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by

Andrew N. Vollmer

University of Virginia School of Law

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FOUR WAYS TO IMPROVE SEC ENFORCEMENT

By Andrew N. Vollmer[*]

The enforcement program at the Securities and Exchange Commission has been the subject of severe criticism in recent years.[1] The SEC has occasionally responded with reforms,[2] but those changes have not begun

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[*] Professor of Law, General Faculty, and Director of the John W. Glynn, Jr. Law & Business Program, University of Virginia School of Law; former Deputy General Counsel of the Securities and Exchange Commission; and former partner in the securities enforcement practice of Wilmer Cutler Pickering Hale and Dorr LLP. The statements in the article are solely my own and do not necessarily reflect the views of any other person.

[1] Center for Capital Markets Competitiveness, Examining U.S. Securities and Exchange Commission Enforcement: Recommendations on Current Processes and Practices (July 2015), available at http://www.centerforcapitalmarkets.com/wp-content/uploads/2015/07/021882_SEC_Reform_FIN1.pdf ("CCMC Study"); Letter from Senator Elizabeth Warren to SEC Chair Mary Jo White 4-6 (June 2, 2015) (addressing use of admissions in enforcement settlements), available at http://www.warren.senate.gov/files/documents/2015-6-2_Warren_letter_to_SEC.pdf; Rootstrikers, Mary Jo White, the SEC, and the Revolving Door 5 (June 2015), available at http://www.valuewalk.com/wp-content/uploads/2015/06/268862403-Rootstrikers-Mary-Jo-White-the-SEC-and-the-Revolving-Door-Report1.pdf; Susan Beck, Ex-SEC Lawyer Speaks Out on Agency Failings, American Lawyer (April 16, 2014); John C. Coffey, Jr., SEC enforcement, What has gone wrong?, The CLS Blue Sky Blog (January 2, 2013), available at http://clsbluesky.law.columbia.edu/2013/01/02/sec-enforcement-what-has-gone-wrong/; Matt Taibbi, Why Isn't Wall Street in Jail?, Rolling Stone (March 3, 2011); SEC Office of Inspector General, Program Improvements Needed Within the SEC's Division of Enforcement, Report No. 467 (September 29, 2009); Minority Staffs of the Sen. Comms. on Fin. and Jud., 110th Cong., 1st Sess., The Firing of an SEC Attorney and the Investigation of Pequot Capital Management (Comm. Print 2007).

[2] See Jean Eaglesham, SEC Takes Steps to Stem Courtroom Defeats, Wall Street Journal C1 (February 14, 2014) (describing decision of Chair to require more coordination between the trial unit and the investigators in the Division of Enforcement); Chair Mary Jo White, Deploying the Full Enforcement Arsenal, Council of Institutional Investors fall conference in Chicago, IL (Sept. 26, 2013) (discussing decision to require more frequent use of admissions in enforcement settlements), available at http://www.sec.gov/News/Speech/Detail/Speech/1370539841202; 75 Fed. Reg. 49820 (August 16, 2010) (final Commission delegation of the power to issue a formal order of investigation to the Director of the Division of Enforcement); Robert Khuzami, Director, Division of Enforcement Securities and Exchange Commission, Remarks Before the New York City Bar: My First 100 Days as Director of Enforcement (August 5, 2009) (creating specialized investigation units in the Division of Enforcement and streamlining the structure of the Division), available at http://www.sec.gov/news/speech/2009/spch080509rk.htm. See also SEC Chairman Mary L. Schapiro, Address to Practising Law Institute's "SEC Speaks in 2009" Program (February 6, 2009), available at http://www.sec.gov/news/speech/2009/spch020609mls.htm.

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to root out the deeper, structural defects with the investigation and charging process at the SEC. Reforms going to the essence of the process and the way the Division of Enforcement operates are needed.

The three fundamental problems with SEC enforcement are that the Commission and the Division of Enforcement (1) advance legal theories that are outside settled boundaries, (2) misunderstand or mischaracterize the factual record, and (3) fail to accord fair and impartial treatment to persons being investigated. The result is an unacceptably high number of cases that lack merit, meaning either that the extensive evidence collected by the SEC does not support the alleged violation or that the case relies on a legal theory that is not likely to be accepted by a court.[3] One law firm study of SEC cases brought against broker-dealers, investment advisers, and their representatives in fiscal 2013 showed that 60 percent of defendants in federal court prevailed on some or all charges at summary judgment or trial. In litigated administrative proceedings, traditionally a forum favorable to the SEC, 35 percent of the charges against broker-dealers or their representatives failed and 43 percent of the charges against investment advisers or their representatives failed.[4]

These percentages are markedly high for a government agency that investigates with compulsory process for years and has total discretion about the cases and charges to bring. The system can do better and be more effective. It can extend more fairness and consideration to those being investigated without any damage to tough enforcement. Below are four ways to improve SEC enforcement: (1) use established and accepted legal theories, (2) create an objective and balanced investigative record, (3) apply rigorous, neutral standards before opening investigations and initiating cases, and (4) substantially shorten investigations. An earlier article of mine discussed a fifth possible reform: significantly narrowing investigative subpoenas.[5]

Some qualifications to all of my comments are important to state early. This article dwells on weaknesses in the process, identified from my

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3 See generally Marc D. Powers et al., A Call for Better SEC Accountability Before Bringing Insider Trading Cases, Sec. Reg. & L. Rep. (Bloomberg BNA), text accompanying n. 6 (November 17, 2014) ("the SEC over the past year has lost eleven insider trading cases or claims brought in multiple jurisdictions ... because, according to our analysis, the SEC's allegations either stretched the law or the facts well beyond reason.").

4 Sutherland Asbill & Brennan LLP, Sutherland Annual Study Finds that It Often Pays for Broker-Dealers, Investment Advisers and Their Representatives to Litigate Against the SEC and FINRA (May 14, 2014), available at http://www.sutherland.com/NewsCommentary/Press-Releases/163239/Sutherland-Annual-Study-Finds-that-It-Often-Pays-for-Broker-Dealers-Investment-Advisers-and-Their-Representatives-to-Litigate-Against-the-SEC-and-FINRA.

5 Need for Narrower Subpoenas in SEC Investigations, N.Y.L.J. 4 (October 9, 2014).

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experience as both a Commission employee and a defense lawyer, but that emphasis does not detract from the need for vigorous – but fair – enforcement of the federal securities laws as a guardian of the efficient functioning of the securities markets. Similarly, the emphasis on criticisms is not intended to fault every SEC investigation and case. My comments apply to too many SEC enforcement matters, but they do not apply to all investigations and cases. Serious securities law violations occur; repeat securities law violators infect the markets. The SEC brings many meritorious proceedings, and the Division of Enforcement has a great many dedicated, professional, and fair-minded investigators who treat the persons being investigated with objectivity, respect, and courtesy. In addition, the defense bar is not without fault in contributing to the flaws of SEC enforcement, although the quality of defense lawyers is extremely high in general.

I. LEGAL THEORIES OF LIABILITY PROPOSED DURING AN INVESTIGATION OR USED TO CHARGE A VIOLATION SHOULD BE WELL SETTLED AND WIDELY ACCEPTED AND SHOULD NOT SEEK TO EXTEND CURRENT LAW.

The first way to improve SEC enforcement is for the Commission to assert violations of law based only on well established and widely accepted legal principles and not to base claims on new, untested, and extreme legal theories. Efforts to extend current law increase the chance the SEC will lose, push the boundaries of the agency's authority to act, and deny fair treatment to a private party in the investigation or litigation.

The SEC too frequently asserts a theory of liability during an investigation or in a charging document that is beyond or inconsistent with existing precedent or settled interpretations of statutory or regulatory language, claiming that a violation of law occurred because a person failed to comply with the till then unannounced rule. The history of the SEC's position on questions of law has been that the agency seeks to expand liability to the greatest extent possible and well beyond statutory language or established precedent. This has been true for essential parts of the liability provisions, including the definition of a security, deceit, scienter, insider trading, and the "in connection with" requirement.[6] At the SEC, theories of liability in enforcement cases constantly grow and evolve to reach new situations not seen as unlawful before. They expand to fill the space available.

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[6] See, e.g., SEC v. Edwards, 540 U.S. 389 (2004) (definition of security); SEC v. Zandford, 535 U.S. 813 (2002) (in connection with); United States v. O'Hagan, 521 U.S. 642 (1997) (misappropriation theory of insider trading); Simpson v. AOL Time Warner Inc., 452 F.3d 1040 (9th Cir. 2006) (primary liability under Rule 10b-5); Flannery, SEC Release No. 3981, 2014 WL 7145625 (Dec. 15, 2014) (broad interpretations of primary liability under subparts of main anti-fraud provisions in enforcement adjudication).

The SEC has sometimes prevailed in efforts to persuade courts to adopt new and more expansive legal standards, but it also has a long series of losses on questions of law. The losses are strong evidence of unacceptable aggressiveness in asserting theories of liability. Consider a few examples.

- In case after case, the Supreme Court has rejected the legal standard for liability that the SEC, working with the Department of Justice, proposed. In *Janus*, the Court lost patience with the government's arguments for expanding application of Rule 10b-5 and rebuked the SEC: This "is not the first time this Court has disagreed with the SEC's broad view of §10(b) and Rule 10b-5," listing four earlier decisions.[7] *Janus* itself, *Morrison*, and cases on other securities law issues could be added to the list.[8]
- In an insider trading case based on the redemption of shares of an open-ended mutual fund, the court of appeals castigated the SEC for changing theories of liability at the appellate level. The SEC argued a violation based on the misappropriation theory of insider trading in the court of appeals but had argued a violation of the classical theory in the district court. The agency told the appellate court that it had not decided on one theory or the other during the district court proceedings. The Seventh Circuit referred to the "novelty of the SEC's claims in the mutual fund context," saying the SEC had never before brought a claim for insider trading in a mutual fund, and concluded that the defendant did not have fair notice of the SEC's theory of liability.[9]
- During an investigation, senior enforcement officials threatened to sue an investment adviser under an anti-fraud provision for breach-

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[7] Janus Capital Group, Inc. v. First Derivative Traders, 131 S. Ct. 2296, 2303 n. 8 (2011). The four cases were Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N. A., 511 U.S. 164, 188-191 (1994); Dirks v. SEC, 463 U.S. 646, 666, n. 27 (1983); Ernst & Ernst v. Hochfelder, 425 U.S. 185, 207 (1976); Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 746, n. 10 (1975).

[8] Chadbourne & Parke LLP v. Troice, 134 S. Ct. 1058 (2014) (rejecting government's proposed interpretation of "in connection with" in Securities Litigation Uniform Standards Act, which has same definition for Rule 10b-5); Gabelli v. SEC, 133 S. Ct. 1216, 1221 (2013) (rejecting government argument that discovery rule applied to limitations period for section 2462; government conceded it was aware of no case applying a discovery rule in a government enforcement action for civil penalties); Morrison v. National Australia Bank Ltd., 130 S. Ct. 2869, 2882 (2010) (rejecting government arguments for extraterritorial application of Rule 10b-5 and other federal securities laws); Aaron v. SEC, 446 U.S. 680 (1980) (rejecting government argument that the SEC did not need to prove scienter in a Rule 10b-5 claim); Transamerica Mortgage Advisors, Inc., 444 U.S. 11, 23 (1979) (rejecting government position that the Investment Advisers Act created an implied private action for violation of anti-fraud provision).

[9] SEC v. Bauer, 723 F.3d 758, 769-70 & n. 4 (7th Cir. 2013).

> ing its duties to a client by picking investment assets the staff claimed were not as good as other assets. The problem with the staff's approach was that the anti-fraud provision in the Investment Advisers Act has not been construed to regulate the merits of investment products an adviser purchases or recommends for a client; it requires disclosures by advisers, for example, when the adviser has a financial interest inconsistent with the client's interests, and prohibits materially false statements to an advisory customer.[10] An effort to regulate the merits of an adviser's choices by the anti-fraud law would have up-ended the industry.[11]

Several topics are currently being debated and litigated that raise the same concerns about the SEC's desire to inflate its authority. They include the poorly defined and understood concept of "scheme liability" under Rule 10b-5, uncertainty about the scope of aiding and abetting liability, and disagreements about appropriate disgorgement calculations.[12]

An additional area of controversy is the Commission's plan to begin the frequent use of Section 20(b) of the Exchange Act to charge individuals who would not be liable directly under Rule 10b-5.[13] Section 20(b) applies

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[10] See Belmont v. MB Investment Partners, Inc., 708 F.3d 470, 503, 505 (3d Cir. 2013) (the court said duties under the anti-fraud provision of the Advisers Act focus "on the avoidance or disclosure of conflicts of interest between the investment adviser and the advisory client"; the court also said "[t]he mere fact that [the defendant] made what turned out to be an ill-advised recommendation to [the investor] is not sufficient to establish a breach of" those duties).

[11] Other examples of flawed Commission legal positions include Fezzani v. Bear, Stearns & Co., 777 F.3d 566, 571 (2d Cir. 2015) (court said an SEC amicus brief "incorrectly reads our opinion"); SEC v. SIPC, 758 F.3d 357 (D.C. Cir. 2014) (court rejected every SEC argument to treat investors in the CDs of an offshore bank as customers of a related U.S. broker-dealer for purposes of the Securities Investor Protection Act); Siegel v. SEC, 592 F.3d 147, 150 (D.C. Cir. 2010) (an SEC decision affirming NASD disciplinary sanctions was "fatally flawed," "incomprehensible," and "not supported by reasoned decisionmaking" or precedent); SEC v. Steffelin, No. 11-cv-4204 (S.D.N.Y.) (transcript of October 25, 2011 hearing on motion to dismiss (pages 8, 10, 33-35, 38-39) shows that the court dismissed a claim under Section 17(a) of the Securities Act because the law was settled that the defendant did not have a fiduciary duty to investors in an entity that became the client of an adviser; the SEC later stipulated to dismiss the entire case with prejudice).

[12] See SEC v. Apuzzo, 689 F.3d 204 (2d Cir. 2012) (aiding and abetting liability); SEC v. Contorinis, 743 F.3d 296 (2d Cir. 2014) (order to disgorge profits earned by an advisory client rather than the defendant); SEC v. Goldstone, 952 F. Supp. 2d 1060, 1203-05 (D. N.M. 2013) (discussing scheme liability authorities). The SEC recently took the position that an allegation of participation in an overarching "scheme" to defraud is not sufficient for a claim under Rule 10b-5(a) and (c) and Section 17(a)(1) and (3), although, in general, the Commission broadly defined primary liability under Section 17(a) and Rule 10b-5. Flannery, SEC Release No. 3981, 2014 WL 7145625, at *29 n. 142 (Dec. 15, 2014).

[13] See, e.g., Ironridge Global Partners, LLC, Admin. Proc. File No. 3-16649 (June 23, 2015) (litigated case alleging that a company violated Section 20(b) by using a wholly-

to a person who commits a violation "through or by means of any other person." The Chair and the Enforcement Division plucked the provision from obscurity,[14] and many questions about the proper use of the provision exist. What conduct satisfies the "through or by means of" language? What actions must the defendant have taken, and what actions must the other person have taken? Does the defendant need to have controlled the other person's actions,[15] and does control mean having a power to direct the conduct of another person even if not exercised or does it mean actual exercise of the power to cause the relevant conduct? Does the provision apply only to the use of "dummy" entities?[16] What mental state does the defendant and the other person need to have? What are the proper limitations on the application of the provision?

As discussed below,[17] fairness to potential defendants demands answers to these questions before the SEC charges any further violations of Section 20(b). The courts will have the last word on the issues, and they will use traditional tools of statutory construction to determine them, but the SEC should give public notice of its views and its legal analysis on the meaning and limitations of Section 20(b). In her speech referring to the plan to use Section 20(b), the SEC Chair did not provide many details,[18]

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owned subsidiary as an unregistered broker-dealer to exchange debt for unregistered securities of issuers), available at http://www.sec.gov/litigation/admin/2015/34-75272.pdf; Houston American Energy Corp., Admin. Proc. File No. 3-16000 (April 23, 2015) (settled enforcement case asserting a Section 20(b) violation), available at http://www.sec.gov/litigation/admin/2015/33-9756.pdf; Marc J. Fagel & Monica K. Loseman, Exchange Act Section 20(b): The SEC Enforcement Division Dusts Off an Old Weapon, 18 Wall St. Law. (2014), available at http://www.gibsondunn.com/publications/Documents/Fagel-Loseman-SEC-Exchange-Act-Section-20(b)-Wall-Street-Lawyer-September-2014.pdf.

[14] SEC Chair Mary Jo White, Three Key Pressure Points in the Current Enforcement Environment, Speech to NYC Bar Association (May 19, 2014), available at http://www.sec.gov/News/Speech/Detail/Speech/1370541858285#.U4UNUF5N3wI; Yin Wilczek, SEC to Aggressively Use Obscure Provision To Pursue Individuals, Chairman Says, Bloomberg BNA Securities Law Daily (May 23, 2014).

[15] SEC v. Coffey, 493 F.2d 1304, 1318 (6th Cir. 1974) ("Under section 20(b), there must be shown to have been knowing use of a controlled person by a controlling person before a controlling person comes within its ambit.").

[16] See Stock Exchange Practices: Hearing on S. Res. 84 (72d Cong.) and S. Res. 56 and 97 (73d Cong.) before the Senate Comm. on Banking and Currency, 73d Cong., 1st Sess. 6571 (1934) (statement of Thomas G. Corcoran) (section 20 was to "prevent evasion of the provisions of the section by organizing dummies who will undertake the actual things forbidden by the section.").

[17] See text accompanying notes 21-24 below.

[18] The Chair said Section 20(b) provides a form of primary liability and does not depend on proof of a violation by another person. She also said it applies to persons who engaged in unlawful activity but attempted to insulate themselves from liability by avoiding direct communication with the defrauded investors, such as those who disseminated false or misleading information to investors through offering materials, stock promotion-

and, until the agency does, it should be hesitant to use Section 20(b) in an enforcement case.[19]

Regulating and enforcing by unelaborated and expanding legal rules raise serious issues for both the private party and the system as a whole. Once the government charges a private party, the person is labeled publicly as a law breaker, even if a small group of knowledgeable practitioners appreciates that the legal theory is new and untested, and faces severe and frequently career or business ending sanctions. The private party must incur the costs, distress, and adverse publicity associated with a defense or succumb and settle, and the pressure to settle is over-powering even when the SEC case lacks merit.

The threats to the overall system are equally grave, and here they come in two forms. First, a federal agency breaks fundamental bonds of trust and accountability in our system of democratic governance when it exceeds its governing law.[20] An Executive Branch agency must take care to stay well within the legal boundaries set by Congress or it acts as lawlessly as those who really violated the securities laws.

Second, enforcement agencies must exercise their power within established rules and precedent so regulated persons know what is required of them and may act accordingly and "so that those enforcing the law do not act in an arbitrary or discriminatory way."[21] "A fundamental principle in our legal system is that laws which regulate persons or entities must give fair notice of conduct that is forbidden or required."[22] A charge based on a new agency legal interpretation is essentially a claim against an inno-

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al materials, or earnings call transcripts but who did not have ultimate authority and control over a statement. SEC Chair Mary Jo White, Three Key Pressure Points in the Current Enforcement Environment, Speech to NYC Bar Association (May 19, 2014), available at http://www.sec.gov/News/Speech/Detail/Speech/1370541858285#.U4UNUF5N3wI.

[19] See Utility Air Regulatory Group v. EPA, 134 S. Ct. 2427, 2444 (2014) ("When an agency claims to discover in a long-extant statute an unheralded power to regulate 'a significant portion of the American economy,' [citation omitted], we typically greet its announcement with a measure of skepticism.").

[20] City of Arlington v. FCC, 133 S. Ct. 1863, 1868 (2013) ("No matter how it is framed, the question a court faces when confronted with an agency's interpretation of a statute it administers is always, simply, *whether the agency has stayed within the bounds of its statutory authority*.") (emphasis in original); Louisiana Pub. Serv. Comm'n v. FCC, 476 U.S. 355, 374 (1986) ("an agency literally has no power to act ... unless and until Congress confers power upon it"); Stark v. Wickard, 321 U.S. 288, 309 (1944) ("When Congress passes an Act empowering administrative agencies to carry on governmental activities, the power of those agencies is circumscribed by the authority granted."); California Independent Sys. Operator Corp. v. FERC, 372 F.3d 395, 398 (D.C. Cir. 2004) (a federal agency is a creature of statute, has no constitutional or common law existence or authority, and has only those authorities conferred on it by Congress).

[21] FCC v. Fox Television Stations, Inc., 132 S. Ct. 2307, 2317 (2012).

[22] Id.

cent person. "It is one thing to expect regulated parties to conform their conduct to an agency's interpretations once the agency announces them; it is quite another to require regulated parties to divine the agency's interpretations in advance or else be held liable when the agency announces its interpretations for the first time in an enforcement proceeding and demands deference."[23] An SEC enforcement case based on an interpretation that has not been properly communicated to the public is not valid.[24]

Thus, when the Chair said SEC enforcement should be "aggressive and creative,"[25] she sent the wrong message to her staff. Expansive, untested theories of law to impose liability weaken the SEC's enforcement efforts, short-change investigations of core misconduct, mistreat the private parties who must respond, and breach a trust between the agency and the country. One way to improve the SEC enforcement process therefore is to reward the staff for recommending cases based on established and accepted legal doctrines and to eschew over-reaching legal positions.

II. **THE STAFF'S AND COMMISSION'S VIEW OF THE EVIDENTIARY RECORD SHOULD BE OPEN-MINDED, OBJECTIVE, AND BALANCED.**

A second way to improve SEC enforcement is for the staff to collect and evaluate evidence of a possible violation neutrally and fairly. When the staff recommends or the Commission brings an enforcement action with one-sided or incomplete evidence, the agency increases the chances it will lose, wastes resources, and harms the private parties that are involved.

The purpose of an enforcement investigation is to collect factual information in a balanced and fair-minded way to understand what happened and whether a violation appears to have occurred. It is not intended to be a feint for a prejudged outcome or an opportunity to assemble a partial picture that can be touted publicly as villainous misconduct. The investigating staff must bring an objective, clear-eyed, and open-minded approach to the collection of evidence.

The main problem in this area is that many times the staff starts with a predisposition that the person under investigation violated the se-

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[23] Christopher v. SmithKline Beecham Corp., 132 S. Ct. 2156, 2168 (2012).

[24] In SEC v. Upton, 75 F.3d 92, 97-98 (2d Cir. 1996), the court vacated a Commission disciplinary sanction against a broker-dealer employee because the defendant was not on reasonable notice that the broker-dealer was violating an SEC rule. "The Commission may not sanction [the defendant] pursuant to a substantial change in its enforcement policy that was not reasonably communicated to the public." Neither a settled SEC enforcement case nor informal guidance during a regulatory examination qualified as reasonable notice.

[25] Chair Mary Jo White, Deploying the Full Enforcement Arsenal, Council of Institutional Investors fall conference in Chicago, IL, (Sept. 26, 2013), available at http://www.sec.gov/News/Speech/Detail/Speech/1370539841202.

curities laws. It is just a matter of finding the evidence of the violation. The staff is committed to "winning," which means having the Commission authorize a proceeding, and that will-to-win warps the fact-gathering process. The staff looks so hard for something that seems wrong or that can be portrayed as wrong that they lose perspective and objectivity.

The attitude causes the staff to misunderstand legitimate market practices, misinterpret emails and other evidence, distort and exaggerate snippets of emails out of context, and ignore the larger, often far more benign, picture conveyed by the evidence. Time and again, the staff will quote a sentence or phrase from a string of emails, ignore the overall meaning of the exchange, and assert as a fact a hypothesis about the communications that is not substantially supported by the weight of the other evidence. They disregard or discount exculpatory testimony as self-serving even when a string of witnesses with differing interests relate a consistent story.

As a result, the staff builds an evidentiary record that succeeds in persuading the Commissioners to approve an enforcement case but that forms a flawed and rickety basis for the enforcement charges. A few cases illustrate.

- A case against a broker-dealer employee accused of market timing collapsed in large part at the trial and then entirely on appeal. The jury rejected all the SEC's claims of intentional misconduct but found that some of the defendant's actions were negligent. The court of appeals reversed the remaining negligence claims because of the insufficiency of the evidence.[26]
- The Commission charged that a CEO tipped a friend about the sale of the CEO's company and that the friend, who was the defendant, then traded in the company's securities before public announcement of the deal. The court held a bench trial, found for the defendant, and upbraided the SEC for its case. It cited "the overreaching, self-serving interpretation that the SEC imposed on the evidence presented at trial" and said the SEC had selected "an interpretation of the evidence that ignores other interpretations that discredit the SEC's … theory." The SEC provided no evidence of the content of any tipping communication between the CEO and the friend and failed to satisfy its burden of proof that the defendant had material, non-public information about the company. Indeed, the CEO had convincingly discredited the SEC's evidence.[27]

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[26] SEC v. Ginder, 752 F.3d 569 (2d Cir. 2014).

[27] SEC v. Schvacho, 991 F. Supp. 2d 1284 (N.D. Ga. 2014). See also SEC v. Benger, No. 09 C 676 (N.D. Ill. August 13, 2014), available at https://scholar.google.com/scholar_case?case=14135904855985147199&q=SEC+v.+Benger&hl=en&as_sdt=3,47 (magistrate refused to enter the broad injunction the SEC re-

- In a 2010 case concerning credit default swaps, the court conducted a bench trial and rejected the SEC's charges. Time and again the court said: "the SEC produced no evidence," "the SEC has failed to prove," and the "SEC has not established" necessary elements of the insider trading claim. The judge referred to the "ample evidence that undercuts the SEC's theory that the defendants engaged in insider trading."[28]
- In 2013, the Commission sued unnamed traders in call options of Onyx stock and froze several broker-dealer accounts in the United States. The trades occurred shortly before Onyx publicly announced that another company made an unsolicited bid for Onyx. Two individuals who had traded the options and had proceeds in the broker-dealer accounts came forward and moved to dismiss the complaint. The court granted that motion using language highly critical of the SEC: The complaint was based "upon information and belief," but essential allegations were "all belief and no information."[29] The "factual allegations in this case are insufficient to support a reasonable inference of insider trading. There is no indication that the SEC knows whether material nonpublic information was tipped, who did the tipping, or who received the tip. It is impossible to infer that the Defendants acted with a culpable state of mind in the absence of that information."[30]

Overreaching also occurs in criminal securities fraud cases. In a case alleging accounting misconduct by a CFO, a court of appeals reversed a jury conviction because the government failed to prove key elements of the counts. Judge Kozinski added these harsh words about the government's case: "in the end, the government couldn't prove that the defendant engaged in *any* criminal conduct. This is just one of a string of recent cases in which courts have found that federal prosecutors overreached by trying to stretch criminal law beyond its proper bounds."[31]

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quested, criticizing the SEC for its inability to cite a case to support its request and for its selective quotation of emails from the defendant, whose full text, in the court's view, showed the defendant in a much more favorable light).

[28] SEC v. Rorech, 720 F. Supp. 2d 367, 371-73 (S.D.N.Y. 2010)

[29] SEC v. One or More Unknown Traders in the Securities of Onyx Pharmaceuticals, Inc., 296 F.R.D. 241, 250-51 (S.D.N.Y. 2013).

[30] Id. at 254. The SEC staff collected further information and filed an amended complaint against the two traders. The court denied a motion to dismiss the amended complaint. SEC v. One or More Unknown Traders in the Securities of Onyx Pharmaceuticals, Inc., 2014 WL 5026153 (S.D.N.Y.).

[31] United States v. Goyal, 629 F.3d 912, 922 (9th Cir. 2010) (Kozinski, J., concurring) (emphasis in original).

The solution to this set of problems is tighter internal management and discipline. From the beginning, the investigating staff should gather evidence with a view to both wrongdoing and innocent explanations. The key factual assertions supporting a violation must be tested and potential alternative explanations must be discussed. Senior enforcement officials must dig into the evidentiary record on a selective basis to verify the staff's description. They must examine key documents, read portions of the testimony of important witnesses, and read defense submissions. At critical phases of an investigation, both senior and investigating staff should take a few steps back and with an objective, unblinking eye consider how a neutral fact-finder would evaluate the totality of the admissible evidence from both the SEC and the defendant. How strong are the documents, the witnesses, and the experts, and is the misconduct and harm sufficiently clear and severe to justify an enforcement action.

III. THE SEC SHOULD BEGIN A FORMAL INVESTIGATION WHEN CREDIBLE EVIDENCE PROVIDES A REASONABLE SUSPICION ABOUT A POSSIBLE VIOLATION AND THE MATTER MERITS THE USE OF SCARCE RESOURCES; IT SHOULD INITIATE AN ENFORCEMENT CASE WHEN THE COMMISSION IS MORE LIKELY THAN NOT TO PREVAIL ON THE FACTS AND THE LAW AND THE PROCEEDING WOULD SERVE VALID ENFORCEMENT GOALS.

A third way to improve SEC enforcement is to apply neutral standards when beginning a formal investigation or an enforcement case. The SEC, before opening a formal investigation, should have a reasonable basis to believe a violation might have occurred and, before bringing a case, should reasonably expect to be correct about its legal theory and the relevant facts and evidence. In both situations, the action should advance an enforcement priority and should be aimed at achieving benefits that outweigh the use of the resources. These standards would not seem to be controversial, but in many cases they are not followed. Over the years, enforcement decisions have been susceptible to undue influence from factors other than the merits.

The SEC has become too reactive to pressure from the press, Congress, and other regulators. Concern about a hostile congressional hearing, letter, or statement, a negative media report, or the imminent enforcement action of a competitive regulatory agency puts a thumb on the scale when the SEC decides to initiate an investigation or bring an enforcement case. Examples include investigations into sudden and severe market declines, the structuring of collateralized debt obligations, market

timing,[32] auction rate securities,[33] and options backdating. Isolated instances of misconduct were uncovered in some of these areas, but the costs to the SEC and innocent parties were disproportionately high.

Alarm about high frequency trading ("HFT") seems to fit into this same pattern. The SEC, market participants, and scholars are knowledgeable about HFT,[34] yet you would hardly know that from the reaction to a journalist's publication of a pop account of high speed trading. Not long after that account began to receive widespread attention, the SEC and Department of Justice made known that they had launched investigations.[35] Private plaintiffs filed a sprawling class action complaint.[36]

When enforcement activity results from external pressures instead of an expert evaluation of the merits, the system and private parties suffer. The SEC shifts resources away from higher priority areas selected by its more traditional criteria.[37] Weak cases on the law or the facts are brought. Conduct that could well have been lawful and socially beneficial is condemned because of the adverse public distortions.

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32 The SEC and state regulators obtained settlements in many market timing cases, but, as mentioned above, the SEC was completely unsuccessful in a litigated case. SEC v. Ginder, 752 F.3d 569 (2d Cir. 2014).

33 After the SEC brought many settled enforcement cases for problems with auction rate securities, the Second Circuit turned back a series of private cases alleging fraud and manipulation in that market. See, e.g., Louisiana Pacific Corp. v. Merrill Lynch & Co., 571 Fed. Appx. 8 (2d Cir. 2014) (summary order) ("We have thrice rejected this theory of liability on the grounds that investors were sufficiently on notice of the liquidity risks inherent in ARS (and the market was therefore not misled)").

34 See SEC, Concept Release on Equity Market Structure, 75 Fed. Reg. 3594 (January 21, 2010); Staff of the Division of Trading and Markets of the SEC, Equity Market Structure Literature Review, Part II: High Frequency Trading (March 18, 2014), available at http://www.sec.gov/marketstructure/research/hft_lit_review_march_2014.pdf; Staff of the Division of Trading and Markets of the SEC, Equity Market Structure Literature Review, Part I: Market Fragmentation (October 7, 2013), available at http://www.sec.gov/marketstructure/research/fragmentation-lit-review-100713.pdf.

35 See Mayer Brown, Increased Public and Private Scrutiny of High-Frequency Trading (May 14, 2014), available at http://www.mayerbrown.com/files/Publication/272e9281-0ab5-481d-b98b-bca0b872e344/Presentation/PublicationAttachment/53b4f4ad-1a78-4553-9ede-d850bf05458c/UPDATE_Increased_Public-Private_Scrutiny_0514.pdf; Rob Tricchinelli, "The Markets Are Not Rigged," SEC Chair Says of High Speed Trading, Sec. Reg. & L. Rep. (Bloomberg BNA) (May 5, 2014).

36 City of Providence, Rhode Island v. BATS Global Markets, Inc., No. 14-cv-2811 (S.D.N.Y. filed April 18, 2014).

37 See Stephen J. Choi et al., Scandal Enforcement at the SEC: The Arc of the Option Backdating Investigations, 15 Am. L. & Econ. Rev. 542 (2013) (finding that, in the wake of many media articles on the practice of options backdating, the SEC shifted its mix of investigations significantly toward backdating investigations and away from investigations involving other accounting issues).

The effect of an investigation or proceeding on private parties can be devastating. An SEC Canon of Ethics minces no words on this topic when it states: "The power to investigate carries with it the power to defame and destroy."[38] The need to respond to SEC requests distracts management from business affairs, slows growth or recovery, and delays capital investment or new lines of business. Information about an investigation or a case can leak or be disclosed to customers or the public, tarnishing reputations and threatening the revenue, profits, or even the continued operation of the business. Companies many times feel they must sideline or fire individuals who are under suspicion. The expenses of outside counsel, document production, and testimony can run in the millions of dollars.[39]

Because of this potential for damage, the SEC should guard against inappropriate influences when beginning an investigation or an enforcement case. Section 2.3.2 of the Enforcement Manual already describes an acceptable approach to opening a formal investigation, but the process is not rigorously followed and should be strengthened with additional controls. The staff should have credible evidence providing a reasonable suspicion of a possible violation[40] and should consider the severity of the possible misconduct and the size of the potential loss or victim group. They also should consider whether the case fits within an existing enforcement priority. The Commission and Division should resist the temptation to respond to uninformed pressure to pursue the latest headline or to congressional or press second-guessing.

After an investigation, the senior staff of the Division of Enforcement should not recommend enforcement action and the Commissioners should not authorize a proceeding unless they believe a reasonable person would conclude that the SEC is more likely than not to prevail on the facts and the law. In addition, they should determine that a proceeding would serve broad and legitimate enforcement goals of deterrence or prevention. The Commission should not compromise on these standards just to add another case to the statistics on the number of cases brought in a year, a

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[38] 17 C.F.R. § 200.66.

[39] See CCMC Study, note 1 above, at 39-40 (survey of expenses of informal and formal investigations); Nelson Obus, Refusing to Buckle to SEC Intimidation, Wall Street Journal A15 (June 25, 2014) (after jury found no liability, author described experience with SEC enforcement: "our story is only one example of unbridled regulatory overreach without accountability"; "the potential cost and distraction of an extended investigation could be intimidating" with "the possibility that investors could depart"; eight "grueling years passed before we had our day in court"; costs included "more than $12 million in legal and trial expenses," "inordinate amounts of time and distraction, and untold opportunity cost to our business").

[40] The SEC's regulations require the agency to have an evidentiary basis to open an investigation. A rule states that an investigation commences when, from complaints or otherwise, "it appears that there may be violation." 17 C.F.R. § 202.5(a).

measurement that creates bad incentives for both the Commissioners and the staff.[41]

Some SEC staff members are not ashamed of being willing to lose and bringing a case that is a close call on the law or the facts,[42] but that is a view worth re-thinking. If a case is a close call, that is, if the SEC personnel are not able in good faith to conclude that the agency is more likely than not to be successful, the Commission and the staff do not have sufficient confidence that the defendant's conduct was a violation. Put another way, if, under an objective assessment, the conduct was more likely to have been lawful than to have been unlawful on the facts or the law, the SEC would be asserting a violation for conduct that was probably permissible at the time. In those cases, the SEC should not proceed by enforcement. Suing is not being "tough" or "aggressive"; it is being arbitrary and tyrannical. The case should not be approved on the ground that it is worth a risk of losing or that the conduct "should be" unlawful. These types of rationalizations are not appropriate for a government law enforcement agency. Close calls must go to the private party and not to the government. If the conduct is more than isolated and raises concerns about social harms, the Commission has a wide variety of tools other than enforcement it may use to address the issue, such as rulemaking, recommended legislation, referral to another agency, Section 21(a) reports, speeches, congressional testimony, and staff guidance.

IV. THE LENGTH OF INVESTIGATIONS SHOULD BE MUCH SHORTER.

Another area worth attention is the time SEC investigations take. Potential wrongdoing must be investigated promptly and charges, when justified, must be brought promptly to serve a range of important interests. Avoiding delay during investigations helps deter, uses SEC resources efficiently, reduces uncertainty and costs for private parties, keeps evidence fresh, and promotes finality.

Unfortunately, investigations lasting for many years are the norm.[43] According to respondents in a recent survey, 26 percent of formal investi-

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[41] The study of the SEC enforcement process by the Center for Capital Markets Competitiveness of the U.S. Chamber of Commerce also observed ill effects from the undue emphasis on the number of cases brought. See CCMC Study, note 1 above, at 43-44.

[42] See Yin Wilczek, SEC Monetary Penalties to Be Larger, More Common, Official Says, Bloomberg BNA Securities Law Daily (June 20, 2014) (reporting remarks from SEC enforcement official); Insider Trading Gets More Sophisticated, So Regulators Must Follow Suit, Panel Says, Bloomberg BNA Securities Law Daily (January 16, 2014) (same).

[43] See Andrew N. Vollmer, Need for Narrower Subpoenas in SEC Investigations, N.Y.L.J. 4, 9 (October 9, 2014) (giving examples of long investigations).

gations took one to three years to complete and another 26 percent took over three years; 16 percent finished in less than a year.[44]

Long investigations mean that trials, when they occur, reconstruct old events and depend on aged evidence. In April and May 2014, the SEC successfully tried a case against the Wyly brothers. Much of the conduct alleged in the complaint occurred in the 1990s, although some extended to the early or mid-2000s. The Commission staff learned information to begin an investigation at least by November 2004 and entered into several tolling agreements with the Wylys, but the SEC did not file its complaint until July 2010, nearly 6 years later.[45] The Kovzan trial in November 2013 examined events from 2002-2006, which was 7 to 11 years after they occurred.[46] The Tourre trial in July and August 2013 concerned conduct in early 2007,[47] more than 6 years earlier.

The problem of lengthy investigations has existed for years. Chairman Harvey Pitt famously promised real time enforcement in 2002,[48] and, in the Dodd-Frank Act, Congress expressed frustration with enforcement delays, requiring the Commission to file an action or decide not to sue

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44 See CCMC Study, note 1 above, at 38-39.

45 Bob Van Voris & Patricia Hurtado, Wylys Found Liable of Using Offshore Trusts to Hide Trades, Bloomberg BNA Sec. L. Daily (May 13, 2014); John Carreyrou, Civil Trial To Start of Wyly Brothers in SEC Tax-Haven Case (March 30, 2014), available at http://online.wsj.com/news/articles/SB10001424052702304157204579471364109869216; Complaint, SEC v. Wyly, No. 10-CV-5760 (S.D.N.Y. filed July 29, 2010).

46 SEC, Jury Finds Stephen Kovzan Not Liable for Securities Violations, Litigation Release No. 22918 (February 4, 2014), available at https://www.sec.gov/litigation/litreleases/2014/lr22918.htm; SEC, SEC Charges NIC, Inc. and Four Current or Former Executives for Failing to Disclose CEO Perquisites, Litigation Release No. 21809 (January 12, 2011), available at http://www.sec.gov/litigation/litreleases/2011/lr21809.htm.

47 Susanne Craig, Fabrice Tourre Seeks a New Trial (October 1, 2013), available at http://dealbook.nytimes.com/2013/10/01/fabrice-tourre-seeks-a-new-trial/?_php=true&_type=blogs&_r=0; SEC, The SEC Charges Goldman Sachs With Fraud In Connection With The Structuring And Marketing of A Synthetic CDO, Litigation Release No. 21489 (April 16, 2010), available at http://www.sec.gov/litigation/litreleases/2010/lr21489.htm.

48 Testimony Concerning Appropriations for Fiscal 2003, by Harvey L. Pitt Chairman, Securities and Exchange Commission, Before the Subcommittee on Commerce, Justice, State, and the Judiciary Committee on Appropriations, United States Senate (March 7, 2002) ("One of our major new initiatives -- "real-time" enforcement -- is ... to provide quicker, and more effective, protection for investors, and better oversight of the markets with our limited enforcement resources. ... [T]he SEC must resolve cases and investigations *before* investors' funds vanish forever ....") (emphasis in original), available at https://www.sec.gov/news/testimony/030702tshlp.htm; Speech by Chairman Harvey L. Pitt, Securities & Exchange Commission, Fall Meeting of the ABA's Committee on Federal Regulation of Securities (November 16, 2001), available at http://www.sec.gov/news/speech/spch524.htm.

within 180 days of a written Wells notification, subject to extensions for complexity.[49]

Nonetheless, investigations continue to take too long. At the moment, staff requests for tolling agreements are not uncommon, and a series of extensions is not rare. The staff avoids sending a written Wells notification to circumvent the time limit added by the Dodd-Frank Act.[50]

The main reason for prolonged investigations, especially since the Madoff affair, is the staff's reluctance to close an investigation because of a fear of overlooking a serious issue or of being criticized for failing to enforce the securities laws vigorously.[51] Other obstacles also exist, such as complexity of the issues, high workload, and changing priorities.

Extended investigations disserve the enforcement process and the persons being investigated. The delays increase the costs of defense and the burdens on private parties. Lengthy investigations create uncertainty for both companies and individuals, and uncertainty about the SEC's plans can harm reputations, stall careers, and postpone financings and investments, research, and product development.

The delays also seriously harm the quality of justice and the SEC's cases. As the Supreme Court regularly reminds us, time limits for beginning legal proceedings serve weighty social goals:

> repose, elimination of stale claims, and certainty about a plaintiff's opportunity for recovery and a defendant's potential liabilities. Statutes of limitations are intended to promote justice by preventing surprises through the revival of claims that have been allowed to slumber until evidence has been lost, memories have faded, and witnesses have disappeared. They provide security and stability to human affairs. We have deemed them vital to the welfare of society and concluded that even wrongdoers are entitled to assume that their sins may be forgotten ….[52]

The problems with delayed justice listed by the Supreme Court are real. Anyone experienced with the extended SEC investigation and litigation process knows that documents are lost, data are misplaced, and memories degrade. The passage of time blurs the picture that can be presented to senior staff, the Commission, or a judge or jury and raises seri-

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49 15 U.S.C. § 78d-5(a).

50 See CCMC Study, note 1 above, at 22.

51 See id. at 43; Kara Scannell, SEC Watchdog Faults Agency in a Bear Case, Wall Street Journal (October 11, 2008), available at http://online.wsj.com/news/articles/SB122369284039125491.

52 Gabelli v. SEC. 133 S. Ct. 1216, 1221 (2013) (quotation marks and citations omitted).

ous questions about the accuracy of the factual foundation used to determine whether a violation of law occurred. Whether the inaccuracy systematically favors the SEC or the defendant is not clear, but the Commission should not tolerate a system suspected of producing questionable outcomes.

Possible solutions are available, but they depend on more disciplined internal management. During the periodic internal reviews of the inventory of investigations, senior Enforcement officials must be more discerning and ruthless about terminating or accelerating investigations. All staff should make decisions about things not to do. They should narrow requests for documents[53] and reduce the number of individuals called for testimony. They should limit testimony of a witness to one day of seven hours absent compelling need approved by an Associate Director or higher. They should set internal deadlines for reviewing documents and testimony transcripts shortly after they are received and for making decisions on Wells calls and enforcement recommendations. The staff should move things along rather than let investigations idle for months after the last response from persons requested to provide information.

Typically, the SEC tries to meet concerns about the length of its investigations by shortening the time allowed for responses from persons being investigated. The norm is for the staff to give a person two weeks to comply with a long, complicated subpoena or to make a Wells submission in a complex matter that has been under investigation for years. Nearly every time period set for responses from private parties is unreasonably and unrealistically short. This is <u>not</u> the solution to the length of investigations. The SEC staff should shorten the amount of time they take on tasks but must give private parties reasonable amounts of time to respond to requests for information or Wells calls.

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Vigorous enforcement is essential to the smooth and reliable operation of the U.S. securities markets. That is why the Commission and the Division of Enforcement periodically must re-evaluate the actual operation of the enforcement process to assess whether it is achieving its goals of setting the right priorities, bringing strong, meritorious cases, closing investigations of innocent or marginal behavior quickly, and fairly treating the legitimate interests of the private parties being investigated. Improvements in the four areas discussed above would be a start on reviving the process.

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53 See Andrew N. Vollmer, Need for Narrower Subpoenas in SEC Investigations, N.Y.L.J. 4, 9 (October 9, 2014).