

# U.S. SECURITIES AND EXCHANGE COMMISSION: A Roadmap for Transformational Reform

## SUMMARY OF RECOMMENDATIONS

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CENTER FOR CAPITAL MARKETS  
COMPETITIVENESS



By Jonathan G. Katz



The U.S. Chamber of Commerce, which represents the interests of more than 3 million businesses and organizations of every size, sector and region, strongly believes that the U.S. capital markets are the lifeblood of our economy.



## CENTER FOR CAPITAL MARKETS COMPETITIVENESS

Since its inception, the U.S. Chamber's Center for Capital Markets Competitiveness has led a bipartisan effort to modernize and strengthen the outmoded regulatory systems that have governed our capital markets. Ensuring an effective and robust capital formation system is essential to every business from the smallest start-up to the largest enterprise.

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Jonathan G. Katz served as Secretary of the SEC for almost 20 years. During his tenure he served under the leadership of seven Chairmen, four Acting Chairmen, and nineteen Commissioners. While at the SEC, Katz actively participated in numerous initiatives to improve agency operations and efficiency. He also authored the Chamber's 2009 Report, entitled *Examining the Efficiency and Effectiveness of the U.S. Securities and Exchange Commission*.

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# U.S. Securities and Exchange Commission: A Roadmap for Transformational Reform

In response to the stock market crash of 1929 and the Great Depression, Congress created the U.S. Securities and Exchange Commission (SEC). Throughout much of its history, the SEC has been the preeminent financial regulator, successfully overseeing the world's leading capital markets. However, for more than a decade, the SEC regulatory and enforcement structures have failed to keep pace with rapidly changing markets. This is attributable to a variety of factors including, but not limited to, structural and managerial inefficiencies at the SEC, rapidly evolving markets, and the rise of intense global competition. The purpose of this report and its recommendations is to restore the SEC as the world's premier financial services regulator.

Businesses and investors alike need a modern, efficient, fair, and tough regulator. America's ability to maintain the world's deepest and most liquid markets hinges in part on having a strong, effective, and even-handed regulator. While outdated and broken regulations and ineffective application of regulatory authority were not the primary cause of the 2008 financial crisis, they should not be overlooked as contributory causes. The financial crisis has laid bare many of the shortcomings of an agency that is grounded in an outdated view of the world's financial markets and is in profound need of transformational reform.

This need for transformational change supplants earlier proposals for reform. In 2009, the U.S. Chamber of Commerce released its first SEC reform report: *Examining the Efficiency and Effectiveness of the U.S. Securities and Exchange Commission* (2009 Report). While the 2009 Report made 23 recommendations for reform, they were proposals for incremental change. We fully recognize that over the past few years, the current leadership of the SEC has begun to address some of the key weaknesses of the agency and positive progress has been made in some areas. However incremental change will no longer do.

This report makes constructive reform proposals that, taken together, would help to achieve the level of change needed to transform the agency. In order to achieve fundamental reform of the agency, we recommend:

- 1. Developing a bold and clear plan.** We provide many ideas in this report, including how to make rulemaking, supervisory inspections, and enforcement more effective.
- 2. Putting someone in charge of implementing the plan.** We recommend increasing the size of the Commission from five to seven members and designating a Deputy Chairman for Management and Operations among the Commissioners to lead the day-to-day implementation of this turnaround program.
- 3. Removing statutory and practical obstacles to transformational reform.** Fixing some of the structural weaknesses of the SEC, including the number of mandated direct reports to the Chairman, will require statutory revisions. And the Commission will need sufficient labor flexibility to make changes to ensure it has the staff with the appropriate skills to carry out its expanded and modernized responsibilities. This report recommends

ensuring that the Commission has the ability to hire the right people with the right skills to regulate the 21st century capital markets, and ensure that staff are put in positions to succeed—or are removed. It also recommends changes in procedures to ensure that necessary technology improvements can be effectively developed and successfully incorporated into the agency’s core programs.

- 4. Tying increased funding and resources to the transformation process.** The transformation of the SEC will need to be adequately resourced. While current resources of the SEC can be used much more effectively, additional resources will also be needed. However, Congress should insist on an honest and thorough examination of core programs, followed by timely and clear progress in implementing necessary changes as a condition for expanded funding.

We believe that readers of this report will acknowledge that the level of change proposed here is overdue and that extraordinary steps are needed to achieve change. At the same time, we recognize that everyone may not agree on the specific solutions proposed in each of these recommendations. The Chamber will remain an active and constructive voice for positive change and will continue to work with all of those who share our goal of maintaining the U.S. position as the world’s preeminent, best-regulated capital market. We welcome the debate on all ideas to help achieve transformational reform.

We know this will not be easy. Some will surely criticize us for even suggesting this level of change. But we must also recognize that the status quo is no longer acceptable. A vigorous debate, followed with a rational plan of action, is needed to ensure that America’s businesses and job creators have access to capital necessary to compete in a 21st century global economy.

The U.S. Chamber of Commerce’s Center for Capital Markets Competitiveness was established to help ensure that our nation’s capital markets are the most fair, efficient, and innovative in the world. Unquestionably, reforming the SEC is a critical component of achieving that goal.



David Hirschmann  
President and CEO  
Center for Capital Markets Competitiveness

## SUMMARY OF RECOMMENDATIONS

The 2009 Report was based on an external assessment of three core SEC functions. That report contained recommendations for change at the SEC. Each recommendation was made with the goal of improving SEC efficiency and effectiveness and enabling the agency to increase its capacity to meet its dual responsibilities of investor protection and promoting American capital formation.

In 2011, the Chamber commissioned this second study and report. Chapter One discusses the need for a comprehensive transformation of the SEC. It addresses the Commission's leadership, management, and organization; the related issues of resources, accountability, and performance metrics; and the importance of engaging in a serious and thorough review of the core regulatory programs as part of the transformation process. Chapters Two and Three examine two of the most important functions of the SEC—enforcement and rulemaking. These functions were not discussed in the 2009 Report. These chapters include several recommendations to improve these critical responsibilities. Chapter Four updates the 2009 Report and assesses whether the recommendations have been adopted and, if not, whether they continue to be appropriate two years later. The chapter also discusses the many changes at the Commission since 2009.

This report was prepared in the same manner as the 2009 Report. Its findings are based in part on a review of public actions, reports, and statements of the SEC, as well as third party reports and, in part, on a series of informal, confidential interviews and meetings with highly knowledgeable persons. The individuals interviewed include current and former SEC Commissioners and staff (at both senior and subordinate levels), employees of public companies, employees of financial services firms regulated by the SEC, and lawyers and other professionals specializing in the capital markets sector. To encourage open and frank discussions, all persons were interviewed on a “not for attribution” basis.

### CHAPTER ONE: TRANSFORMING THE SEC

For most of its history, the SEC has been viewed as an outstanding government regulator. It has been trusted by the public, respected by the industry it regulates, and viewed positively by Congress. Moreover, it has been a model for other countries on how regulation can provide investor protection and at the same time promote capital formation and economic growth. Sadly, the events of the past decade, and the perception that the SEC failed to identify problems early and failed to respond strongly and quickly, has eroded the trust and confidence of the public, the industry, and policymakers.

This chapter discusses some of the fundamental problems of the Commission that must be honestly and carefully examined. The first section of this chapter examines the Commission's leadership structure—how it is managed and organized, and how responsibilities are divided among the Chairman, the Commissioners as a collegial decision

making body, the Division directors and office heads, and the career senior officers. The second section examines the perennial issues of agency resources, agency accountability, and performance metrics. The third section discusses the need for a thorough examination of long-standing regulatory programs that have not changed to keep pace with the changes in the capital markets. Recommendations are provided on how to solve these problems.

**RECOMMENDATION 1**—Congress should increase the number of Commissioners from five to seven and specify that at least one Commissioner must be an accountant, one an economist, and one an attorney.

**RECOMMENDATION 2**—One Commissioner should be designated by the President, on the recommendation of the Chairman, as Deputy Chairman for Management and Operations. This Commissioner should be required to have expertise and experience in the management of a large organization. The Chief Operating Officer should report directly to the Deputy Chairman.

**RECOMMENDATION 3**—The Chairman should appoint the Deputy Chairman for Management and Operations to oversee a comprehensive review and reorganization of the Commission, as the Chief Transformation Officer.

**RECOMMENDATION 4**—The SEC must develop a comprehensive set of performance measures that are based on the significance, efficiency, and quality of results, rather than simply measuring the quantity of actions and the processing time taken for interim steps in the process.

**RECOMMENDATION 5**—The metrics adopted by the SEC for its annual Performance Evaluation Report should be developed and selected by the Chief Operating Officer, in conjunction with trained staff in Risk, Strategy, and Financial Innovation (RSFI).

**RECOMMENDATION 6**—The SEC should adopt and vigorously apply a formal process for evaluating new employees during the initial three-year probationary period. Retention decisions should be made by a committee of second-level supervisors based on a recommendation from the first-level supervisor.

**RECOMMENDATION 7**—Senior officers should be hired for renewable five-year term appointments. A public personnel recruitment competition for the position should be a mandatory component of the renewal process.

**RECOMMENDATION 8**—The SEC should develop a comprehensive executive development program for its most promising staff who are interested in staying at the Commission.

**RECOMMENDATION 9**—A rotational assignment program should be established for junior staff, mid-level supervisors, and senior officers.

**RECOMMENDATION 10**—The Commission should require the development of a full business process plan before developing a new IT system or adopting a new rule mandating the filing of detailed information for use and analysis by Commission staff. The business process plan should be formally approved by the director of the relevant program division or office and by the Chief Data Officer.

**RECOMMENDATION 11**—In its current configuration, the resource-constrained examination program is untenable. The Commission must confront the brutal fact that it has insufficient resources and that Congress is unlikely to substantially increase its budget or provide the agency with self-funding authority. If an effective self-regulatory organization cannot be created, the SEC should adopt one of the several alternative approaches structured around a private sector examination program.

**RECOMMENDATION 12**—The SEC should undertake and complete a comprehensive review of its corporate disclosure regulatory system to align disclosure requirements with the needs of the primary users of the information.

**RECOMMENDATION 13**—The SEC should thoroughly review its disclosure review program and, based on its findings, align the resources expended with the benefits obtained, in terms of investor protection and efficient capital formation.

**RECOMMENDATION 14**—The knowledge management program recommended in the Chamber’s 2009 Report and in the Boston Consulting Group Report should include an internal autopsy program and an informal “red flag” process that enables staff to quickly highlight important events and ideas for senior SEC staff.

**RECOMMENDATION 15**—Congress should create and fund a blue ribbon team of experts to undertake a thorough review of the SEC and the American capital markets.

## CHAPTER TWO: SEC ENFORCEMENT—EXAMINING THE CHANGES IN THE PROGRAM AND DEFINING ITS MISSION

The Division of Enforcement has made a wide range of organizational, management, and policy changes, changes its Director has described as the most sweeping in the Division since it was created in 1972. While the changes are largely positive and should, over time, improve the effectiveness of SEC enforcement, it is too soon to conclude that they are already successful. More time is needed to assess their impact. In several cases additional changes are needed to achieve the desired results and, in other cases, the Division must demonstrate a commitment to full implementation of reforms.

**RECOMMENDATION 16**—The Office of the Managing Executive for Enforcement should develop an in-depth training program on investigative techniques.

**RECOMMENDATION 17**—The Division should establish a goal of reducing its open case inventory each year by identifying one-third of its investigations that are least likely to warrant action, due to age, significance, or weak evidence. Any investigation that is more than 18 months old or based on a possible violation older than three years should be closed routinely unless the Division Director or Deputy affirmatively concludes that it is essential to continue the investigation.

**RECOMMENDATION 18**—The procedure for assignment of investigations should be revamped. The process should not be based largely on the person or group that first identified the matter or the geographical location of the issuer of securities or headquarters of a registered firm. A disciplined top-down system should assign cases based upon staff expertise and experience in the area and the availability of sufficient resources to complete the investigation in a timely manner.

**RECOMMENDATION 19**—The investigation management process should consider the mix of cases in the pipeline when assessing investigations. The Division should have an explicit goal of bringing cases that advance the Commission’s entire regulatory agenda.

**RECOMMENDATION 20**—The Division should develop an internal autopsy report to carefully examine problems after the fact and use it for training.

**RECOMMENDATION 21**—The number of specialty units should be increased and the staffing of the specialty units should grow to 40% of the Division. A specialty unit responsible for complex accounting frauds or misstatements should be created. A corporate debt market unit should also be created. The market abuse unit should have a subunit devoted to alternative trading systems, dark pools, and other nonexchange platforms. The Foreign Corrupt Practices Act (FCPA) group should have expanded responsibility for all investigations of foreign issuers listed in the United States.

**RECOMMENDATION 22**—Use specialty staff to promote consistency throughout the Division. Eliminate dual reporting for regional staff assigned to specialty groups. Provide group leaders with broad oversight authority over all investigations relevant to their subject authority and responsibility for quarterly reviews. Permit defense counsel to request meetings with specialty teams to discuss relevant investigations conducted by other units.

**RECOMMENDATION 23**—The SEC should update the Seaboard principles on voluntary cooperation and then commit itself to applying them whenever appropriate.

**RECOMMENDATION 24**—The Division must use its metrics consistently. It should refrain from issuing press releases that evaluate its performance based on the total number of cases and the amount of money ordered to be paid. Instead it should rely on measures of case importance and timeliness. Enforcement actions that duplicate parallel criminal actions, that are based on previous SEC actions, or that involve companies that are defunct or persons who are no longer registered or active should not be included in measures of performance. Statistics on money judgments should be based on the amounts paid, not the amounts ordered to be paid. Staff who conduct, complete, and close a thorough investigation that does not result in a recommendation for action when that is the appropriate action should also get positive recognition.

### CHAPTER THREE: SEC RULEMAKING PROCESS—BUILDING A NEW PROCEDURAL MODEL

During the last decade the SEC has suffered an unprecedented series of judicial reversals of high-profile rules that it adopted. Notwithstanding the well-established principle of judicial deference to regulatory agencies concerning legal questions central to their

regulatory expertise, the courts vacated Commission rules dealing with the regulation of hedge fund advisers, the regulation of mutual fund board chairmen, and the regulation of a shareholder's ability to nominate persons to a corporation or mutual fund's board. In vacating these rules, the courts of appeal published harsh opinions questioning the Commission's interpretation of its legal authority and the quality and sufficiency of the record compiled to justify the rule. In the process, they suggested that the Commission, as part of its rulemaking process, has to improve its use of empirical information when examining the regulatory questions; its process for accessing the costs of its rule; and its consideration of alternative approaches to address problems. This chapter identifies problems in the rulemaking process that have contributed to the adverse judicial decisions vacating Commission rules. It also discusses the problem of *de facto* rulemaking through the inspection program.

Smart regulation requires a re-thinking of the process for developing and implementing regulations. A final regulation is the start of the process, not its completion. Because it is difficult if not impossible for any regulator to know what will happen when a regulation is adopted, the Commission should combine a pre-adoption cost-benefit analysis with a post-adoption look-back requirement. Under this approach, the Commission would collect data and re-evaluate a rule after a defined period to determine the effectiveness of a rule and the need to keep it on the books or modify it. This look-back process would fundamentally change how rules are developed. Knowing that rules will be empirically examined will force the staff to carefully consider how this will be done and to develop internal discipline in the drafting process.

The chapter contains other specific recommendations to improve the rulemaking process of the SEC.

**RECOMMENDATION 25**—The cost-benefit analysis should be an integral component at the earliest stage of the rule development process. The analysis should guide the regulatory process leading to a rule, rather than serve as an after the fact justification of the approach taken.

**RECOMMENDATION 26**—The Commission should adopt a regulatory look-back requirement whenever it adopts a "major rule" as defined in the Small Business Regulatory Enforcement Fairness Act (SBREFA).

**RECOMMENDATION 27**—Whenever the Office of Compliance Inspections and Examinations (OCIE) requests the same information from nine or more persons or entities through an exam or series of related exams, it should comply with the Paperwork Reduction Act.

**RECOMMENDATION 28**—While industry best practices may be effective techniques to promote regulatory compliance, the failure to adopt these practices should not be viewed as regulatory deficiencies. The Commission should mandate adoption of a best practice only through the rulemaking process.

## CHAPTER FOUR: PROGRESS TOWARD IMPROVING THE EFFICIENCY AND EFFECTIVENESS OF THE SEC

The final chapter of this report examines the progress made in adopting the recommendations contained in the Chamber's 2009 Report. The chapter updates findings

on the size and significance of problems in the earlier report. It also highlights unadopted recommendations that are still valid today.

The 2009 Report contained 23 recommendations grouped into four areas:

- Review of self-regulatory organization (SRO) rule changes by the Division of Trading and Markets;
- Review of exemptive applications from investment companies by the Division of Investment Management (IM);
- Review of no-action letter requests and other forms of staff interpretive guidance by the Division of Corporation Finance (Corp Fin) as well as the other regulatory divisions;
- Improving SEC management, structure and oversight.

The greatest improvement has been in the review of SRO filings. This progress is largely the result of congressional mandates for change included in the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010. There has been limited progress in the three other primary areas of concern in the 2009 Report. IM and Corp Fin have not embraced the recommendations made, even though the available evidence examined indicates that the problems identified in the 2009 Report are more substantial in 2011. The Commission should recognize that these critical functions are not performing well and direct its attention to the 2009 Report recommendations to improve the efficiency and effectiveness of these core functions.

The Commission should also address the seven recommendations in the 2009 Report on improving SEC management, structure, and oversight. The following three recommendations in the 2009 Report are of greatest importance:

**RECOMMENDATION**—The Division of Trading and Markets and the Division of Investment Management should be realigned into a Division of Investor Protection and Retail Financial Services Regulation and a Division of Market Oversight and Operations. The Examination Programs of the Office of Compliance Inspections and Examinations (OCIE) should be assigned to these new divisions.

**RECOMMENDATION**—The SEC should create an accelerated conditional approval process for new investment products or services.

**RECOMMENDATION**—The five-member Commission should play a greater ongoing role in the interpretation and application of regulatory policy. This may require congressional action to amend the Government in the Sunshine Act (Sunshine Act) that was passed in 1976 that, among other requirements, mandates that every portion of every meeting of an agency shall be open to public observation. Although the Act was developed to create greater openness in government, it has had the unintended consequence of restricting valuable communications between Commissioners and SEC staff.

**An updated discussion of all 23 recommendations in the 2009 Report is contained in Appendix A of *U.S. Securities and Exchange Commission: A Roadmap for Transformational Reform*.**



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