Statement before the United States House of Representatives
Committee on Financial Services
On Fixing the Watchdog: Legislative Proposals to Improve and Enhance the SEC

Statement of Paul S. Atkins

The Honorable Paul S. Atkins

Visiting Scholar

American Enterprise Institute

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BEFORE THE UNITED STATES HOUSE OF REPRESENTATIVES
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Thank you very much, Mr. Chairman, Ranking Member Frank, and Members of the Committee, for inviting me to appear today at your hearing. It is an honor and privilege for me to provide information for your deliberations regarding organizational issues at the Securities and Exchange Commission.

I come before you today as a visiting scholar at the American Enterprise Institute for Public Policy Research, as well as a former commissioner of the Securities and Exchange Commission and a former member of the Congressional Oversight Panel for the TARP.

I would like to begin by congratulating this Committee for taking up the issue of improving and enhancing the SEC. I have had the privilege of working at the SEC a total of ten years, first as a staffer in two chairmen's offices and then as a commissioner under three chairmen. In that time the SEC has grown from an agency of approximately $170 million to the current budget of more than $1 billion.

REORGANIZATION OF THE SEC

Because the public sector lacks the crucible of competition to winnow out inefficiencies and promote better management systems, it is periodically necessary for Congress and the president to step in to do so. A good example of this was the approach that the Congress and several administrations undertook from the end of the 1930s in various steps to try to reorganize the federal bureaucracy. Of course, by the end of the 1930s they had to do something because of the creation and huge growth of the alphabet soup of agencies under President Franklin Roosevelt. A rationalization was necessary. In the SEC's case, it became clear by 1950 that the consensus-driven management of the agency by the five commissioners was no longer efficient – the size of

the agency required that there be a leader who would run the business aspects of the agency, versus the policy aspects, which were to remain the domain of the five-person bipartisan commission. So, Reorganization Plan Number 10 of 1950[1] was formulated. It in effect increased the power of the SEC chairman: the chairman would have clear authority over hiring and supervision of staff (except for the appointment of the heads of the major offices, who would be approved by the commissioners), the budget, and allocating responsibilities among the staff.

Thus, in about one page, the management of the SEC – and the relationship of the chairman to the other commissioners – was drastically changed. The staff, therefore, should know who the boss is. Other agencies have a similar organization, including the Federal Reserve, the CFTC, and the FTC. That sort of management organization gives certainty and also accountability. No one can hide behind a "committee" or "commission" – the buck stops with the chairman, as it should. In a greater sense, at the SEC the buck stops with the president, since the president at the stroke of a pen in an executive order can designate at will any other sitting commissioner as chairman.

The Dodd-Frank Act. In contrast to Reorganization Plan 10, last year the Dodd-Frank Act was enacted. In its 2,319 pages, Dodd-Frank attempted to address many things. Simply put, that is its problem – it addressed too many things not very well. As to the SEC, it haphazardly touched on certain organizational and managerial issues, seemingly as an afterthought and not part of any articulated, integrated plan. It became a grab-bag of ideas that through micro-management has made management of the SEC more difficult.

For example, Dodd-Frank added four statutorily mandated, direct reports to the chairman: the Investor Advocate, the Office of Minority and Women Affairs, the Office of Credit Ratings, and the Office of Municipal Securities. Because these provisions are statutory, the chairman has little alternative to do things differently, especially since the chairman already has more direct reports than is practicable. These provisions depart from the less-prescriptive approach of Reorganization Plan 10, which allows the chairman to allocate responsibilities among the staff.

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[1] Reorganization Plan No. 10 of 1950, 15 F.R. 3175, 64 Stat. 1265 (found at 15 U.S.C. § 78d note).

Similarly, Section 911 codifies the Investor Advisory Committee that the current chairman established, which itself was similar to the Consumer Affairs Advisory Committee that I helped Chairman Levitt establish when I worked in his office in the mid-1990s. Chairman Levitt's committee replaced a couple of advisory committees that Chairman Breeden had established, which focused on emerging markets and market structure issues. So, this statutory provision etches in stone one way of doing things to the exclusion of others. It even prescribes how the members of the committee should be chosen. In addition, the Investor Advocate, an independent office established under Section 915, is statutorily empowered to hire his own attorneys, accountants, and consultants and to make independent reports to Congress, with no review by the chairman or the commission. The joke at the SEC these days is that the budget will have to be built around the Investor Advocate – the chairman will have to find out what the Investor Advocate determines that his office needs, and then the rest of the agency can make its plans within the resources set by Congress. Again, these provisions are departures from the approach of Reorganization Plan 10.

In the process of this micro-management, the intent of the statute's authors will not even be achieved. For example, Section 965 of Dodd-Frank, including its history, clearly sets forth the proposition that Congress intended that the examiners of the Office of Compliance Inspections and Examinations (OCIE) be transferred to the Divisions of Trading and Markets and Investment Management. The hoped-for synergies that partly drove the creation of OCIE in 1995 clearly were not achieved, as demonstrated most notably by the Madoff and Stanford failures. The SEC chairman, however, apparently has decided to leave the general organization of the examination office in place, but consider Dodd-Frank Section 965 satisfied by housing the credit-rating agency examiners in the Division of Trading and Markets and adding a few examiners to the Division of Investment Management to act as liaisons with OCIE.

Current SEC Management. Recently the SEC has had its share of management issues. Congress recognized the problem in Dodd-Frank under Section 967 to require that the SEC commission an independent review of its management and organization. Unfortunately, this review does not appear to be independent and was not very well done. In the process, the SEC

spent almost $5 million on the consultants to produce the report. I understand that Jack Katz will address specific components of the report.

Other aspects of the report's recommendations demonstrate how even recent organizational changes were not well thought through. For example, the chairman created a new position of chief operating officer in early 2010, which took on some, but not all, of the functions of the existing executive director's position, which resulted in an artificial division of back-office functions. The BCG report recommended combining the positions, which the chairman did. To her credit, she reversed her earlier decision. The resulting "chief operating officer" is basically just a new title for the former executive director position, and is still not a "chief operating officer" as such a position is normally understood to be, since it is responsible only for back-office functions.

POTENTIAL LEGISLATIVE REFORM

SEC Modernization Act of 2011. I commend this Committee for taking a fresh, deliberate look at the organizational structure of the SEC with the draft legislation under discussion today. I also commend Chairman Bachus for proceeding in regular order – holding legislative hearings to gather commentary and consider openly the best approach before introduction of actual legislation.

The Committee correctly perceives that the SEC desperately needs organizational change to increase efficiency and to improve its regulation of the markets that it is tasked with regulating, considering how dramatically the markets have evolved. With that said, I would caution against being too prescriptive regarding the internal organization of the SEC. Times and circumstances change, and the example of Reorganization Plan 10 demonstrates that general guidelines may be sufficient. Much depends on good managerial experience to lead the agency, which of course cannot be legislated.

The draft bill contains many good ideas. Perhaps most importantly, the draft bill recognizes that economists have been second-class citizens too long at the SEC. The SEC historically has been

an agency of, by, and for lawyers. Does this make sense for an agency that is charged with overseeing and regulating the largest capital markets in the world and promoting efficiency and capital formation? The current chairman's reorganization of the chief economist's office in effect demoted the economists' function – they reported to a lawyer rather than an economist. Many economists left as a result. The endemic problem is that economic analysis at the SEC has been performed as a post hoc exercise: the policy for rulemaking is mostly determined first by the lawyers and only near the end of the process are the economists brought in to justify the actions on a cost-benefit basis. A recent example is the case *Business Roundtable and Chamber of Commerce v. SEC,* which the SEC lost in the D.C. Circuit. In that case, the SEC failed to perform adequate economic analysis. The draft bill envisions the restoration of economists to their proper role as advisors to the Commission.

However, the draft bill suffers in part from the same prescriptive tendencies of Dodd-Frank. I understand the necessity to correct the Dodd-Frank deficiencies, but the most direct approach would be to repeal Dodd-Frank, or at least its most problematic provisions. Thus, I would encourage this Committee to address the specifics of Dodd-Frank and leave other organizational aspects at a general level and to the SEC chairman's discretion.

Among the issues raised or created by Dodd-Frank that need to be addressed are the examination function, the many new positions reporting to the chairman, the Investor Advocate, and the Investor Advisory Committee. For example, Congress correctly is frustrated at the management and results of the SEC's examination function. Unfortunately, the structure of the Office of Compliance Inspections and Examinations (OCIE) was never addressed during the last few years. The restructuring of OCIE gained substantial support while I was on the Commission, even though the question never came to a vote. The current director, having taken over from a director who served since the office's creation in 1995 – almost 15 years – has tried to make organizational and operational changes. But, the best reorganization at this point would be to put the examiners closer to the staff who are considering and formulating regulations, and vice versa.

Dodd-Frank clearly directed the SEC to make this organizational change. The current work-around of this congressional direction – keeping OCIE, but putting examiner liaisons in the

Division of Investment Management – actually makes the examination function at the SEC, especially on the investment adviser and investment company side, less coherent and potentially conflicting. It certainly does not change the status quo, which has been shown to be fatally flawed in a way that all the world could see and, most importantly, devastated so many innocent investors to the tune of billions of dollars.

Thus, making the change to OCIE is important. I submit it can be done using the approach of Reorganization Plan 10 – specifying that it is the sense of Congress that the examiners and the rule-writers be as close as possible in the organizational framework.

The draft bill does not go far enough with respect to the other Dodd-Frank-mandated direct reports to the chairman – they should be eliminated, because each function already can be performed in existing units at the SEC. In particular, with respect to the Investor Advocate, the SEC itself is the investor's advocate. If Congress does not like the work of the agency, or think that it is lacking, it can influence that work and priorities through hearings and other communications with the chairman. An anomalous staff position that seeds the agency with potential conflicts only makes management more difficult and will distract from the business of the agency.

In other respects, the draft bill would retain some dated aspects of the SEC's organization. For example, Chairman Breeden established the Office of International Affairs as a central point of contact for international matters when the Iron Curtain fell and the SEC began to establish relationships and negotiate memoranda of understanding with many nations forming new capital markets. Twenty years later, international matters are integral to almost every aspect of policy in the various offices and divisions. Rather than Congress mandating this particular structure, perhaps a chairman may wish to reallocate responsibilities among the various divisions and offices.

While I acknowledge that Congress must act, Congress should be careful in prescribing a detailed statutory reorganization of the Commission. Congress's role should be to provide guidance to the SEC without binding it by statute. Because statutes are inflexible and difficult to

change, a statutory reorganization of the SEC would prevent the SEC from evolving with the marketplace in the future. With its hands-off approach that encourages accountability in a chairman, Reorganization Plan No. 10 is a good model for future legislation.

The SEC Regulatory Accountability Act. As I mentioned earlier, the SEC has for years failed to incorporate true economic analysis into its rulemaking process, especially in a way to help direct and prioritize rulemaking. For example, with respect to the proxy access rules recently struck down by the U.S. Court of Appeals for the D.C. Circuit, the court found that the SEC failed to provide meaningful economic analysis. The stinging opinion, written by Judge Ginsburg, reproaches the SEC for failing to provide sufficient data to support its legal conclusion that proxy access rules would improve board performance, and for failing to adequately assess the economic effects of the rules. This is indicative of the general rulemaking procedure at the agency.

For that reason, I submit that Chairman Garrett's proposed SEC Regulatory Accountability Act contains many good ideas. This bill directs the SEC to utilize economists to decide whether or not to propose or adopt a regulation—and to do so only after considering the costs and benefits. Regulation may be indicated when there is a market failure, but the key is determining whether there is a market failure and how best to approach it. Otherwise, unintended consequences may result. These sorts of determinations should be the motivating force behind rules; lawyers generally are ill-equipped to make such determinations. Input is necessary from economic, market, and product experts to craft effective regulation.

Modifying the Sunshine Act. Currently, the Sunshine Act engenders the unintended consequences of inhibiting collegiality and policy development between commissioners. Even informal gatherings of a quorum of commissioners are difficult to arrange. The result is that the commissioners must rely on the staff more than direct contact. Amending the Sunshine Act to allow informal gatherings, even to discuss policy matters, as long as a rulemaking is not discussed, would increase the efficiency of commission work. Sufficient protections, however, must be put in place so that the letter and spirit of the Administrative Procedure Act and the Sunshine Act are maintained.

Merger of the SEC and CFTC. Arcane vagaries of regulation exist in the space shared by the SEC and CFTC on futures and derivative instruments. For example, a security futures product (SFP) is both a futures contract and a security. Entities effecting SFP transactions must be registered both with the CFTC as futures commission merchants and with the SEC as broker-dealers. Even more arcane are the statutory provisions that divide securities and futures products. For example, futures on "narrow-based" securities indices, which are products with nine or fewer component securities, are jointly regulated by the SEC and CFTC. Futures on "broad-based" securities indices—or futures on indices with ten or more component securities with a certain weighting—are under the exclusive jurisdiction of the CFTC. That is a division that arises more from bureaucratic turf conflicts than from sound regulatory (or common sense) policy.

Merging the SEC and CFTC and creating a new agency with seven Commissioners would save money and reduce bureaucracy, owing to the scheme's fewer Commissioners and a reorganized staff. It could also solve some of the unintended consequences of the Sunshine Act. With more commissioners, larger numbers could meet to discuss issues. The agency chairman could even take an approach that the Federal Reserve takes and designate a commissioner or two (even one from each party) to look over various agency functions. More interaction among the commissioners could even make the commission less politicized.

Of course, if this merger is to be effected, it should be done with care. The statutes and rules governing the securities and futures markets are different, and the approaches that the two agencies take are different. The futures markets are mostly dealer markets, while the securities markets have a large retail investor component. A merger cannot simply be the combining of two agencies under one roof; it would be a complicated task.

The Investment Adviser Oversight Act of 2011. Another area of potential reform required by Dodd Frank is the SEC's oversight and reliance on self-regulatory organizations (SRO), most notably FINRA, and the possible delegation of investment adviser oversight to an SRO. This Committee held a hearing two days ago regarding this issue. The BCG study addressed the

SEC's interactions with SROs in broad terms, and made a few recommendations: strengthen oversight of SROs through enhanced disclosures about regulatory activities, improved metrics and standards to measure performance, and enhanced oversight of FINRA; centralize and coordinate the agency's interactions with SROs; and strengthen the processes for reviewing SRO rule proposals. As discussed in Tuesday's hearing, these gaps in SEC oversight should certainly be corrected, and I hope the next SEC report will be able to mark progress beyond "outreach and collaboration opportunities."

Unfortunately, this discussion ignores the more glaring problems of what FINRA has become. Today's FINRA has departed from the worthwhile goals of self-regulation envisaged in the 1930s; namely, the balance of efficient and effective regulation with the need to be accountable and transparent. Its budget has reached $887 million – not far from that of the SEC itself – while compensation for its top ten executives exceeded $11 million in 2009. FINRA has a virtual monopoly on oversight of broker-dealers. And while most of the blame over the Madoff and Stanford schemes has been placed on the SEC, both firms were registered with and examined by FINRA for years.

Perhaps most concerning is the lack of transparency. While FINRA and other SROs can enact rulemakings that carry the force of law, they are not subject to the Administrative Procedures Act, Freedom of Information Act requests, and are not required to conduct any cost-benefit analyses. The disciplinary process raises due process concerns. Its board meetings are private and not subject to the Sunshine Act, of course. This lack of transparency and accountability to either the SEC, its members, or the public is a real concern underlying the present discussion over delegating authority to oversee investment advisers. The question of whether FINRA is a state actor is another issue that sooner or later will be raised in Congress or in the courts, as it has already been raised in at least one case concerning the invocation of the Fifth Amendment when the defendant was a registered person being investigated by FINRA as well as by the SEC and the Department of Justice.

Although the subject of an SRO for advisors is not necessarily the subject of this hearing, I must raise serious concerns regarding expanding FINRA's empire without a fundamental re-evaluation of its statutory functions and organization.

GENERAL MANAGEMENT APPROACH OF THE SEC

Management philosophies like Total Quality Management and Six Sigma teach that in any organization, measurement drives human behavior because the incentive is to try to meet the measurement criteria ("You get what you measure").

For example, Enron SEC filings were not reviewed for years because review personnel were judged by how many filings they reviewed, not necessarily by the quality of their review. The incentive was to postpone review of the complicated Enron filing because one could review many others in the time it would take to review Enron. By the late 1990s, this focus on numbers more than quality had decreased staff morale so much that employees began to organize to form a union. Despite management's campaign to thwart it, in July 2000, SEC employees voted overwhelmingly to unionize the workforce.

The emphasis on numbers over quality also affects behavior in the enforcement division and examination office. Every enforcement attorney knows that statistics (or "stats") help to determine perception and promotion potential. The statistics sought are cases either brought and settled or litigated to a successful conclusion, and amount of fines collected. These statistics do not necessarily measure quality (such as an investigation performed well and efficiently, but the evidence ultimately adduced did not indicate a securities violation). Thus, the stats system does not encourage sensitivity to due process.

In addition, the stats system tends to discourage the pursuit of penny stock manipulations and Ponzi schemes, which ravage mostly retail investors. These frauds generally take a long time and much effort to prove – the perpetrators tend to be true criminals who use every effort to fight, rather than the typical white-collar corporate violator of a relatively minor corporate reporting requirement who has an incentive to negotiate a settlement to put the matter behind him and

preserve his reputation and career. Thus, over the years several staff attorneys have told me that their superiors "actively discourage" them from pursuing Ponzi schemes and stock manipulations, because of the difficulty in bringing the case to a successful conclusion and the lack of publicity in the press when these cases are brought (with the exception of Madoff, these sorts of cases tend to be small). Some senior enforcement officers openly refer to these sorts of cases as "slip-and-fall" cases, which disparages the real effect that these cases have on individuals, who can lose their life savings in them. Because of the interstate and international aspect of many of these cases, if the SEC does not go after them, no one can or will. Not to discount the importance of combating any fraud, we need to remember that one individual losing his entire life's savings is extremely serious, even if it is "only" five digits in size.

During my tenure as commissioner, I advocated the need for the enforcement division not to minimize the importance of fighting microcap fraud, including Ponzi schemes, pump-and-dump schemes, and other stock manipulations. I was a strong advocate for the formation of the Microcap Fraud Group in the Enforcement Division, which was finally formed in 2008. I had also strongly supported the good efforts of the Office of Internet Enforcement, established under Chairman Levitt in the late 1990s, which worked closely with other law enforcement agencies to tackle internet and other electronic fraud. Unfortunately, it appears that while the administrative overhead functions within enforcement are gaining resources, insufficient attention is being paid to "boots-on-the-ground" investigative resources to combat the pernicious frauds that prey on individual investors.

Three years ago, in an article published in the Fordham Journal of Corporate and Financial Law[2], I called for the SEC to follow the example from 1972 of Chairman William Casey, who formed a committee to review the enforcement division – its strategy, priorities, organization, management, and due-process protections. Almost forty years later, and especially after the Madoff incident, this sort of review is long overdue.

[2] *See* Paul S. Atkins and Bradley J. Bondi, "Evaluating the Mission: A Critical Review of the History and Evolution of the SEC Enforcement Program," 8 Fordham Journal of Corp. & Fin. Law 367 (2008).

CONCLUSION

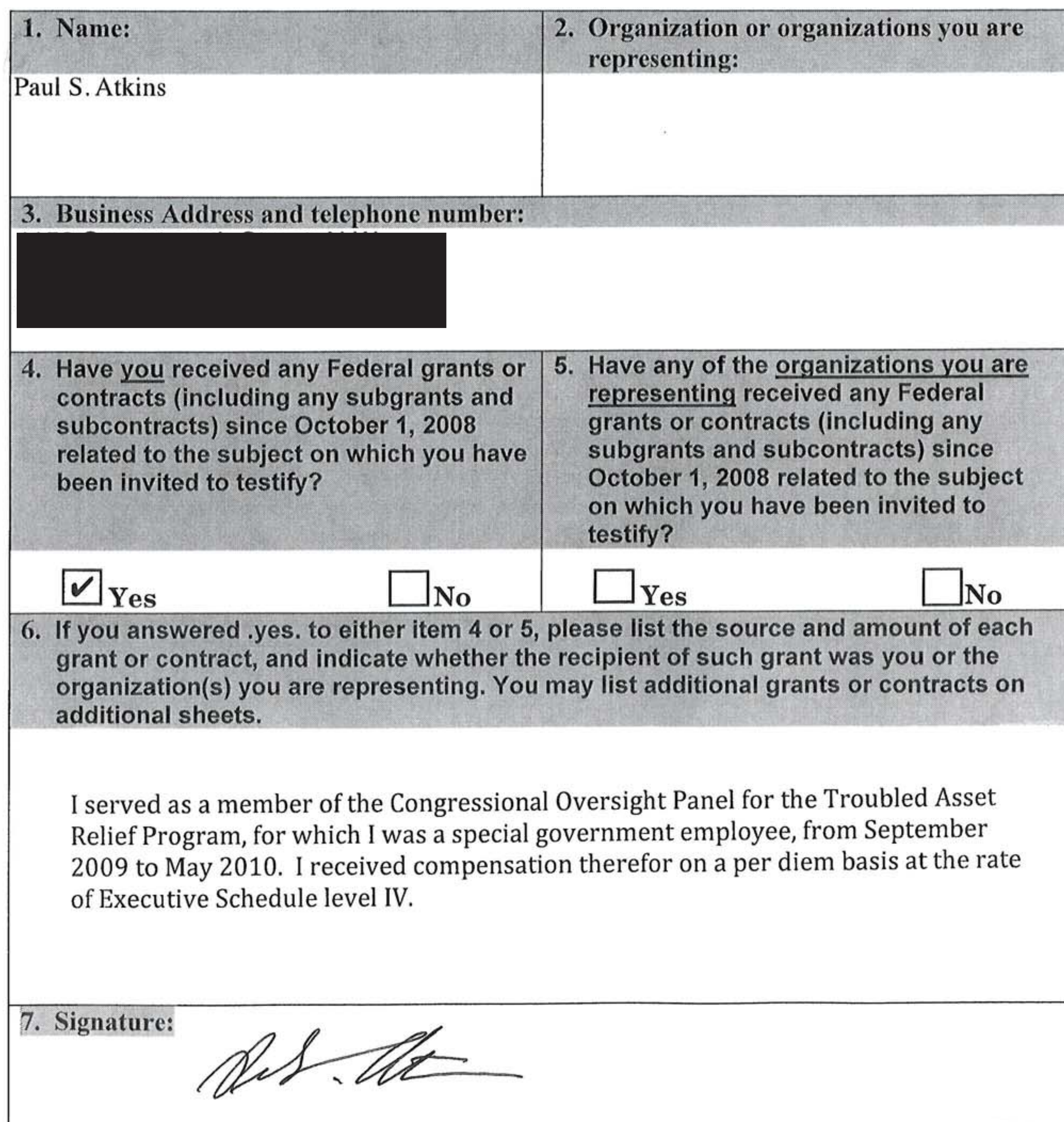
There are many intelligent, competent, dedicated, hard-working people at the SEC. It is the management system and how it determined priorities over the past decade that has let them down. The system essentially is unchanged today. I salute this Committee for taking on this issue and continuing a public discussion. It is far from a problem that is easily addressed by money or creating new offices, as Dodd-Frank has done. In the past decade, the SEC's budget has increased threefold and the fundamental problems remain. For the sake of investors, who have lost billions in fraudulent schemes that should have been discovered, it is high time that these organizational issues be addressed.

Thank you again for the invitation to come here and testify before you today.

United States House of Representatives
Committee on Financial Services

"TRUTH IN TESTIMONY" DISCLOSURE FORM

Clause 2(g) of rule XI of the Rules of the House of Representatives and the Rules of the Committee on Financial Services require the disclosure of the following information. A copy of this form should be attached to your written testimony.



1. Name:	2. Organization or organizations you are representing:
Paul S. Atkins	

3. Business Address and telephone number:

[redacted]

4. Have you received any Federal grants or contracts (including any subgrants and subcontracts) since October 1, 2008 related to the subject on which you have been invited to testify?	5. Have any of the organizations you are representing received any Federal grants or contracts (including any subgrants and subcontracts) since October 1, 2008 related to the subject on which you have been invited to testify?
☑ Yes ☐ No	☐ Yes ☐ No

6. If you answered .yes. to either item 4 or 5, please list the source and amount of each grant or contract, and indicate whether the recipient of such grant was you or the organization(s) you are representing. You may list additional grants or contracts on additional sheets.

I served as a member of the Congressional Oversight Panel for the Troubled Asset Relief Program, for which I was a special government employee, from September 2009 to May 2010. I received compensation therefor on a per diem basis at the rate of Executive Schedule level IV.

7. Signature:

Please attach a copy of this form to your written testimony.