Remarks to the Securities Enforcement Forum 2014

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Good morning. Thank you, Bruce [Carton], for that wonderful introduction. I appreciate the opportunity to be here today in the company of such a large number of distinguished practitioners in the field of securities enforcement.

As the website for today's conference proclaimed, the forum will "address the most pressing and important issues and trends in the world of civil and criminal securities enforcement."[1] I will try to do my part in this endeavor. But as with the other Commission speakers, the views I express today are my own and do not necessarily represent the views of the Commission or the other commissioners.

I have enjoyed my time at the Commission since joining about 14 months ago with my good friend and colleague from the Senate Banking Committee staff, Commissioner Kara Stein. We came to the Commission only four months after Chair Mary Jo White took office. One of Chair White's earliest decisions was to ask Andrew Ceresney to join the Commission staff as co-director of the Division of Enforcement. With all of these new faces at the Commission and on the staff, there was an adjustment period while everyone learned the new dynamics, personalities and preferences. Fortunately, this transition period quickly passed and the Commission is now handling enforcement matters in a productive manner. A good deal of the credit goes to the leadership of Chair White and Enforcement Director Ceresney.

I believe that I am only the third Ph.D. economist to serve as an SEC commissioner. As a non-lawyer, in an agency that tends to be dominated by lawyers, I have often been asked for my perspectives about the law, especially as it applies to actions undertaken by the Commission.

Due Process and SEC Enforcement

Our legal obligations start at the top – with the Constitution. As Commissioner, I took a sworn oath to "support and defend the Constitution of the United States against all enemies, foreign and domestic."[2] One of the most important protections enshrined in the Constitution is in the Bill of Rights. The Fifth Amendment states that "no person shall . . . be deprived of life, liberty, or property, without due process of law."

For me, due process starts with fundamental notions of fairness. Persons should be on notice as to what acts, or failures to act, constitute violations of the law and our regulations. Persons should also be on notice as to the potential sanctions and liabilities that may be imposed as a result of those violations.

In administering the securities laws, we seek behavioral conformity by all market participants with a particular set of expectations and norms. Regulatory enforcement is an important tool in achieving this objective. But our ultimate goal is not achieving regulatory compliance. Our goal is to have a healthy, robust, and resilient capital market ; hence, our mission to protect investors, maintain fair, orderly, and efficient trading markets, and facilitate capital formation. It is important to recognize that regulatory compliance is not a final objective in and of itself, but rather a tool to assist in achieving our larger goal. We must be cognizant to avoid situations in which this tool may in fact impede the achievement of our overall objective.

One particular problem has been the vastly increasing complexity of the laws and rules that govern the securities industry. As a simple example, one need only look at the 2014 version of the Code of Federal Regulations published by the Government Printing Office, which now needs three volumes to cover the securities-related regulations, up from two volumes in years past. But more regulations do not necessarily result in better outcomes. Moreover, the Code of Federal Regulations only contains the formal regulations issued by the Commission. In determining their behavior, market participants must consider an ever increasing number of positions taken by the Commission in other contexts, such as the preambles to rulemaking releases, briefs filed with the courts, and a variety of administrative orders and opinions. In addition, there are a large number of views expressed by the staff in no-action letters, frequently asked questions, compliance and disclosure interpretations, risk and compliance alerts, and comment letters to registrants.

It is under these circumstances, in which there is a high level of complexity and at times significant ambiguity, that a "broken windows" approach to enforcement may not achieve the desired result. If every rule is a priority, then no rule is a priority. If you create an environment in which regulatory compliance is the most important objective for market participants, then we will have lost sight of the underlying purpose for having regulation in the first place. Rather than enabling vital and important economic activity, we will have unnecessarily shackled it – and our country will be far worse off from the absence of such activity.

In this respect, enforcement efforts will be most successful in achieving desired outcomes when those efforts are closely aligned with the priorities developed by our policy-making divisions. Decisions on enforcement priorities and the use of investigative discretion must complement these efforts, rather than serve as an independent source of policy. That is why the thoughtful application of investigative discretion in an enforcement program is a powerful tool. These decisions, by and large, reside with the staff, so it is important that the Commission's senior leadership provide appropriate guidance so that the nearly 1,300 employees in the Division of Enforcement can use our enforcement authority to achieve desired outcomes.

Since 2006, when I left the Commission's Office of Economic Analysis (now called the Division of Economic and Risk Analysis), the Commission has benefitted from significant advances in our ability to engage in a rigorous, data-driven approach to decision-making. Our staff in the Office of Compliance Inspections and Examinations (OCIE) utilizes such an approach when setting their annual examination priorities. OCIE staff works with other groups, such as our Division of Trading and Markets and Division of Investment Management, to determine which areas may present heightened risks. Part of this process involves a review of data and information available to the Commission, from both internal and external sources. Once draft priorities for the upcoming year have been identified, the Commissioners are briefed on the proposed priorities and their supporting analyses and are invited to provide appropriate feedback to OCIE. This process heightens the efficiency and effectiveness of our inspection program.

Additionally, I oppose the use by the Commission of enforcement measures as an alternative to rulemaking under the Administrative Procedure Act.[3] The Administrative Procedure Act, with its requirements for the government to engage in notice and comment rulemaking, implements key due process protections. I understand the frustrations of the rulemaking process. It takes a significant amount of time, effort, and bandwidth for the Commission to propose and adopt rules under the Administrative Procedure Act. Nevertheless, I have significant concerns when Commission orders – especially in settled administrative actions – create new interpretations of the laws or regulations or impose new regulatory requirements. When Commission actions create such results, we fail in our duty to uphold due process.

Measuring Effectiveness and Elder Fraud

In fiscal year 2013, the Commission brought more than 675 enforcement actions and obtained monetary sanctions in excess of $3.4 billion.[4] However, as Enforcement Director Ceresney points out "Numbers tell only a part of the story."[5]These numbers are flawed metrics to use as a measure of enforcement effectiveness. We need to re-think how we evaluate and describe the effectiveness of our enforcement program. Because when the agency and the media make the number of enforcement actions a key

measure, it is bound to create pressure on the staff to increase those numbers year after year.[6] It harks back to the adage, "what gets measured gets done." But we need to make sure that the focus is on measuring outcomes, not outputs.

Most Americans would be outraged if we measured the effectiveness of traffic safety efforts primarily based on the number of tickets issued by police officers and the amount of monetary fines collected. Rather, we look to a more important metric – whether the number of deaths from traffic accidents has increased or decreased.

Determining overall effectiveness of our enforcement program by the amount of monetary sanctions, such as disgorgement and civil penalties, ordered against wrongdoers is also a poor metric. I recognize that a large monetary sanction may be more likely to attract attention. Thus, properly utilized, these types of sanctions can, in addition to removing the ill-gotten gains from the hands of wrongdoers, deter others from committing such violations. But if there is a perception among our staff that cases with large monetary sanctions are key to recognition and promotion, then there will be, at minimum, a subconscious shift of efforts to pursue those types of cases.

Part of the focus on the amount of monetary sanctions may stem from how we think about measuring investor losses. It would be a mistake to put too much emphasis on aggregate dollars as the primary measure of investor harm.

For example, a financial reporting fraud by a large company may result in the loss of billions of dollars of market capitalization and affect, directly or indirectly, millions of investors. But the risk to any single investor of financial reporting fraud by any single issuer can be mitigated by holding a diversified portfolio of securities. So while investors are injured by such a fraud, individually, they may only incur a relatively small amount of harm as a percentage of their investments. On the other hand, a dishonest or corrupt broker, investment adviser, or promoter might cause an investor to lose *all* of his or her investments. Even if it is a relatively small amount of dollars, it might account for 100% of that person's holdings. So we must ensure that our efforts appropriately focus on these types of frauds as well.

Many victims of securities fraud are senior citizens. With the first Baby Boomers becoming age 65 in 2011, the U.S. population is poised to experience a population aging boom over the next two decades, as the percentage of population that is 65 years or older is projected to increase from 13.0% percent in 2010 to 16.8% in 2020 and 20.3% in 2030.[7] The Commission's Investor Advisory Committee held a discussion of elder fraud at their July meeting,[8] our Investor Advocate has placed the topic on his policy agenda for 2015,[9] and Commissioner Aguilar organized a conference on the topic held at our headquarters this past February.[10] However, the Commission as a whole has not held a senior summit since September 2008[11] – nearly six years ago – and the Commission publicly needs to put the protection of seniors back high on the agenda.

Investigations of frauds committed against seniors need to remain a high priority of our investor protection mission. As the Division of Enforcement continues to implement the many important and needed post-Madoff and post-financial crisis improvements, attention to these types of violations should not be overlooked. I pay special attention to the enforcement recommendations relating to elder abuse and senior fraud and I am particularly grateful for the dedication of the staff who bring these cases. We must continue to be vigilant and unrelenting in our pursuit of these wrongdoers. We must continue to work with criminal prosecutors – whether at the federal or state level – to appropriately address these types of frauds.

Consideration of Corporate Penalties

Another fundamental component of due process is that those who violate the federal securities laws should be held responsible for those violations. Individuals commit, or conspire to commit, violations. I have observed recommendations from the staff, often in connection with proposed settlements, that assert that an enforcement action is warranted against a company or a regulated entity, but no individuals are being

charged because of lack of evidence. In these situations, I often wonder whether the entity is settling because individuals have actually committed violations or whether the entity is settling simply to resolve the investigation, regardless of the merits.

In 2006, the Commission issued a statement concerning financial penalties that addressed whether, and if so, to what extent, to impose civil penalties against a corporation.[12] The Commission stated that it proceeded "from the fundamental principle that corporate penalties are an essential part of an aggressive and comprehensive program to enforce the federal securities laws" and that, as part of a range of remedies, they contribute to the Commission's ability to achieve an appropriate level of deterrence.[13] The reason the statement was issued was because the "Commission believes it important to provide the maximum possible degree of clarity, consistency, and predictability in explaining the way that its corporate penalty authority will be exercised."[14] I fully agree with that sentiment. In fact, I believe that not only is such transparency desirable, but it is mandated by the Constitution's due process clause.

The framework described in the Commission's 2006 statement turns principally on two considerations: one, the presence or absence of a direct benefit to the corporation as a result of the violation and, two, the degree to which the penalty will recompense or further harm the injured shareholders. The statement also discussed seven additional non-principal factors that would be appropriate for consideration in determining whether to impose a corporate penalty. Moreover, the Commission acknowledged the significant concerns raised in the legislative history of the penalty provisions that innocent shareholders may ultimately bear the cost of penalties imposed on corporate issuers.

The statement, and the analytical framework described therein, was unanimously adopted by the Commission at the time. Since then, some have questioned the role that the 2006 statement should play in Commission enforcement decisions. If one disagrees with the 2006 penalty statement, then we should consider making revisions. If the 2006 penalty statement is no longer applicable, then the statement should be withdrawn by means similar to the manner in which it was promulgated. In recent months, I have become concerned by the increasing number of staff recommendations that have not been accompanied by analysis of the principal factors described in the 2006 penalty statement. If we were a publicly-traded company, then we would likely be subject to an investigation if we knowingly permitted a misleading statement to remain outstanding without corrective disclosure. More importantly, we will have not accorded appropriate due process if we fail to follow our own publicly-announced framework for monetary penalties.

I would welcome a discussion about our analytical framework for corporate penalties. As with any other rule or policy, retrospective review is one of the most important instruments that we have towards ensuring the rules and policies we implement are actually achieving their intended objectives. If we decide to replace the 2006 penalty statement with a revised analytical framework that reflects actual experience, then my preference is to do it through an interpretative release by the Commission subject to the public notice-and-comment process. This approach will satisfy any due process concerns, allow all interested persons to express their comments on the proposed framework, and provide a stronger defense of our approach should it be challenged in the future.

Moreover, corporate penalty due process concerns have heightened since the enactment of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act).[15] As this audience is well aware, one of the provisions of the Dodd-Frank Act allows the Commission to impose a civil penalty on *any person* who violates, or causes a violation, of the securities laws or regulations in an administrative proceeding.[16] Prior to the Dodd-Frank Act, the Commission only had the authority to seek monetary penalties in administrative proceedings against *regulated entities* and would have needed to file an action before an Article III federal court to obtain a monetary penalty against any other person.

Assuming the appropriateness of bringing more cases in administrative forums, rather than in judicial forums, it is now more important than ever that a clear analytical framework exists for determining corporate penalties. Given the significant concerns expressed in Congress and elsewhere about penalizing

innocent shareholders by imposition of a corporate penalty, it is appropriate to have a more refined analysis rather than only relying on past amounts or statutory maximums.

Our administrative law judges (ALJs) should have appropriate guidance as to the application of corporate penalties. Otherwise, how should the ALJs evaluate and apply corporate penalties in administrative proceedings? Upon review of ALJ decisions by the Commission, what standards and analytical framework should apply with respect to corporate penalties? And how will a federal court of appeals, to which most appeals of a Commission administrative opinion directly go, evaluate the appropriateness of a penalty? Thus, for purposes of transparency, clarity, and, most importantly, due process, the Commission should be forthcoming as to the appropriate analytical framework for corporate penalties.

Commission Ombudsman

Finally, I would like to touch on implementation of our Office of Ombudsman. Section 919D of the Dodd-Frank Act created the position of ombudsman, who reports directly to our Investor Advocate, Rick Fleming. By statute, the duties of the ombudsman are to act as a liaison in resolving problems that retail investors may have with the Commission or self-regulatory organizations (SROs).[17] The ombudsman also shall review and make recommendations regarding policies and procedures to encourage persons to present questions to the Investor Advocate regarding compliance with the securities laws. Last month, the Commission named its inaugural ombudsman, Tracey McNeil, who previously worked in our Division of Corporation Finance and in our Office of Minority and Women Inclusion.[18] Given the limited jurisdiction of the ombudsman – which focuses on resolving problems that *retail investors* may have only with the Commission or SROs – I suspect that many of the concerns sent to the ombudsman regarding the Commission will relate to the status of tips or complaints on potential securities laws violations. I look forward to working with Tracey and seeing how the role of our ombudsman develops over the next several years.

The creation of an ombudsman for retail investors, though, also raises the issue as to whether there should be a similar process to resolve complaints and concerns of regulated entities, issuers, and other persons subject to the Commission's regulatory efforts. Indeed, the Dodd-Frank Act also created an ombudsman for the Bureau of Consumer Financial Protection ("Bureau") with authority to handle any problem that a person "may have in dealing with the Bureau, resulting from the regulatory activities of the Bureau,"[19] and can provide an alternate method of resolving issues.

To implement this provision, the Bureau has created an independent ombudsman with authority to address concerns raised by a bank or nonbank with a process issue arising from the Bureau's supervision or enforcement activities.[20] As the Bureau notes, it is not uncommon for both government and private entities to have an ombudsman, including the federal banking regulators at the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the Office of the Comptroller of the Currency, and the National Credit Union Administration.[21]

The Commission should consider whether it makes sense to have an ombudsman with these other types of responsibilities. Such an ombudsman would provide an additional, but less formal, means to address concerns without involving our Office of Inspector General or creating a more formal investigative unit such as the Justice Department's Office of Professional Responsibility. Such an approach is another safeguard that the Commission can undertake to preserve and uphold the due process rights set forth in our Constitution.

Conclusion

Thank you for being a wonderful audience. I look forward to hearing from you in the future about how we can continue to improve the effectiveness of our enforcement efforts and how we can ensure that no one is deprived of due process. Enjoy the rest of the conference.

[1] http://www.securitiesenforcement.com/?page_id=155 (last accessed Oct. 3, 2014).

[2] 5 U.S.C. Sec. 3331.

[3] 5 U.S.C. Sec. 551 *et seq*.

[4] Press Release, "SEC Announces Enforcement Results for FY 2013," (Dec. 17, 2013), available at http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370540503617.

[5] *Id*.

[6] *See, e.g.,* Jean Eaglesham, "SEC Cases Climb for First Time Since 2011," Wall Street Journal (Sept. 30, 2014), at C1.

[7] U.S. Census Bureau, "Current Population Reports: 65+ in the United States: 2010" (June 2014), at 5, available at http://www.census.gov/content/dam/Census/library/publications/2014/demo/p23-212.pdf.

[8] Agenda, July 20, 2014 Meeting of the Securities and Exchange Committee Investor Advisory Committee, available at http://www.sec.gov/spotlight/investor-advisory-committee-2012/iac071014-agenda.htm.

[9] U.S. Securities and Exchange Commission, Office of the Investor Advocate, Report on Objectives: Fiscal Year 2015 (June 30, 2014), at 12-13, available at http://www.sec.gov/reportspubs/annual-reports/sec-office-investor-advocate-report-on-objectives-fy2015.pdf.

[10] *See* The American Retirement Initiative Winter 2014 Summit—Retirement: It's About People! (Feb. 4, 2014), available at http://www.americanretirementinitiative.org/2014-02-04-winter-summit/; *see also* Commissioner Luis A. Aguilar, Protecting the Financial Future of Seniors and Retirees (Feb. 4, 2014), available at http://www.sec.gov/News/Speech/Detail/Speech/1370540744550.

[11] http://www.sec.gov/investor/seniors/ss3.htm.

[12] SEC Press Release No. 2006-4, "Statement of the Securities and Exchange Commission Concerning Financial Penalties" (Jan. 4, 2006), available at http://www.sec.gov/news/press/2006-4.htm.

[13] *Id*.

[14] *Id*.

[15] Public Law No. 111-203.

[16] Section 929P(a) of the Dodd-Frank Act.

[17] Section 919D of the Dodd-Frank Act.

[18] SEC Press Release No. 2014-186, "Tracey L. McNeil Named as SEC's First Ombudsman" (Sept. 5, 2014).

[19] Section 1013(1)(5) of the Dodd-Frank Act.

[20] http://www.consumerfinance.gov/ombudsman/ (last accessed on Oct. 6, 2014).

[21] *Id*.

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