WRITTEN TESTIMONY OF HARVEY L. PITT,
"FIXING THE WATCHDOG: LEGISLATIVE PROPOSALS TO IMPROVE AND ENHANCE THE SEC"
BEFORE THE HOUSE FINANCIAL SERVICES COMMITTEE

(September 15, 2011)

Chairman Bacchus, Ranking Member Frank, Members of this Committee:

## Introduction

I am pleased to appear here today, at your invitation, to discuss legislative proposals intended to improve and enhance the performance of the U.S. Securities and Exchange Commission ("SEC"), as well as the legislatively-mandated report issued by the Boston Consulting Group ("BCG"), examining the SEC's structure, operations and the need for SEC reform, and the SEC's response to that report.[1]

I am currently the Chief Executive Officer of the global business consulting firm, Kalorama Partners, LLC, and its affiliated law firm, Kalorama Legal Services, PLLC (together, "Kalorama"). My testimony at this hearing represents solely my own personal views, and does not necessarily reflect Kalorama's views, or the views of any Kalorama clients or employees.[2] As the Committee is aware, I had the honor of serving the SEC in two separate tours of duty, the first as a member of the SEC's Staff, from 1968-78, culminating with my service, from 1975-78, as SEC General

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1 The BCG Report was undertaken pursuant to §967 of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("DFA") Pub. L. 111-203, H.R. 4173, available at http://www.gpo.gov/fdsys/pkg/BILLS-111hr4173enr/pdf/BILLS-111hr4173enr.pdf. On September 9th, the SEC issued a response to that Report, which is available at http://sec.gov/news/studies/2011/secorgreformreport-df967.pdf.

2 Both Kalorama firms assist businesses seeking to improve their governance, transparency and/or regulatory compliance. Neither firm is available to oppose government (or self-regulatory) enforcement proceedings. Neither Kalorama firm has received any Federal grant or contract within the current and prior two fiscal years.

I was interviewed by the team that produced the BCG Report. I did not see anything that led me to question the Report's independence and good faith. *Cf.*, *see* David Hilzenrath, Washington Post, *Integrity of Report on SEC Questioned* (Mar. 18, 2011), *available at,* http://www.washingtonpost.com/business/economy/integrity-of-report-on-sec-questioned/2011/03/17/AB0fJ6m_story.html.

Counsel, and the second, from 2001-03, during which I served as the SEC's 26th Chairman.[3] For the past forty-three years I have either been employed by, or involved in matters affecting the SEC, and the Agency's organization, structure and efficacy are matters of great concern to me. My testimony today is based on my background in SEC operations, policies, and procedures, as well as my various positions in the private sector.

## Operative Assumptions

The key to successful financial services regulation requires that this Committee embrace several fundamental premises:[4]

- ***Government is a service business.*** The role of government, in my view, is to set normative standards of behavior for those subject to its commands, and then to expend its energies facilitating the good faith efforts of those who seek to comply with legitimate government standards. Of course, it follows, as it must, that government must also take swift and effective action to redress knowing or willful violations of appropriate regulatory requirements.

- ***The overarching obligation of government regulators is, first, to do no harm.***[5] Put another way, the answer to every problem is *not* necessarily to throw another regulation at it. In adopting rules and regulations, it is incumbent upon the government to minimize its intrusion into legitimate business activities, and in a careful and intellectually honest manner to assess the likely costs and benefits of any proposed regulatory action. This also means that government has an obligation to find the least burdensome, least expensive method of solving whatever problem is the object of its efforts.

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[3] As the Committee has requested, I have attached a copy of my current resume, summarizing my education, experience and affiliations pertinent to the subject matter of this hearing.

[4] Nearly eight decades ago, Congress recognized that the regulation of financial services and products is far more complex and involved than other forms of human endeavor, since the products being marketed are "intricate merchandise." H.R. Rep. No. 85, 73rd Cong., 1st Sess. (1933) 8.

[5] This phrase comes, originally, from the Hippocratic Oath to which all doctors presumably subscribe, but seems even more appropriate to apply to government regulators. The Oath can be found at http://nktiuro.tripod.com/hippocra.htm.

- ***The SEC's role in the first instance is to facilitate capital formation and enhance the efficacy of our capital markets.*** Although some perceive the SEC as an enforcement agency that also has regulatory powers, in reality it is a regulatory agency that also has enforcement powers. The best way to regulate complex markets is to start by adopting clear and concise standards of conduct, and then to provide assistance to those who seek to comply with those standards. Since there will always be some who do not abide by even the clearest and most concise standards, regulators must be prepared to enforce the standards they adopt. But, by definition—when a major violation of regulatory requirements occurs, and it has become necessary for an enforcement action to be brought—our regulatory system has already failed, in one sense. The most effective form of regulation is that which is readily understood, and relatively easily embraced, by those subject to its commands, and for which there is ample assistance from regulators for those desiring to comply in both letter and spirit of applicable regulations.

- ***Effective regulation requires a constructive, collegial and respectful partnership between regulators and their Congressional overseers.*** Administrative agencies were—and remain—a brilliant invention both Congress and the Executive branch of government seized upon because neither Congress nor the President have the capacity to perform the functions necessary to ensure the expertise, attention and oversight of complex private sector activities that enhance our economic well-being. And, while the private sector may boast greater efficiencies, it is essential for these regulatory functions to be guided first and foremost by the public interest, not solely by a profit motivation.

There are, of course, additional operative principles that should guide regulators, but the principles set forth above capture the essence of the best environment to promote agency effectiveness.

Effective regulation *cannot* result if regulators are treated as if they cannot be trusted to do anything right, and whose actions or inaction is subject to contemptuous and harsh public criticism and scorn. This does not mean that agencies should be immune from criticism. But, to have a salutary effect, criticism must be constructive, not destructive. Over the last several years, it has become fashionable to treat the SEC as if it were an institutional piñata. No agency can maintain the highest standards of regulatory excellence if those who toil under its banner are demoralized by constant criticism and paralyzed by the fear that—no matter what they

do or do not do—they will be criticized. For the Agency to perform optimally, there must be an effective partnership between the SEC and its oversight committees—one where Congress sets the goals to be achieved, and works to provide the Agency with the tools and, even more importantly, the trust and authority, to achieve those goals.[6]

Those who wield government power must be held accountable for the policy choices they make, those they eschew, and the natural and logical consequences of both. In turn, accountability requires holding agencies like the SEC to appropriate standards that provide, in reasonable detail, the reasons for administrative action or inaction, and explain the alternatives rejected along the path to creating new regulatory mandates. These precepts also require that Congress provide agencies with substantial flexibility to achieve Congressionally-mandated goals, flexibility that will permit the agency to adapt its regulations to new and different private-sector activities in future years, without having to receive new authorizations from Congress every time a creative and unanticipated new product or service arrives on the market.

In assessing the effectiveness of a multi-headed agency such as the SEC, there is a fundamental distinction between commissions and boards, on the one hand, and single-administrator agencies, on the other. The benefits of a commission or a board include the ability to bring a diversity of viewpoints, perspectives, expertise and regulatory philosophy to any nettlesome problem. In agencies like the SEC, collegiality becomes a major component of the agency's effectiveness. Decisions must be made on the basis of compromise, and reflect respect for a variety of perspectives. Single-administrator agencies are often capable of greater efficiency, since only one person's approval is required, but they also can succumb to a lack of independence, a failure to consider differing viewpoints, and an insularity that is the ineluctable result of having action or inaction determined solely by one individual's point of view.

**Regulation by Habit**

Agencies, like the individuals who guide them, can become set in their ways, resistant to change, and insensitive to changing dynamics all around them. One major benefit of *constructive* Congressional oversight is that it provides an external check on any agency's lapse into regulation by habit—the notion that, since the agency has always done something one way, there is no reason to consider doing it any other way. Without

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[6] Mia Hamm, a U.S. soccer legend, expressed it well when she noted that "success breeds success." Conversely, agencies that are constantly pilloried find it hard not to live down to their newly-denigrated stature, no matter how undeserved that reputation might initially have been.

Congressional oversight, the accountability of administrative agencies would be significantly diminished.

When I returned to the SEC in 2001, I had spent the immediately preceding quarter of a century in the private sector, observing the effects of "regulation by habit" on businesses. As a result, I commissioned a top-to-bottom review of the SEC's effectiveness and efficiency. Aware of the Staff's deep mistrust of those who seek to "reform" the Agency or make it more "efficient," I directed that we conduct this review by utilizing two people from every SEC Office and Division to conduct the study, with the proviso that no member of the Staff could perform the review with respect to his or her own division or office. We also hired an outside consultant to facilitate, but not to lead, the process. The result was a detailed set of recommendations on the ways that every one of the Agency's principal offices and divisions could improve its effectiveness and efficiency.

I intended to release the study to the public, but our completion of the effort coincided with the last few months of my tenure. I gave a copy to my successor, and acquiesced in his request that he be allowed to release the study after having had a chance to review it. Among the report's observations was a recognition that the SEC and its Staff tended to be reactive to marketplace events, rather than getting ahead of issues before they became crises. Unfortunately, the study has never been released, although a number of recommendations—including the creation of a risk management unit—were ultimately implemented.

As I had expected, there were Staff concerns about some of the recommendations. While I did not necessarily agree with all of the objections that were raised, I did want to accommodate legitimate concerns and demonstrate that the effort was intended solely to improve the responsiveness of the SEC to the needs of those whose businesses are affected by the Agency's activities, not to impose more onerous and unnecessary restrictions on the Staff's ability to react to situations nimbly and effectively. Putting to one side, for the moment, the substance of the BCG Report, I believe the effort embodied in the DFA—leading to the BCG Report—was an appropriate way for Congress and the SEC to collaborate on whether, and how, the Agency's powers, practices and resources should be revised or reformed.

The BCG Report having only been issued in March, and the SEC's responses to the Report only having been released last week, I believe that it is wise to give the process a chance to develop itself and move forward. There is certainly more that needs to be done, and more information that will need to be gathered. But, having adopted a sensible mechanism to look at the issue of SEC effectiveness, it is my view that Congress should facilitate the process it created, and determine whether

it provides an effective way to consider important issues that clearly warrant deliberation.

**Reflections on the SEC Management Review I Initiated**

The review I initiated as SEC Chairman was constructive for the Agency, for several reasons. Among others, it brought the skills of some of very able Staff members to bear in evaluating how other Divisions and Offices functioned, and permitted a fresh perspective on how ably and efficiently the Commission as a whole was performing its functions. Beyond this, the mere act of rethinking how an agency performs its functions makes everyone more focused on exactly what it is the agency is supposed to be achieving, and assessing whether, and how well, the agency fulfills its mission.

Those who seek sustainable change must accept one axiomatic proposition—sustainable change for either individuals or regulatory agencies can only come from within. Change that is motivated from outside an agency, no matter how forcefully it is urged, rarely produces beneficial changes that can be sustained for significant periods of time. Periodic self-examination is beneficial, especially if it causes professionals to rethink existing approaches to problems and tasks, and to use their creativity to conjure up more imaginative and effective ways to tackle the same issues the agency has been facing for decades.

But I believe that the review I initiated could have been more consequential in modernizing and reinventing the SEC, had it been done somewhat differently. One significant improvement that could have been made in our methodology would have been to involve other groups in the process of review and reform. Congress, for example, was not a party to the processes we followed, and that effectively deprived our efforts of an important level of guidance and oversight that could have helped track our study's progress and recommendations. Additionally, knowledgeable groups that are removed from politics and government could have played a constructive role in offering objective and independent perspectives.

My concern at the time was to avoid posturing and defensiveness—two frequent responses of those whose activities are subject to efficiency reviews. In hindsight, that would have been mild compared to the criticism the SEC now seems to garner daily, even from those who presumably need no persuasion that the SEC's mission is absolutely critical for our economic growth and personal freedoms. One important role Congress can perform is to ensure that the process of self-evaluation is taken seriously, and executed in a manner that makes it more likely that the ultimate results will have appropriate utility. That, of course, is not the only—or even the most important—role that Congress can perform, but it

is a significant role nonetheless. By identifying the issues it believes are worthy of review and reflection, Congress can define the scope of Agency self-examination, and ensure that the results will definitely matter.

**Assessing DFA §967 and the Resulting Report**

As I am sure the Members of this Committee are aware, I have been critical of a great deal of the DFA, not because the goals were not salutary, but rather because the execution did not provide any reasonable assurance, in my view, that the problems that led to DFA's enactment would readily be solved, or cabined, by the legislation. But, the preceding observations lead me to offer my strong support for the approach to self-assessment embodied in DFA §967. Congress mandated that the SEC engage an independent consultant in embarking upon a program of review and reform of the Agency. The basic elements are all present here:

- Congress provided a general framework for the SEC to engage in a process of review and reform, and included core principles to guide the process;
- The SEC was afforded substantial authority and flexibility in engaging the process of review and implementation;
- An independent outside group—BCG—was selected to offer its independent and objective guidance, and the consultant was given concrete and clear definition as to the issues on which it should focus; and
- Congress maintained its essential oversight function, to ensure that the SEC continues with the designed framework into the future.

In its review, BCG focused on four critical areas of the SEC's operations:

- Organizational structure,
- Personnel and resources,
- Technology and resources, and
- Relationships with SROs.

In addition to outlining the areas that needed to be reviewed, DFA §967 directed that the resulting Report contain recommendations

regarding the possible elimination of unnecessary or redundant SEC units, improving communications between and among internal SEC offices and divisions, the need to develop a clear chain-of-command structure, particularly with respect to the work of both the Division of Enforcement and the Office of Compliance Inspections and Examinations ("OCIE"), the effect of high-frequency trading and other technological advances on the market and what the SEC requires to monitor both such trading and advances in technology, the SEC's hiring authorities, and whether the SEC's oversight of, and reliance on, SROs is necessary to promote more efficient and effective governance of our securities markets.

The BCG Report noted the SEC's demonstrated commitment to self-improvement, even prior to the passage of the DFA. As previously noted, this is an essential prerequisite to effecting sustainable change. I believe Chairman Schapiro and the current Commission deserve high praise for the efforts they have undertaken to improve the efficiency and performance of the Agency. Prior to the commencement of Chairman Schapiro's tenure, the SEC was facing the prospect of being relegated to the regulatory agency scrapheap. I believe that there are valid criticisms that can be leveled at how the SEC handled some fairly crucial issues, but having the Agency totter on the brink of extinction was never a good idea. I think the current leadership at the SEC has done a remarkable job of restoring the Commission's effectiveness, in the face of criticism that continues unabated, despite significant improvements in its performance and structure.

Of the many changes the SEC adopted on its own, its reorganization of the Division of Enforcement and OCIE, and the changes it made with respect to the positions of Chief Operating Officer and Chief Information Officer, were deemed especially noteworthy, and rightfully so. The Commission does not, unfortunately, get credit for these efforts, and they go largely unnoticed and unsung. There are valuable recommendations in the BCG Report, although no one can embrace all of them. But, of great significance to this Committee and its Senate counterpart, I believe, was the Report's recognition that, even if the SEC were fully committed to each of the Report's recommendations, optimization would only go so far, limited as a result of the paucity of the SEC's current resources.

The Report challenged Congress with an ultimatum that—at its foundation—recognizes the gross chasm between the SEC's current mandate (a mandate that seems to grow repeatedly) and its resources: the BCG Report challenged Congress to give the Agency the resources it needs to fulfill its extensive list of responsibilities, or maintain the current level of resources but narrow the Agency's mandate. I find this challenge interesting, but largely irrelevant. There is no doubt that Congress cannot, and should not, retreat from the SEC's current mandate. The

Agency has been working assiduously since the DFA's passage to introduce a host of regulatory changes that will have profound effects on our financial and capital markets. Whether that was the right approach or not is no longer a meaningful question; Congress did what it did, and there is a compelling need for it to act responsibly and give the SEC the tools it needs—and the public interest demands that it have—to succeed in meeting its many and difficult challenges.

In response to these conclusions, it has been suggested that the SEC should first demonstrate its competence, and then Congress can consider whether it should receive additional resources. Given the passage of the DFA, the syllogism implicit in this approach is:

- The SEC's past performance of its mandate is troubling;
- We have exponentially increased the SEC's existing mandate; and
- If the SEC adequately performs its exponentially-expanded mandate with inadequate resources, we will consider giving it more resources!

This reasoning, in my view lacks merit. Indeed, in many ways, it reminds me of the TV show in the mid-'60s, "Get Smart," a riff on spy-genre movies and TV shows, starring Don Adams as Agent Maxwell Smart, and Barbara Feldon as Agent 99. The opening sequence each week showed a huge, thick and closed steel door that said, in bold letters, "Knock before Entering." Right below that was a second, smaller sign, that read simply "Don't knock." If the SEC has exhibited certain deficiencies, how can piling on additional responsibilities but depriving the Agency of the necessary resources to fulfill its functions actually improve its performance?

I believe that the appropriate solution is to give the SEC what many other U.S. financial regulators possess—the ability to self-fund their operations. Doing this would provide flexibility to respond to unanticipated market developments, permit better market surveillance, enhance the SEC's technology resources, enable the agency to recruit individuals with relevant skill-sets, and enhance the critical SEC attribute of political independence.

The argument against this approach is that it would deprive Congress of the ability to see how the SEC spends the money it receives. I do not believe the SEC should be given a blank check, but rather, that it should have to account for every dollar it spends. In these times of budgetary crisis, not permitting the SEC to self-fund is the surest way to put unnecessary pressures on the Country's budget, deprive the SEC of the resources it needs to do its expanded obligations effectively, and set

the SEC up for failure, no matter how hard it works and no matter how creative it is.

Other Solutions

Beyond self-funding, there are other solutions that could facilitate the SEC's improved effectiveness. In particular, in February 2003, at my direction, the Commission proposed a solution I believed was necessary back then, and even more necessary today, in light of the new rigors imposed by the DFA.

When I took office in 2001, OCIE claimed that it was examining registered investment advisers on a purported five-year cycle. I had two problems with that statement. First, based on my own experience representing many of the leading money managers, I knew the statement was not accurate. Second, and even more importantly, I was concerned that, even if accurate, a five-year cycle was meaningless: you can hide a lot of fraud in the five years between examinations! Investors are entitled to have annual or, in the case of smaller money managers, biennial, examinations of those to whom they entrust their money. As much sense as that approach might have made in 2003, it is inescapable and unarguable in 2011. The Commission is responsible for 6,000 broker-dealers, 11,000 investment advisers, numerous ratings agencies, self-regulatory organizations, 8,000 hedge funds, not to mention ATSs and other regulatees.

In February, 2003, the Commission published for comment a proposed regulatory regime that would require anyone who engaged in securities transactions with the investing public, or any segment of the investing public, to procure a compliance audit every year or every other year from a truly independent, knowledgeable compliance auditor that would be required to meet SEC qualifications and conduct examinations pursuant to guidelines and standards the SEC would set.[7] These compliance audits would be modeled after financial audits required to be obtained by public companies every year. While the requirement of an independent financial audit does not prevent financial frauds from ever occurring, it does provide a mechanism to deter those hell-bent on committing fraud, and to enable the Commission to pursue prior audits as a means of ascertaining how frauds may have been committed and how they may be redressed.

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[7] *See* Compliance Programs of Investment Companies and Investment Advisers, Investment Company Act Rel. No. 25925, Investment Advisers Act Rel. No. 2107, 79 SEC Docket 1696 (Feb. 5, 2003).

## Comparing the DFA Framework with the Modernization Act

There are additional reasons to allow the DFA framework to continue, vis-à-vis the top-to-bottom review of the SEC that it mandated. The SEC has demonstrated a strong commitment to reform, even before the BCG Report was issued. As the BCG Report accurately notes, the SEC already has made great strides in its restructuring of both the Division of Enforcement and OCIE. Having addressed this issue legislatively within the past year, and with the effort still ongoing, it would seem prudent for Congress to let the process it commenced work its way toward a conclusion.

The SEC's restructuring of its Division of Enforcement has been underway for well over a year. To date, it has already eliminated a layer of management to streamline the Division's internal management and processes. Flattening the Division's management structure has already created efficiencies at the SEC. With the removal of unnecessary internal reviews, there is less duplication and reduced time required to complete decision-making, two flaws in an over-managed organization, freeing up additional resources to utilize in connection with substantive investigative efforts. This result is especially significant in light of the proposal in the Modernization Act to increase reporting lines by restructuring the Agency so that numerous offices report to the Office of the Chairman—an increase in management layers, leading to less efficiencies of the sort already realized by the Agency's own restructuring of the Enforcement Division.

The BCG Report also discusses the fruitful and comprehensive self-assessment the Commission has implemented vis-à-vis OCIE, a process that began before the BCG Report had been commissioned. OCIE assessed its strategy, structure, people, processes and technology to strengthen its examination program, and established an integrated National Examination Program to enhance consistency, effectiveness and efficiency across the regions. It is manifest that the SEC has begun a serious process of self-assessment and restructuring, in advance of the BCG Report, reflecting its commitment to drive significant change from within.

In this respect, the Commission has demonstrated not only that it is open to constructive criticism, but even more so that it can be relied upon to respond intelligently and effectively to its myriad responsibilities. Just six days ago, on September 9, 2011, the Commission issued a statement detailing its progress with respect to the implementation of the BCG Report's recommendations. Significantly, the SEC cites resource constraints and time demands as difficult challenges—pragmatic realities that must remain at the forefront of Congressional consideration when

contemplating the current and future structure and responsibilities of the SEC.

The Commission already has taken meaningful strides, including designating the SEC's new Chief Operating Officer—Jeffrey Heslop—as the Executive sponsor for the Agency-wide analysis and implementation efforts in response to the recommendations in the BCG Report. The Commission has established "workstreams" to address the BCG Report's recommendations for further analysis and action. The Agency has even established a program management and government infrastructure in order to oversee this change initiative. There is no reason to burden this Written Statement with a recitation of everything the Commission detailed in its September 9th Response, but it is noteworthy that its release described progress on eighteen workstreams, including organizational assessments, improving personnel, cost improvements, restructuring, prioritizing regulatory activities and a host of additional efforts.

This evidences the fact that the SEC has been working for well over a year on its own reform, and has been expending a great deal of time and resources on analyzing and implementing the recommendations in the BCG Report, as mandated by the DFA. It would be short-sighted and, potentially, counterproductive to abort these efforts mid-stream, without giving them a chance to work. In discussing inefficiencies, one critical management inefficiency to avoid is veering off a path mid-way through the effort, especially where, as here, the path has proven beneficial so far. No Agency efficiencies will be realized by an about-face at this point, and much inefficiency will surely result. This is clearly not the intent of the Modernization Act's sponsors, so it is important that this Committee make sure that an undesirable and unintended consequence of that Bill does not occur.

Insofar as the obligation to perform cost-benefit analyses is concerned, it is perhaps important for this Committee to ascertain what, if any costs and benefits are likely to result from the adoption of either the Modernization Act or the Regulatory Accountability Act, or both. In 2006, I wrote an Op-ed piece that was published in the Wall Street Journal, and noted that many of "[t]he SEC's troubles can be traced to a mentality that often plagues regulatory bodies and legislative efforts: that any time a problem arises, the solution is to toss another regulation or statute at it."[8] To honor the critical values that undergird both legislative proposals—the need for greater efficiency, and developing a healthy suspicion towards additional regulation—necessarily demands that we pause before embracing a legislative solution to an existing legislative program that does not call for repair.

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[8] A copy of the Article is attached hereto.

## The Modernization and Regulatory Accountability Acts

Both the Modernization Act and the Regulatory Accountability Act stem from admirable purposes, but ultimately fall short of their intended mark. I agree with the notion in the Modernization Act that the DFA should be modified, but any modification that is proposed, much less enacted, should give the SEC more flexibility in the way it is required to implement Congressional mandates. The Modernization Act is, like the DFA, too restrictive, and does not give the SEC the requisite flexibility required if the Agency is to achieve the salutary results the sponsors of the Modernization Act would like to see.

If this Committee truly wants to assist the SEC to achieve its multiple mandates far more effectively, it should focus on giving the Agency the flexibility to govern itself so that it can adapt instantly and meaningfully to new trends, services and products that are cropping up on a daily basis. This notion is supported in the BCG Report, which found that the DFA's directive to the SEC to create five new offices, and have four of them report to the Chairman, is too rigid. Instead, the BCG Report recommends that Congress act to authorize flexibility for the Agency to organize these offices in a way that reduces duplication within existing divisions and offices. That is precisely the type of flexibility the SEC requires, and deserves, if it is to create efficiencies and a sensible management structure.

The same principle applies equally to the consolidation of offices that would be required if the Modernization Act were enacted. Interestingly, the Bill and the sponsors' statements do not discuss any cost-benefit analysis performed, or even any purported rationale, to show how the consolidations and restructuring efforts it proposes, and that how adding additional management layers under the Office of the Chairman, would create efficiencies or save on resources. Moreover, the Modernization Act would likely cause certain critical SEC functions to lose independence—for example, the Office of General Counsel—if they are suddenly required to report to the Commission's Chairman, rather than the five Commissioners.

Even apart from independence, the SEC's restructuring of the Enforcement Division already demonstrates that efficiencies result from less bureaucracy at the SEC, not more. And, beyond the SEC's own restructuring efforts, the Modernization Act would make it difficult for the Commission to effect efficiencies, since far too many employees, and far too many responsibilities, would be placed under a single office or division head. This would cause the existing offices and divisions to diffuse or lose their focus, as a necessary by-product of an increase in too many issues

for which individual division and office heads would be required to assume responsibility.

The legitimate Congressional concerns that have led to the proposal of the Modernization Act can be addressed and satisfied without mandating rigid frameworks. For example, improving the SEC's technological framework for more effective communication and cross-divisional collaboration can work to solve problems that may have motivated proposed consolidations.

From an institutional standpoint, when Congress weighs in on the minutiae of an agency's organizational structure, it is reaching beyond its expertise. This is why self-assessments and independent assessments, like that of the BCG Report, are so effective, and should be given a chance to fulfill the promise that's already been shown. The Division of Risk, Strategy and Financial Innovation is another area that has already been shown to produce beneficial results. Those benefits would be lost if this new office were split up, or extinguished, as proposed in the legislation. The synergies between risk identification and management will produce many intellectual benefits that would not exist in the proposed structure that would be forced upon the Agency.

The decision to establish this Division was quite significant in the Agency's history, especially in light of emerging trends and utilizing the economic approach of logical consequences for behavior choices—something the Agency cannot afford to lose. A cost-benefit analysis of the Modernization Act, on balance, does not evidence efficiencies that could conceivably outweigh the cost of such an endeavor.

**The Accountability Act**

The proposed SEC Regulatory Accountability Act is focused on cost-benefit analyses, something critical for the Commission to master and perfect, and something that the Agency has not recently proven itself. As a result, regulatory accountability is quite important, but the framework proposed to achieve that result is too rigid, the same flaw from which the Modernization Act suffers.

There should be no doubt that the Agency should adopt the most efficient, least costly alternatives available to it; however, the complexity of the analysis that would be prescribed by the Accountability Act seems far too cumbersome to provide any practical guidance for the SEC to attempt to satisfy. The public would be better served if Congress were to give the SEC more general guidance, and perhaps specific guidance with respect to individual statutory requirements, to address specific issues related to the purposes behind a particular legislative provision.

Furthermore, one major difficulty in the structure of the Accountability Act is its failure to distinguish between those legislative provisions in which Congress *authorizes* the SEC to adopt rules—for example, the DFA authorization permitting, but not requiring, the SEC to adopt so-called "proxy access" rules—and those statutory provisions that *mandate* the SEC to take specified regulatory action. The two circumstances do not equally lend themselves to the kind of analysis the Accountability Act would impose.

Thus, looking at the DFA provision permitting the SEC to adopt "proxy access" rules, but not compelling that it do so, the Accountability Act articulates standards for the performance of a cost-benefit analysis, although it is not clear that a new statutory framework is needed to achieve that goal. Indeed, the notion that the SEC might be subject to different standards than other agencies raises questions that should be explored, rather than merely assuming that it is appropriate to require this Agency to engage in a burdensome analysis that its financial services regulatory peers are not required to undertake.

To her credit, Chairman Schapiro issued a very cogent statement regarding the Agency's decision not to seek further review of the D.C. Court of Appeals' proxy access decision, indicating that the Agency intended to pursue the wisdom the court's decision imparted to it. This does not seem to be the kind of situation that requires yet more standards for the SEC to meet. Since the Agency will continue adopting rules, whether or not the Accountability Act is enacted into law, it begs the question of why Congress would want to drain the Agency's meager resources even further by requiring it to litigate every single challenge to the DFA rules it must enact.

This leads to the principal drafting flaw in the Accountability Act—its imposition of onerous standards not just where the Agency has discretion whether or not to adopt a particular rule, but also in those situations where the Agency has no choice but to adopt a rule because that is what Congress directed the Agency to do. In those cases, almost without exception, the notion that the SEC must nevertheless consider such alternatives as not adopting any rule at all, is imprudent. If Congress has told the SEC it *must* adopt a rule, why should it also require the same Agency to consider whether it should not adopt any rule at all? To ask this question is effectively to answer it, and yet that is what the Accountability Act would require of the SEC.

The Accountability Act may reflect an understandable effort on the part of the Bill's sponsors to find a way around some of the mandates contained in the DFA. If Congress is troubled by some of its recent mandates to the SEC, however, it should confront that issue directly. The

SEC should not be put forced to contend with those who think the DFA was a good legislative effort and those who prefer to see it repealed. Rather than adding mandates and rulemaking obligations to the SEC's obligations, and modifying the prior DFA mandates to the SEC piecemeal, Congress should reconsider its prior mandates *in toto*. It should not, however, create an impossible burden for the SEC to try to meet. Moving forward with a blended approach will only serve to burden the SEC with an awkwardly imbalanced mandate, and is sure to result in great inefficiencies.

Administrative accountability is both critical and valuable, provided the standards established are workable, and can actually be satisfied. Of course, even if the standards established are workable, the manner in which those accountability standards are actually implemented can destroy an effective idea.

A case in point is the SEC's Inspector General, and his unprincipled approach to Agency and employee performance. Every agency has, and can benefit from, an effective, vigilant and thoughtful Inspector General. But if the incumbent is unable to conduct his reviews fairly or impartially, the IG will not enhance performance or accountability; he will produce an inappropriate environment of fear, where employees are afraid to put anything in writing for fear that anything, regardless of how innocuous it is, can be turned into some sort of purported scandal. This has the effect of reducing accountability, not increasing it.

At the SEC, the current IG apparently has no securities background. And yet, he opines on issues of substance, almost invariably finding that the Agency or its employees have acted contrary to what they should have done. Many of the criticisms leveled against hard-working, well-intending, SEC Staff members are not calculated to educate or improve employee performance, or prevent fraud and corruption; rather, they appear aligned with their consequences of destroying reputations, destroying Staff morale, and crippling true Agency effectiveness. The end result of these investigations—curiously and typically—are media headlines, which begs the question of motive.

When employees are afraid to seek assistance, put their questions in writing, or explore issues of complexity, accountability is destroyed, not enhanced. Since this Committee is interested in improving SEC accountability, it should consider the activities of a single individual, and the office he heads, who seemingly operates on the assumption that he can effectively terrorize innocent employees under the guise of upholding the law but not follow the law himself, even with respect to basic

constitutional and ethical requirements, nor be held accountable for any of this behavior.[9]

## Conclusion

As I noted at the outset, I am grateful for this opportunity to express my views on a broad array of important issues, all revolving around making an important regulatory agency even more effective than it has previously been. I stand ready to try to assist the Committee in any way I can, and to respond to any questions the Members of the Committee might have.

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[9] On several occasions, I have represented individuals before the current SEC OIG (as I have done with respect to his predecessor), strictly on a *pro bono* basis. I have found the process currently employed to be Kafka-esque, fraught with diatribes and bereft of professional integrity.

THE WALL STREET JOURNAL.
WSJ.com

BUSINESS WORLD | JULY 26, 2006

# Over-Lawyered at the SEC

By HARVEY L. PITT

The rule of law -- first articulated in the 17th century and the foundation on which this nation was built -- holds that governmental authority must be exercised in accordance with its terms and restrictions. It is a necessary precondition for the emergence and flourishing of free-market economies in general and capital markets in particular. For markets to work, the rules must apply not only to people and businesses subject to authority, but also -- especially -- to the actions of government itself.

To descend from these theoretical heights, we turn to the SEC. Over the past 72 years, it has built a strong record of enforcing the rule of law in America's capital markets. And yet three recent regulatory fiascos in the tumultuous period between 2003 and 2005 seem to betray that history.

The SEC's twice-failed efforts to compel mutual fund boards to be governed by independent chairmen, and its now discredited effort to regulate heretofore unregulated hedge funds, may appear to be merely more examples of bad lawyering -- which, of course, they are. But there are very capable legal minds at work at the SEC, and even they couldn't salvage these rulemaking efforts. The problem was more fundamental.

The SEC's troubles can be traced to a mentality that often plagues regulatory bodies and legislative efforts: that any time a problem arises, the solution is to toss another regulation or statute at it.

Even if that bias were occasionally appropriate as an instinctual response -- a doubtful proposition -- it doesn't work at an agency that should be far more attuned to economic analysis. The SEC approached its mutual fund and hedge fund rulemaking efforts as if they presented legal issues; but they were -- and remain -- inherently economic.

Wanting to respond to the twin mutual fund peccadilloes of market timing and late trading, the SEC decided to require that funds be governed by independent chairs and a supermajority of outside directors. These were not rational responses to the economic realities of the concerns that were raised at the time.

There were four fundamental problems: First, authority over and responsibility for mutual funds actually -- and quite rightly -- resides with the investment managers, not with passive boards. In large part, this problem was compounded by the 60-year-old legislation the SEC administers: It treats mutual funds as companies when the economic reality is that they are products. Second, the SEC adduced no evidence that funds with independent chairs had functioned (or would function) any better than funds with management chairs. There was empirical data available, but it was ignored. Third, the SEC had no idea what the costs or economic effects

of its regulatory solutions might be. Last, the SEC failed to adequately consider less-invasive alternatives to its majority's preferred approach.

The problems with the SEC's now-aborted effort to regulate hedge funds were even worse. While the commission concluded that it ought to extend its regulatory yoke, it failed to deliver any empirical support for that conclusion and only presented lip-service justifications. The economic reality of hedge funds is that they cater to sophisticated investors, and the SEC never adequately addressed why it should stretch its limited resources to try and cover investors who can fend for themselves. Moreover, the SEC reversed an exemptive rule it had adopted two decades earlier -- one on which hedge funds had relied to their economic detriment -- with no indication as to why or how economic reality had changed the rationale for that exemptive rule. As SEC Chairman Chris Cox testified before the Senate Banking Committee yesterday, the SEC now needs to adopt a panoply of emergency rules to undo the effects of its ill-advised prior effort to extend its regulatory reach to hedge funds.

This is surprising for an agency that's directed by Congress not simply to protect investors, but to do so by facilitating the efficiency and functioning of our capital markets, and by improving innovation and competition. It's the latter obligation that far too often gets lost in the rush to promulgate new rules and new obligations -- without doing the necessary homework beforehand or evaluating whether its existing regulations serve their intended purposes.

Ultimately, the problem with the SEC's failed rulemakings (which has permeated agency efforts since its creation) is that it's over-lawyered: The agency relies too heavily on legal doctrinarism.

In light of its capital market functions, the atrophied state of the SEC's economic analysis capacity is glaring. A steady flow of relevant information is the lifeblood of sound capital markets. If data is generated and made available, market participants can make determinations without needing government paternalism. All too often economic analyses are performed at the SEC because they're required, not because it genuinely wants to know the economic implications of its various initiatives.

The SEC has a critical mandate -- enforce the rule of law -- and it's developed a potent enforcement capability. But its sometimes excessive reliance on lawyers and rules, instead of economists and analyses, has caused the commission to stumble badly.

It's time that things begin to change. With its third foray into mutual fund regulation, there is a chance to consider solutions that will better protect the investing public, yet limit the need for heavy-handed government regulations. And, with a chance to reconsider the wisdom of any effort to regulate hedge funds, the agency has a chance to back away from an ill-advised initiative; to do that, it will require the willing assistance of the hedge fund community to shoulder responsibility for developing its own best-in-class standards that obviate the need for government intervention.

The stars now seem aligned to enable the agency to address its real mandate -- promoting efficient as well as honest capital markets -- rather than devolving backwards and reflexively deciding to pursue additional regulatory initiatives merely for the sake of appearing to have responded to perceived problems.

***Mr. Pitt, CEO of Kalorama Partners, was chairman of the SEC from 2001 to 2003.***

Printed in The Wall Street Journal, page A15

# 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: |
|---|---|
| HARVEY L. PITT | SELF |

**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? |
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| ☐ Yes ☑ No | ☐ Yes N/A ☐ 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.**

**7. Signature:**

Harvey L. Pitt

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