U.S. House of Representatives

Committee on Oversight and Government Reform

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The SEC: Designed for Failure

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I. Executive Summary

- **FINDING:** Spanning nearly two decades, five Commission investigations of allegations against Bernard Madoff failed to discover that his purported trading activity was fabricated. After pulling the wool over the Commission's eyes for years, Madoff finally decided to blow the whistle on himself. Following this stunning episode, a report by the Commission's Inspector General found that Commission investigators did not understand Madoff's business; separate investigation teams did not coordinate or communicate with one another; simple, blatant project-management and follow-up failures were constant; and available information technology was not properly used.

- **FINDING:** The Commission's failed and cancelled Consolidated Supervised Entity (CSE) program, which had voluntary supervisory authority over Bear Stearns, Goldman Sachs, Lehman Brothers, Merrill Lynch, and Morgan Stanley, showcased many of the Commission's wider systemic problems. Without the necessary expertise, or even a mandate from Congress, the Commission sought to expand its bureaucratic fiefdom while many festering problems at its core were left unaddressed.

- **FINDING:** The Commission's securities disclosure processes are technologically backward. It reviews corporate filings manually, using printouts, pencils, and calculators. It has never developed the ability to perform large-scale quantitative analysis to find fraud. Commission staff use Google Finance, Yahoo! Finance, and other commercially-available resources to analyze corporate filings. If the Commission had a robust database of the financial information filed by its registrants, it could automatically prioritize the thousands of tips and complaints it receives. But no such database has ever been constructed.

- **FINDING:** Auditors, journalists, and academics – not Commission investigators – have led the pursuit of the highest-profile frauds, including Enron and Worldcom. In addition to problems detecting fraud and reporting failures in the companies it regulates, the Commission has struggled to govern itself, and failed to implement reforms recommended by the GAO and its own Inspector General.

- **FINDING:** From 1997 to 2004, the Commission conducted four staff investigations of Texas financier R. Allen Stanford, but failed to pursue him seriously until 2005. A report by the Commission's Inspector General reveals that Commission examiners concluded four times between 1997 and 2004 that Mr. Stanford's businesses were fraudulent, but each time decided not to go further. Stanford was running a Ponzi scheme that bilked investors out of $7 billion.

- **FINDING:** Despite a budget that nearly tripled between 2000 and 2010, the Commission's current Chairman and senior staff have argued that its recent failures can be addressed by increasing the agency's funding. The Commission's

regulatory and management failures, however, are caused by systemic structural and cultural problems, not lack of funding.

- **FINDING:** The Commission suffers from an acute "silo problem," which has been admitted by former Chairmen, current and former commissioners, senior staff, and the SEC Inspector General. The Commission is divided into five operating divisions and sixteen independent offices – all but three reporting directly to the Chairman. The Commission's fragmentation into operational silos has devastating effects on collaboration, encourages uninformed rulemaking, prevents effective IT investment, and generates bureaucratic rivalries.

- **FINDING:** The Commission's lawyer-heavy approach to regulation and enforcement has discouraged creativity, devalued management skills, and damaged its expertise in the financial products and industry that it regulates.

- **FINDING:** The Commission's work force of attorneys, accountants, and analysts was unionized in the 1990s, rendering the Commission effectively incapable of firing poorly-performing employees. A combination of untouchable job security, toothless performance reviews, recruiting cronyism, powerful and self-interested permanent staff, and incentives that discourage knowledge-sharing and innovation have had a predictable impact on the agency's effectiveness.

- **FINDING:** The complexity of the Commission's securities disclosure rules and forms drains resources, prevents technological innovation, and overloads the staff with lawyers. Worse, disclosures that investors cannot understand, and do not read, violate the Commission's basic philosophy of protecting investors through transparency.

- **Recommendation:** Congress should pass legislation to simplify the Commission's structure.

- **Recommendation:** Congress should insist that Chairman Schapiro fulfill her promise to appoint a Chief Operating Officer with sufficient power to change longstanding practices.

- **Recommendation:** Congress should aggressively investigate the Commission's employee hiring, firing, and review processes; internal culture; and staff incentives.

- **Recommendation:** Congress should require the Commission to overhaul, update, and simplify its securities disclosure rules and forms.

- **Recommendation:** Congress should require a detailed, independent study of the Commission's mission, organization, and work force.

II. Introduction

The mission of the U.S. Securities and Exchange Commission, an independent federal agency, is to protect investors, ensure efficient securities markets, and facilitate capital formation.[1] The Commission regulates public companies and public offerings of securities under the Securities Act of 1933[2] and the Securities Exchange Act of 1934.[3] The Commission also oversees other participants in the financial industry, including securities exchanges, brokers and dealers, investment advisers, and mutual funds.

In recent years, the Commission has suffered high-profile setbacks. Most notably, it failed to apprehend Ponzi schemer Bernard Madoff and to anticipate the financial crisis. The Commission's failures are symptoms of interlocking, systemic problems: an unworkable organizational structure, a lawyer-driven reactive approach, a counterproductive employee culture, and an overly-complex regulatory regime. These problems represent systemic risks to the Commission's mission – risks that have remained and grown more serious despite significant political change in Washington, and despite the attempts of successive Chairmen and Commissioners. As Congress considers legislative proposals to address the systemic risks in the nation's financial system,[4] it should not continue to ignore these risks.

This Report describes the Commission's most significant recent failures, outlines the long-term, systemic causes of these failures, and recommends that Congress constructively reform the agency through legislation and enhanced oversight.

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[1] *See* U.S. Securities and Exchange Commission, "The Investor's Advocate: How the SEC Protects Investors, Maintains Market Integrity, and Facilitates Capital Formation," *at* **http://www.sec.gov/about/whatwedo.shtml** (accessed April 27, 2010); *see also* National Securities Markets Improvement Act of 1996, Pub. L. 104-290, § 106 (1996) (amending Securities Act of 1933, Securities Exchange Act of 1934, and Investment Company Act of 1940 to require the Commission to consider investor protection, efficiency, competition, and capital formation in order to determine whether a proposed rulemaking is necessary and appropriate in the public interest).

[2] 15 U.S.C. § 77(a) *et seq.*

[3] 15 U.S.C. § 78(a) *et seq.*

[4] *See* Wall Street Reform and Consumer Protection Act of 2009, H.R. 4173, 111th Congress (passed by House Dec. 11, 2009); Restoring American Financial Stability Act of 2010, S. 3217, 111th Congress (introduced in Senate April 15, 2010).

III. The Commission's Regulatory and Management Failures

Starting in the late 1990s, the Commission experienced a string of regulatory and management failures that have come to light in recent years. Four episodes are particularly probative of the Commission's systemic problems: the failure of its enforcement and compliance functions to apprehend Ponzi schemer Bernard Madoff; the cancellation of its Consolidated Supervised Entity ("CSE") program; the surprising technological backwardness of its securities disclosure system; and the failure of its enforcement function to apprehend Ponzi schemer R. Allen Stanford.

The Commission's Inspector General's reports on Madoff and the CSE program have generated a great deal of media attention, but some of the the systemic problems they reveal – particularly the Commission's chronic lack of internal cooperation – are not as well-reported. Meanwhile, the disclosure system's twentieth-century approach to crucial financial-industry intelligence is little-known outside the Commission. The following discussion focuses on facts and episodes that have received less public attention.

A. The Commission's Failure to Apprehend Bernard Madoff

- **FINDING: Spanning nearly two decades, five Commission investigations of allegations against Bernard Madoff failed to discover that his purported trading activity was fabricated. After pulling the wool over the Commission's eyes for years, Madoff finally decided to blow the whistle on himself. Following this stunning episode, a report by the Commission's Inspector General found that Commission investigators did not understand Madoff's business; separate investigation teams did not coordinate or communicate with one another; simple, blatant project-management and follow-up failures were constant; and available information technology was not properly used.**

On December 10, 2008, Bernard Madoff contacted the Commission to admit that he had victimized advisory clients of his firm, Bernard L. Madoff Investment Securities LLC, in the largest Ponzi scheme in U.S. history. Since at least the early 1990s, Madoff had represented to his clients that he was investing their money in shares of common stock, options, and other securities of large, well-known corporations. Those representations were lies. Madoff never invested his victims' funds. Instead, he paid false profits directly out of their assets.[5] His firm created bogus financial statements that showed high and suspiciously consistent returns.[6] Madoff explained these returns by pretending he had developed a unique trading strategy.[7] To help conceal the fact that he was not actually trading, Madoff claimed he was making purchases in overseas markets and created account statements with falsified transactions and positions.[8]

[5] *See* Plea Allocution of Bernard L. Madoff, *United States v. Bernard L. Madoff*, 09-Cr-213(DC) (S.D.N.Y. March 12, 2009), *available at* http://www.scribd.com/doc/13219846/Bernard-Madoffs-Plea-Allocution ("Madoff Plea Allocution") at 1.

[6] *See, e.g.*, BARRON'S, *What We Wrote About Madoff*, December 22, 2008, *available at* http://online.barrons.com/article/SB122973813073623485.html.

[7] Madoff Plea Allocution, *supra*, at 2.

[8] *Id.* at 3.

The Commission's Inspector General, H. David Kotz, conducted an eight-month investigation into the Commission's failure to uncover the Madoff's scheme.[9] His exhaustive, 457-page report, released on August 31, 2009, revealed that the Commission had received warnings about Madoff and his firm many times over the 16 years before he chose to turn himself in. Anonymous informants complained to the Commission about Madoff at least three times.[10] A hedge fund manager questioned his trading and purported returns.[11] Financial magazines published articles that noted Madoff's secrecy and the uncanny consistency of his firm's financial statements.[12] During an unrelated investigation of another firm, Commission staff discovered e-mails from that firm's due-diligence investigation of Madoff which explained why Madoff's representations about his trading could not possibly be true.[13] Most significantly, derivatives expert Harry Markopolos submitted very specific and detailed complaints to the Commission in May 2000, March 2001, October 2005, and June 2007.[14]

The Commission conducted five investigations in response to these warnings, including several which lasted longer than a year and incorporated detailed reviews of Madoff's documents, site visits at his offices, or sworn testimony by Madoff himself.[15] Since the Commission can – and frequently does – request independent verification of brokers' trades from stock exchanges and other intermediaries, Madoff's lack of trades should have been quickly discovered. That discovery would have led quickly to the conclusion that Madoff was operating a Ponzi scheme. But Commission staff never took these steps.

During the same time period, numerous private entities conducting due diligence on Madoff's operations concluded that he could not be trusted and chose not to invest with his firm. The Commission – despite having vastly greater resources, compulsory subpoena power, specific and detailed complaints, and a statutory obligation – failed to notice what was evident to many in the private sector.[16] How could the Commission's investigators have failed to discover that Madoff was not making the trades he claimed, and, in fact, was not trading at all?

First, Commission staff assigned to the investigations often had no experience with equity and options trading. They did not understand Madoff's business, and therefore failed to realize what would have been clear to industry experts: that his claimed investment strategy, transactions, and returns were preposterous. The Inspector General's report describes investigations conducted by attorneys with "general litigation

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[9] U.S. Securities and Exchange Commission, Office of Investigations, *Investigation of Failure of the SEC to Uncover Bernard Madoff's Ponzi Scheme (Public Version)*, Report No. OIG-509, Aug. 31, 2009 ("IG Madoff Report"), *available at* **http://www.sec.gov/news/studies/2009/oig-509.pdf**.

[10] *Id.* at 22; *see also id.* at 430, *etc.*

[11] *Id.* at 21; *see also id.* at 77, *etc.*

[12] *Id.* at 27; *see also id.* at 86.

[13] *Id.* at 21.

[14] *Id.*at 21; *see also id.* at *passim.*

[15] *See id.* at 21. The Inspector General found that the Commission's Office of Compliance Inspections and Examinations (OCIE) conducted three for-cause examinations of Madoff and his firm, while the Commission's Division of Enforcement ("Enforcement") conducted two investigations. For convenience, this Report refers to all five inquiries as "investigations."

[16] *See id.* at 25, 411, *etc.*

experience" but no relevant knowledge, or by attorneys who had recently graduated from law school.[17] Inexperienced investigators who met with Madoff in person were overly impressed by his storytelling and name-dropping.[18]

Another consequence of the investigators' unfamiliarity with the industry they were investigating was that they often focused on the aspects of Madoff's business that they understood and ignored what they did not. Commission staff responding to one of the complaints focused on whether Madoff was engaging in front-running[19] because, in their supervisor's words, "that was the area of expertise for my crew."[20] Another investigation supervisor denied a request to expand the investigation's scope beyond front-running, telling junior examiners to "keep their eyes on the prize."[21] A third investigation focused on whether Madoff should be required to register with the SEC as an investment adviser – even though its background documents called a Ponzi scheme "highly likely."[22]

Second, the Inspector General's investigation revealed constant and consistent failures by Commission staff to coordinate their activities with other Commission divisions and offices, or even with other teams in the same office. For example, attorneys in the Division of Enforcement who investigated one of Markopolos' complaints learned that the separate Office of Compliance Investigations and Examinations (OCIE) had recently finished investigating due-diligence e-mails discussing Madoff, but they never received copies of those e-mails from OCIE. For their part, the OCIE staffers minimized their concerns in meetings with Enforcement lawyers.[23] The same Enforcement team contacted experts in the Commission's separate Office of Economic Analysis (OEA) to ask for assistance in analyzing Madoff's purported trading. OEA did not respond to the request for two and a half months.[24] Even after the two staffs finally did make contact, Enforcement never shared Markopolos' complaint with OEA and OEA never shared the most important aspects of its analysis with Enforcement.[25] Most incredibly, two OCIE teams investigated Madoff simultaneously and yet were totally unaware of one another until one of the teams learned of the parallel investigation from Madoff himself.[26] Even after Madoff told them of one another's existence, the two teams did not share their notes or compare the separate complaints they were investigating.[27]

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[17] *See, e.g., id.* at 29, 36. As a result, these attorneys did not appreciate that Madoff's explanations for his suspiciously high returns were not credible – even his claim that "[s]ome people feel the market. Some people just understand how to analyze the numbers they're looking at." IG Madoff Report at 39.

[18] *See, e.g., id.* at 18.

[19] Front-running occurs when a broker trades on his or her own account in advance of placing trades ordered by a client in order to benefit from price changes that will be caused by the client's trade. *See,* L. Loss & J. Seligman, SECURITIES REGULATION, § 9-c-1, n. 27 (3d ed. 2004).

[20] IG Madoff Report, *supra*, at 30, 93-94, 139.

[21] *Id.* at 35.

[22] The Inspector General concluded: "In fact, the Enforcement staff's investigative plan primarily involved comparing documents and information that Madoff had provided to the examination staff (which he fabricated) with documents that Madoff had sent his investors (which he also fabricated)." *Id.* at 37.

[23] *Id.* at 36, 225.

[24] *Id.* at 38, 296.

[25] *Id.* at 38. The same Enforcement team never consulted the Commission's Division of Trading and Markets, where they could have found staff with expertise in options trading. *Id.*

[26] *Id.* at 34, 132.

[27] *Id.* at 34.

Third, all of the investigations were rife with simple project-management failures, as Commission staff failed to perform logical and even routine follow-up tasks. One OCIE team drafted a letter to the National Association of Securities Dealers (NASD, now called FINRA) seeking independent data on Madoff's trades.[28] Such data would have quickly confirmed that Madoff was not trading at all. But the team never sent the letter, believing that "it would have been too time-consuming to review the data they would have obtained."[29] Another OCIE team did request independent data on Madoff's trades from a financial institution. The institution responded that there were no trades during the relevant time period, but the OCIE supervisor who received the response never forwarded it to the rest of the team.[30] One Enforcement team took Madoff's testimony under oath. Madoff gave them his account number[31] at the Depository Trust Corporation (DTC), which clears equity trades in the United States. But the staff never attempted to request trading data from DTC.[32] Several investigations were inexplicably delayed for many months after the Commission received the complaints that triggered them,[33] and several were closed without resolving most of the issues.[34] In fact, one investigation ended when senior staff ordered the investigators to stop and shift their focus to higher-priority projects.[35]

Fourth, the Commission staff failed to properly use available information technology. For example, the investigation by OCIE into the hedge fund manager's complaint was never logged into OCIE's Super Tracking and Reporting System (STARS).[36] A listing in STARS could have alerted other staff – particularly an investigation team that pursued a similar matter the following year – that a review of Madoff was ongoing.[37] Similarly, the Division of Enforcement did not create an electronic record of a matter under inquiry (MUI) for two months after receiving Markopolos' October 2005 complaint – even though the director of the Commission's Boston district office had personally transmitted the complaint to the relevant Enforcement staff to ensure it would be quickly addressed.[38] Since there was no electronic record that Madoff was the subject of an inquiry, an anonymous complaint about Madoff that the Commission received in October 2005 was never forwarded to the correct staff.[39] Moreover, the returns reported by Madoff to his

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[28] *Id.* at 24.

[29] *Id.*

[30] *Id.*

[31] *Id.* at 39, 312, *etc.*

[32] *Id.* at 39, 333, *etc.* The Inspector General's office made inquiries with DTC of the sort that the Enforcement staff should have pursued. DTC provided records showing that one Madoff account contained less than two percent of the assets that Madoff's fabricated records said it did. *Id.* at 39. Madoff himself later stated in an interview with the Inspector General that he had expected his scheme would be discovered when he provided the DTC account number: "I thought it was the end game, over. Monday morning they'll call DTC and this will be over … and it never happened." *Id.*

[33] *See, e.g., id.* at 142, 164, *etc.*

[34] *See, e.g., id.* at 32, 33.

[35] *Id.* at 35.

[36] *See, e.g.*, *id.* at 132.

[37] The Inspector General concluded, "The failure to properly track the examination and coordinate among offices resulted in embarrassment and a waste of Commission resources as two examination teams from two different offices essentially conducted the same examination." *Id.* at 142.

[38] *Id.* at 36.

[39] *Id.* at 37.

firm's customers were facially suspicious, but they were never electronically analyzed or compared with other firms' results using statistical software.[40]

Inspector General Kotz concluded that the complaints received by the Commission between 1992 and 2008 "all contained specific information and could not have been fully and adequately resolved without thoroughly examining and investigating Madoff for operating a Ponzi scheme."[41] And yet the Commission never attempted to verify Madoff's trading through an independent third party, though such verifications are commonplace,[42] and never focused on the possibility that Madoff might be running a Ponzi scheme.[43]

B. The Cancellation of the Commission's Consolidated Supervised Entity Program

- **FINDING: The Commission's failed and cancelled Consolidated Supervised Entity (CSE) program, which had voluntary supervisory authority over Bear Stearns, Goldman Sachs, Lehman Brothers, Merrill Lynch, and Morgan Stanley, showcased many of the Commission's wider systemic problems. Without the necessary expertise, or even a mandate from Congress, the Commission sought to expand its bureaucratic fiefdom while many festering problems at its core were left unaddressed.**

In 2004, the Commission created the Consolidated Supervised Entity (CSE) program, a regulatory regime that permitted large investment banking firms to voluntarily submit to the Commission's supervision.[44] The Commission has no statutory authority to regulate investment banks,[45] but it does regulate broker-dealers under the Exchange Act, including broker-dealers that are owned by larger parent companies. Under the CSE program, broker-dealers owned by investment bank holding companies could receive special exemptions from the Commission's standard net capital rules if their holding companies consented to group-wide supervision by the Commission.[46] Five firms volunteered to be regulated by the Commission in the CSE program: Bear Stearns, Goldman Sachs, Lehman Brothers, Merrill Lynch, and Morgan Stanley.

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[40] *See id.* at 299.

[41] *Id.* at 22.

[42] *See Id.* at 23.

[43] *Id.*

[44] Securities and Exchange Commission, Final Rule: Alternative Net Capital Requirements for Broker-Dealers That Are Part of Consolidated Supervised Entities, 69 Fed. Reg. 34.428 (June 21, 2004) ("CSE Rule")

[45] Like all public companies and issuers of publicly traded securities, the firms subject to the CSE program made filings with the Commission under the Securities Act and the Exchange Act, but the Commission did not, and does not, have a statutory mandate to oversee the safety and soundness of investment banks.

[46] Under the CSE program, the Commission would only extend group-wide supervision over a broker-dealer's parent company if the parent company did not already have a primary regulator. Broker-dealers owned by JP Morgan and Citigroup also applied for, and received, exemptions from the Commission's net capital rules. Since those broker-dealers' parent companies were bank holding companies already regulated by the Federal Reserve, the Commission did not include them in the CSE program. "In essence, the entire CSE program was constructed around an alternative net capital regime at the broker-dealer, which carried as a condition the affiliated holding company's consent to group-wide supervision by the Commission. This is a significant regulatory extrapolation that the Commission believed was necessary to fill a significant statutory gap." Testimony of Erik Sirri before the Subcommittee on Securities, Insurance, and Investment, May 7, 2008, *available at* **http://www.sec.gov/news/testimony/2008/ts050708ers.htm**.

Under the CSE program, these five firms were required to maintain risk management controls and report regularly on risk to the Commission; calculate a firm-wide capital adequacy measure and report the calculations to the Commission; and maintain sufficient liquidity to meet "expected cash outflows without access to unsecured financing" for at least one year.[47] The Commission, for its part, undertook to monitor the firms' risk controls and watch for "financial or operational weakness that might place regulated entities within the group or the broader financial system at risk."[48] If the Commission found weaknesses or risks, it could respond by forcing a firm to change its risk management controls, increasing its capital requirement, or requiring it to expand its liquidity pool.[49]

By September 2008, Bear Stearns collapsed and was acquired by JP Morgan; Lehman Brothers went bankrupt; Merrill Lynch signed a merger agreement with Bank of America; and both Goldman Sachs and Morgan Stanley became financial holding companies regulated by the Fed to gain access to the Fed's discount window. With no companies remaining in the CSE program, the Commission terminated it.[50]

At least two detailed inquiries into the conduct and failure of the CSE program were conducted. On September 25, 2008, the day before the program's termination, Inspector General Kotz released a report[51] evaluating the Commission's oversight of Bear Stearns. On February 8, 2010, the court-appointed bankruptcy examiner in the Lehman Brothers bankruptcy case filed his final report.[52]

The CSE program represented an attempt by the Commission to fulfill a bank regulator's role for the five financial firms – a role with which the Commission was not familiar and which Congress had not requested it to take. Given that experienced U.S. banking regulators did not arrest, or mitigate the 2008 financial crisis, it would be unreasonable to suggest that the CSE program should have succeeded where the other regulators failed. Nevertheless, the agency's short-lived experiment in taking on the role of a prudential regulator underscores the importance of management retaining its focus on the Commission's core competencies and adherence to its statutory mandates. Moreover, the findings of the Inspector General and the bankruptcy examiner provide instructive evidence of the Commission's decades-old structural and cultural problems, which magnified the inherent flaws in the design of the CSE program itself.

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[47] *Id.*; *see also* CSE Rule. CSE firms' internal risk management control systems were required to manage "the risks of the affiliate group, including market, credit, leverage, liquidity, legal, and operational risks." Testimony of Erik Sirri.

[48] *Id.*; *see also* U.S. Securities and Exchange Commission, Consolidated Supervision of Broker-Dealer Holding Companies Program Overview and Assessment Criteria, March 16, 2007, *cited in* U.S. Securities and Exchange Commission, Office of Investigations, *SEC's Oversight of Bear Stearns and Related Entities*, Report No. 446-A, Sept. 25, 2008 ("IG CSE Report"), *available at* **http://www.sec-oig.gov/Reports/AuditsInspections/2008/446-a.pdf**,at viii.

[49] *See* Testimony of Erik Sirri.

[50] Press Release, U.S. Securities and Exchange Commission, "Chairman Cox Announces End of Consolidated Supervised Entities Program," Sept. 26, 2008, *available at* **http://www.sec.gov/news/press/2008/2008-230.htm**.

[51] IG CSE Report, *supra*. The IG's investigation was prompted by a letter from Sen. Charles E. Grassley (R-IA). *See* Letter from Charles Grassley to David Kotz, April 2, 2008.

[52] Report of Anton R. Valukas, Examiner, *In re Lehman Brothers Holdings Inc.,* et al*., Debtors*, No. 08-13555 (JMP) (S.D.N.Y. March 11, 2010) (public version) ("Bankruptcy Report").

First, the Commission's Trading and Markets division (TM), which administered the CSE program, did not collaborate with other Commission offices or divisions, seek their expertise, or utilize their unique perspectives. All five firms in the CSE program were also publicly traded companies, and therefore required to file registration materials and periodic reports with the Commission's Division of Corporation Finance (CF). The information the firms were required to provide as voluntary members of the CSE program could have been cross-checked against their regular securities filings with CF, and vice versa, to ensure that both divisions were receiving accurate information.[53] But neither TM nor CF made any effort to do so.

In fact, the two divisions did not collaborate at all, except that TM staff gave CF a briefing on how the CSE program worked.[54] For example, Bear Stearns filed its annual report for 2006 on Form 10-K on February 13, 2007. CF staff reviewed the annual report and determined that Bear needed to provide more detail about its exposure, as of 2006, to subprime mortgage securities. CF requested this information in a comment letter to Bear on September 27, 2007 – seven and a half months after the original filing. Bear's reply was due ten days later, on October 12, 2007, but Bear requested – and received – multiple extensions from CF. Finally, on January 31, 2008, nearly one year after the original filing and three and a half months after the initial due date, Bear sent a reply letter that "described its criteria for classifying loans as sub-prime" and quantified its subprime mortgage investments.[55] CF then did not finish its review of the reply letter until April 2, 2008, after Bear had already collapsed.[56] Bear's more detailed descriptions of its subprime mortgage disclosures "could potentially have been beneficial to dispel the rumors that led to [its] collapse."[57] TM and CF should have worked together to prioritize CF's review of securities filings by CSEs, and insisted on quicker responses to CF's comment letters for those filings.

Likewise, the bankruptcy examiner found that Lehman's securities filings for late 2007 and early 2008 were lacking. In particular, Lehman did not disclose temporary accounting-motivated transactions and off-balance sheet arrangements, which, in hindsight, rendered its 2007 Form 10-K and quarterly report for the first quarter of 2008 misleading.[58] Although the CSE program was not designed to spot and address deficiencies in Lehman Brothers' securities filings, collaboration between the CSE program and CF might have accomplished this.

TM's coordination with other parts of the Commission was similarly inadequate. Responsibility for the CSE program's inspections had originally rested with the Commission's Office of Compliance Inspections and Examinations (OCIE), with TM in charge of CSE supervision overall. In 2007, Chairman Christopher Cox decided to transfer inspection responsibility from OCIE to TM in order to consolidate the program. The IG found that TM failed to follow up on issues OCIE had identified in previous

[53] IG CSE Report, *supra*, at 42. For example, the Commission could have determined whether a CSE firm was trying to hide risk from TM by reviewing its disclosures to CF. *Id.*

[54] *Id.* at 42.

[55] *Id.* at 45.

[56] *Id.* at 45-46.

[57] *Id.* at 46.

[58] Bankruptcy Report, *supra*, at 985, *et seq.*

inspections because "they did not view the OCIE issues as material and they assumed that these issues were OCIE's responsibility." For its part, OCIE dropped the issues after losing its inspection responsibility.[59] Moreover, TM had not developed any agreement with the Commission's separate Office of Risk Assessment (ORA) to regularly provide ORA with the information it was receiving about the CSE firms – despite the fact that risk assessment was the core of ORA's mission (and even its name).[60]

Second, TM did not employ even a rudimentary tracking system to ensure that each issue raised by its staff was properly addressed and resolved. The Inspector General noted:

> [TM's] monitoring staff mainly identify issues through meetings with CSE firm staff. Currently, TM staff document some issues … in e-mails and organize[] them by firm while other issues are documented in monthly memoranda to senior management (*e.g.*, the Division Director). However, these current methods are not reliable and do not provide an audit trail … In some instances [when queried by the IG], the staff needed to perform detailed research in order to determine how the issues were eventually resolved.[61]

The Inspector General's and the bankruptcy examiner's findings demonstrate that simple failures in management, collaboration, and tracking prevented the CSE program from exercising effective oversight. The Commission seems to have entirely overlooked the possibility of buttressing the CSE program by having CF apply extra scrutiny in its normal reviews of the five investment firms' securities filings.

C. The Commission's Ineffective Disclosure Technology

- **FINDING: The Commission's securities disclosure processes are technologically backward. It reviews corporate filings manually, using printouts, pencils, and calculators. It has never developed the ability to perform large-scale quantitative analysis to find fraud. Commission staff use Google Finance, Yahoo! Finance, and other commercially-available resources to analyze corporate filings. If the Commission had a robust database of the financial information filed by its registrants, it could automatically prioritize the thousands of tips and complaints it receives. But no such database has ever been constructed.**

The much-repeated philosophy of U.S. securities regulation is that public disclosure protects investors, ensures efficient markets, and facilitates capital formation: "Sunlight is said to be the best of disinfectants."[62] Therefore the securities laws require corporations and other regulated entities to publicly file certain disclosures, ranging from lengthy

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[59] IG CSE Report, *supra*, at 39.

[60] *Id.* at 43. As mentioned *supra*, TM also failed to take on the issues identified by OCIE when Chairman Cox transferred inspection responsibility.

[61] *Id.* at 37.

[62] Louis Brandeis, "What Publicity Can Do," HARPER'S WEEKLY, Dec. 20, 1913.

annual reports on Form 10-K to brief disclosures of stock ownership by corporate insiders. The Commission is in the business of disclosure data – collecting it from regulated entities, checking for compliance with laws and rules, looking for fraud, and disseminating it to investors and the public.

Despite concerns about information overload,[63] the volume of securities disclosures has grown exponentially in recent years. The Commission has both added new types of disclosure forms and inserted new types of disclosure requirements into existing forms. Meanwhile, information from securities disclosures is absorbed and acted upon by the markets more quickly than ever before. These developments demand that the Commission incorporate information-technology solutions to review securities disclosures more efficiently and make them more digestible for investors. But technological progress at the Commission has ranged from grindingly slow to completely nonexistent, with the result that the information investors receive is both less accurate and less useful than it should be.

First, the Commission has thus far failed to incorporate technology into its own review of securities disclosures. The Commission's Division of Corporation Finance (CF) employs hundreds of attorneys and accountants to read and check public companies' registration statements, prospectuses, proxy materials, periodic reports, and other filings. A large portion of this work consists of simple calculations. For example, a CF accountant might check to make sure that no item labeled "Miscellaneous" in a company's financial statements represents more than 10% of the total of its category, or calculate simple financial ratios using numbers contained in the statements. CF accountants also usually compare numbers from the current period with numbers from previous periods to check for unusual changes. These tasks are performed manually, using printouts, pencils, and calculators.[64] The private sector has for many years used software that automatically calculates important ratios, flags significant year-on-year changes, and checks the mathematics of financial statements. CF does not, which wastes untold amounts of highly-educated attorneys' and accountants' review time. In fact, CF officials have actively resisted internal suggestions that some manual calculations and checks could be automated to save reviewer time for the tasks that require more skill.[65]

Another common review task is to check whether various disclosure elements are present or not. For example, CF's reviewers regularly check to make sure that a company has included the required CEO and CFO certifications with its quarterly and annual reports on Forms 10-Q and 10-K, in the proper format. These disclosure elements are not tracked in any centralized system. Instead, CF's reviewers use Microsoft Word templates and create documents with typed X's indicating the presence or absence of such elements in a company's filings.[66] This makes it impossible for CF to respond quickly when a company has omitted a required disclosure element. Instead, CF reviewers compile long lists of deficiencies in a company's filings and send comprehensive comment letters to

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[63] *See, e.g.*, Troy A. Paredes, *Blinded by the Light: Information Overload and its Consequences for Securities Regulation*, WASHINGTON UNIVERSITY LAW QUARTERLY, 2003, *available at* **http://lawreview.wustl.edu/inprint/81-2/Paredes.pdf**.

[64] Interviews with Commission staff.

[65] Interviews with Commission staff.

[66] Interviews with Commission staff.

the company requesting changes. After negotiations, the company might make an amended filing. CF's internal policy for comments on annual reports, at least as of 2008, was to "send a comment letter to a firm prior to the firm's next fiscal year-end."[67] In other words, it might take eight months for CF to even contact a company about a deficient annual report, and longer for that company to file an amended report.

Second, the Commission employs no automatic, electronic screening software to check filings for indicia of fraud or errors. Outside analysts, academics, and accounting associations have developed lists of risk factors and ratios that are correlated with accounting misstatements.[68] But the Commission has not incorporated this knowledge into any comprehensive risk-monitoring software. Instead, CF relies on the eyes of its reviewers to find errors, and the Commission's Division of Enforcement relies on tips, complaints, news stories, and referrals to find fraud. The Commission has long promised to develop the ability to perform industry-wide quantitative forensic analysis. It has failed to do that, and academia has instead taken the lead in uncovering fraud through number-crunching.[69]

The Commission maintains no central electronic database of companies' financial information, other than EDGAR's electronic repository of text-based disclosure documents.[70] Commission staff use Google Finance, Yahoo! Finance, and commercially-available resources to perform or check their analyses.[71]

Because it cannot perform quantitative analysis, the Commission has no means of prioritizing the thousands of tips and complaints it receives. If the Commission had a robust database of the financial information filed by its registrants, it could automatically prioritize tips relating to registrants fitting a risk profile. But no such database has ever been constructed.[72] In September 2009, the Commission created the Division of Market Risk, which it tasked with, among other things, "strategic and long-term analysis" and "conducting research and analysis in furtherance and support of the functions of the Commission." The new Division's accomplishments remain unclear. As of April 24, 2010, its website redirected to a September 2009 press release announcing the appointment of its first director.[73] Meanwhile, the Division of Enforcement announced a new Office of Market Intelligence,[74] which, judging from published news reports, may be

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[67] IG CSE Report, *supra*, at 44.

[68] *See, e.g.*, Patricia Dechow, Weili Ge, Chad Larson, and Richard Sloan, *Predicting Material Accounting Misstatements* (working paper), American Accounting Association 2008 Financial Accounting and Reporting Section, Nov. 16, 2009, *available at* d **http://ssrn.com/abstract=997483**.

[69] *See, e.g.,* Jonathan G. Katz, *Reviewing the SEC, Reinvigorating the SEC*, forthcoming PITT. L. REV. (on file with Oversight Committee minority staff) ("Katz Article"), at 7, *citing* William Christie & Paul Schultze, *Why do NASDAQ Market Makers Avoid Odd-Eighth Quotes?*, J. FIN., Dec. 1994, at 1813 (using quantitative analysis to demonstrate collusion by NASDAQ market makers).

[70] Interviews with Commission staff.

[71] Interviews with Commission staff.

[72] Interview with Commission staff.

[73] *See* Press Release, Securities and Exchange Commission, "SEC Announces New Division of Risk, Strategy, and Financial Innovation," *available at* **http://www.sec.gov/news/press/2009/2009-199.htm** (redirected from directory of Commission divisions and offices *at* **http://www.sec.gov/divisions.shtml**).

[74] Speech, Robert Khuzami (Director, Division of Enforcement), "Remarks Before the New York City Bar: My First 100 Days as Director of Enforcement," Aug. 5, 2009, *available at* **http://www.sec.gov/news/speech/2009/spch080509rk.htm** ("Khuzami Speech").

working on the sort of "proactive analytics" that have hitherto been missing.[75] But full-scale analysis of all the data received from the Commission's regulated entities is probably still years in the future.

Third, the Commission's information technology resources are fragmented and unconnected. For one example, the agency lacks a universal internal search function. Commission staff have no automatic means of finding all of the electronic records that relate to a particular registrant – a corporation, a mutual fund, an investment adviser, or another entity. Information is scattered throughout dozens of databases; to find all the information the Commission might have about a particular company, they all must be searched.[76] Even worse, there is no consistent naming or numbering convention for regulated entities – an essential element of any enterprise-wide approach to data management.[77] The Commission's Web-accessible, public database of EDGAR filings is similarly limited. For instance, there is no means of searching within a single company's filings.[78] Investors and Commission staff who use EDGAR are faced with a "stack of electronic documents" whose component parts cannot be separately searched.[79] For another example, the Commission has no agency-wide data management policy or plan, and no Chief Data Officer. Most large organizations that deal with large amounts of electronic information have senior officers and separate departments dedicated to ensuring data quality; the Commission has neither. As a result, its data compilations are redundant and corruptible.[80]

The Commission's disclosure technology is clearly inadequate to ensure investor protection. Without electronic tools to automatically flag obvious errors and omissions in corporate filings, CF must rely on its slow, cumbersome comment-letter process to require companies to correct their filings. Similarly, without electronic tools to flag indicia of fraud, Enforcement must rely on tips, complaints, news stories, and referrals. The Commission's whole mission suffers from its failure to manage its huge data compilations.

D. The Commission's Other Regulatory and Management Failures

[75] *See, e.g.*, Securities Docket, "Details Emerge on SEC Office of Market Intelligence," Feb. 9, 2010, *at* **http://www.securitiesdocket.com/2010/02/09/details-emerge-on-sec-office-of-market-intelligence/**.

[76] Interviews with Commission staff.

[77] Interviews with Commission staff.

[78] *See* "Search the Next-Generation EDGAR System," *at* **http://www.sec.gov/edgar/searchedgar/webusers.htm** (accessed April 28, 2010).

[79] Joseph Grundfest and Alan Beller, *Reinventing the Securities Disclosure Regime: Online Questionnaires as Substitutes for Form-Based Filings* (working paper), Stanford Law and Economics Olin Working Paper No. 361; Rock Center for Corporate Governance at Stanford University Working Paper No. 2 (Aug. 4, 2008), *available at* **http://ssrn.com/abstract=1235082** ("Grundfest and Beller Working Paper"); *see also* U.S. Securities and Exchange Commission, Office of Inspector General, *EDGAR Utility to Commission Staff*, Audit No. 351 (Jan. 15, 2003), *available at* **http://www.sec-oig.gov/Reports/AuditsInspections/2003/351fin.htm** ("We found that the EDGAR system cannot extract financial statement information to automate the selection of filings for review, identify financially troubled companies or analyze financial statement information during reviews. Moreover, it cannot compare original and amended filings to show changes resulting from filing review comments"). Another significant weakness of the Web-accessible EDGAR database is that there is no notice to investors when a company amends a filing. The original filing remains accessible, with no notice that an updated filing has been made.

[80] Interviews with Commission staff.

- **FINDING: Auditors, journalists, and academics – not Commission investigators – have led the pursuit of the highest-profile frauds, including Enron and Worldcom. In addition to problems detecting fraud and reporting failures in the companies it regulates, the Commission has struggled to govern itself, and failed to implement reforms recommended by the GAO and its own Inspector General.**

The Commission's failures – to catch Bernard Madoff, achieve the goals of the CSE program, and utilize information technology – are instructive. But they are not atypical. Over the past decade, the Commission's systemic problems have been manifested in numerous other ways, including the following.

For many years, the Commission has frequently failed to detect high-profile frauds in advance. The Enron and Worldcom scandals in the early 2000s were first pursued by auditors and journalists, not Commission investigators. A wave of mutual-fund abuses in 2003 was first detected and pursued by state law enforcement authorities, not the Commission.[81] In fact, the Commission had received numerous tips, just as with Madoff, but had failed to perceive their import or follow up.[82] Academics, not Commission staff, used data analysis to uncover widespread options-backdating practices.[83] Despite conspicuous advantages – its law enforcement powers, its investigative resources, its nationwide vantage point, and its mandate to scrutinize detailed filings by public companies, broker-dealers, and other players in the financial industry – the Commission seems unable to match these efforts.

- **FINDING: From 1997 to 2004, the Commission conducted four staff investigations of Texas financier R. Allen Stanford, but failed to pursue him seriously until 2005. A report by the Commission's Inspector General reveals that Commission examiners concluded four times between 1997 and 2004 that Mr. Stanford's businesses were fraudulent, but each time decided not to go further. Stanford was running a Ponzi scheme that bilked investors out of $7 billion.**

Most recently, Inspector General Kotz issued a report finding that the Commission's Fort Worth office had become aware as early as 1997 that Texas financier Robert Allen Stanford was conducting a Ponzi scheme. But the Division of Enforcement refused to open a full investigation until 2005; the Inspector General concluded, "senior Fort Worth officials perceived that they were being judged on the numbers of cases they brought, so-called 'stats,' and communicated to the Enforcement staff that novel or complex cases were disfavored. As a result, cases like Stanford, which were not considered 'quick-hit' or 'slam-dunk' cases, were not encouraged."[84] Stanford was charged with fraud on

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[81] *See* Testimony of Richard Hillman, Director, Financial Markets and Community Investment, General Accounting Office, Before the Subcommittee on Government Efficiency and Financial Management, Committee on Government Reform, House of Representatives, April 20, 2004, *available at* **http://www.investorscoalition.com/hillmanstatement42004.pdf**

[82] Interviews with former Commission staff.

[83] *See* Katz Article, *supra*, at 8.

[84] U.S. Securities and Exchange Commission, Office of Inspector General, *Investigation of the SEC's Response to Concerns Regarding Robert Allen Stanford's Alleged Ponzi Scheme* , Case No. OIG-526 (March 31, 2010) (public

February 17, 2009.[85]

Second, the Commission has repeatedly flunked Government Accountability Office (GAO) audits, demonstrating that it is unable to manage its own finances and financial reporting. Most recently, on November 16, 2009, the GAO issued an opinion that the Commission did not have effective internal control over its financial reporting[86] and identified six significant internal control weaknesses. Among other problems, the GAO pointed out the Commission's "extensive use of manual workarounds and data handling in its financial reporting processes," such that the Commission's automatic systems could not generate useful financial reports, while its general ledger system used unconventional posting models.[87] The GAO also found that the Commission's financial reporting risk assessment and monitoring process to be inadequate; among other problems, the Commission "did not specifically include the internal risks over financial reporting; rather, the risks identified were solely external risks associated with [the Commission's] task of regulating the markets."[88] As the primary regulator of U.S. companies' compliance with accounting principles and disclosure rules – including rules that require corporate officers to certify, on pain of perjury, that their companies have no internal control weaknesses[89] – the Commission loses credibility if its own financial reporting is not in order.

Third, outside groups and commentators have frequently found fault with the Commission's internal governance. For example, in a February 2009 report, the Center for Capital Markets Competitiveness of the U.S. Chamber of Commerce examined the Commission's processes for issuing corporate no-action letters, exemptive orders for investment companies, and rule approvals for securities exchanges, and concluded, "Regulated persons and entities believe that obtaining guidance or key decisions from the SEC through these processes is increasingly difficult and unpredictable."[90] In December 2009, a study by the Project on Government Oversight (POGO) recently concluded that the Commission had failed to act on hundreds of recommendations by its IG.[91] The Commission has recently been embarrassed by revelations that 33 employees and contractors, including some senior staff, made extensive use of its computer systems to view and download pornography during work hours.[92] On April 27, 2010, the

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version released April 16, 2010), *available at* **http://www.sec.gov/news/studies/2010/oig-526.pdf** ("OIG Stanford Report"), at 17.

[85] Complaint, *Securities and Exchange Commission v. Stanford Int'l. Bank, Ltd.* et al., (S.D.N.Y. Feb. 16, 2009, *available at* **http://www.sec.gov/litigation/complaints/2009/comp20901.pdf**.

[86] Government Accountability Office, Financial Audit: Securities and Exchange Commission's Financial Statements for Fiscal Years 2009 and 2008, GAO-10-250 (Nov. 16, 2009), *available at* **http://www.gao.gov/new.items/d10250.pdf**.

[87] Government Accountability Office, Management Report: Improvements Needed in SEC's Internal Controls and Accounting Procedures, GAO-10-443R (March 31, 2010), *available at* **http://www.gao.gov/new.items/d10443r.pdf**.

[88] *Id.* at 18.

[89] *See* Sarbanes-Oxley Act of 2002, Pub. L. 107-204, §§ 302, 906.

[90] U.S. Chamber of Commerce Center for Capital Markets and Competitiveness, *Examining the Efficiency and Effectiveness of the U.S. Securities and Exchange Commission* (Feb. 2009), *available at* **http://www.uschamber.com/NR/rdonlyres/etmclmvxg2t3efi6b2gjdsp34p5wnh6l6lztnxmtbmx3xtra7ftcla3wf7nbcsvbijfmgpeivhlrhevjyxbjlr3getf/ExaminingtheSECrdcfinal.pdf** ("C of C Study").

[91] Letter from Danielle Brian, Executive Director, Project On Government Oversight, to Mary Schapiro, Dec. 16, 2009, *available at* **http://www.pogo.org/pogo-files/letters/financial-oversight/er-fra-20091216.html**.

[92] *See* U.S. Securities and Exchange Commission, Office of Inspector General, *Summary of Pornography-Related*

Commission admitted that it had not terminated any of the employees whose conduct had been investigated.[93]

Investigations Conducted by the Securities and Exchange Commission, April 22, 2010, *attached to* Letter from H. David Kotz, Inspector General, to Sen. Charles E. Grassley, April 22, 2010.

[93] Letter from H. David Kotz, Inspector General, to Sen. Charles E. Grassley, April 27, 2010.

IV. The Commission's Long-Term Systemic Problems

- **FINDING: Despite a budget that nearly tripled between 2000 and 2010, the Commission's current Chairman and senior staff have argued that its recent failures can be addressed by increasing the agency's funding. The Commission's regulatory and management failures, however, are caused by systemic structural and cultural problems, not lack of funding.**

The Commission's current Chairman and division leadership have argued that its recent failures can be addressed by increasing the agency's funding. Given that the Commission's budget nearly tripled between 2000 and 2010,[94] poor funding does not explain its failures during that decade to ferret out fraud, utilize technology, and manage itself. More staff, doing more of the same, will not help the Commission address ingrained patterns. Instead, the failures reveal systemic weaknesses that continue to imperil the Commission's ability to fulfill its mission.

Four basic weaknesses help to explain the Commission's failures: its fragmentary, "siloed" structure; an undersupply of managers and management skills among its lawyer-heavy senior leadership; a corrosive staff culture with incentives that discourage innovation and cooperation; and outdated, cumbersome disclosure rules and processes.

In a forthcoming article in the Pittsburgh Law Review,[95] Jonathan Katz, who served under seven Chairmen and four acting Chairmen as the Commission's Secretary from 1984 to 2006, points out that the Commission has repeatedly failed to pursue its mission effectively and argues persuasively that long-standing systemic problems are responsible for the Commission's regulatory failures. Unless these problems are addressed, the failures will continue. Increased funding and ad-hoc staff initiatives will not prevent them.

A. The Commission's Fragmentary Structure

- **FINDING: The Commission suffers from an acute "silo problem," which has been admitted by former Chairmen, current and former commissioners, senior staff, and the SEC Inspector General. The Commission is divided into five operating divisions and sixteen independent offices – all but three reporting directly to the Chairman. The Commission's fragmentation into operational silos has devastating effects on collaboration, encourages uninformed rulemaking, prevents effective IT investment, and generates bureaucratic rivalries.**

The Commission's single greatest weakness is its unwieldy staff structure. Divided into five operating divisions and sixteen independent offices,[96] and lacking operational

[94] *See* Securities and Exchange Commission, "Frequently Requested FOIA Document: Budget History – BA vs. Actual Obligations," June 23, 2009 *available at* http://www.sec.gov/foia/docs/budgetact.htm (showing increase in enacted budget authority from $377 million in 2000 to $960 million in 2009).

[95] Katz Article, *supra*.

[96] U.S. Securities and Exchange Commission, Organizational Chart, *available at* http://www.sec.gov/images/secorg.pdf (accessed April 24, 2010).

leadership, the agency is unmanageable. Except for three administrative offices, the head of each office and division reports directly to the Chairman. It is not possible for the Chairman and her staff to effectively manage eighteen direct reports – particularly in the light of the Chairman's extensive interagency responsibilities and high-profile public role. Former Chairmen, current and former Commissioners,[97] senior staff, and the Inspector General have all recognized that the agency suffers from a "silo problem." Nevertheless, the Commission continues to respond to criticisms and crises by adding new offices or divisions with direct reports to the Chairman.[98]

The "silo problem" has devastating effects on the Commission's ability to enforce the securities laws and regulate the financial markets. First, staff do not effectively share intelligence among separate divisions and offices. For example, Madoff might have been apprehended years before his confession if Enforcement attorneys had consulted the Office of Economic Analysis for expert advice on his purported options trading, or if OCIE examiners had communicated their concerns to Enforcement. If CF and TM had worked together to effectively regulate large investment bank holding companies, Bear Stearns' 2006 annual report might have been corrected sooner, conveying crucial information about Bear's subprime investments to the market. Lehman's inadequate disclosures in early 2008 might have been questioned, revealing a fuller picture of its problems and pushing its management to seek financing more quickly.

Second, the Commission's regulatory functions are walled off from its enforcement and examination functions. For example, when the Commission founded OCIE in the mid-1990s, it separated the examination of broker-dealers and investment companies from the divisions in charge of writing rules to regulate those entities. Professionals specializing in those entities had commonly followed a career path starting in on-site inspections and progressing eventually to rule-writing. The separation disrupted this progression. The Divisions of Trading and Markets and Investment Management now hire staff without fieldwork experience straight into rule-writing. Some observers charge that the regulatory staff have, as a result, lost their understanding of the industry.[99]

Third, the silo problem contributes to the Commission's serious information-technology weaknesses. For example, with no staff – except the Chairman, Commissioners, and their offices – taking an agency-wide view of the Commission's information needs, developing a universal search function is within nobody's job description.[100]

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[97] *See, e.g.*, Paul Atkins, Speech by SEC Commissioner: Remarks Before SIFMA's 40th Annual Seminar (April 1, 2008), *available at* **http://www.sec.gov/news/speech/2008/spch040108psa.htm** (mentioning "silo mentality").

[98] In the past six years, the Commission has created one new operating division and at least two new independent units.

[99] Interviews with former Commission staff.

[100] To be sure, the agency's technological backwardness can be attributed in part to other factors, such as unwieldy federal acquisition regulations. For example, according to former Commission staff, the electronic case-tracking system used by the Division of Enforcement, which is known as "HUB," was developed in the 2000s by unpaid interns from the Massachusetts Institute of Technology working in the Commission's Boston field office. Commission managers had been unwilling to purchase commercial case-management software of the type used by law firms because a commercial purchase, governed by the federal acquisition laws and rules, would have taken many years. Before HUB was installed, Enforcement managers had no means of taking inventory of the Commission's caseload except to "ask around the office."

Finally, the silo problem generates long-term concentrations of informal power among senior staff and cultivates counterproductive intra-agency rivalries. According to Katz: "To understand how the SEC operates, think of Germany prior to Bismarck: a series of semi-autonomous feudal states that operate autonomously in most ways and occasionally compete amongst themselves except when a common enemy appears at the border."[101] Katz's observation has been confirmed by other former Commission employees. At times, suspicion between divisions and offices manifests itself in unwarranted and counterproductive secrecy. For example, the Division of Corporation Finance keeps its review memoranda – the documents that track CF's required reviews of public companies' disclosure filings – secret from other divisions and offices.[102]

The Commission's fragmented structure is ineffective, and arguably inconsistent with its statutory mandate.[103] But the leadership of each division and office, quite understandably, would resist being subordinated and losing a direct link to the Chairman. The Commission's attempts to resolve its silo problem include new cross-divisional operating teams,[104] but unless the number of high-level officers is reduced, the problem will probably persist.

B. The Commission's Reactive, Overlawyered Approach to its Mission

- **FINDING: The Commission's lawyer-heavy approach to regulation and enforcement has discouraged creativity, devalued management skills, and damaged its expertise in the financial products and industry that it regulates.**

The Commission has heard repeated, bipartisan calls for it to take a more proactive approach to regulation and enforcement.[105] Secretary Katz describes the problems of reactive enforcement this way:

> [First,] The one common thread of [the NASDAQ fraud], Enron/Worldcom and Madoff is that each of these cases began with a public announcement, followed by an SEC investigation. In essence, the SEC investigated and put out the fire after it was clearly visible on the horizon and the damage was done. This is a systemic problem that is rooted in the SEC. It reflects the traditional perspective of a lawyer; a preference to wait for "cases and controversies."[106]

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[101] Katz Article, *supra*, at 15.

[102] Interviews with Commission staff.

[103] *See* National Securities Markets Improvement Act of 1996, *supra*, § 106.

[104] *See* Testimony by Chairman Mary Schapiro before the Financial Crisis Inquiry Commission (Jan. 14, 2010), *available at* **http://www.sec.gov/news/testimony/2010/ts011410mls.htm** ("Schapiro FCIC Testimony").

[105] *See, e.g.*, Rep. Edolphus Towns, Hearing before the Subcommittee on Government Efficiency and Financial Management of the Committee on Government Reform (April 20, 2004), *available at* **http://www.gpo.gov/fdsys/pkg/CHRG-108hhrg10895221/html/CHRG-108hhrg10895221.htm** ("For too long the SEC has been reactive to these scandals and unethical practices. We need to ensure that the SEC has the resources, tools, expertise, planning to be proactive so that it can identify and prevent abuses before they happen").

[106] Katz Article, *supra*, at 9.

> [Second, there is] a recurring staff tendency to open new investigations that mirror the hottest case of the moment … [and] the regulatory consequences are substantial. Open investigations that are not hot tend to be ignored or back burnered.[107]

Katz attributes the Commission's reactive posture to its dominance by lawyers: "Attorneys find it difficult to draft a formal order of investigation that lacks information pointing to specific misconduct by specific persons. Because the goal of every investigation is to find a violation and bring a case, broad open inquiries that do not initially identify a specific, possible violation are less appealing."[108] Every Commissioner is a lawyer; most division and office heads are lawyers; and many observers, including Commissioners and current employees, have commented on the prevalence of lawyers on the staff. The Commission needs legal expertise because the interpretation and the enforcement of the securities laws are legal tasks. But the Commission has come to overemphasize lawyers and lawyering skills. The consequences have been serious.

First, lawyers – even good lawyers – often are bad managers, and many of the Commission's signal failures are the result of poor management. Dozens of times between 1992 and 2008, Commission staff nearly discovered Madoff's Ponzi scheme, but failed to follow up on obvious leads, request independent trading records, or consult with colleagues – and their superiors did not hold them accountable for doing so. These supervision failures were continual and systemic, and worked to prevent 16 years of detailed complaints from leading to Madoff's apprehension.

The failure of the CSE program also demonstrates poor management: Commission staff who did not effectively track the issues and problems they found at investment bank holding companies did not exercise effective oversight. More recent episodes seem to further confirm that management skills are not valued at the Commission. For example, in the wake of the Madoff scandal, Chairman Schapiro announced in February 2009 that the Commission would overhaul its system for handling tips, complaints, and referrals ("TCR") in order to better prioritize information about possible securities law violations. Although the overhaul was a top Commission priority, it took nearly a year for the agency to issue a formal request for proposals from vendors.[109] Centralized operational management, clearly, is sorely lacking. Chairman Schapiro testified before the Senate in July 2009 that she would appoint a chief operating officer for the entire agency, but no further announcement has been forthcoming, nearly eleven months later.[110]

Second, lawyers often lack the type of expertise and creativity that the Commission needs to effectively regulate the complex financial industry. Recall, for instance, the OCIE

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[107] *Id.* at 11.
[108] *Id.* at 12-13.
[109] Interviews with Commission staff.
[110] Testimony by Chairman Mary Schapiro before the Subcommittee on Financial Services and General Government, U.S. Senate Committee on Appropriations (June 2, 2009), *available at* **http://www.sec.gov/news/testimony/2009/ts060209mls.htm**.

examination team with litigation experience but no options-trading experience. As Harry Markopolos testified:

> I have nothing against lawyers, but putting them in charge of supervising our capital markets has been an unmitigated disaster. Very few SEC lawyers understand the complex financial instruments of the 21st century and almost none of them have ever sat on a trading desk or worked in the industry other than in a legal capacity.[111]

Meanwhile, Katz suggests the Madoff scandal demonstrates that Commission staff responsible for the examination and regulation of broker-dealers and investment advisers were isolated from the industry:

> It is interesting, post-Madoff, to hear how many people in the industry informally questioned Madoff and his performance. Remakably, this occasional gossip never seemed to filter back to the SEC staff in a meaningful way. The agency must regain its access to talk heard on the street.[112]

The CSE program further demonstrates the Commission's need for, and lack of, staff who demonstrate original thinking. The program validated the CSEs' existing practices. TM staff may have been reluctant to challenge investment banks' assumptions that – until the housing market collapsed – seemed to be working well.

Third, Commission lawyers may be ignorant of brokers and traders, but they are quite likely to have joined the Commission from private law firms, after specializing in corporate transactions or corporate securities litigation. They are also likely to return to such practices after leaving the Commission. They are familiar with, and sympathetic to, the needs and desires of large corporate securities issuers, but much less likely to understand the perspectives of small issuers or investors.[113]

C. The Commission's Counterproductive Staff Culture and Incentives

- **FINDING: The Commission's work force of attorneys, accountants, and analysts was unionized in the 1990s, rendering the Commission effectively incapable of firing poorly-performing employees. A combination of untouchable job security, toothless performance reviews, recruiting**

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[111] Testimony by Harry Markopolos before the U.S. Senate Banking, Housing, and Urban Affairs Committee, Sept. 10, 2009, *available at* **http://www.acfe.com/documents/Markopolos-Senate-Banking-Testimony.pdf**, at Recommendation no. 1. *See also id.* at Recommendation no. 3 ("…the SEC staff is so untrained, it's almost as if this is advanced rocket science, because the SEC examiners are so inexperienced and unfamiliar with financial concepts they are afraid to interact with real finance industry professionals and choose to remain isolated in conference rooms inspecting pieces of paper"). *See also* Katz Article, *supra*, at 15("When Mr. Markopoulos suggested to Congress that the SEC staff members who read his letter did not understand it, he may well have been correct").

[112] Katz Article, *supra*, at 24-25.

[113] Interviews with Commission staff.

cronyism, powerful and self-interested permanent staff, and incentives that discourage knowledge-sharing and innovation have had a predictable impact on the agency's effectiveness.

On September 15, 2009, Oversight Committee staff were astonished to learn, during a meeting with Commission representatives, that the Commission had not fired any staff whose mistakes had contributed to the Commission's failure to apprehend Madoff.[114] Moreover, the Commission told the Oversight staff, new staffers with expertise in options trading and Ponzi schemes could not be hired until existing employees left.[115] The Commission's work force of attorneys, accountants, and analysts was unionized in the 1990s, rendering the Commission effectively incapable of firing poorly-performing employees.[116] Unionization also contributed to a toothless employee review process. As a result of litigation by employees who received bad reviews, employees are now rated either "satisfactory" or "unsatisfactory" by their supervisors, with no other scoring.[117] The union continues to oppose Chairman Schapiro's efforts to achieve a meaningful pay-for-performance regime.[118]

Meanwhile, hiring is frequently based on personal connections, rather than on other qualifications. For example, the Inspector General reported an OCIE employee's observation that "many people … appeared to be hired by the SEC more for their personal connections to other SEC employees than for any substantive experience or knowledge they possessed."[119] Such practices perpetuate the bias in favor of lawyers on the Commission's staff. Lawyers who obtain recruiting responsibilities within the Commission tend to recruit and hire people from their own career, social, and educational networks – overwhelmingly, other lawyers.[120]

The Commission also appears to have far lower turnover than comparable organizations employing attorneys and accountants.[121] Some senior permanent employees have served in the same job for decades. For example, the first Director of OCIE held that office from the time the office was created in 1995 until she resigned, following the Madoff scandal, in July 2009.[122] Senior permanent staff have accumulated so much power that they are able to prevent Chairmen and Commissioners from pursuing internally-

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[114] Interview with Commission employees, Sept. 15, 2009. Some high-ranking Commission staff, including the Directors of Enforcement and the Office of Compliance Inspections and Examinations, resigned after the Madoff scandal broke.

[115] *Id.*

[116] Interviews with former Commission staff.

[117] Interviews with former Commission staff. Litigation by unionized Commission employees appears to have contributed to problems with morale and cohesion.

[118] *See* NTEU Chapter 293, "Analysis: Pay for Performance at the SEC," Winter/Spring 2010, *available at* **http://www.secunion.org/PayforPerformanceApril2010Newsletter**.

[119] IG Madoff Report, *supra*, at 91.

[120] Interviews with Commission staff. For example, one recruiting manager, a lawyer, maintains a thick file of the resumes of job-seekers, nearly all of whom are lawyers with whom the recruiting manager has had social contact, and attempts to place these job-seekers in legal and non-legal positions throughout the Commission.

[121] Interviews with current and former Commission staff.

[122] Press Release, U.S. Securities and Exchange Commission, "Lori Richards, Director of the Office of Compliance Inspections and Examinations, to Leave SEC" (July 8, 2009), *available at* **http://www.sec.gov/news/press/2009/2009-153.htm**.

unpopular projects. Former Commission staff report an internal culture marked by entitlement, territoriality, and personal feuds.[123]

The incentives facing Commission staff are equally counterproductive. For one thing, knowledge-sharing and cooperation are practically discouraged. Employees who intend to spend their careers at the Commission seek to become indispensable; employees who intend to leave for the private sector or for other jobs in government want to enhance their marketability by developing unique expertise. Either way, they are incentivized against sharing their knowledge.[124] The U.S. Chamber of Commerce recommended a Commission-wide knowledge management program:

> Anyone who has worked at the SEC knows how extensively the agency relies upon written memos to document and memorialize staff actions or decisions not to act … It is ironic that this enormous body of information explaining decisions taken is not a readily available resource for new staff trying to understand past actions. At a minimum, the staff of the Commission should have electronic access to a searchable database of all internal memos submitted to the Commission or circulated within a division or office.[125]

The Commission has not yet announced such a program.

The metrics used by the Commission to evaluate its staff's effectiveness represent another set of counterproductive incentives. For example,

> [S]taff in the Division of Corporation Finance who review corporate disclosure filings are evaluated on the basis of the number of filings reviewed and the speed with which the review is completed … Why would a staff person choose to review the reports of Enron or carefully examine the obtuse disclosures contained in a sub-prime asset-backed securities (ABS) registration statement? Equally importantly, the measures are focused on discrete filings.[126]

Meanwhile, attorneys in the Division of Enforcement are subject to a counterproductive "hot case" mentality:

> Not surprisingly, everyone wants to conduct the hot investigation. During the 1980s, every member of the staff wanted to do insider trading or penny stock cases. In the 1990s, the staff looked for Internet frauds to investigate, no matter how small. A few years later, it was mutual fund late trading cases. Most recently, it was option-backdating cases. Today, post-Madoff, it is Ponzi schemes. And post-financial crisis, it is sub-prime

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[123] Interviews with former Commission staff.

[124] Interviews with Commission staff. The hoarding of expertise is a well-known phenomenon within the Commission, and was even discussed at a fall 2009 all-employee town hall meeting.

[125] C of C Study, *supra*, at 23.

[126] Katz Article, *supra*, at 20.

> securities. In effect, every branch and every attorney is in competition with each of the others to bring the "fraud du jour." The obvious problem with this "hot case" mentality is that it focuses reactively on the past. It diverts attention and resources away from what may be on the horizion. In the military, this is often referred to as "fighting the last war." The consequences to regulatory efficacy are substantial. Open investigations that are not "hot" tend to be ignored or left on the back burner. Unusual or complex facts or circumstances that may not be understood or those that do not fit neatly into a known type of fraud are never opened, or, if they are opened, they langish until they are closed.[127]

Many published reports purporting to explain the Commission's recent failures have focused on the lack of expertise and experience of particular staff members. The Commission's officials have similarly argued that the agency needs more staff with more experience and better training. If the Commission could avoid future failure simply by better training its staff, and by hiring better-qualified staff, then more funding would be the obvious solution. But these explanations are simplistic and unsatisfying, particularly considering that some of the Commission's worst failures happened after its funding increased during the last decade, and after Congress enacted pay parity legislation for the agency.[128] Compared to other federal employees, Commission staff are well-paid. Instead, the staff's deficit of expertise and experience – dramatically demonstrated by the Madoff scandal – appears to be the result of a corrosive culture, incentives that discourage collaboration, and inappropriate metrics.

The Division of Enforcement has begun to address some of its culture and incentive problems. In 2009, Director Robert Khuzami eliminated middle-management branch chief positions and moved those employees to investigative roles.[129] He also announced the creation of new investigating units "dedicated to particular highly specialized and complex areas of securities law."[130] But there is little evidence that other division and office directors have engaged in similar self-scrutiny.

D. The Commission's Byzantine Disclosure Regime

- **FINDING: The complexity of the Commission's securities disclosure rules and forms drains resources, prevents technological innovation, and overloads the staff with lawyers. Worse, disclosures that investors cannot understand, and do not read, violate the Commission's basic philosophy of protecting investors through transparency.**

When Congress and the Commission first created the U.S. securities disclosure system, printed paper documents were the most efficient means of collecting, disseminating, and storing such information. The securities acts required, and the Commission's rulemaking

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[127] Katz at 11.

[128] Investor and Capital Markets Fee Relief Act, Pub. L. 107-123, 115 Stat. 2390-2401 (2002).

[129] This relatively bold move met significant opposition from the Division's staff. To mitigate this opposition, the Commission either promoted every branch chief whose position was eliminated or else awarded a pay increase.

[130] *See* Khuzami Speech, *supra*; *see also* Robert Khuzami, Remarks at News Conference Announcing Enforcement Cooperation Initiative and New Senior Leaders (Jan. 13, 2010), *available at* **http://www.sec.gov/news/speech/2010/spch011310rsk.htm**.

created, a system that required companies and other participants in the financial industry to draft, print, and deliver paper disclosure documents based on forms prescribed by rule, such as Form 10-K for annual reports by issuers of publicly-traded securities. As the Commission continues to expand the disclosure requirements for regulated entities, the forms multiply and lengthen. An internal study discovered over six hundred separate forms and other submission types.[131] The primary disclosure documents run into the hundreds of pages and contain many diverse types of information, from risk factors to sales figures to directors' resumes.[132] Disclosure obligations are overly complex, and result in confusing disclosure documents; investors read only bits and pieces.[133] Secretary Katz puts it this way:

> Over an extended period of time, spanning decades, the concept of [securities] disclosure has metamorphosed from the goal of providing investors with documents containing clear and comprehensive information into documents containing highly legalistic and all-encompassing statements designed to protect the issuer from future litigation. The result has been the worst of both worlds .... The recent financial crisis demonstrates how poor or inadequate disclosure in structured finance offerings made it impossible for even the savvy institutional investors to assess the risk-reward potential of offerings. The poor quality and inadequate quantity of disclosure made it inevitable that investors would depend on credit ratings to make investment decisions.[134]

The complexity of the Commission's disclosure system has contributed to the agency's failures in several ways. First, the increasing length of the disclosure documents has generated ever-larger workloads for Commission staff in charge of reviewing the filings, and also has spawned legalistic, checklist-based review procedures. The effort required for Commission staff to understand and apply the overly complex rules crowds out time and energy for finding errors and apprehending fraud. The Division of Corporation Finance spent six months preparing a comment letter on the shortcomings of Bear Stearns' annual report on Form 10-K for 2006, then spent another six months negotiating with Bear Stearns over corrections to the filing.[135] In today's capital markets, where

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[131] Interviews with Commission staff.

[132] The order in which the form-based disclosure docuements present information follows no overarching logic. They are sequential collections of the hundreds of descriptions, certifications, recitations, specifications, and financial figures that the securities laws and the Commission's rules and forms require. Even after determining which document contains desired information, an investor may be hard-pressed to find it. The length and complexity of disclosure documents reduces the accessibility of the information investors must use. Moreover, the plain-text formatting of disclosure documents means that related pieces of disclosure information are illogically separated from one another. For instance, the investor has no automatic means of comparing a company's risk factors discussion from the current year with the corresponding discussion from the previous year. In fact, the investor cannot even easily jump back and forth between the two pieces of disclosure information – even though they directly correspond – and must manually hunt through two 10-K forms.

[133] *See, e.g.*, Speech, William Lutz, Director, 21st Century Disclosure Initiative, "The Future of Financial Reporting" (Jan. 15, 2009), *available at* d **http://www.sec.gov/news/speech/2009/spch011509wl.htm** (citing study by Commission's Office of Investor Education and Advocacy finding that "a majority of … investors surveyed never actually read the various reports. Instead, they gather that information from other sources").

[134] Katz Article, *supra*, at 28.

[135] *See* Section III.b., *supra*.

information and rumors travel instantly, Bear Stearns collapsed in a matter of days. When the Commission needs an entire year to force a company to correct crucial information, investors are left unprotected.

Second, the Commission has been unable to systematically update its disclosure rules for an electronic information age. The rules do not contemplate electronic disclosure formats. Frequently, they require paper-based methods for presenting information, such as attachments, incorporation by reference, and footnotes, that are difficult to translate into an all-electronic system. For another example, the cover pages of Forms 10-K, 10-Q, and others include checkboxes. The checkboxes indicate whether the issuer is current on its reporting obligations, whether it has posted interactive data files on its website, and whether it is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. Astonishingly, the checkboxes are not linked to any electronic database. EDGAR has no means of limiting searches based on issuers' responses to the checkboxes.

As described above, the Commission lacks a complete, element-by-element database of the information reported by public companies and other participants in the financial markets.[136] No such database will be possible without a disclosure system that eliminates form-based disclosure documents in favor of database elements. But the rules are so complex and interconnected that any comprehensive update would require a great deal of time, significant workforce devotion, and institutional determination that the Commission lacks.[137]

Third, the disclosure rules have become so complex that they can only be understood by specialized lawyers who work for the Commission and private law firms and investment banks. Some members of this elite group circulate back and forth between the Commission and the firms.[138] Maintaining the complexity of the system is in their personal financial interest.

The Commission's complex disclosure rules and forms have sapped staff resources, made technological innovation difficult, and overloaded the Commission with lawyers. They have also made raising capital ever-more expensive for public companies. However, the most important consequence of unnecessary complexity in securities disclosures is that it runs counter to the Commission's basic philosophy of investor protection through transparency. Sunlight cannot serve as disinfectant if investors cannot easily understand or use the information they receive.

Electronic information technologies, which permit data to be tagged, copied, and rearranged instantly, make the form-based documents' plain-text formatting, multiplicity, complexity, sequencing, and discrete nature unnecessary. In 2009, the Commission

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[136] *See* Section III.c., *supra*.

[137] Meanwhile, the Commission makes little effort to ensure that new disclosure rules elicit responses that are easily searchable and sortable by electronic means. Many disclosure requirements would result in more useful, searchable data if they permitted electronically-structured responses. But Oversight Committee staff have learned, for instance, that the Division of Corporation Finance does not seek input from the Office of Information Technology – or elsewhere – on the information-technology implications of its proposed disclosure rules.

[138] For example, the last three directors of the Division of Corporation Finance all had previously worked in private transactional securities practice.

began to phase in a requirement for public companies to submit their financial statements in the eXtensible Business Reporting Language (XBRL).[139] This requirement represented a leap forward for the Commission's disclosure system. Financial statements in XBRL can be automatically downloaded and fed into analysts' and users' databases for instant analysis – in stark contrast to the manual transcription necessary for plain-text financial statements. However, the Commission has not yet moved to require that non-financial information be submitted in XBRL. Moreover, it continues to require companies to file plain-text financial statements alongside the XBRL-formatted statements, which will restrain future innovation and streamlining.

[139] U.S. Securities and Exchange Commission, Final Rule: Interactive Data to Improve Financial Reporting, Securities Act Release No. 33-9002 (Jan. 30, 2009), *available at* **http://www.sec.gov/rules/final/2009/33-9002.pdf**.

V. Conclusion and Recommendations

In Congressional testimony, Chairman Schapiro stated the causes of the 2008 financial crisis; she mentioned "insufficient risk management and risk oversight by companies involved in marketing and purchasing complex financial products," and "[a] siloed financial regulatory framework that lacked the ability to monitor and reduce risks flowing across regulated entities and markets."[140] Although they were not intended as such,the Chairman's comments also neatly fit many of the regulatory failures of the SEC itself. In order to make the Commission capable of fulfilling its mission, Congress must overhaul the agency's structure; renew the call for proactive regulation and enforcement; aggressively investigate its staff problems; require it to simplify and update the securities disclosure regime; and mandate an independent study of its resources, mission, and future.

RECOMMENDATION: Congress should pass legislation to simplify the Commission's structure.

First, the Commission's structure is the single most significant barrier to its mission. Eighteen direct reports are too many for any Chairman. The multiplicity of divisions and offices provides too many opportunities for high-level permanent staff to become entrenched. Congress should therefore consider reorganizing the Commission according to its statutory mandate, with Divisions of Capital Formation, Investor Protection, and Efficient Markets.[141] Three division heads – plus, possibly, a fourth division head for a separate division of administrative services – are all of the direct reports that any Chairman can be expected to handle.[142] With a smaller number of senior managers, the Commission would function more efficiently.[143]

It is clear that Congressional action is required to alleviate the Commission's structural problems. Any chairman who attempted to pursue reforms on her own would risk alienating the agency's division and office heads if she attempted a reorganization that would result in forced demotions.

RECOMMENDATION: Congress should insist that Chairman Schapiro fulfill her promise to appoint a Chief Operating Officer with sufficient power to change longstanding practices.

The Commission has too many lawyers and too few managers. It also has lost touch with the industry it regulates. Katz observed that Wall Street gossip about Madoff, for example, "never seemed to filter back to the SEC staff in a meaningful way."[144]

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[140] Schapiro FCIC Testimony, *supra*.

[141] *See* National Securities Markets Improvement Act of 1996, *supra*, § 106.

[142] Congress should also consider mandating Presidential appointments, Senate confirmation, and limited terms for the Commission's division directors to ensure turnover and accountability.

[143] Under a more streamlined model, the Commission might function like a corporate board, providing more active oversight that is currently possible, with the division heads functioning like senior management. *See also* Katz Article, *supra*, at 23 (proposing "functional regulation" structure).

[144] Katz Article, *supra*, at 24-25.

The Commission desperately needs an agency-wide chief operating officer with clear authority over day-to-day operations and the power to challenge long-term practices and confront powerful permanent staff.[145] Congress must insist that Chairman Schapiro fulfill her promise to appoint one. Meanwhile, the Commission's dominance by lawyers has no easy legislative fix. Innovative, and even drastic, solutions should be on the table – even including, as Harry Markopolos suggested, moving the Commission's headquarters away from Washington.

RECOMMENDATION: Congress should aggressively investigate the Commission's employee hiring, firing, and review processes; internal culture; and staff incentives.

Congress must intensify its oversight of the Commission. Investigations and hearings exploring all of the issues raised by this report – detailed, thorough, and probing – are necessary to illuminate the way to effective, long-lasting reform of the nation's financial system. In particular, Congress should pursue investigations to answer the following questions:

- Has the Commission fired any employees who were responsible for recent regulatory and management failures?
- How do the Commission's turnover, employee evaluation processes, and disciplinary record compare to private-sector law firms and accounting firms?
- Have employees' appeals and lawsuits prevented the Commission from protecting the quality of its workforce?

RECOMMENDATION: Congress should require the Commission to overhaul, update, and simplify its securities disclosure rules and forms.

The Commission's disclosure rules are outdated and overly complex. Congress should require the Commission to overhaul its entire regulatory framework. If necessary, Congress should amend the Securities Act and the Exchange Act to make simplification easier.

Congress should also require the Commission to create a fully electronic system that permits each individual piece of information to be separately searchable, and utilize the system to enhance the search for errors and fraud. The new disclosure system should be a single, integrated platform for the administration of the Securities Act and the Exchange Act.[146] Compliance with the new system should be simpler and cheaper, removing barriers to capital formation. At the very least, Congress should mandate that the Commission extend its XBRL disclosure rules for corporate issuers to non-financial as well as financial information.

RECOMMENDATION: Congress should mandate a detailed, independent study of the Commission's mission, organization, and workforce.

[145] C of C Study, *supra*, at 18.

[146] For a proposal for such a platform, *see* Grundfest and Beller Working Paper, *supra*.

Since at least the 1960s, the Commission has not engaged in any enterprise-wide, systematic self-examination.[147] As part of any financial services reform, Congress should mandate and fund an independent evaluation of the agency's goals, resources, and performance. The evaluation should be supervised by former Commissioners and conducted by management consultants. It must be wide-ranging, objective, and ruthless, scrutinizing the Commission's mission, organization, and work force.

Sustainable economic recovery will depend on the stability and efficiency of the American capital markets, the affordability of capital for American public companies, and the confidence of American investors. These goals are the Commission's mission, but the Commission will be unable to carry out that mission effectively without immediate constructive criticism, legislation, and oversight by Congress.

[147] *See* Katz Article, *supra*, at 3 (describing efforts of Commission's 1960s Special Study Team to asses the Commission's operations: "In fact, the subtext mission of the group was to critically assess the operations of the SEC and advise [Chairman William Cary] on what must be done to rebuild the agency. Largely because of this second agenda, the Special Study Team operated in an independent environment. Its budget was funded by a separate Congressional appropriation and the Commissioner transmitted its final report (all seven volumes) to Congress without an endorsement").

About the Committee

The Committee on Oversight and Government Reform is the main investigative committee in the U.S. House of Representatives. It has authority to investigate the subjects within the Committee's legislative jurisdiction as well as "any matter" within the jurisdiction of the other standing House Committees. The Committee's mandate is to investigate and expose waste, fraud and abuse.

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