of the SEC to permit more investigative case work. Also exemplifying a more agile agency were newly amended SEC regulations passed by Congress designed to empower the Director of Enforcement or his deputies to issue subpoenas, initiate investigations and/or start settlement proceedings without preliminary approval from the presidentially appointed commissioners.[37]

Perhaps most importantly, the new leadership at the SEC did not accept the premise that its people were intellectually inferior and unmotivated relative to the human capital of the firms it regulated. Nonetheless, Shapiro did come to realize that the Commission was guilty of operating in a vacuum. Her staff needed to be trained-up in the genre of the contemporary hedge fund financial services business model where leveraged products (albeit reduced from the lofty pre-crisis levels), sophisticated arbitrage, and byzantine investment strategies with embedded third party relationships created risk profiles that had befuddled her predecessors. Even in the days of early reform under Chairman Harvey Pitt, the agency continued to react to financial crime and scandal rather than seek out market intelligence to proactively examine, inspect and enforce the regulatory doctrine of the SEC. Most critically it had failed to solicit and act upon whistle blower information, the very essence of informed opinion which, in retrospect, might have at least mitigated the Madoff affair to something less than the rip-off of the century. Shapiro had to improve the odds that the Big Bet paid off.

In theatre, follow on acts tend to up the ante relative to suspense and plot development. The changes about to be implemented at the SEC were perhaps not necessarily the stuff of high drama—think Congressional inquiries—but the reform clearly exuded a whiff of risk assumed by Shapiro and her growing band of regulatory jedi. Restoring SEC credibility was job one. No one, either inside the capital beltway or casually observing the SEC as Reform II got underway, were of the opinion that the restoration of the Commission would occur in a fortnight let alone in the first Obama administration which was being increasingly compared to the Carter "one and done" term. Nonetheless, by early 2010 it was clear that the Big Bet was well underway and the SEC was engaged in a makeover that would make the most seasoned reality show producer cringe at the potential plausible outcomes.

XI. *Throw Back to the States*

As a first step to alleviate the asymmetric condition, Dodd-Frank intends to change the state-federal registration dynamic by expanding the prohibition

37. Delegation of Authority to Director of Division of Enforcement, 17 C.F.R. § 200.30-4 (2010).

on federal registration to include any adviser with assets under management greater than $25 million but less than $100 million, effectively reducing the number of federally registered advisers by 44%. Further, the amended 1940 Act[38] places "rule authority" with the SEC wherein the agency could invoke by rule additional changes to the federal-state registration interplay in the future.[39]

With the stroke of a presidential pen, a solution as elegant as rare Haiku provided very near term relief to the staff asymmetry wherein the number of registered advisers requiring direct Commission oversight would be nearly halved.[40] The ratio of qualified regulatory auditors to regulated firms remains perilously high but clearly not as bad as it could have been. The fifty state securities regulators would now assume oversight of as many as 5,000 investment advisers formerly regulated by the SEC.[41]

While the states might grouse over this re-allocation, they really did not seem to have much choice. Indeed, there might even be a silver lining in this regulatory cloud as state registration fees and enforcement revenues derived from state oversight could provide fiscal relief to the growing number of states projecting significant fiscal deficits while contemplating the specter of state and municipal debt defaults. Of course the demographic ratio was only one aspect of the asymmetric regulatory condition. A deficiency of capable field investigators and a dearth of aggressive civil prosecution had nearly driven a stake through the Commission in the dark days of early 2009.

XII. *Hiring Spree*

Chairman Shapiro was fully aware of the growing public and Congressional apprehension surrounding the perceived lack of technical and jurisprudential capability at her agency. She was therefore determined to reform the Commission along the lines of a professional risk management enterprise. Undoubtedly, more boots on the ground were needed to audit the growing number of registered entities with a risk-based inspection and examination protocol, while just as evident was the need to rectify the intellectual capital mismatch extant between the regulated and the regulator. No longer could Congress, the public, and most importantly the regulated firms themselves expect the Single A-Quad A varsity matchup to ensue and then accept the inevitable outcome, the Big Bet had made that a non-option now.

Indeed, one must assume that a multithread calculus was being assessed at this time by SEC Directors and their Chairman, i.e., "How can I make my staff more capable when interviewing the CIO of a hedge fund or the CEO

38. Investment Advisers Act of 1940 § 206(4)-7, 15 U.S.C. § 80b-6 (2006).

39. Dodd-Frank Wall Street Reform and Consumer Protection Act § 410.

40. Luis Aguilar, Chairman, U.S. Sec. & Exch. Comm'n, SEC Oversight of the Advisor Industry Bolsters Investor Protection, (May 7, 2009).

41. *Id.*

of an integrated broker-adviser like Madoff?" This question led to others, such as, "How can my authority be more effectively delegated to offset the bureaucratic gridlock embedded in virtually every federal agency, and how do we attract top drawer talent to a discredited agency?" Questions involving the agency reorganization that typically followed the installation of a new administration went beyond functional delegation to include strategic issues encompassing ways and means to develop timely market and business intelligence and to aggressively act upon it within the ever present confines as dictated by the rule of law.

As noted, the SEC had already undertaken significant reform to reduce bureaucratic red tape when it prevailed upon Congress to amend Commission rules attendant to initiating investigations and subpoenas.[42] The SEC had also made changes on the recruiting front wherein a number of high profile executives from the private financial sector had been hired to inject new and informed vigor into the investigative protocol. These hires included a nuclear physicist from Princeton, a professor who was the leading authority on emergent risk management issues confronting the financial services industry, and an MIT-educated economist and former hedge fund manager with experience managing risk at Salomon Brothers.[43] Shapiro was fully aware that the days of investigating and enforcing the securities laws of the United States with an army of securities lawyers were over. To close the intellectual asymmetry extant between the SEC and its regulated constituents the Commission realized that it had to staff and train-up with a significant element sourced from Wall Street trading and risk management desks.

In the words of a newly installed senior manager at the SEC, Richard Bookstaber (the former Salomon manager and hedge fund professional), "this job cannot be done by lawyers or career government workers . . . We [the SEC] need to entice market professionals into government service who are on par with those in industry."[44] New hires also included a former derivatives manager from AIG Financial Products (the same guys that rang up a multibillion dollar 911 call to the U.S. Treasury in 2009) and others from the alternative investments sector intent on rectifying the mistakes and missteps of their predecessors.

XIII. *New Infrastructure, New Initiatives*

Reform was not limited to the new hiring strategy as the creation of the first new division in thirty-seven years was completed in September 2009

42. 17 C.F.R. § 200.30-4.

43. Zachary A. Goldfarb, *SEC is hiring more experts to assess complex financial systems*, WASHINGTON POST, (June 15, 2010), http://www.washingtonpost.com/wp-dyn/content/article/2010/06/14/AR2010061404757.html.

44. *Id.*

with the birth of the Division of Risk, Strategy, and Financial Innovation.[45] This initiative was seen as a direct effort to ramp up the Commission's risk-based regulatory paradigm to redress the noted inability of the Commission to utilize interdisciplinary resources to discern patterns of conduct and business operations emanating from separate but related sources (e.g., hybrid broker/dealer operations, and synthetic securitization). Additionally, the Division of Enforcement created new units to better leverage its new found subpoena power and to appropriately reflect its desire to become far more agile in opening and pursuing investigations. The Office of Market Intelligence was created in January 2010 to collect and analyze tips *and complaints* received by the SEC (this entity will also receive significant funding to procure technology enabling improved data aggregation and triage capabilities). Finally, four new units were created to "help provide the additional structure, resources, and expertise necessary for[the division of] enforcement staff to keep pace with the ever changing markets and more comprehensively investigate cases involving products, markets, regulatory regime, practices and transactions."[46]

The new units focused on market products and practices are as follows:

(1) Asset Management - focusing on investment advisors, investment companies, hedge funds and private equity funds;

(2) Market Abuse - concentrating on large scale market abuses and complex manipulation schemes by professionals;

(3) Structured and New Products - analyzing complex derivatives, credit default swaps, collateralized debt obligations (CDOs) and securitized products;

(4) Foreign Corrupt Practices - focusing on violations of the Foreign Corrupt Practices Act (prohibits bribes and other kickbacks to/from U.S. companies and foreign officials); and

(5) Municipal Securities and Public Pensions - focusing on underwriting, trading and sales of municipal securities and marketing practices interfacing with the public pension market.

Finally, the Commission had announced the establishment of the Enforcement Cooperation Initiative, an effort designed to entice private individuals to come forward with information about violations of securities stat-

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45. Mary L. Schapiro, Chairman, U.S. Sec. & Exch. Comm'n, Looking Ahead and Moving Forward, (Feb. 5, 2010).

46. *SEC Names Specialized Unit Heads and Head of New Office of Intelligence*, U.S. SEC. & EXCH. COMM'N, (Jan. 13, 2010), http://www.sec.gov/news/press/2010/2010-5.htm.

utes.[47] This initiative was to be predicated upon the utilization of the following insider agreements with prospective witnesses and/or sources of information, wherein each agreement provided progressively greater protection to the cooperating party:

(1) Cooperation Agreement, whereby under written agreement the insider would receive leniency credit for the information provided;

(2) Deferred Prosecution Agreement, whereby the Commission would take no action against the insider as long as the party continued to cooperate with the investigation and/or trial; and

(3) Non-prosecution Agreement, wherein the SEC agrees to undertake no *civil* enforcement action against the cooperating party (the Department of Justice retains criminal enforcement authority though the SEC could presumably intercede on the party's behalf).

XIV. *New Risk Appetite*

Collectively the increased budget authorization, technology acquisitions, new hires, internal reorganization measures, and streamlined reporting and work flow would complement the significant new legal and oversight authority granted by Congress to the SEC and delegated internally by Directors to their staff associates. These are the quantitative and qualitative resources which the risk-based SEC must harness if it is to achieve a very significant amount of regulatory reform as posited by Dodd-Frank and as perceived in the Big Bet. However, in no small measure, the results of this calculated risk at effective reform will hinge on a rather nuanced but nonetheless critical aspect of regulatory reform as envisioned by Chairman Shapiro and the Director of Enforcement in their endeavor to reform the Commission. Not only would the Commission have to develop a risk-based regulatory model wherein hiring non-attorney personnel and refining the OCIE targeting protocol for examinations and inspections were to be a tangible manifestation of the risk-based paradigm underway at the SEC, the enforcement apparatus itself would have to be willing to assume more risk, thus placing the precious credibility of the SEC in more immediate jeopardy.

When a case under investigation for violation of federal securities laws proceeds to the point where litigation is seriously considered (as determined by the preponderance of evidence and the rule of law pertaining to the case

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47. *SEC Announces Initiative to Encourage Individuals and Companies to Cooperate and Assist in Investigations*, U.S. SEC. & EXCH. COMM'N, (Jan. 13, 2010), http://www.sec.gov/news/press/2010/2010-6.htm.

as determined by SEC legal staff), the case is generally settled without trial through a settlement or default judgment (in the latter instance, the SEC prevails due to failure of defendant to appear) or will proceed to litigation in civil and/or criminal trial. Settled cases generally involve a monetary settlement (penalty/disgorgement) where the party in question neither admits nor denies the validity of the subject allegation(s).Were the case to be tried as a civil offense it would be litigated by the Division of Enforcement where the matter is adjudicated in a civil court of law. In a criminal court the case would be referred by the SEC to the Department of Justice for litigation at which point it becomes a shared responsibility with Enforcement. When civil or criminal litigation is pursued, the outcome is either guilty or not guilty (this paper will not explore the other nuanced judicial outcomes which may occur) with the added caveat that in the case of criminal referrals, a guilty finding requires that the defendant be guilty beyond a reasonable doubt, thus setting the bar for a positive outcome substantially higher from the perspective of the SEC and the Department of Justice.

For decades the SEC had experienced a significant decline in referred cases to the Division of Enforcement. The reasons for this development are numerous however suffice to say that resource allocation to litigate is far more substantial than that required to reach settlement. The settlement is negotiated and closed with far less time, effort and expense versus that associated with a civil or criminal litigation.[48] Further, in the case of the latter scenarios the outcome is generally far less certain (i.e., litigation risk) whereas in the case of a negotiated settlement the outcome, while not exactly assured, is often a relative known.

From 1990 through 2007, annual Wall Street bonuses increased by over 1,200%. The Commission was already perceived as a chronic late arrival on regulatory matters of the day and increasingly perceived as a mere speed bump on the stairway to heaven.[49] Director Khuzami's intent to change the regulatory dynamic required more funding, better trained human resources and most importantly, the assumption of more litigation risk. To successfully litigate meant not only to have the evidentiary goods on the defendant, it also required "command of the securities laws (the rule of law), mastery of the legal process and a passion for the work."[50] Integral to protecting investors and maintaining orderly markets was a need to proactively regulate. To

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48. *White Paper on Arbitration in the Securities Industry*, SEC. INDUS. & FIN. MART. ASS'N, 62 (Oct. 2007), http://www.sifma.org/regulatory/pdf/arbitration-white-paper.pdf. The author provides evidence that cases filed in arbitration come to resolution 40% faster than civil litigation. *Id.*

49. *Turmoil on Wall Street: the Impact of the Financial Sector Meltdown on New York's Labor Market*, NY STATE DEPT. OF LABOR, 4 (June 2009) http://www.labor.ny.gov/stats/PDFs/Wall_Street.pdf.

50. *Chief Litigation Counsel Leaving the SEC*, U.S. SEC. & EXCH. COMM'N, (Nov. 9, 2009) http://www.sec.gov/news/press/2009/2009-240.htm.

develop and effectively wield this capability was to refute the collective cynicism which had accumulated in the preceding decades.

XV. *By the Numbers*

By 2010, there was data forthcoming to indicate that the SEC had indeed embarked on a new path to fulfilling its mission. In April, Goldman Sachs was charged with civil fraud by the SEC. The complaint, a derivative of the financial crisis which included credit default swaps, hedge funds, and billions of dollars of alleged losses, put the national spotlight on the SEC and its Director of Enforcement. The case was subsequently settled for $500 million, the largest civil settlement in the history of the Commission. Also evident at this time were high profile enforcement actions at hedge funds like Galleon Group where for the first time in memory the Commission utilized wiretaps, a practice often associated with organized crime investigations, to accumulate evidence. The Galleon case is still in discovery and scheduled for trial in early 2011. The number of enforcement cases initiated by the SEC had been trending upward, and while the delta of some key enforcement metrics has settled, overall the Commission has clearly been far more ambitious in its enforcement activity. After a heavy burst of activity in the first six months of 2009, several key enforcement metrics continued to show significant growth in 2010 versus 2008 as noted below.[51]

Temporary Restraining Orders[52]	12	34
	Feb-May 2008	Feb-May 2009
Investigations Opened	292	358
Formal orders	74	188

	Jan-Jun 2008	Jan-Jun 2009	Jan-Jun 2010
Injunctive Actions	114	167	118
Defendants Charged	317	527	333

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51. Eduardo Gallardo, *SEC Enforcement in 2009: A Year of Changes, With More This Year*, THE HARVARD LAW SCHOOL FORUM ON CORPORATE GOVERNANCE AND FINANCIAL REGULATION (Feb. 1, 2010, 9:36 AM), http://blogs.law.harvard.edu/corpgov/2010/02/01/sec-enforcement-in-2009-a-year-of-changes-with-more-this-year/#more-6752.

52. Emergency temporary restraining orders show an increase, primarily due to the rash of Ponzi schemes discovered during this period. Roberty Khuzami, *Testimony Concerning the SEC's Failure to Identify the Bernard L. Madoff Ponzi Scheme and How to Improve SEC Performance*, U.S. SEC. & EXCH. COMM'N, (September 10, 2009) http://webcache.googleusercontent.com/search?q=cache:AxJGnJAPVLsJ: www.sec.gov/news/testmony/2009/ts091009rkw.htm+Shapiro+utilizes+emergency+restraining+orders+in+response+to+ponzi+schemes&cd=2&hl=en&ct=clnk&gl=us.

% Defendants settling at filing	32%	20%	21%

Percentage of Defendants Settling at Filing - Annual Comparison[53]

CY2009	24%
CY2008	35%
FY2007	74%
2006	64%
2005	48%
2004	67%

These statistics clearly reflect a more aggressive SEC enforcement regimen in the aftermath of the financial crisis and the installation of Chairman Shapiro and Enforcement Director Khuzami. With a surge of activity in 2008 continuing into 2009, enforcement metrics reflect a slight settling of the coincident indicators (e.g., cases opened and defendants charged) in 2010 but nonetheless more entities certainly have the SEC on their mind as the first decade of this millennium draws to a close. The more interesting statistic in this data however is the precipitous decline in the percentage of settled cases year-over-year for the preceding six years. This is a direct reflection of the Commission assuming increased litigation risk in its enforcement actions. Indeed, data for the first six months of 2010 reflect that the SEC is on track for its lowest settlement ratio in seven years (21%).

There is a respected school of thought suggesting that the drop in settled cases reflects adversely on the Commission.[54] These observers maintain that the SEC has used the settlement process in the past to grab headlines and cash, both desired results, especially in the eyes of Congress who are the beneficiaries of excess penalties and fee assessments. In their view, the decline in settled cases portends continued difficulty by the SEC to "get it" relative to proactive financial regulation. Perhaps SEC litigants are emboldened by the recent missteps of the Commission, especially evident in two highly visible setbacks wherein the U.S. District Courts for New York and the District of Columbia in separate and unrelated rulings rejected proposed settlements for enforcement actions brought against Bank of America and CitiGroup. While the basis for the judicial reproofs was more rather than less in terms of monetary penalties, the Commission nonetheless suffered a blow to its credibility. After all, if settlements are signed, sealed and delivered by the Commission to the District Justice for approval only to be subsequently rebuffed, what does this portend for contested actions wherein the defendant

53. *SEC Enforcement Trends*, FOLEY & LARDNER LLP, (2007), http://www.foley.com/files/tbl_s31Publications/FileUpload137/3990/SECEnforcementTrends.pdf.; Gallardo, *supra*, note 51.

54. Thomas O. Gorman, *Rejuvenating SEC Enforcement: A Long Road*, SEC ACTIONS (Sept. 1, 2009, 5:56 AM), http://www.secactions.com/?p=1448).

intends to fight the Commission on the rule of law and/or the basis of evidence?

Of course the opposing view posits that the decrease in settlement activity represents a more aggressive enforcement effort seeking to obtain guilty trial verdicts rather than settlements which permit the party under investigation to "neither admit nor deny" the allegations in question while they write a check to the SEC. Civil or criminal litigation conceivably could result in monetary penalties, financial disgorgement and reputational risk for the defendant, but would also carry the positive publicity value which is central to achieving Khuzami's objective of focusing "on cases involving the greatest and most immediate harm and on cases that send an outsized message of deterrence"[55].

XVI. *Early Returns*

The outcome of these initiatives remains inconclusive, especially in the case of unsettled/ pending litigation. There are some encouraging indications, however, that these reforms and changes are having a positive effect. In a September 7, 2010 Wall Street Journal article, the SEC maintained that new awards and prospective informants under the Enforcement Cooperation Initiative had resulted in a "surge of very high quality tips" while the enforcement action data presented above certainly reflects a more aggressive and motivated SEC. However, the public may not know the impact that many of the initiatives in technology (RADAR/RADIUS), process (Office of Market Intelligence, Division of Risk, Strategy, and Financial Innovation), and protocol (a risk-based inspection and examination targeting protocol that remains highly confidential) will have for a long time.

It has been about a year since the Chairman fully staffed the agency's Director positions, while ongoing staffing of over 1,000 new hires continues. To date there have been mixed signals about the effects of the reformed SEC regulatory strategy. However, despite the fact that more insight into the efficacy of a reformed SEC will have to wait, at least until the adjudication of several key pending actions is known, in public statements the Commission has tipped its hand in some respects as to what tactics regulated firms may come to expect.

For example, the OCIE has historically realized the cost/benefit advantage of conducting industry wide regulatory sweeps (a.k.a., "strategically initiated risk-based investigations") to obtain timely perspective of a particular practice area of interest to the regulator. The newly reformed SEC is no different and fully intends to increase the number of sweeps which in addition to putting a finer point on industry practices also assists the OCIE in its targeting

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55. Robert Khuzami, Dir., Div. of Enforcement, U.S. Sec. & Exch. Comm'n, Remarks Before the New York City Bar: My First 100 Days as Director of Enforcement (Aug. 5, 2009).

protocol (e.g., failure to respond, untimely responses, red flag responses, or perhaps responses which are contradicted by ADV disclosures).[56] In fact, OCIE Director di Florio has stated that while the SEC will continue the cyclical examination protocol for now wherein regulated entities are examined approximately every *ten years*, it will likely be phased out.[57] In keeping with the risk-based paradigm however, the OCIE will also initiate risk-based exams that may be shorter than traditional cyclical exams for investment firms that demonstrate good practices. Director di Florio notes,

"As we see there are issues and concerns, let's try to go deeper . . . but if we don't, let's not necessarily continue—if it means doing it at the cost of another registrant who has never been visited and who might have some risks."[58]

Furthermore, Director di Florio would like to complement risk-based exams with random (i.e., unannounced) spot checks on various issues to "keep advisors on their toes" and deny them the ability to game the OCIE protocol as in years past.[59] It would appear the Director intends to change the one-way street of regulatory chicken which has so severely handicapped the Commission in prior decades.

Of course, it is also apparent that with the judicial branch pushing back on civil settlement protocol, the Commission is placed in a difficult position to drive for harsher settlement agreements or be forced to litigate even more cases. This introduces significant execution risk to Director Khuzumi's strategy of sending outsized regulatory messages to the market by focusing upon "the programmatic importance of enforcement actions." To the extent that shareholders bear the brunt of settlement costs as alleged in the Bank of America and CitiGroup bench opinions and follow-on orders, Congress too may insert its opinion on such a populist matter as shareholder rights in the era of reputational clawback. As referenced earlier, clawback is actually more than a redemptive regulatory mode, it is actually a legal remedy applied in times of financial crisis or scandal. The SEC recently utilized section 304 of Sarbanes Oxley to seek clawback of compensation to executives not accused of any wrongdoing per se but of having obtained significant compensation during a financial period which was later substantially restated in terms of financial performance. In *SEC v. Jenkins* the Commission maintained it did not have to prove wrongdoing on the part of the parties from whom the compensation clawback was sought. The U.S. District Court of

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56. Jordan, *John Walsh, SEC OCIE Director Speaks at NSCP Conference*, ENFORCEMENT SEC (Oct. 6, 2009), http://complianceavenue.com/2009/10/06/john-walsh-sec-ocie-director-speaks-at-nscp-conference/.
57. *SEC Inspections To Focus on Risk*, FINANCIAL ADVISER NEWS (Apr. 21, 2010), http://www.financialadvisormagazine.com/fa-news/5457-sec-exams-to-focus-on-risk.html?tmpl=component&print=1&page=.
58. Gallardo, *supra* note 51.
59. *Id*.

Arizona ruled in favor of the SEC on June 9, 2010, thus potentially placing many executives in a compensation twilight zone.[60]

XVII. *Moving the Needle*

Some registrants have realized that federal regulators will in fact be more motivated to manage their regulatory domain. Hedge funds and private equity firms for example have been keen to place former high powered regulators on advisory boards while the financial services industry, across virtually all subsectors, continues to maintain or even increase financial resources dedicated to compliance programs despite ongoing compressed margins. Nonetheless, these anecdotal observations are dwarfed by the certain fact that the vast majority of regulated firms continue to game the calculus of the regulatory cycle and question the ability of the SEC to successfully reverse the preexisting mindset of the asymmetric condition.

A firm that has pursued the perfunctory development and implementation of compliance risk management policy and procedure, i.e., not exactly ignoring the regimen but certainly not endeavoring to develop the Commission's regulatory aspiration of a culture of compliance either, will probably not alter that approach unless given a tangible reason to do so. Likewise, the "new" SEC will not be able to immediately impel firms that must conform to the new ADV Part 2 narrative to prepare a succinct and articulate disclosure document which embraces the Commission's plain English initiative. These advisers instead may choose to cut and paste ADV Schedule F as a means to conserve man-hours (the SEC estimates that on average advisers will expend more than thirty-six man-hours to comply with the amended filing).[61]

In fact, one may even argue that it is imperative for these firms to reacquaint themselves with the SEC in order to appropriately align compliance risk management resources with the risk articulated by Director di Florio's comments in May, 2010, where he stated, "these changes should make clear to all listening—and those who thought they didn't have to listen and we would just go away—that the Enforcement Division has sharpened its teeth and will use them."[62]

As Director di Florio further noted, if your firm has been selected for any type of inspection or examination (cyclical, risk, sweep, etc.) examiners will be looking for reasons to extend their stay so contrary to the life wellness

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60. SEC v. Jenkins, No. CV-09-1510-PHX-GMS, 2010 WL 2347020 (D. Ariz. June 9, 2010). Although the court stated that this rule could lead to constitutional issues to the extent that the statute or remedy sought under it resulted in a severe and unjustified deprivation to the defendant, it concluded that these concerns required factual development not possible on a motion to dismiss. The holding was essentially codified in the Dodd-Frank bill.

61. Amendments to Form ADV, Investment Advisers Act Release No. IA-3060, 17 CFR 275, 279, at 83 (Oct. 12, 2010).

62. Elisse B. Walter, Commissioner, U.S. Sec. & Exch. Comm'n, Remarks at 42nd Annual Rocky Mountain Securities Conference (May 7, 2010).

mantra extolling the virtues of a healthy perspective, it behooves CCOs to sweat the small stuff to ensure that if the Commission pings your firm, you graciously deny them the opportunity to extend their stay.

CONCLUSION

This article has attempted to frame the asymmetrical condition which has plagued the SEC for decades. To do this, it was necessary to provide a realistic representation of the consequent underlying psychology attendant to the federal financial regulatory regime existing in the pre-crisis era. As with most things psychological, this explanation was rather complex. Continued rampant cynicism associated with all things SEC represents a real and substantial threat to the economy of the United States and increasingly to the majority of households in this country that rely on the securities markets as a means to generate wealth to fund lifestyle and retirement objectives. Recent media reports have run stories which portend frightening fiscal scenarios for baby boomers intent on retiring in the style of their parents, e.g., retire before age 60 or 65 and retain a lifestyle which closely replicates pre-retirement years. These reports reflect a dual risk to retirement investment strategies—a low assumed rate of return for investors as interest rates and equity appreciation continue to languish in a manner similar to the *current* post-1989 Japanese macro-economic experience and a declining birth rate which may accompany sustained economic slow growth/no growth cycles. For example, Russia and Japan have been experiencing a declining birth rate for a number of years now wherein the former is a respected member of the BRIC economic bloc (Brazil, Russia, India and China) and the latter until very recently retained an unchallenged economic status second only to the United States until it was bumped to number three by China in 2010. Their economic performance for the past decade has been at best uneven.

Arguably, the reliance of U.S. households on capital investment and its subsequent appreciation creates a rather vital imperative for the SEC to succeed in restoring the investor confidence and capital formation attributes of the domestic capital markets. A component of the U.S. household stake in securities markets is due to the evolution of the overwhelming majority of private pension plans that are now structured as defined contribution plans rather than defined benefit plans thereby placing the return on asset responsibility squarely on the investor. Retirees that are tasked to invest their nest eggs undertake the responsibility seriously and certainly by now (after 10 years of up, down and where are we now) have the certain knowledge that in doing so they may win or they may lose. Unfortunately there is also now an emergent third rail attendant to the investor scenario such that it now may read win, lose or cheated.

The tragic results of the Madoff era cannot even begin to be adequately portrayed. No publication or replay of recorded testimony can truly capture the human tragedy of shattered dreams for families and foundations, retire-

ment retrograde, and even human suicide. There are a number of imminent SEC enforcement cases nearing trial, many of them with very large headlines and highly significant implications for this new era of regulatory reform. Without a doubt, the SEC has a very large side-bet on its relative success or failure to prevail upon both the applied rule of law and the merits of each particular case. In the larger picture, a.k.a., the Big Bet, while initial signs are encouraging, it remains to be seen whether the Commission will effectively rehabilitate itself in the eyes of Congress, the public, and of course, the regulated. In all likelihood the markets and investing public will know a lot more by mid-2011. In the meantime, to quote my father, the ultimate source of significant enforcement, arbitration, and settlement actions as the patriarch of a family of nine, "all will be revealed in the fullness of time."