

THE DISTORTING INCENTIVES FACING THE U.S. SECURITIES AND EXCHANGE COMMISSION

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INTRODUCTION

This Article is about the incentives that motivate the Securities and Exchange Commission (SEC) and the ways in which those incentives influence the SEC's policies. Unlike most other treatments of bureaucratic incentives,¹ this analysis begins with the assumption that the SEC is populated by honest, professional, and skilled personnel who work hard and are motivated to succeed. Despite the high quality of its staff, the SEC has not been successful in recent years. This Article argues that the SEC's lack of success results from the way that staff members respond to three sets of endogenous incentives.

First, of course, the SEC wants approval from its congressional overseers and from the general public. Unfortunately, however, these constituencies have short attention spans and are not particularly sophisticated observers. Consequently, the SEC tends to pursue high profile matters, to change its priorities frequently in accordance with public opinion, and perhaps most significantly, to pursue readily observable objectives, often at the expense of more important but less observable objectives. In particular, the SEC's performance is measured by Congress and in the court of public opinion on the simplistic basis of how many cases it brings and on the size of the fines it collects. This inclination to value only what can be easily measured has not served the SEC well. For example, the SEC's

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1. See, e.g., WILLIAM NISKANEN, BUREAUCRACY AND REPRESENTATIVE GOVERNMENT (1971); David D. Haddock & Jonathan R. Macey, *Regulation on Demand: Special Interest Groups and Insider Trading Law*, 30 J.L. ECON. 311, 323 (1987); Jonathan R. Macey, *Administrative Agency Obsolescence and Interest Group Formation: A Case Study of the SEC at Sixty*, 15 CARDOZO L. REV. 909, 914 (1994).

narrow focus on such measurable indicia of success as the raw number of cases brought explains, among other things, the SEC's complete lack of interest in exposing the fraud at Bernard L. Madoff Investment Securities, LLC.

A second major factor that influences the SEC's conduct is the metamorphosis of the SEC from an administrative agency dominated by a combination of industry experts, economists and lawyers into an agency dominated exclusively by lawyers.² This metamorphosis has affected the culture of the SEC profoundly. In particular, the glacial speed at which the SEC operates is largely attributable to the Commission's lawyer-dominated culture. The culture has also exacerbated the problems associated with the revolving door connecting the SEC with Wall Street. SEC staffers are now focused narrowly on maximizing their reputations within the legal community rather than within economics and business as well as law.

Thirdly, the SEC has strong incentives to promote the appearance that the capital markets are in crisis and to eschew the development of market mechanisms that might solve the very problems that the SEC is tasked with solving. So long as people believe that the SEC is needed in times of crisis and that there are no superior substitutes for the SEC's style of crisis intervention, then there will be a need for the Commission. Ironically, the more financial crises there are, the more the SEC can claim a need for greater resources to meet such crises.

Nonetheless, the SEC is virtually untouched by scandal. This fact is in keeping with the argument, advanced in this Article, that the SEC as an institution, and its staff as individuals, are both professionally ambitious and ethically honest. Because corruption weakens the future mobility of SEC personnel, it is highly costly and studiously avoided. In this narrow context, at least, the SEC's response to incentives has produced positive social results.

At the same time, there have been significant, ongoing, and valid criticisms of the SEC's performance over the past decade. These criticisms became very loud when the SEC failed to recognize the fraud and attendant abuses at Enron in 2001, shortly followed by similar problems at Adelphia, WorldCom, Global

2. See Troy A. Paredes, SEC Comm'r, Remarks Before the Mutual Fund Directors Forum Ninth Annual Policy Conference (May 4, 2009), available at <http://www.sec.gov/news/speech/2009/spch050409tap.htm>.

Crossings, Tyco, and a host of other companies. Only months later, Eliot Spitzer issued scathing attacks on the SEC's dismal performance in regulating mutual fund abuses.³ This was followed by the SEC's failure to respond to, or even to comprehend, the excessive risk-taking at Bear Stearns, Lehman Brothers, and other broker-dealer firms. The parade of shortcomings ended most recently with the SEC's failure to respond to glaring warnings about the massive fraud of Bernie Madoff.⁴

Part I of this Article develops several arguments about the factors that motivate the SEC. Part II attempts to link the incentives facing the SEC to particular failures in the agency over the past decade.

I. WHAT MOTIVATES THE SEC?

Bureaucrats are people, too. They respond to incentives just like everybody else. Strangely, however, the theories about precisely what incentives bureaucrats respond to are sketchy. Of course bureaucrats care about their professional futures and their reputations, and perhaps even the amount of 'regulatory turf' they control. Bureaucrats at the SEC and elsewhere also seem to be concerned with congressional oversight, because Congress controls the budgets of the bureaucrats' administrative agencies. They also care about public opinion because public opinion deeply affects most of the other concerns (reputation, professional advancement, and budgets) that matter to bureaucrats.

At the same time, the SEC is staffed by highly capable, extremely well-qualified professionals, most of whom are lawyers,⁵ and many of whom come from or move on to extremely

3. Among other broad denunciations, Spitzer made the famous remark that "heads should roll at the SEC. There is a whole division that is supposed to be looking at mutual funds. Where have they been?" See Riva D. Atlas, *Spitzer Vows Legal Action Against Head of Fund Family*, N.Y. TIMES, Oct. 30, 2003, at C1; see also Walter Hamilton, *Strong Capital May be Indicted; Prosecutor says Criminal Charges Against the Mutual Fund Giant and Its Founder are Possible*, L.A. TIMES, Oct. 31, 2003, at C1 (noting that "[t]he SEC has lagged behind Spitzer in uncovering mutual fund trading abuses").

4. See U.S. SEC. & EXCH. COMM'N, OFFICE OF INVESTIGATIONS, INVESTIGATION OF FAILURE OF THE SEC TO UNCOVER BERNARD MADOFF'S PONZI SCHEME (2009) [hereinafter MADOFF INVESTIGATION].

5. See Jed Horowitz, *SEC commish: We need fewer lawyers and more economists*, INV. NEWS, Sept. 24, 2009, <http://www.investmentnews.com/apps/pbcs.dll/article?AID=/20090924/FREE/909249990/-1/Topic>; see also Paredes, *supra* note 2 ("For an agency

successful careers in the most rigorously competitive parts of the private sector (primarily law, but also investment banking). Finally, but by no means least of all, there is little corruption at the SEC. Although potential future employers of top SEC personnel appear to have considerable clout, few SEC employees have been seriously accused of generating bad public policies or enforcement decisions for corrupt motives.⁶ The lawyers and

that regulates the world's largest securities markets to be so dominated by lawyers is ill-advised.").

6. A notable exception to this general situation is the apparently successful effort by the investment banking firm Morgan Stanley to limit the SEC's insider trading investigation of a hedge fund called Pequot Capital Management. For a retelling of the story, see 153 CONG. REC. S1381-91 (daily ed. Jan 31, 2007). The SEC's investigation was going to require taking testimony from—and perhaps investigating—John Mack, Morgan Stanley's CEO who had worked with Pequot during the time period of the alleged insider trading. Maneuvering within the SEC delayed Mack's testimony until after the statute of limitations had lapsed. Congressional investigators found that:

In June 2005, Morgan Stanley's Board of Directors hired former U.S. Attorney Mary Jo White to determine whether prospective CEO John Mack had any exposure in the Pequot investigation. White contacted Director of Enforcement Linda Thomsen directly, and other Morgan Stanley officials contacted Associate Director Paul Berger. Soon afterward, SEC managers prohibited the staff from asking John Mack about his communications with Arthur Samberg at Pequot. . . .

SEC management delayed Mack's testimony for over a year, until days after the statute of limitations expired. After Staff Attorney Aguirre complained about his supervisor's reference to Mack's "political clout," SEC management offered conflicting and shifting explanations for blocking Mack's testimony. Although Paul Berger claimed that the SEC had always intended to take Mack's testimony, Assistant Director Mark Kreitman said that definitive proof that Mack knew about the GE-Heller deal was the "necessary prerequisite" for taking his testimony. The SEC eventually took Mack's testimony only after the Senate Committees began investigating and after Aguirre's allegations became public, even though it had not met Kreitman's prerequisite.

The SEC fired Gary Aguirre after he reported his supervisor's comments about Mack's "political connections," despite positive performance reviews and a merit pay raise. Just days after Aguirre sent an e-mail to Associate Director Paul Berger detailing his allegations, his supervisors prepared a negative re-evaluation outside the SEC's ordinary performance appraisal process. They prepared a negative re-evaluation of only one other employee. Like Aguirre, that employee had recently sent an e-mail complaining about a similar situation where he believed SEC managers limited an investigation following contact between outside counsel and the Director of Enforcement.

other professionals want to be successful and have rewarding careers. They want to be viewed as successful by their professional peers outside of the SEC.

In light of these facts, it is puzzling why the honest, competent people at the SEC appear to perform so poorly at their appointed tasks. Another question is why their behavior never seems to improve from crisis to crisis. This Article argues that the fault lies not with the bureaucrats, but rather with the incentives that motivate them. To understand the failures of the SEC, one has to look at precisely how the personnel are motivated to do their work.

First, it is clear that the SEC is largely evaluated on the basis of how well its Division of Enforcement performs. The SEC is divided into five divisions. Four are rather obscure and have not attracted much controversy, including: the Division of Corporate Finance, which reviews SEC registration statements; the Division of Trading and Markets, which pursues the SEC's mandate for maintaining fair, orderly, and efficient markets; the Division of Investment Management, which is supposed to protect individual investors by overseeing and regulating the \$26 trillion investment management industry; and the Division of Risk, Strategy, and Financial Innovation, which was established in 2009 "to help further identify developing risks and trends in the financial markets" by "providing the Commission with sophisticated analysis that integrates economic financial and legal disciplines."⁷

The principal SEC division is the Division of Enforcement. The SEC describes itself as: "first and foremost . . . a law enforcement agency."⁸ The Division of Enforcement exists to enable the Commission to investigate possible securities law violations, and, where appropriate, it recommends to the Commission that a civil action be brought against individuals and companies that have violated such laws. Upon obtaining the necessary approval from the Commission, the Division of Enforcement then prosecutes on behalf of the Commission the cases it has inves-

MINORITY STAFF OF S. FIN. COMM. & S. COMM. ON THE JUDICIARY, 110TH CONG., THE FIRING OF AN SEC ATTORNEY AND THE INVESTIGATION OF PEQUOT CAPITAL MANAGEMENT 5-6 (Comm. Print 2007).

7. Sec. & Exch. Comm'n., *The Investor's Advocate: How the SEC Protects Investors, Maintains Market Integrity, and Facilitates Capital Formation*, <http://sec.gov/about/whatwedo.shtml> (last visited Mar. 5, 2010).

8. *Id.*

tigated.⁹ An additional component of the Division of Enforcement mandate is to work closely with law enforcement agencies in the United States and around the world to file criminal charges. In the United States, this task is done through a referral process in which the SEC refers cases to the Criminal Division of the U.S. Department of Justice and then works with the Assistant U.S. Attorneys to bring criminal actions.

At the SEC, “enforcement actions have traditionally defined the mission of the agency.”¹⁰ In fact, economic sociologist William Bealing has posited correctly that it is the activities of the Enforcement Division of the SEC that legitimize the Commission’s existence and its federal budget allocation to Congress.¹¹ It certainly appears that “the SEC is carrying out its (enforcement) duties so as to maintain a base of support within the Congressional budget process.”¹²

Assuming that the SEC is deeply concerned with its budget and that the performance of the Enforcement Division is critical to the SEC’s success, the strategy that the SEC employs to maximize its appeal to Congress, and more generally to maximize the overall notion that it is effectively using the resources that Congress has allocated to it, is to focus on available, salient criteria. In particular, the SEC focuses on the raw number of cases that it brings and on the sheer size of the fines that it collects. For example, when criticized recently for failing to respond to numerous tips from whistle-blowers and red flags in the case of Bernard Madoff’s massive fraud, the SEC noted in congressional testimony that:

[C]omparing the period from late January to the present to the same period in 2008, Enforcement has:

- opened more investigations (1377 compared to 1290);
- issued more than twice as many formal orders of investigation (335 compared to 143);

9. *Id.*

10. John Sivoella, *Bureaucratic Decision Making—SEC Enforcement and the Federal Courts’ Ideology* 29 (Apr. 2007) (unpublished manuscript), available at http://www.allacademic.com/meta/p196843_index.html.

11. William E. Bealing, Jr., *Actions Speak Louder Than Words: An Institutional Perspective on the Securities and Exchange Commission*, 19 ACCT. ORG. & SOC’Y 555, 555–57 (1994).

12. Sivoella, *supra* note 10, at 30.

- filed more than twice as many emergency temporary restraining orders (57 compared to 25); and
- filed more actions overall (458 compared to 359).¹³

The SEC's 2008 Annual Report is similarly clear in its emphasis on the easily measurable criteria of number of enforcement actions brought and the amount of fines assessed:

During FY 2008, the Enforcement Division also brought the highest number of insider trading cases in the agency's history. In addition, the SEC brought a record-high number of enforcement actions against market manipulation in 2008, including a precedent-setting case against a Wall Street short seller for spreading false rumors. Overall for the fiscal year just ended, the SEC completed the highest number of enforcement investigations in any year to date, by far. We also initiated the second-highest number of enforcement actions in agency history.

Not just in 2008, but in each of the last two years, the Commission set the record for the highest number of corporate penalty cases in the agency's history. And for the second year in a row, the SEC returned more than \$1 billion to harmed investors using our Fair Funds authority under the Sarbanes-Oxley Act. To support this record level of law enforcement, the SEC now devotes more than one-third of the entire agency staff to our enforcement program. That is a higher percentage of the SEC's total staff than at any time in the past 20 years. The SEC's internal allocation of funds for enforcement in FY 2008 was the highest in the agency's history. In this past year, we also increased the number of enforcement personnel by 4 percent.¹⁴

The SEC's 2008 Annual Report was written when the Commission's reputation was under severe stress. Three events in particular—the collapse of Enron, the emergence of regulatory competition from state attorneys general (particularly Eliot

13. *Oversight of the SEC's Failure to Identify the Bernard L. Madoff Ponzi Scheme and How to Improve SEC Performance: Hearing Before the S. Comm. on Banking, Hous. & Urban Affairs*, 111th Cong. 22–23 (2009) (statement of Robert Khuzami, Dir., Div. of Enforcement, U.S. Sec. & Exch. Comm'n, & John Walsh, Acting Dir., Office of Compliance Inspections & Examinations, U.S. Sec. & Exch. Comm'n) [hereinafter Khuzami & Walsh Hearing], available at http://banking.senate.gov/public/index.cfm?FuseAction=Files.View&FileStore_id=64355cc6-d04c-4b4f-be96-ed0d4a93c244.

14. U.S. SEC. & EXCH. COMM'N, 2008 PERFORMANCE AND ACCOUNTABILITY REPORT (2008).

Spitzer), and the SEC's incompetence in its handling of the \$50 billion securities fraud orchestrated by Bernard Madoff—tarnished the SEC's traditional standing as America's foremost administrative agency in terms of quality and integrity.

Many have criticized the SEC in recent years, and it is difficult to imagine that the Commission's position at the center of a political maelstrom has not affected the agency's behavior. For example, the report makes salient "a long-standing criticism that the SEC has largely failed to prosecute cases against corporate executives, opting for quick settlements in which companies themselves are penalized instead of their leaders."¹⁵ The SEC has rationally pursued this policy of opting for quick settlements because the agency is largely judged on the basis of the number of cases it wins. The agency needs fewer resources to sue companies than individuals because companies do not defend themselves as vigorously as individuals do. In addition, and for the same reasons, the SEC has moved to a policy of suing and settling with industry groups. Similarly, the SEC in recent years has attempted to expand the contours of the law, which makes it easier for them to bring cases, and to keep the law vague by refusing to define insider trading. The SEC has thus pursued a policy that is consistent with the Commission's rational self-interest but clearly suboptimal from a societal perspective of economizing the performance of investigations.

In particular, as social psychologists would predict, the SEC's enforcement effort is evaluated both internally and externally in overly simplistic ways because of the trust and reliance that those evaluating the SEC place in readily available evaluative heuristics. The focus is on the number of cases brought by the Division, and, to a lesser extent, on the size of the fines collected by the SEC. The more cases that are brought and the greater the amount of fines collected during a particular time frame, the better the enforcement staff at the SEC is thought to perform.

In light of this metric of success, it is not surprising that the SEC focuses on low-hanging fruit. Because investigations take time, the SEC focuses on bringing cases that do not require much, if any, investigative effort. Indeed, the SEC makes no secret of the limited amount of detective work it does. It de-

15. Zachary Kouwe, *Judge Rejects Settlement Over Merrill Bonuses*, N.Y. TIMES, Sept. 14, 2009, at A1.

rives its docket of cases from scandals that are reported in the press and from tips from whistleblowers. Indeed, as Maureen O'Hara and I have argued in other work, the SEC often does not even pay attention when evidence of fraud appears in well-known scholarly journals in corporate finance.¹⁶ Instead, enforcement comes only after an issue is made politically salient by the financial press.¹⁷

A major theme of this Article is that the performance-based incentives to which even the most able bureaucrats respond are perverse and lead to perverse results. The number of enforcement actions and the size of fines may not be the best criteria by which to evaluate the conduct of the SEC, but they are data that are "available," a factor that social psychology and behavioral finance tell us often drives decision making.¹⁸ In social science, the availability heuristic posits that people tend to use evaluative techniques on the basis of "the ease with which instances or associations come to mind."¹⁹

Thus, the SEC's apparent focus on how many cases it brings and on the size of the fines collected appears to represent the availability heuristic in action. As in other contexts, this reliance on availability leads to predictable biases. In other words, the SEC's apparently odd behavior in recent years is not due to corruption or incompetence on the part of the agency. Rather, the SEC simply has been responding, more or less rationally, to the rather odd set of incentives that it faces from its overseers in Congress and from the general public.

In addition to its focus on the number of cases that it brings and on the size of the fines it collects, another factor that influences the SEC's conduct is the dominance of lawyers within the

16. See Jonathan R. Macey & Maureen O'Hara, *Regulation and Scholarship: Constant Companions or Occasional Bedfellows?*, 26 YALE J. ON REG. 82, 102-13 (2009).

17. See *id.*

18. Herbert Bless et al., *Ease of Retrieval as Information: Another Look at the Availability Heuristic*, 61 J. PERS. & SOC. PSYCH. 195, 195 (1991). In addition to the SEC, it also appears that the Financial Industry Regulatory Authority (FINRA) is evaluated on the basis of how many cases it brings and how big the fines are that it collects. See Susanne Craig, *Finra's Susan Merrill to Exit as Enforcement Chief*, WALL ST. J., Mar. 18, 2010, at A1 ("The executive hired by Wall Street to enforce its rules is stepping down after nearly three years in which the organization's disciplinary actions and fines against the brokerage industry have declined, the group said.").

19. Aaron Tversky & Daniel Kahneman, *Availability: A Heuristic for Judging Frequency and Probability*, 5 COGNITIVE PSYCH. 207, 208 (1973).

agency.²⁰ The consequences of this domination include increased concern with process and decreased concern with social science evidence in decision making. Moreover, because lawyers are less knowledgeable about how the financial markets operate than actual participants in the industry, the rise of a lawyer-dominated culture at the SEC has resulted in less understanding of complex financial instruments and the operation of financial markets during an era in which complexity has been increasing rapidly.

The glacial speed at which the SEC operates is largely attributable to the Commission's lawyer-dominated culture. Harry Markopolos, the industry whistle blower who tried unsuccessfully to bring the SEC's attention to Bernie Madoff's Ponzi scheme, has described the SEC as "too slow" and further observed that the Commission "was hindered by lawyers, did not understand red flags, could not do the math and was captive to the financial industry."²¹ Mr. Markopolos also testified that "the SEC staff lacks the financial expertise and is incapable of understanding the complex financial instruments being traded in the 21st century," and that "the SEC is overlawyered and has [too few] staff with relevant industry experience and professional credentials to find fraud even when a multi-billion dollar case is handed to them on a silver platter."²² Combating simple fraud and old-fashioned Ponzi schemes may help the capital markets and protect small investors, but it does little to help SEC officials develop the skills and expertise that will make them valuable to Wall Street law firms, the clear focus of SEC staffers today.

In addition to slowing things down, the SEC's domination by lawyers has affected Wall Street. For example, the people heading the Enforcement Division of the SEC in recent years all have moved to jobs as advisers to banks. The most recent Director is now a partner at Davis, Polk & Wardwell. Her predecessor is the general counsel at JPMorgan Chase. His predecessor became general counsel at Deutschebank. Others in recent years have gone to Credit Suisse and Morgan Stanley. One "could be forgiven for thinking that the whole point of landing a job as the SEC's Director of Enforcement is

20. See Paredes, *supra* note 2.

21. *Fraud Investigator Blasts SEC*, WKRG.COM NEWS, Feb. 5, 2009, http://www.wkrg.com/politics/article/fraud_investigator_blasts_sec/23318/Feb-05-2009_6-46-am.

22. *Id.*

to position oneself for the better paying one (as a lawyer) on Wall Street.”²³ The available empirical evidence supports the conclusion that SEC lawyers have significant mobility. The turnover rate for SEC attorneys is almost twice as high as the turnover rate for all government attorneys.²⁴ SEC officials thus want to develop practice specialties in technical legal fields that will help them to find jobs in high-powered law firms when they leave the SEC, rather than do their job as financial regulators.

Finally, the SEC has strong incentives to promote the appearance that the capital markets are in crisis and to eschew the development of market mechanisms that might solve the very problems that the SEC is tasked with solving. The SEC is thus in a difficult position. On the one hand, of course, the SEC wants to be viewed as successful. On the other hand, if financial crises do not arise every so often the SEC might well come to be viewed as unnecessary.²⁵ From the SEC’s perspective, the optimal way to handle this balancing act is to blame any and all failures on a lack of resources. The SEC pursued this strategy with great success after the collapse of Enron in 2002. The SEC long claimed that it faced a “staffing crisis” due to its “inability to compensate [its] employees adequately.”²⁶ As Table 1 indicates, the collapse of Enron in 2001 led to unprecedented budget increases for the SEC staff in 2002 and 2003. In fact, the SEC budget more than doubled between 2001 and 2004 from \$422.8 million to \$913 million, and the SEC was the only federal agency to receive substantial budget increases both in 2003 and 2004.²⁷

23. Michael Lewis & David Einhorn, Op-Ed., *The End of the Financial World as We Know It*, N.Y. TIMES, Jan. 4, 2009, at WK9.

24. SEC. & EXCH. COMM’N, PAY PARITY IMPLEMENTATION PLAN AND REPORT (2009), <http://www.sec.gov/news/studies/payparity.htm>. During the eight-year period for which data is available (1994–2001) annual turnover rates for SEC attorneys averaged 14.05% while annual turnover rates for government attorneys generally averaged only 7.6%. *Id.*

25. *See, e.g.*, Macey, *supra* note 1, at 937, 948.

26. SEC. & EXCH. COMM’N, *supra* note 24.

27. SUSAN DUDLEY & MELINDA WARREN, REGULATORY SPENDING SOARS: AN ANALYSIS OF THE U.S. BUDGET FOR FISCAL YEARS 2003 AND 2004: 2004 ANNUAL REPORT 11–12, 16 (2003).

Table 1: SEC Budget History²⁸

Fiscal Year	Budget Authority (in thousands of \$)	Change from Previous Year
1990	166,633	---
1991	189,083	13%
1992	225,792	19%
1993	253,235	12%
1994	269,150	6%
1995	300,437	12%
1996	300,921	0.2%
1997	311,100	3.4%
1998	315,000	1.3%
1999	341,574	8%
2000	377,000	10%
2001	422,800	12%
2002	513,989	22%
2003	716,350	39%
2004	811,500	13%
2005	913,000	13%
2006	888,000	-3%
2007	888,000	0%
2008	906,000	2%
2009	960,000	6%

28. See Sec. & Exch. Comm'n, Frequently Requested FOIA Document: Budget History, <http://www.sec.gov/foia/docs/budgetact.htm> (last visited Mar. 6, 2010).

The crisis also led to increases in the salaries for SEC staff. SEC Chairman Harvey L. Pitt testified in early 2002 that the SEC did not have adequate resources or staff to deal with the regulatory and enforcement demands created by the collapse of Enron, and asked Congress for an extra \$91 million to boost salaries and to hire one hundred new accountants and lawyers.²⁹ Shortly thereafter the SEC Executive Director stated that “[t]he SEC cannot afford to continue suffering the staffing crisis it has endured for the past decade at such an important juncture.”³⁰ In fact, SEC staffers received the largest pay increases of any administrative agency in the U.S. government in 2001 when Congress elevated the pay of SEC staff members to the same pay scale as employees of the Board of Governors of the Federal Reserve System.³¹

The next Part of this Article will attempt to provide support for the predictions and implications articulated in the previous paragraphs about the direction that the SEC is taking with examples and case studies from the SEC’s recent history.

II. THE SEC IN ACTION: HEURISTICS AT WORK

A. *The SEC is More Likely to Sue Companies Than to Sue Individuals*

It has long been said that the SEC is more likely to sue companies than to sue individuals within those companies for securities fraud and other SEC rule violations.³² This longstanding practice has “effectively allowed corporate managers to buy immunity (for themselves) with their shareholders’ money.”³³

The SEC’s tendency to resist prosecuting corporate executives and instead to pursue prompt settlements against corpo-

29. See *Departments of Commerce, Justice, and State, the Judiciary, and Related Agencies Appropriations for Fiscal Year 2003: Hearing on S. 2778 Before a Subcomm. of the S. Comm. on Appropriations*, 107th Cong. 226–27 (2002) (written statement of Harvey L. Pitt, Chairman, Sec. & Exch. Comm’n).

30. *Vital Assets: Human Capital in Federal Economic Regulatory Agencies: Hearing Before the Subcomm. on Oversight of Gov’t Mgmt., Restructuring, and the Dist. of Columbia of the S. Comm. on Governmental Affairs*, 107th Cong. 73 (2002) (written statement of James M. McConnell, Executive Dir., U.S. Sec. & Exch. Comm’n).

31. Investor and Capital Markets Fee Relief Act, Pub. L. No. 107-23, § 8, 115 Stat. 2390, 2398 (2002).

32. Kouwe, *supra* note 15.

33. *Id.*

rate defendants is consistent with the hypothesis that the SEC maximizes the number of cases it brings and the size of the fines it collects for two reasons. First, individual defendants are far more likely than corporate defendants to take cases to trial because fines paid by individual defendants are likely to come from their own pockets. Corporations, conversely, quickly settle cases by paying with their shareholders' money.

Second, the settlement decisions made by corporations are not, of course, made by the corporations themselves or by their shareholders, but rather by senior-level corporate executives. Because these corporations often have extremely deep pockets, and because the individuals making settlement decisions on behalf of corporations (who may be far more interested in deflecting blame from themselves than in conserving the corporation's wealth) are not spending their own money, corporate defendants are more likely to agree to more generous settlements with the SEC than are individual defendants.

The recent controversy over a proposed settlement between the SEC and Bank of America provides a very useful window on this point. The proposed settlement was to end a lawsuit challenging misrepresentations made by Bank of America in connection with the Bank's solicitation of shareholder support for its proposed merger with Merrill Lynch in late 2008.

In its complaint, the SEC alleged that Bank of America "made materially false and misleading statements" to its shareholders in the proxy statement of November 3, 2008, in which the bank solicited the approval of its shareholders to complete the bank's proposed \$50 billion acquisition of Merrill.³⁴ According to the complaint, Bank of America

represented that Merrill had agreed not to pay year-end performance bonuses or other discretionary incentive compensation to its executives prior to the closing of the merger without Bank of America's consent [notwithstanding the fact that] contrary to the representation . . . Bank of America had agreed that Merrill could pay up to \$5.8 billion—nearly 12% of the total consideration to be exchanged in the merger—in discretionary year-end and other bonuses to Merrill executives for 2008.³⁵

34. Complaint at 1–2, *SEC v. Bank of Am. Corp.*, No. 09 Civ. 6829 (S.D.N.Y. Aug. 3, 2009).

35. *Id.* at 2.

The litigation was solely against Bank of America. No individual defendants were named. Under the terms of the settlement, Bank of America, without admitting or denying the accusations, agreed to be enjoined from making future false statements in proxy solicitations and agreed to pay the SEC a fine of \$33 million. In rejecting the settlement, U.S. District Judge Jed Rakoff acknowledged the strong presumption in favor of settlements, observing that “an ordinary civil settlement that includes dismissal of the underlying action is close to unreviewable.”³⁶

Nevertheless, Judge Rakoff, “even upon applying the most deferential standard of review for which the parties argue,” was “forced to conclude that the proposed Consent Judgment [was] neither fair, nor reasonable, nor adequate.”³⁷ Judge Rakoff described the proposed settlement as follows:

[T]he parties were proposing that the management of Bank of America—having allegedly hidden from the bank’s shareholders that as much as \$5.8 billion of their money would be given as bonuses to the executives of Merrill who had run that company nearly into bankruptcy—would now settle the legal consequences of their lying by paying the S.E.C. \$33 million more of their shareholders’ money.³⁸

Judge Rakoff’s “first and foremost” grounds for rejecting the settlement were that forcing the shareholders who were the victims of the bank’s alleged misconduct now to pay the penalty for that misconduct did “not comport with the most elementary notions of justice and morality.”³⁹ In other words,

36. Memorandum Order at 3, SEC v. Bank of Am. Corp., No. 09 Civ. 6829 (S.D.N.Y. Sept. 14, 2009).

37. *Id.* at 3.

38. *Id.* at 2.

39. *Id.* at 4. The SEC defended making the shareholders pay for the company’s fraud on the grounds that “[a] corporate penalty . . . sends a strong signal to shareholders that unsatisfactory corporate conduct has occurred and allows shareholders to better assess the quality and performance of management.” *Id.* (alteration in original) (citation omitted). As Judge Rakoff noted, the SEC’s justification

makes no sense when applied to the facts here: for the notion that Bank of America shareholders, having been lied to blatantly in connection with the multi-billion-dollar purchase of a huge, nearly-bankrupt company, need to lose another \$33 million of their money in order to ‘better assess the quality and performance of management’ is absurd.

Id.

Judge Rakoff could not “justify imposing penalties on the victims of [Bank of America’s] lie, the shareholders.”⁴⁰

In his opinion, Judge Rakoff was particularly cognizant of the conflict of interest whenever management settles an SEC action brought against the corporation for the management’s own conduct. Judge Rakoff intimated strongly that it might be beyond the purview of management, when it is “accused of having lied to its shareholders to determine how much of those victims’ money should be used to make the case against the management go away.”⁴¹

Judge Rakoff left no ambiguity about the SEC’s self-interest in agreeing to settle with Bank of America. He opined that the parties’ proposed Consent Judgment “was a contrivance designed to provide the SEC with the facade of enforcement and the management of the Bank with a quick resolution of an embarrassing inquiry—all at the expense of the sole alleged victims, the shareholders.”⁴² Moreover, according to the Judge,

[t]he proposed Consent Judgment in this case suggests a rather cynical relationship between the parties: the SEC gets to claim that it is exposing wrongdoing on the part of Bank of America in a high-profile merger; the Bank’s management gets to claim that they have been coerced into an onerous settlement by overzealous regulators. And all this is done at the expense, not only of the shareholders, but also of the truth.⁴³

B. *In Pursuit of Low-Hanging Fruit*

In testimony before the Senate Committee on Banking, Housing, and Urban Affairs, two top SEC officials attempted to explain the SEC’s failure to detect the massive fraud perpetrated by Bernard Madoff.⁴⁴ The SEC’s failures were rigorously catalogued in a 477-page report by the SEC’s Office of Inspector General (OIG), a relatively independent office within the Commission.⁴⁵ Although there are many candidates for the designation, the SEC’s failure to pursue Bernard Madoff’s Ponzi

40. *Id.* at 5.

41. *Id.* at 7 (noting that “even if this decision is arguably within [management’s] purview, it calls for greater scrutiny by the Court than would otherwise be the case”).

42. *Id.* at 8.

43. *Id.* at 11.

44. Khuzami & Walsh Hearing, *supra* note 13.

45. MADOFF INVESTIGATION, *supra* note 4, at 1–2.

scheme may well be the most flamboyant and salient series of missteps in the agency's history. The SEC itself acknowledges that "no one can or should defend, excuse, or deflect responsibility for the SEC's handling of the Madoff matter."⁴⁶

The OIG investigation did not find evidence that any SEC personnel conducting the examination of Madoff had any inappropriate connection with Madoff that influenced their examination or investigatory work. Nonetheless, the OIG investigation revealed that the SEC had received an astonishing amount of incriminating information about Madoff and failed to follow up thoroughly on any of it:

[T]he SEC received more than ample information in the form of detailed and substantive complaints over the years to warrant a thorough and comprehensive examination and/or investigation of Bernard Madoff and BMIS (Bernard Madoff Investment Securities) for operating a Ponzi scheme, and that despite three examinations and two investigations being conducted, a thorough and competent investigation or examination was never performed. *The OIG found that between June 1992 and December 2008 when Madoff confessed, the SEC received six substantive complaints that raised significant red flags concerning Madoff's hedge fund operations and should have led to questions about whether Madoff was actually engaged in trading. Finally, the SEC was also aware of two articles regarding Madoff's investment operations that appeared in reputable publications in 2001 and questioned Madoff's unusually consistent returns.*⁴⁷

Stunningly, the reason that the SEC did not pursue these complaints against Madoff was because the Commission did not want to devote the necessary resources.⁴⁸ In particular, an SEC official testified that there was no effort to obtain what is known as "audit trail data" because the SEC, as a general matter, believes that obtaining and analyzing this data is too expensive and time-consuming.⁴⁹ Audit trail data provides information on individual trades and is the primary manner in which the SEC and the self-regulatory organizations (the Financial Industry Regulatory Authority and the New York Stock Exchange) obtain

46. Khuzami & Walsh Hearing, *supra* note 13.

47. MADOFF INVESTIGATION, *supra* note 4, at 20–21 (emphasis added).

48. *Id.* at 98.

49. *Id.* at 108–09 ("I can tell you we were always hesitant to get audit trail data because it can be tremendously voluminous and difficult to deal with and is a huge resource issue for us. It takes us a ton of time.").

the detailed trading data necessary for the detection of fraud, manipulation, insider trading, and other securities law violations. If the SEC had pursued the audit trail data, it would have discovered that Madoff was not actually doing the trades he claimed to be doing and that his entire business enterprise was a sham. An SEC official observed that he “had no explanation for why the request for detailed audit trail data would be eliminated, stating, ‘I can’t account for this, but it would have been, frankly, asinine for us to not get the audit trail.’”⁵⁰

Another way that the SEC easily could have detected the Madoff fraud was by investigating Madoff’s counterparties, that is, the people with whom Madoff claimed to have been trading. Because Madoff falsely claimed to be profiting from trading activity, communicating with the companies that he claimed were his counterparties would have revealed the fraud.

The OIG investigated why the SEC did not attempt to obtain information about Madoff’s counterparties. In response, the SEC officials involved in the Madoff investigation noted that the entities that Madoff claimed were his counterparties were European banks, Royal Bank of Scotland (RBS) and the Swiss bank UBS. Because these banks were foreign, the SEC Division of Enforcement personnel investigating Madoff would have to consume time and resources either dealing with these companies’ U.S. affiliates or dealing with their colleagues at the SEC Office of International Affairs. Neither of these options was attractive to the SEC enforcement staff, apparently due to “the scarcity of resources and the difficulty of obtaining such records.”⁵¹

In fact, even beyond the Madoff investigation, investigating Ponzi schemes in general seems to have been regarded as a “burning [of] resources.”⁵² Yet, the most striking thing about the SEC Division of Enforcement’s failure to conduct an adequate investigation into the Madoff scheme is that such an investigation would not have required much in the way of resources. If the SEC is not even willing to investigate a suspected massive fraud on the basis of tips from numerous credible informants, one wonders what the SEC does investigate.

50. *Id.* at 109.

51. *Id.* at 339. In all, the OIG investigation of Madoff cites the unwillingness or inability to devote resources to the investigation over thirty times.

52. MADOFF INVESTIGATION, *supra* note 4, at 244 n.167.

According to the SEC Division of Enforcement, the SEC opens a matter for inquiry (known in SEC parlance as a Matter under Inquiry or “MUI”) when it

receives information from a variety of sources that may warrant the opening of a new MUI, including newspaper articles, complaints from the public, whistleblowers, and referrals from other agencies or self-regulatory organizations. Assigned staffers are encouraged to use their discretion and judgment in making the preliminary determination of whether it is appropriate to open a MUI.⁵³

Among these various sources of leads, the dominant one appears to be newspaper articles.⁵⁴ An example of the significance of newspaper articles can be seen in research that has found that accounting fraud that occurs relatively far away from the SEC home office in Washington, D.C., or from one of the SEC regional offices is less likely to be investigated by the SEC. This is largely due to the reliance by SEC staffers on “stories in the regional press, which by its nature tends to focus on local events. This means that unless SEC staffers carefully monitor the newspapers of all cities in their regions (which typically span several states) this [type of] source [(newspapers)] is likely to bias investigations towards geographically proximate companies.”⁵⁵ This bias appears to be so significant that researchers have found that auditors located farther away from SEC Regional Offices perceive a lower risk of enforcement actions and thus are more likely to compromise their independence than auditors located close to SEC Regional Offices.⁵⁶

Newspaper articles appear to be the preferred external source⁵⁷ for leads for two reasons. First, when a newspaper ar-

53. SEC. & EXCH. COMM’N, DIV. OF ENFORCEMENT, ENFORCEMENT MANUAL 20 (2010).

54. Ehsan H. Feroz, Kyungjoo Park & Victor S. Pastena, *The Financial and Market Effects of the SEC’s Accounting and Auditing Enforcement Releases*, 29 J. ACCT. RES. 107, 111 n.6 (1991) (observing that former SEC Enforcement Division Chief Accountant Robert Sack believes that approximately one-third of SEC investigation leads are initiated by perusing the financial press).

55. Mark L. DeFond, Jere R. Francis & Xuesong Hu, *The Geography of Auditor Independence and SEC Enforcement* 5–6 (May 13, 2008) (unpublished manuscript), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1132885.

56. *Id.* at 4–5.

57. The primary internal source is referrals to the Division of Enforcement from the Division of Corporate Finance. See Michael J. Kigin, Assoc. Chief Accountant, Office of the Chief Accountant, Sec. & Exch. Comm’n, Remarks to Business Issues and Audit Conference, *The Institute of Internal Auditors: The SEC’s View on*

ticle is published, by definition a reporter already has investigated a matter, done sufficient research to write a story about it, had the story subjected to some measure of fact checking, and faced the obligation to print a retraction if the companies and individuals who are subjects of the article are able to refute its assertions. Thus, the SEC is able to free ride on the resources of newspapers and on the investigative talents of newspaper reporters. Second, because, like other agencies, the SEC is intensely concerned with public opinion,⁵⁸ it has a strong independent motive to pursue allegations of securities fraud contained in newspaper stories, regardless of whether such stories are likely to be accurate.

C. *Vagueness as a Bureaucratic Goal*

The SEC likes to bring a large number of cases, and it likes to settle those cases promptly. Vague rules serve the interests of the SEC by making it less likely that the agency will invest substantial resources in conducting an investigation and then be unable to bring a case against the putative defendants. The SEC is likely to prefer vague rules to clear rules because vague rules expand the Commission's discretion about what cases it can bring.

On the other hand, cases that invoke and rely on vague legal doctrine are more likely to be litigated than cases that rely on clear legal doctrine.⁵⁹ The SEC does not like to litigate cases for a variety of reasons, not the least of which is resource constraints. The SEC wants to bring a large number of cases, and settling rather than litigating allows it to do so.⁶⁰ The SEC actually litigates so few cases, however, that on balance vagueness serves the interests of the SEC by expanding its discretion to bring cases, which it can then settle. Moreover, because the SEC has no real clients who must pay the marginal costs of pursuing weak or nonexistent claims, the SEC can pursue cases

Government and Enforcement Activities 3 (Oct. 25, 1993), available at <http://www.sec.gov/news/speech/1993/102593kigin.pdf>.

58. See JOSEPH P. CHAMBERLAIN & PAUL R. HAYS, *THE JUDICIAL FUNCTION IN FEDERAL ADMINISTRATIVE AGENCIES* 76–78 (1970); see also HARWOOD L. CHILDS, *PUBLIC OPINION: NATURE, FORMATION, AND ROLE* 298 (1965).

59. See George Priest & Benjamin Klein, *The Selection of Disputes for Litigation*, 13 *J. LEGAL STUD.* 1, 16 (1984).

60. Donald C. Langevoort, *The SEC and the Madoff Scandal: Three Narratives in Search of a Story* 8 (Georgetown Law Faculty Working Papers, Paper No. 116, 2009), available at http://scholarship.law.georgetown.edu/fwps_papers/116/#.

based on vague or dubious legal theories. On the other hand, the SEC's counterparties must bear the high costs of litigating even dubious claims against the SEC, and if these litigation and transaction costs are sufficiently high, even the most innocent client will find it in its best interests to settle.

Current Supreme Court doctrine always encourages and sometimes actually requires lower federal courts to rely on the legal interpretations of administrative agencies when they are interpreting a statute, particularly when the statutes are those that the agencies are empowered by Congress to enforce.⁶¹ Thus, even the most vague or far-reaching SEC interpretation is entitled to deference, a factor that is bound to encourage defendants to settle.

An area clearly affected by this SEC penchant for promulgating vague rules is insider trading. The Division of Enforcement prefers bringing insider trading cases to bringing other sorts of cases. The SEC likes cases "with an attention-grabbing angle," and "many kinds of insider trading cases are particularly well suited for this."⁶² Thus, it is not surprising that the SEC consistently has pushed for vague interpretations of the rules against insider trading. It actually has refused, persistently and for decades, to promulgate a definition of what constitutes illegal insider trading because it prefers to keep the contours of the rule vague, and it does not want to provide too much guidance to market participants.

As a remedy, insider trading is not defined either by the SEC or by statute. To the extent that there is a definition, courts have created it and offered interpretations of insider trading doctrine incrementally, on a case-by-case basis. Studies of the SEC's enforcement effort acknowledge "[t]he reluctance of the SEC to use its rule-making authority and its tendency to regulate piecemeal through adjudication."⁶³

61. *See Chevron U.S.A. Inc. v. Natural Res. Def. Council, Inc.*, 467 U.S. 837 (1984); *Skidmore v. Swift & Co.*, 323 U.S. 134 (1944).

62. Langevoort, *supra* note 60, at 8.

63. Joseph K. Tanimura, *The Effects of Insider Trading Restrictions: Evidence from Dividend Initiations and Omissions (1935–1974)*, at 23 (Mar. 14, 2009) (unpublished manuscript), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1359679; accord Louis Loss, *History of S.E.C. Legislative Programs and Suggestions for a Code*, 22 *BUS. LAW.* 795, 795–96 (1967). The defense of the SEC's refusal to formulate a definition of insider trading was that it was not possible to define this sort of illegal behavior and that any definition promulgated simply would create a "blueprint for fraud." *See* Donald C. Langevoort, *Seeking Sunlight in Santa Fe's Shadow: The SEC's Strategic Pursuit of Managerial Accountability* 40 (Georgetown

D. *The SEC Prefers Rules that Are Not Only Vague, but Also Broad*

To the extent that the securities laws are interpreted rather than left vague, the SEC prefers that such laws are interpreted as expansively as possible to maximize the Commission's ability to bring cases. In fact, from the SEC's perspective, the optimal insider trading rule would make insider trading a status offense. Under such a rule, officers, directors, large shareholders, professional investors, or anybody with an informational advantage of any kind over his trading partners would be forbidden to use that informational advantage when trading. Such a broad rule would enable the SEC to meet its quota for cases more easily and would give the SEC discretion to sue virtually anybody who was able to make money in securities trading.

The most recent example of the SEC's efforts to expand the contours of the laws against insider trading concerns the insider trading action against Mark Cuban.⁶⁴ This case involved Cuban's trading in the stock of a public company called Mamma.com.⁶⁵ The company was on the verge of entering into a financing transaction that would depress significantly the share price of the company's outstanding stock. Mr. Cuban, although a major shareholder, was not a member of the Mamma.com board or an officer or employee of the company, and he learned of the impending transaction and sold his stock in advance to avoid the loss.⁶⁶ The transaction in question was a so-called "PIPE" ("Private Investment in Public Equity") deal in which a company makes money by making a private placement of stock to a small number of institutional investors when the company has previously made a public offering of the same class of identical stock.⁶⁷ Where the PIPE private placement is made at a discount to the current market price of the outstanding publicly traded stock, the owners of the publicly traded stock suffer a dilution in the value of their investments. The SEC sued Cuban for illegally avoiding \$750,000 in losses by selling his entire holding of

University Law Center, Working Paper No. 265144, 2001), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=265144.

64. See *SEC v. Cuban*, 634 F. Supp. 2d 713 (N.D. Tex. 2009). The Author participated in writing and filing an amicus brief supporting the dismissal of the SEC's complaint.

65. *Id.* at 717.

66. *Id.* at 717-18.

67. See *id.* at 717.

600,000 shares when he learned from the CEO of Mamma.com that the company was about to make its private PIPE sale.⁶⁸

One of the rules that the Supreme Court has promulgated for the specific purpose of curbing baseless insider trading cases is that a defendant must breach a duty of trust owed to the source of the information.⁶⁹ In the Cuban case, Mamma.com, the issuer, was the source of the information. Cuban, however, had never signed an agreement not to use information that management might pass along to him, although he had signed an agreement in which he promised to keep information provided to him by the company confidential.⁷⁰

In dismissing the SEC's complaint, the district court made the rather obvious point that a promise to keep information confidential is not the same as a promise to refrain from trading. In order to give rise to a legal duty to refrain from trading, a shareholder must have a "legal duty to refrain from trading on or otherwise using the information for personal gain."⁷¹ Because the SEC's complaint did not allege that Cuban agreed to refrain from trading while aware of the impending PIPE offering, the judge held that the confidentiality agreement that Cuban signed could not form the basis for an insider trading prosecution.⁷²

Significantly, the court ruled further that the SEC could not unilaterally make Cuban's conduct illegal. Specifically, in 2000, the SEC promulgated Rule 10b5-2(b)(1), covering situations in which "a person agrees to maintain information in confidence."⁷³ As this rule bases misappropriation theory liability "on a mere confidentiality agreement lacking a non-use component," the court ruled that the SEC could not rely on it to establish Cuban's liability under the misappropriation theory.⁷⁴ In other words, the SEC could not simply transform confidentiality agreements between private parties into agreements not to trade.

68. *Id.* at 717–18.

69. *See* *United States v. O'Hagan*, 521 U.S. 642 (1997) (adopting the misappropriation theory of liability for insider trading).

70. *Cuban*, 634 F. Supp. 2d at 728.

71. *Id.* at 725.

72. *Id.* at 725–28.

73. 17 C.F.R. § 270.10b5-2(b)(1) (2009).

74. *Cuban*, 634 F. Supp. 2d at 730–31.

E. The More the Merrier

Because the SEC wants to maximize the number of cases it brings, it will try to develop theories of wrongdoing that can support litigation against multiple defendants for the same sort of conduct without the need for significant extra work. Examples of the phenomenon of suing entire industries are the SEC's campaigns against late trading and penny stocks.

1. Late Trading and Market Timing

The crusades against market timing and late trading began in 2003 when Eliot Spitzer, then New York Attorney General, began to develop and enforce law on these issues, deeply embarrassing the SEC. Market timing is "[a]n investment strategy based on the forecasting of changes in the direction of market prices," by which investors hope to make a profit by buying and selling at opportune moments.⁷⁵

Not only is market timing legal, but because virtually all unsophisticated traders (and many sophisticated traders) attempt, in some fashion, to "buy low and sell high," it would not seem to be practical or advisable to attempt to ban the practice. On the other hand, if the SEC wants to maximize its prosecutorial discretion to maximize its ability to bring cases, then being able to sue market timers would be a highly attractive option for the SEC.

Some market timers attempt to profit by exploiting stale prices. The model strategy is "time-zone arbitrage," which involves attempting to profit from differences between the net asset value, or "NAV,"⁷⁶ and the actual current market value of the underlying securities in the mutual fund portfolio.

When a U.S. mutual fund holds shares in Asian or European markets, market timing arbitrage is possible. Suppose, for example that a U.S. mutual fund holds shares in German, French,

75. *Market Timing*, in A DICTIONARY OF BUSINESS AND MANAGEMENT 355 (5th ed. 2009). The efficient markets hypothesis (also known as the Efficient Capital Markets Hypothesis, or ECMH) predicts, among other things, that share prices adjust very rapidly to new information and already reflect historical information. A basic implication of the efficient markets hypothesis is that most market timing strategies cannot possibly succeed because they attempt to predict future share prices on the basis of historical patterns of share prices. This is fundamentally incompatible with the efficient markets hypothesis.

76. The NAV is the value of the mutual fund shares as calculated by the Mutual Fund Company's adviser divided by the number of mutual fund shares outstanding.

and Italian companies that are traded in Frankfurt, Paris, and Milan. The U.S. mutual fund determines the NAV for its shares, which is the price at which investors can buy and sell the mutual fund's shares in the late afternoon, usually not long after 4:00 p.m. when U.S. markets close. Markets close in Europe when it is only 11:00 a.m. in New York, however, so the price used to compute the prices of the German, French, and Italian stocks in the mutual fund portfolio will be several hours old and probably quite "stale" when the NAV of the U.S. mutual fund is calculated.

Suppose, for example, that there is some news released that is clearly going to lead to an increase in the value of the European stocks owned by the U.S. mutual fund.⁷⁷ Suppose further that this news is released between 11:00 a.m. and 4:00 p.m., that is, between the time when the European markets close and when the NAV for the mutual fund is computed. When this sequence of events occurs—and it occurs frequently—a market timer can buy or sell at the old, stale price of the mutual fund by buying it soon after the news is released and before the NAV is calculated by the mutual fund. In the example here, this purchase enables the market timer (who in this case is acting as a time zone arbitrageur) to buy shares cheaply because the shares will be priced at the old 11:00 a.m. price even though they can be bought during the period after 11:00 a.m. when the news is released and before the fund sets its NAV much later in the day.

Once the mutual fund price has adjusted upward, the market timer generally will sell as quickly as possible in order to lock in the gain. It is for this reason that market timers sometimes engage in rather frequent trading.

Late trading is the term used to describe what happens when a mutual fund investor is permitted to receive the current day's NAV for his purchase or sale of mutual fund shares despite submitting the order after the mutual fund has calculated its NAV for that day. Late trading is prohibited by SEC Rule 22c-1 (the "forward pricing rule") which provides, in pertinent part, that

[n]o registered investment company issuing any redeemable security . . . shall sell, redeem, or repurchase any such security except at a price based on the current net asset value of such security which is next computed after receipt

77. The European Central Bank may announce, for example, that it will lower interest rates because manufacturing is up and employment is down.

of a tender of such security for redemption or of an order to purchase or sell such security⁷⁸

Thus, by its plain terms, Rule 22c-1 does not require that mutual funds calculate their NAVs at any particular time (although mutual funds are required to calculate their NAVs at least once a day).⁷⁹ Late trading occurs when mutual funds either accept orders from certain favored customers at the previously calculated NAV or permit such customers to cancel their orders after the mutual fund has calculated its NAV. The potential problem with late trading is that it allows traders to take advantage of information released late in the day, after the markets have closed, by trading at the old, stale price that existed earlier in the day, before the NAV was calculated.

For years it was widely accepted that the SEC had been captured by the mutual fund industry.⁸⁰ All of this changed in late 2003 when Eliot Spitzer began his crusade against the same industry.

On September 3, 2003 Spitzer announced the settlement of a complaint against Canary Capital Partners, a large hedge fund, for alleged actions involving a number of mutual fund companies with whom Canary traded.⁸¹ Spitzer alleged that these mutual funds permitted Canary, a favored customer, to engage in late trading in violation of Rule 22c-1 and inappropriate market timing arrangements in violation of other SEC rules.⁸² Spitzer's claim that he had identified abuses in the mutual fund industry, and his use of his office to enforce rules that the SEC had promulgated and was supposed to enforce, was deeply embarrassing to the SEC. In

78. 17 C.F.R. § 270.22c-1(a).

79. 17 C.F.R. § 270.22c-1(b).

80. See Edward Sherwin, *The Cost-Benefit Analysis of Financial Regulation: Lessons from the SEC's Stalled Mutual Fund Reform Effort*, 12 STAN. J.L. BUS. & FIN. 1, 19 (2006) (describing "[t]he SEC's usually cooperative relationship with the mutual fund industry"); see also Paula Dwyer, *Breach of Trust*, BUS. WK., Dec. 15, 2003, at 98 (describing the close relationship between the SEC's mutual fund regulators and the mutual funds they were supposed to regulate and explaining how this relationship led to a situation in which illegal activity was condoned).

81. Landon Thomas Jr., *Big Fine Over Trader's Mutual-Fund Moves*, N.Y. TIMES, Sept. 4, 2003, at C1.

82. *Id.* As noted above, market timing and frequent trading are not illegal. Of course, mutual funds may not violate the terms of their own prospectuses by permitting frequent trading to the extent that such trading violates their prospectuses. And, others may not actively conspire with a mutual fund to violate the terms of its prospectus. The SEC is, in theory, supposed to police prospectus disclosures.

fact, as with a number of other high profile “controversies roiling the securities and insurance industries, many of these [mutual fund] abuses were not discovered by the SEC, but by New York State Attorney General Eliot Spitzer, a fact that forced the SEC to play catch-up with state regulators.”⁸³

Soon thereafter, the SEC began investigating the entire mutual fund industry, sending a letter to the eighty largest fund complexes in which it requested information on “market timing, late trading, and other practices alleged of others in the New York Attorney General’s complaint.”⁸⁴ In subsequent letters the SEC attempted to figure out what international mutual funds were doing to deal with market timing arbitrage.⁸⁵

Despite the vagueness of the rules and the lack of harm to investors, the SEC found it politically expedient to pursue virtually an entire industry for alleged wrongdoing. This method is clearly an efficient way for the SEC to increase the number of cases it brings because the research and investigation necessary to bring a lawsuit against one defendant can be amortized over many defendants, thereby greatly reducing the costs of bringing lawsuits.

2. *A Penny for Your Stock*

The strategy of going after entire industries is not new. For years the SEC has taken the view that people who specialize in selling so-called penny stocks should be pursued. This strategy serves not only the interest that the SEC has in bringing cases, but also the interests of the established broker-dealer firms that compete with the upstart penny stock operations. This group of established broker-dealer firms is an important constituency of the SEC, not to mention an important source of employment for SEC alumni.⁸⁶

Penny stocks are simply equity investment instruments that trade at low prices, usually less than one dollar. Penny stocks generally are high-risk, as they typically are issued by young, start-up or highly speculative ventures. The SEC imposes a

83. Sherwin, *supra* note 80, at 19–20.

84. Dimensional, News/Late Trading and Market Timing, http://www.dfaus.com/news/late_trading/ (last visited Mar. 7, 2010).

85. *Id.*

86. As noted above, recently SEC alumni from the Division of Enforcement have placed themselves in senior positions at Deutsche Bank, JPMorgan Chase, and Morgan Stanley. See *supra* text accompanying note 23.

substantially higher regulatory burden on penny stocks than on other stocks.⁸⁷ The SEC has attempted to delegitimize all firms that issue low-price shares and all firms that deal in or broker such securities. Thus,

[t]he [SEC's] successful efforts to regulate penny stocks provide a classic example of an administrative agency seeking to create a demand for its own existence by turning an industry into a cartel, thereby establishing that industry as a major source of political support for the agency. The [SEC] provided a major service to the established firms and exchanges by eliminating their fastest growing competitors—start-up brokerage firms and market makers providing capital and liquidity to firms issuing penny stocks.⁸⁸

F. *The Culture of the SEC*

Because the SEC is dominated by lawyers, its culture is focused on process, and has become slow and exceedingly bureaucratic. The SEC appears to be at the outer-range of federal agencies both in terms of the extent to which it is dominated by lawyers and the extent to which its operation is paralyzed by bureaucracy. In general, it has been reported by the GAO that at the SEC,

[s]ome attorneys estimated that they spend as much as a third to 40 percent of their time on the internal review process, thus making it harder to meet the division's emphasis on bringing cases on a timely basis. A number of attorneys told us that the effect of the intensive review process is to create a culture of risk aversion, an atmosphere of fear or insecurity, or incentives to drop cases or narrow their scope. . . . In one instance, an attorney closed a case rather than go through a review with another division. . . . In two other cases, charges were dropped or reduced because the matters had taken so long that people were unable to recall earlier considerations of evidence. In another situation, it took 2 1/2 months to prepare a paragraph requesting permission to send a Wells notice; in another case, staff prepared multiple drafts of a Wells memo over 3 years before finally closing the case because it was so old. Finally, one investigative attorney told us that a company under investigation offered to pay whatever penalty amount Enforcement

87. See Macey, *supra* note 1, at 946.

88. *Id.* at 948.

asked; 5 months later, the matter still remained open, with an action memorandum in its tenth draft. Some attorneys noted that such delays may encourage violators.⁸⁹

In connection with the collapse of Madoff's financial empire, the SEC Inspector General allocated much of the blame for the SEC's failure to the crippling bureaucracy, noting that administrative burdens prevented the agency from effectively doing much real work:

You had to have people writing closing memos, which is of course, you should be shutting down your old cases, but that's what [one employee] spent a lot of her time doing, writing closing memos because she had inherited a branch where everybody had left and left these old cases in shambles, and you had to go back to the court records, pulling all these court files, and recreating files to close them. [This employee] had tons of this stuff, much more than [the other Branch Chief in Bachenheimer's group]. It was crazy. Then you had to have six month memos on cases, whether or not you should keep them open, memos to write. The joke that we had in the office was that you had to write a memorandum to get permission to write a memo. You know, a lot of this was to make the performance measurable, which is great, and it should be measurable, but you have to provide people the resources to do it.⁹⁰

CONCLUSION

The SEC is the government agency that is supposed to ferret out securities fraud. Unfortunately, the SEC's excessive focus on bringing a large number of cases and collecting large fines has led it to abandon the critical "ferreting" aspect of its mission. Ferreting is time-consuming and expensive. From the SEC's perspective, it makes sense to bring cases that do not require costly, time-consuming, and risky investigations.

This Article has focused on the incentives facing the Enforcement Staff of the SEC and shown how, to a large extent, the decline of the SEC is not actually the SEC's fault. The SEC,

89. See GOV'T ACCOUNTABILITY OFFICE, SECURITIES AND EXCHANGE COMMISSION: GREATER ATTENTION NEEDED TO ENHANCE COMMUNICATION AND UTILIZATION OF RESOURCES IN THE DIVISION OF ENFORCEMENT 28 (2009).

90. MADOFF INVESTIGATION, *supra* note 4, at 366 (identifying administrative burdens facing the SEC staff attorneys charged with investigating Madoff).

in pursuing large numbers of cases, was trying to meet the performance objectives generated by the simple evaluative heuristics that elected officials and bureaucrats used to evaluate the agency's performance. In building a bureaucracy, the lawyers at the SEC were acting as lawyers are trained to act, which is to create elaborate administrative decision-making structures.

Unfortunately for the SEC, the environment in which it has been operating has led the agency to stumble repeatedly. Large scandals have erupted continuously over the past decade and few, if any, observers believe that the SEC is effective at fighting corporate fraud and abuses in U.S. capital markets. One would predict that the SEC would react decisively in response to the bad publicity it has been receiving, and it has. It appears that the SEC's response to the current crisis is to attack the hedge fund industry just as it attacked the penny stock industry in 1990.

The SEC is in search of a scapegoat. It thinks that it has found one in the hedge fund industry. The tool it is using to pursue the hedge funds is its authority to regulate insider trading. If the SEC can convince the courts that most, if not all, of what the most successful hedge funds do is illegal insider trading then the agency will be able to run the hedge fund managers out of U.S. markets once and for all.

Thus, insider trading in general, and insider trading at hedge funds in particular, is at the top of the SEC's agenda once again. Even the SEC's staunchest defenders like SEC alumnus-turned-law-professor Norm Poser lament that the SEC "was known for years as one of the finest, if not the finest, of the federal regulatory agencies," but is now "at a time when the reputation and effectiveness of the agency are at their lowest point in history."⁹¹ Bringing high-profile insider trading cases against prominent businessmen like Mark Cuban may be the SEC's only shot at garnering some good press these days. For example, in what has been described as a "wake-up call" for hedge fund managers, on October 19, 2009 the SEC and the Department of Justice charged Mr. Raj Rajaratnam, along with a number of his colleagues and acquaintances, in the biggest insider trading scheme ever to involve a hedge fund.

91. Norman S. Poser, *Why the SEC Failed: Regulators Against Regulation*, 3 BROOK. J. CORP. FIN. & COM. L. 289, 289 (2009).

This lawsuit is not merely an attack on insider trading. It is an attack on the way that hedge funds do business. It is extremely common for hedge fund managers to share information with other hedge fund managers. The SEC believes that the world of hedge funds is a corrupt world of “you scratch my back and I’ll scratch yours,” which is precisely the way Preet Bharara, the U.S. Attorney for the Southern District of New York, describes the Rajaratnam case.⁹² But since when has trading of any kind, whether such trading involves cars, or turnips, or information, been illegal in this country? Hedge funds often hire experts to analyze companies and new legislation to look for a trading edge. As long as no ethical line is crossed in obtaining such information, the hedge funds should be free to use it as they wish. They should be free to trade on it, and they should be free to share the information with their industry colleagues.

On the other hand, if Rajaratnam obtained his information by subterfuge or by brokering pilfered information among corporate insiders who stole it from their employers, then he crossed a line and should be punished. Among the accusations against Rajaratnam is that he received an inside tip from one of his hedge fund colleagues who was also a member of the board of directors of an outsourcing company called PeopleSupport about ongoing merger negotiations between PeopleSupport and a subsidiary of the Indian company Essar Group.⁹³ If the tipper revealed information to Rajaratnam that his employer did not want to be used, then Rajaratnam broke the law if he traded on it while knowing that the source of his information had violated a duty to his employer.

The SEC is taking a big risk in embarking on its latest crusade against insider trading in hedge funds, particularly given the still fragile condition of U.S. equity markets. Too little regulation of insider trading means the markets begin to look rigged. If insider trading is not regulated at all, smart, honest players will be discouraged from participating because nobody wants to play against a rigged deck. But clamping down on insider trading too hard may even be worse. If trading on the basis of superior in-

92. Preet Bharara, U.S. Attorney for the Southern Dist. of N.Y., Prepared Remarks for U.S. Attorney Preet Bharara: Hedge Fund Insider Trading Take-down (Oct. 16, 2009), *available at* <http://www.justice.gov/usao/nys/hedgefund/hedgefundinsidertradingremarks101609.pdf>.

93. Complaint at 22, SEC v. Galleon Management, L.P., No. 09-CV-8811 (S.D.N.Y. Oct. 16, 2009).

sight or information is illegal, then smart, honest players will shy away from trading even more because they risk getting sued, or even thrown in jail, merely for being too smart, too well-informed, or too critical of the companies whose shares they trade.

If insider trading is going to be regulated effectively, the evil insider trading that should be punished should be distinguished from the benign trading that should be rewarded. Unfortunately, making these fine distinctions does not serve the SEC's need for better press clippings. The SEC is suspicious of any and every sort of trading by suspect groups like hedge funds, particularly when such traders have an informational advantage over their counterparties, regardless of whether the methods used to get such information were fair or foul.

The SEC's chronic inability—or unwillingness—to distinguish between the good guys, who help ferret out fraud at companies like Enron, from the bad guys who steal information and use it for selfish purposes is quite unfortunate. It has transformed what should be a simple and easy moral issue into a morass of confusion and wasteful litigation.

Insider trading is bad when, and only when, it involves theft. When people steal and trade on *information* that rightfully belongs to somebody else, they should be punished. When people use their own resources and imaginations to obtain information honestly, they should be able to use that information in any way they please without fear of civil or criminal sanction. This approach to insider trading is consistent not only with our interest in having efficient capital markets, but also with our basic moral intuitions about right and wrong.

The SEC's strategy of pursuing Rajaratnam supports the analysis of the SEC's behavior offered in this Article. The case involves a complicated legal theory that will, if accepted, expand the scope of the SEC's power and authority. As such, the case will not only benefit the SEC as an institution, but it will also advance the careers of the individual attorneys at the SEC who are associated with the case. Further, the SEC has chosen as its target an entire industry, that is, the hedge fund industry. This strategy permits the SEC to maximize the number of cases it brings, because the Commission can sue a large number of defendants on the same set of legal theories and factual premises. Finally, the strategy permits the SEC to expand its regulatory authority over hedge funds, an industry that politicians have conveniently demonized in recent years.