

ARTICLES

THE KEY ELEMENTS FOR DEVELOPING A SECURITIES MARKET TO DRIVE ECONOMIC GROWTH: A ROADMAP FOR EMERGING MARKETS

*Ziven Scott Birdwell**

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* Z. Scott Birdwell is a Branch Chief for Technical Assistance and Special Counsel for Enforcement in the Office of International Affairs, U.S. Securities and Exchange Commission. He obtained his law degree from the University of Georgia School of Law, Athens, Georgia, in 1989. The views expressed here are the author's and do not necessarily reflect the views of the U.S. Securities and Exchange Commission, its officials, or staff.

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I. IN TRIBUTE TO PROFESSOR GABRIEL WILNER

We all have those teachers that inspired and empowered us. Professor Gabriel Wilner was one of those teachers for me. A life changing moment came in my second year of law school when we were holding a public event in 1988 on the anniversary of Cuban Missile Crisis. We invited Dean Rusk, President Kennedy's Secretary of State, and Louis B. Sohn, renowned international law scholar who helped draft the United Nations Charter, to present a panel discussion. I was President of the Georgia Society of International and Comparative Law, which was hosting the event. Professor Wilner came to me and said, "Mr. Birdwell, of course you are going to moderate the program." My response was: "Moderate? Me? Who am I to moderate a discussion among these giants?" Professor Wilner would hear no resistance. The event ended up being one of the great thrills of my cherished time at the University of Georgia School of Law. This is but one example of the many opportunities that Professor Wilner created for his students to step onto the world stage of international law and human rights.

II. ABOUT THIS ARTICLE

The premise of this Article is that one of the most effective development strategies to unleash unprecedented global economic growth is to create the right environment for capital markets to thrive. The Article also argues that the single most effective use of a capital market authority's resources is to build and empower a robust law enforcement program. Finally, this Article will offer fourteen specific steps that governments and their securities authorities can take to provide a legal foundation—including model statutory provisions—for building and developing a world-class enforcement program that will help unleash the fullest potential of a capital market.

III. INTRODUCTION

What is the most effective development strategy that governments and non-government organizations can employ to unleash the fullest potential of capital markets to maximize economic growth? There seven billion people on the planet, and we will add another billion in about thirteen years.¹ About

¹ *World Population Prospects, the 2010 Revision; Frequently Asked Questions*, U.N. DEP'T OF ECON. & SOC. AFFAIRS, <http://esa.un.org/wpp/Other-Information/faq.htm> (last updated Oct. 31, 2011).

half live in poverty on less than \$2.50 a day.² About thirty-six million people still die every year from malnutrition and preventable diseases due to lack of clean water.³ There are an enormous amount of jobs to create, mouths to feed, houses to build, power to generate, and resources to extract. The magnificent Edward O. Wilson notes that “[f]or every person in the world to reach present U.S. levels of consumption with existing technology would require four more planet Earths.”⁴ Security, justice, dignity, and environmental protection⁵ will be incomplete until these basic human needs are met in all corners of the world.

Governments are concerned with taking the actions necessary to improve the business environment and legal infrastructure that will facilitate the development of technology and infrastructure necessary to meet humanity’s basic needs. The economic activity necessary will dwarf all previous historical efforts and must be self-sustaining. While governments must play a crucial role in setting the stage, this effort will require unleashing the private sector’s fullest potential. The premise of this article is that well-policed, competitive, and innovative capital markets must be at the center of this whirlwind of activity. Securities markets are a way in which entrepreneurs and businesses can search for low cost financing—often unavailable from banks—to fuel their enterprises.⁶ The source of that financing is investors, who look to the stock markets to generate higher rates of return than may be available from other sources and to diversify their holdings. These marketplaces thrive when they are characterized by honesty, integrity, disclosure, and transparency.

² *Poverty Analysis*, THE WORLD BANK, <http://www.worldbank.org/> (follow “Topics” hyperlink; then follow “Poverty”; then follow “Poverty Analysis”) (last visited Aug. 20, 2011).

³ Press Release, Comm. on Human Rights, Independent Expert on Effects of Structural Adjustment, Special Rapporteur on Right to Food Present Reports; Commission Continues General Debate on Economic, Social and Cultural Rights, U.N. Doc. HR/CN/1064 (Mar. 29, 2001).

⁴ EDWARD O. WILSON, *THE FUTURE OF LIFE* 23 (2002).

⁵ Economic growth does not have to be inconsistent with preserving the environment. In fact, economic growth is essential for long-term protection of the environment because the environment will always be a secondary priority so long as there are desperate humans seeking basic necessities for their families.

⁶ See Joel Seligman, *The Obsolescence of Wall Street: A Contextual Approach to the Evolving Structure of Federal Securities Regulation*, 93 MICH. L. REV. 649, 702 (1995) (“[A securities market] enables the holder of loans to raise funds at a lower cost than had it borrowed [from banks, for example] on its own credit. . . . [S]ecuritization can lower the cost of funding . . .”).

In terms of capital, the economic growth necessary to meet these needs cannot be fueled by bank lending alone. As a source of capital, bank lending has its strengths, but the banking model is insufficient to meet the financial needs of a fast-growing, innovative economy. Banks tend to be risk averse and not particularly transparent in their operations. These two characteristics substantially reduce the utility of bank lending to power the economic growth necessary to meet humanity's basic needs. Banks tend to be risk averse because of the mismatch between their liabilities, which tend to be short-term, and their assets, which are often illiquid.⁷ However, this risk aversion results in many economically productive and high-value added projects not being financed, even though the potential returns may well justify the risks. The failure to fund such efforts can greatly hamper economic growth.⁸

The lack of transparency in banking is due, in part, to the individualized nature of the many loan transactions into which they enter. To require full public disclosure of the details of these transactions would be prohibitively costly and unnecessarily compromise the proprietary or private information of loan recipients. Yet, the lack of transparency in bank lending means that the details concerning important investment opportunities are kept behind closed doors and tend to be held captive by a handful of market intermediaries.⁹ Indeed, in some developing countries that are dominated by bank lending, in my opinion, there have been decades of lost opportunity for greater economic growth. It is not that banking does not have an important role to play in providing capital; rather, it is that public capital markets also provide a crucial component to efficient capital formation and economic growth.¹⁰ Moreover,

⁷ Charles K. Whitehead, *Reframing Financial Regulation*, 90 B.U. L. REV. 1, 21 (2010) (“[B]anks rely on short-term credit (deposits) to invest in a portfolio of longer-term assets (loans) . . .”).

⁸ See John K. Lawrence & Dickinson Wright, *The Federal Government's Response to the Credit Crisis*, SP042 ALI-ABA 459, 550 (2009) (“[I]f banking organizations retreat from making sound credit decisions, the current market conditions may be exacerbated, leading to slower growth and potential damage to the economy . . .”).

⁹ See Jill E. Fisch, *The Overstated Promise of Corporate Governance*, 77 U. CHI. L. REV. 923, 953–54 (2010) (“In particular, three developments threaten the effectiveness of capital market discipline: a decline in transparency, an increase in the percentage of equity held by investor intermediaries, and a decrease in accountability.”).

¹⁰ See Thorsten Beck, *Financial Development and Economic Growth: Stock Markets Versus Banks?*, PROPARGO'S MAG., Mar. 2010, at 23, available at http://www.ffem.fr/jahia/webdav/site/proparco/shared/PORTAILS/Secteur_privé_developpement/PDF/SPD5_PDF/ProparcoRevue%2005UK%20WEB%20020410Beck.pdf%20article%20Beck.pdf (recognizing that, while there are some studies that suggest that developing stock markets over banking is the superior

vibrant capital markets will also inform bank lending, serving not as competition, but as a complement to bank lending's role in the economy.

Contrast the banking model with the economic benefits of well-functioning public markets for securities in which both risk and opportunity for return are open to any investor, are priced in a public arena with mandatory disclosure requirements for material information, and inform the economic decisions of a wide array of market participants and economic enterprises.¹¹ This publicly shared information and public pricing of opportunities acts like a neuronal network in coordinating the many production and consumption decisions in the economy. In this context, capital flows more efficiently and more rapidly to where the opportunities for return justify the risks. Thomas Friedman aptly describes the movement of capital as the "Electronic Herd" that migrates to graze at the most productive pastures.¹² They move in when conditions are right and move out just as quickly when conditions deteriorate.¹³ Nothing will send capital fleeing more quickly than the high costs associated with an unfavorable regulatory environment and endemic fraud.¹⁴ Investors will always be available to assume the risk of the enterprise, but they will not readily assume the risk of losing their investment to fraud. The role of the government and public policy makers is to create the environment that will keep the electronic herd in your pasture.

A long line of recent studies found a positive correlation between stock market development and economic growth.¹⁵ The authors of a 2007

development strategy to pursue, most studies indicate that the mutual complementarities associated with developing both the banking and stock market sectors carries the greatest benefit).

¹¹ See David A. Westbrook, *Telling All: The Sarbanes-Oxley Act and the Ideal of Transparency*, 2004 MICH. ST. L. REV. 441, 453 ("[W]e should understand mandatory disclosure regimes as the regulatory effort to increase transparency and thereby increase informational efficiency of markets.").

¹² THOMAS L. FRIEDMAN, *THE LEXUS AND THE OLIVE TREE* 112 (2000).

¹³ *Id.* at 113.

¹⁴ See, e.g., Kroll, *Global Fraud Report* (2011), available at <http://www.krollconsulting.com/insights-reports/global-fraud-reports/>. This year's survey found that fraud concerns had dissuaded 48% of respondents (in a survey of 800 executives) from operating in at least one region or country. *Id.* at 4. Those geographies most frequently mentioned were China, from which 11% of respondents had been deterred, Africa with 11%, and Latin America with 10%. *Id.* at 6. The leading worry—corruption—dissuaded more than one in six businesses from operating elsewhere: for that reason 63% stayed away from Africa, and 59% avoided Central Asia based on that concern. *Id.*

¹⁵ See, e.g., Sumit Agarwal & Hamid Mohtadi, *Financial Markets and the Financing Choice of Firms: Evidence from Developing Countries*, 15 GLOBAL FIN. J. 57 (2004)

International Monetary Fund (IMF) Working Paper find that “improvements in trading of shares . . . or liquidity on African stock markets will on the whole boost economic growth by 3.7 percentage points.”¹⁶ This research suggests that these countries could double the size of their economy in twenty years, above the growth they would already achieve, solely by concentrating on improving their stock markets. The studies identify a range of outstanding benefits that a well-functioning stock market can provide to an economy:

- *Savings Mobilization*¹⁷—savings is encouraged “by providing individuals with an additional financial instrument that may better meet their risk preferences and liquidity needs”
- *Liquidity*—increased liquidity means that “initial investors do not lose access to their savings for the duration of the investment project because they can easily, quickly, and cheaply, sell their stake in the company”¹⁸ (as Professor Ross Levine¹⁹ puts it: “investors will come if they can leave”²⁰)

(examining twenty-one emerging markets over eighteen years and finding stock market development contributes to economic growth both directly in both the long- and short-term); Geert Bekaert & Campbell R. Harvey, *Capital Markets: An Engine for Economic Growth*, 5 BROWN J. WORLD AFF. 33 (1998); Soumya Guha Deb & Jaydeep Mukherjee, *Does Stock Market Development Cause Economic Growth? A Time Series Analysis for Indian Economy*, 21 INT'L RES. J. FIN. & ECON. 1442 (2008) (setting forth causality test results that suggest that stock market development leads to economic growth in the Indian economy); Akinlo A. Enisan & Akinlo O. Olufisayo, *Stock Market Development and Economic Growth: Evidence from Seven Sub-Sahara African Countries*, 61 J. ECON. & BUS. 162 (2009); Ross Levine & Sara Zervos, *Stock Market Development and Long-Run Growth*, 10 WORLD BANK ECON. REV. 323 (1996); Muhammad Shahbaz et al., *Stock Market Development and Economic Growth: Ardl Causality in Pakistan*, 14 INT'L RES. J. FIN. & ECON. 182 (2008) (finding a very strong relationship between stock market development and economic growth).

¹⁶ Charles Amo Yartey & Charles Komla Adjasi, *Stock Market Development in Sub-Saharan Africa* 16 (International Monetary Fund, Working Paper No. 209, 2007), available at <http://www.imf.org/external/pubs/ft/wp/2007/wp07209.pdf>.

¹⁷ *Id.* at 14.

¹⁸ *Id.* at 5.

¹⁹ Ross Levine is the James and Merryl Tisch Professor of Economics and Director of the William R. Rhodes Center for International Economics and Finance at Brown University. Ross Levine, RESEARCH AT BROWN: DIRECTORY OF RESEARCH & RESEARCHERS AT BROWN, <http://research.brown.edu/research/profile.php?id=1130162236> (last visited Aug. 20, 2011).

²⁰ Ross Levine, *Stock Markets: A Spur to Economic Growth*, 33 FIN. & DEV. 7 (1996).

- *Risk Diversification*—more financial products are available, which can also facilitate investments in high-return projects²¹
- *Information Dissemination*—securities markets acquire and disseminate information efficiently through company disclosures and through the stock prices of companies²²
- *Corporate Governance*—is improved through transparency and disclosure²³
- *Long-Term Capital*—is perpetually available for both government and private sector industrial and infrastructure projects²⁴
- *Lower cost of capital*—is available to growing companies (so long as the market operates efficiently)²⁵
- *Reduced risk of credit crunches*—because companies are less dependent on bank financing²⁶
- *Efficiency*—securities markets allocate capital to productive investments, leading to economic growth²⁷

Given that securities markets can dramatically increase economic growth and development, and may well be the most efficient and powerful engine for economic growth in existence, the next questions should be: What can governments do to create a favorable environment for a stock market to thrive at its fullest potential? What international best practices can be identified and adopted to give developing markets the opportunity to leap ahead and build world class financial markets without having to suffer the decades of growing pains, mistakes, and periodic crises that have characterized the historical development of the most advanced markets?²⁸

This Article argues that the answers lie primarily in developing the enforcement capacity of the security authority. The premise is that a government's best strategy is to focus on protecting investors through a

²¹ Levine & Zervos, *supra* note 15, at 327.

²² Yartey & Adjasi, *supra* note 16, at 4.

²³ *Id.* at 25.

²⁴ *Id.* at 5.

²⁵ *Id.* at 4.

²⁶ *Id.*

²⁷ Bekaert & Harvey, *supra* note 15, at 1.

²⁸ For an excellent discussion of the lessons from the latest financial crisis, see John H. Walsh, *Combating Fraud in the Caribbean Region: Lessons from Recent Events*, 3 GEO. MASON J. INT'L L. 116 (2011).

robust enforcement program, and to leave the business decisions and most “market development” initiatives to the collective decision making of the capital market participants. While there are undoubtedly many capital markets that would benefit from demutualization, regionalization, and automation, the enduring problem with most capital markets today is that they are operating at only a fraction of their potential because they are rife with fraudulent behavior and abuse, including financial disclosure and accounting fraud, insider trading, market manipulation, pyramid schemes and customer abuse by market intermediaries. An IMF Working Paper reviewing International Organization of Securities Commission (IOSCO) Assessments in seventy-four countries found that “a consistent theme emerges regarding the lack of ability of regulators in many countries to effectively enforce compliance with existing rules and regulations” which the authors characterize as the “overriding weakness.”²⁹ These market abuses and fraudulent schemes render capital markets unable to function the way they are supposed to and incapable of generating the benefits outlined above. This Article focuses on identifying those strategies and tools that a securities authority can employ to create a clean and honest market that is a prerequisite for driving the economic growth that is so important.

IV. WHY ENFORCEMENT ENHANCES MARKET DEVELOPMENT

There are two competing philosophies driving securities authorities. The first, and perhaps most prevalent, is the view of securities authorities who see their role as primarily regulatory; that is, they emphasize the regulation of the business conduct of the market intermediaries whom they regulate, but they place less emphasis on bringing enforcement actions.³⁰ This, by the way, is also characteristic of most banking regulatory authorities whose driving philosophy is safety and soundness. This approach was represented most visibly, at least until recently, by the United Kingdom’s Financial Services Authority, which considered itself “emphatically not an enforcement-led regulator.”³¹ In stark contrast, the U.S. Securities and Exchange Commission

²⁹ Ana Carvajal & Jennifer Elliot, *Strengths and Weaknesses in Securities Market Regulation: A Global Analysis 5* (IMF, Working Paper No. 107/259, 2007), available at <http://www.imf.org/external/pubs/ft/wp/2007/wp07259.pdf>.

³⁰ See Chris Brummer, *Post-American Securities Regulation*, 98 CAL. L. REV. 327, 350 (2010) (discussing the prevalence of the regulatory view and the lesser-used enforcement approach).

³¹ John Tiner, Chief Exec., Fin. Servs. Auth., Address at the FSA Enforcement Law Conference (June 16, 2006), available at http://www.fsa.gov.uk/pages/Library/Communication/Speeches/2006/0616_jt.shtml.

(SEC) is “first and foremost . . . a law enforcement agency.”³² Enforcement represents the SEC’s largest program area and most visible public face.³³

The mission of most securities authorities includes promoting market development.³⁴ Given this focus, many developing market regulators may argue that the emphasis on enforcement would not work because as a smaller market trying to develop and compete they do not want to stifle and burden their market. This Article argues that this argument is flawed. The Article’s conclusion is that a strong emphasis on enforcement by markets at any level of development is the key to market growth and prosperity.

A. Enforcement Lowers the Cost of Capital

Every securities market has varying degrees of financial disclosure and accounting fraud, insider trading, market manipulation, customer abuses by broker-dealers and investment advisors, and pyramid schemes. There will be companies and their principals that will try to “cook their books” and hide their true state of affairs from the public with omissions, half-truths, and outright lies. There will be market manipulators who distort stock prices through misrepresentations, while buying or selling their own stock at the artificial prices. There will be insider traders that buy or sell with an unfair and anti-competitive information advantage, potentially giving the impression to the average investor that the market is unfairly rigged. There will be boiler-rooms that make cold calls to investors and convince them to buy the next “sure thing,” and there will be pyramid scheme operators who rally investors around fictitious investments and use new investor funds to pay off old investors rather than investing in a real venture. A compliance officer at a large international securities firm once told me that he recognized that, given the scale of the operations of the firm it was likely that at any given time an employee was engaged in wrongdoing, such as front-running, churning (excessive buying and selling that generates excessive wealth-destroying fees), or unauthorized transactions in client accounts. These are the abuses that eat away at capital markets, destroy investor confidence, and increase the cost of capital. The fraudsters may represent a small minority of

³² *The Investor’s Advocate: How the SEC Protects Investors, Maintains Market Integrity, and Facilitates Capital Formation*, U.S. SEC. & EXCHANGE COMM’N, <http://www.sec.gov/about/whatwedo.shtml> (last visited Aug. 20, 2011).

³³ *Id.*

³⁴ For example, the U.S. SEC’s mission “is to protect investors, maintain fair, orderly, and efficient markets, and facilitate capital formation.” *Id.*

a market, but this small minority can ruin the market for everyone because customers and investors cannot determine who is telling the truth.

Numerous capital markets have stagnated because their securities authorities have insufficient powers to address the fraud and abuse described above. Most capital markets are suffering from what Nobel Laureate economist George Akerlof once described as the “lemons problem.”³⁵ Any market characterized by an asymmetry of information between the buyers and the sellers—where the sellers know much more than the buyers about what is being sold—can suffer from this problem (like the market for used cars). In a securities market, the problem is that—since the buyers cannot tell who is being honest regarding the quality of financial instruments and services being offered and who is being dishonest—buyers are only willing to pay a price that reflects the expectation that they might be deceived. As Professor Black describes it:

Investors don't know which companies are truthful and which aren't, so they discount the prices they will offer for the shares of all companies. . . . Discounted share prices mean that an honest issuer can't receive fair value for its shares, and has an incentive to use other forms of financing. But discounted prices won't discourage dishonest issuers. . . . The tendency for high-quality issuers to leave the market because they can't obtain a fair price for their shares, while low-quality issuers remain, worsens the lemons or “adverse selection” problem that investors face. Investors rationally react to the lower average quality of issuers by discounting still more the prices they will pay. This drives even more highquality [sic] issuers out of the market and exacerbates adverse selection.³⁶

Professor Black further explains that:

[M]any nations have not developed an acceptable solution to this problem [of informational asymmetry]. Their securities markets have instead fallen into what insurance companies call a “death spiral,” in which information asymmetry and adverse

³⁵ George A. Akerlof, *The Market for “Lemons”: Quality Uncertainty and the Market Mechanism*, 84 Q.J. ECON. 488 (1970).

³⁶ Bernard Black, *The Core Institutions that Support Strong Securities Markets*, 55 BUS. LAW. 1565, 1567–68 (2000).

selection combine to drive almost all honest issuers out of the market and to drive share prices to zero. In [those] countries, a few large companies may develop reputations sufficient to justify a public offering of shares at a price that, though below fair value, is still attractive compared to other financing options. But smaller companies have essentially no direct access to public investors' capital. They must obtain capital from intermediaries (usually banks), or through the internal capital market of a conglomerate group, or else grow only at the rate permitted by reinvestment of past earnings.³⁷

In sum, the prevalence of fraud and abuse can destroy a securities market, as investors continue to further discount the prices they are willing to pay for securities, while the honest issuers flee for the exits.³⁸ For those issuers that remain in such a market, this results in a higher cost of capital.³⁹ This is highly damaging to a country's economic prospects. Businesses will not engage in real investment (in plant and equipment, infrastructure, training and so forth) unless the expected rate of return from such projects exceeds the cost of capital.⁴⁰ As a consequence, a high cost of capital results in very little real investment. This means less job creation, lower incomes, and less economic growth than there would be otherwise. If the cost of capital can be decreased, businesses have an incentive to increase real investment, resulting in more jobs, higher income, and greater economic growth.⁴¹ If a country can reduce the prevalence of fraudsters in its capital market, it will dramatically lower its cost of capital and thereby stimulate economic growth.

³⁷ *Id.* at 1570–71.

³⁸ See Stephen J. Choi & Andrew T. Guzman, *Portable Reciprocity: Rethinking the International Reach of Securities Regulation*, 71 S. CAL. L. REV. 903, 944 (1998) (“[I]f investors are unable to distinguish high quality issues from low quality issues due to a lack of disclosure or unduly weak insider trading laws, investors may discount the price of all issues. This may drive leading high quality issues to more favorable regimes that allow them to distinguish themselves from the low quality issues.”).

³⁹ See *id.* (“To the extent [fraud] occurs, investors may withdraw from the market, which decreases market liquidity and raises the cost of capital.”).

⁴⁰ Robert A. Ragazzo, *Toward a Delaware Common Law of Closely Held Corporations*, 77 WASH. U. L.Q. 1099, 1112 (1999) (“[A business] should reinvest profits only when the new projects promise expected returns at a level equal to or in excess of the corporation's cost of capital.”).

⁴¹ See Robert W. McGee, *Principles of Taxation for Emerging Economies: Lessons from the U.S. Experience*, 12 DICK. J. INT'L L. 29, 76 (1993) (describing the positive correlation between increased investment and employment, income, and economic growth rates).

The good news is that enforcement tools are the most productive and cost-effective means of cleaning out fraud and abuse and, thus, of lowering the cost of capital.⁴² Recent studies demonstrate that the “enforcement intensity” of a securities regulator lowers the cost of capital.⁴³ For example, the U.S. securities market achieves an extremely low cost of capital due, in part, to its vigorous enforcement program.⁴⁴ Similarly, a study of the European Union’s implementation of the market abuse directives and transparency regulations found that “market liquidity increases and firms’ cost of capital decreases” and that these positive effects were largely dependent on the degree of enforcement.⁴⁵ Professor Coffee explains this using a “bonding hypothesis” whereby stock issuing companies seek out markets with strong enforcement so they can bond to a quality regulator.⁴⁶ In bonding, companies are providing an implicit assurance to investors that they can have a relatively higher degree of confidence that the stock price is fairly and accurately priced. This lowers their cost of capital.⁴⁷ The important lesson here is that the studies have shown that having the best rule books in the world will not reduce the cost of capital—only *enforcement* of those rules lowers the cost of capital. This bonding hypothesis strongly suggests that an important way to facilitate market development and capital formation is to focus resources on developing an enforcement program that achieves visible results. The emphasis on enforcement is not only fully consistent with market development but also a necessary condition.

⁴² John Coffee, *‘Regulation-Lite’ Belongs to a Different Age*, FIN. TIMES (Jan. 20, 2008), <http://www.ft.com/cms/s/0/fe8950a6-c776-11dc-10b4-0000779fd2ac.html#axzz1JifQj792> (“Ultimately, stricter enforcement yields . . . a lower cost of capital [resulting in] a higher gross domestic product and lower unemployment.”).

⁴³ See John C. Coffee, Jr., *Law and the Market: The Impact of Enforcement*, 156 U. PA. L. REV. 229, 230 (2007) (“[H]igher enforcement intensity gives the U.S. economy a lower cost of capital and higher securities valuations.”); see also Uptal Bhattacharya & Hazem Daouk, *The World Price of Insider Trading*, 57 J. FIN. 75 (2008) (finding the cost of equity is reduced by approximately 5% if insider trading laws are enforced); Howell E. Jackson & Mark J. Roe, *Public and Private Enforcement of Securities Laws: Resource-Based Evidence*, 93 J. FIN. ECON. 207 (2009).

⁴⁴ Coffee, *supra* note 43.

⁴⁵ See Hans B. Christensen et al., *Capital Market Effects of Securities Regulation: The Role of Implementation and Enforcement* (Nat’l Bureau of Econ. Res., Working Paper No. 16737, Jan. 2011), available at <http://www.nber.org/papers/w16737>.

⁴⁶ Coffee, *supra* note 43, at 235.

⁴⁷ *Id.*

B. Enforcement Is Efficient

On one hand, equity markets can be extraordinarily innovative and dynamic and—may flourish best if allowed to run untethered to government restraints. Certainly, to be innovative and efficient, the private sector generally needs an atmosphere in which executives and managers can make and execute operational and capital decisions without needing to seek prior governmental approval or being second-guessed by the government. On the other hand, history, experience, and theory suggest that capital markets are magnets for fraud and abuse, conflicts of interest, systemic risks, and other imperfections and that the government is in the best position to correct these problems and level the playing field. What, then, is the correct philosophy or optimal balance that securities authorities should pursue?

All indications suggest that securities authorities, if they have not already done so, would be best served by shifting their regulatory philosophy from a primarily *ex ante* approach to a more *ex post* approach. Many securities authorities, particularly those that seem to adopt a banking regulator mentality, tend to micromanage their market on the one hand, while largely failing to sufficiently punish wrongdoers in the marketplace in order to deter future market misconduct on the other hand. With *ex ante* regulation, a regulated entity's business decisions are subject to merit-based pre-approvals by the securities authority.⁴⁸ Such *ex ante* regulation imposes costs, uncertainty and delay, not only on potential wrongdoers, but also on all honest market participants.⁴⁹ Moreover, market growth and innovation will be dragged down by the finite staff and resources of the regulatory authority as they are unable to keep up with the authorizations, licenses, and applications.⁵⁰ At the same time, because such an approach is not well-targeted at preventing wrongdoing, there are still market failures and frauds. In sum, the *ex ante* approach to regulation typically fails in its effort to “play it safe” and, at the same time, hinders market development. Indeed, it is the worst approach to developing a market.

⁴⁸ See, e.g., Ashutosh Bhagwat, *Modes of Regulatory Enforcement and the Problem of Administrative Discretion*, 50 HASTINGS L.J. 1275, 1279 (1999) (describing the workings of an *ex ante* preclearance regulatory scheme).

⁴⁹ *Id.* at 1316 (“[E]x ante enforcement by its nature imposes delay since preview and approval takes time, and during that time activity must be suspended. This delay is in itself costly to society since the economic (or other) benefits of the regulated activity are foregone or deferred.”).

⁵⁰ *Id.* at 1320.

In contrast, an *ex post* approach to regulation takes the government out of private sector decisions and focuses first and foremost on enforcement as a means of punishing and deterring market abuse, customer abuse, and fraud. An *ex post* approach has the great advantage in that it places most of the cost of abuse on those that commit it, rather than on the honest players and the market as a whole. Similarly, an enforcement-led approach prioritizes precious public and regulatory resources into going after the violators,⁵¹ which are, after all, the source of the problems. Simply put, to develop the marketplace, securities authorities need to increase the expected costs on the dishonest market participants while lowering costs for the honest players.

While attention should be paid to carefully crafting cost-effective regulation and supervision systems that reduce conflicts of interest and opportunities for fraud and abuse, without a credible threat of sanctions and a demonstrable track record of successful enforcement actions, it is certain that rules will not be obeyed, thereby undermining the authority of both the regulation and the regulator. Some have charged that the U.S. SEC “regulates through enforcement.” U.S. SEC staff counter that they are simply “enforcing the regulations.” There must be “trophies on the wall” in the form of conspicuous successful enforcement actions with meaningful sanctions.

C. It Is Impossible to Regulate Away Wrongdoing

It is simply impossible for even the smartest, risk-based, algorithm-endowed securities authority to regulate away all wrongdoing or eliminate every instance of fraud and abuse before it begins. For example, corporate financial and disclosure fraud is so sophisticated and complicated that it is almost impossible to detect until after it has occurred. Not many investors, or even market analysts, can verify a company’s financial statements and conduct the extensive investigation required to ensure that the financial statements and other disclosures by the company are complete, accurate, and meet all the accounting standards. Few individuals fully understand the details of, say, accounting standards that cover derivative transactions to a degree that would ensure compliance, and few have access to the company’s internal information to verify the transactions. Even fewer could do so if the company’s officers lie to the accountants. Fraudsters are often sophisticated

⁵¹ *Id.*

in disguising their wrongdoing, and, moreover, may have the complicity of the gatekeeper accountants, bankers and/or lawyers.

The reality is that no one in a market-based society, including the government, is in a position to second-guess the professionals in real time and to double-check with the counterparties to every transaction to ensure the accuracy of revenues, expenses, and other reported data. Nor could a system operate efficiently under such constraints. Soaring transaction costs would completely undermine any economic growth possibilities.⁵² Nonetheless, with respect to financial reporting fraud at least, the truth *eventually* tends to come out. When it does, a securities authority must have an enforcement program that will not only address the immediate problem but also deter others contemplating similar behavior.⁵³ In a world where it is difficult to detect wrongdoing, the importance of wrongdoers eventually having to pay a high price for their misdeeds is paramount. Otherwise, fraud will have positive expected returns, and, consequently, there will be excessive amounts of fraud that will thoroughly undermine the market. Nothing sends a clear message like a good, solid enforcement case.

V. BUILDING AN EFFECTIVE CAPITAL MARKETS ENFORCEMENT PROGRAM

Fraud destroys markets, destroys companies and destroys investors' wealth. If investors cannot rely on the corporate disclosures, the integrity of market-determined prices, and the basic honesty of market intermediaries, then the entire system breaks down. The cost of capital will increase. The good businesses will pull out of the market, and—to put it bluntly—the market will be left with mostly liars and thieves.

A securities commission must be empowered with the necessary tools to catch the wrongdoers and make them pay a price sufficient to deter the bulk of market fraud. A relentless enforcement program underpins the entire regulatory system by creating the deterrence that keeps the majority of people following the rules. An effective enforcement program must both produce the impression and the reality that these frauds and abuses are

⁵² See, e.g., Elizabeth Chamblee Burch, *Securities Class Actions As Pragmatic Ex Post Regulation*, 43 GA. L. REV. 63, 77 (2008) (“[M]inimal ex ante interference enhances market freedom and innovation: in return for regulating consequences, we gain novel products, new businesses, competitive pricing, and employment opportunities, all generally unobstructed by ex ante constraints.”).

⁵³ See, e.g., Bhagwat, *supra* note 48, at 1320 (“Ex post enforcement, on the other hand, might be effectively employed to deter violations even in high-volume contexts through the imposition of stiff penalties.”).

routinely detected, relentlessly pursued, and dealt with effectively. The second part of this Article outlines some of the best techniques available for building an effective enforcement program, with emphasis on techniques that are often lacking in many jurisdictions, yet offer the greatest potential return.

A. Step 1: Establish an Independent, Stand-Alone Enforcement Program with a Mandate

1. An Enforcement Mandate

Securities authorities should establish a stand-alone civil enforcement program that is vested with responsibility for investigating and prosecuting all serious violations.⁵⁴ Capital markets are dominated by powerful and sophisticated persons who are entrusted with managing other peoples' assets. Consequently, the securities authority must have the authority, autonomy, and resources not only to promulgate effective regulations that minimize opportunities for abuse but also to take swift and effective enforcement action against those who abuse the system.

An effective enforcement program should be designed to achieve the following foundational goals:

- Protect investors by bringing enforcement cases designed to protect them from fraud and abuse;
- Stop ongoing fraud via injunctive orders and asset freezes;
- Deter illegal conduct by bringing enforcement actions with demonstrable consequences for wrongdoing;
- Disgorge illegal profits from violators;
- Bar professionals from the industry if they have committed fraud; and
- Maintain confidence that the market is fair and honest.

A number of securities authorities do not have stand-alone enforcement programs or have programs diluted with other responsibilities.

⁵⁴ See, e.g., Ethiopis Tafara, Dir., Office of Int'l Affairs, U.S. SEC, The Benefits of Enforcement Division, Remarks at the Brazilian Securities Comm'n 30th Anniv. Celebration (Sept. 5, 2006), available at <http://www.sec.gov/news/speech/2006/spch090506et.htm>.

2. *Jurisdiction*

The enforcement program must be vested with full statutory powers to investigate, compel evidence from, and prosecute *any* person suspected of violating the securities laws.⁵⁵ Many regulatory authorities have capacity to pursue only licensed or registered persons. These limited powers prevent authorities from properly policing the full range of frauds that can undermine their marketplace. Unlike the banking sector, securities law violations are often committed by unregistered or unlicensed persons. To illustrate the diversity of persons that may be the subject of a securities authority's enforcement portfolio, the U.S. SEC has brought enforcement actions against a fifteen-year-old teenager,⁵⁶ a retired seamstress grandmother in Croatia,⁵⁷ the State of New Jersey,⁵⁸ a chemist at the Food and Drug Administration,⁵⁹ a foreign regulator,⁶⁰ and the owner of the Dallas Mavericks basketball team.⁶¹ Nearly 50% of the U.S. SEC's actions are against non-registered persons and entities.

3. *Staffing*

Investigating and prosecuting securities fraud requires leadership by individuals who are relentless in investigating complaints, tips, referrals, and

⁵⁵ See, e.g., Securities and Exchange Act of 1934, 15 U.S.C.A. § 78u(a)(1)–(b) (West 2011) (“The Commission may, in its discretion, make such investigations as it deems necessary to determine whether any person has violated, is violating, or is about to violate any provision of this chapter . . .”).

⁵⁶ See Press Release, SEC, SEC Brings Fraud Charges in Internet Manipulation Scheme (Sept. 20, 2000), available at <http://www.sec.gov/news/press/2000-135.txt> (charging a teenager for manipulating stock over the internet).

⁵⁷ See Press Release, SEC, Court Freezes Additional Accounts Linked to Suspicious Trades in Reebok (Aug. 19, 2005), available at <http://www.sec.gov/litigation/litreleases/lr19340.htm> (naming Sonya Anticevic whose accounts were used to trade in Reebok securities).

⁵⁸ See *In re* New Jersey, Release No. 9135, Aug. 18, 2010, Administrative Proceeding File No. 3-14009, available at <http://www.sec.gov/litigation/admin/2010/33-9135.pdf> (charging the State for fraudulent municipal bond offerings).

⁵⁹ Press Release, SEC, SEC Charges FDA Chemist with Insider Trading Ahead of Drug Approval Announcement (Mar. 29, 2011), available at <http://www.sec.gov/news/press/2011/2011-76.htm>.

⁶⁰ Press Release, SEC, SEC Charges Two Accountants and Antiguan Regulator for Roles in Stanford Ponzi Scheme (June 19, 2009), available at <http://www.sec.gov/news/press/2009/2009-140.htm> (alleging the CEO of Antigua's Financial Services Regulatory Commission accepted bribes to ignore a Ponzi scheme).

⁶¹ See Press Release, SEC, SEC Files Insider Trading Charges Against Mark Cuban (Nov. 17, 2008), available at <http://www.sec.gov/litigation/litreleases/2008/lr20810.htm>.

cases and in prosecuting those who are responsible for wrongdoing. Those same individuals must also possess a commitment to public service, the professionalism and discretion to prioritize cases, and be guided by principles of fairness and justice. Among others, investigative staff should be comprised of lawyers, accountants, and former police investigators, who are committed to aggressively rooting out wrongdoing and are trained in gathering evidence and prosecuting cases. A primary advantage in having both investigative and prosecutorial functions in the same department is that the prosecutors will be readily available to provide guidance on the evidence necessary to meet the legal elements of any potential prosecutions.

4. Independence

The enforcement program should also have the prosecutorial discretion to open or close its own investigations at any time (subject to oversight) and not have to wait on reports or referrals from other offices and departments before using its own staff to request or compel information to further an investigation. The enforcement program also should not have to cede prosecutorial authority to another agency. Empowering one agency with both the responsibility and accountability for this mission is the best assurance of success. As Napoleon said, “[O]ne bad general is worth two good ones.”⁶²

The enforcement program cannot be independent if the securities authority itself is not operationally independent. A capital market regulator should be structured by law as an independent regulatory and law enforcement agency that is empowered with the discretion to regulate, investigate, and bring enforcement proceedings to protect investors and to keep the capital market clean and honest, all while free of political influence. Securities authorities are often organized under a finance ministry or central bank, which often retains authority to approve budgets, hiring, and even proposed rules, regulations, and enforcement actions. The lack of self-funding nearly led to the shutdown of most SEC operations in early 2011. This lack of independence typically results in an impediment to progress in a securities market because the securities authority is unable to act swiftly and decisively in response to ever-changing market conditions. The independence of securities regulators is one of the International Organization of Securities Commissions (IOSCO) Principles.⁶³

⁶² WILLIAM MILLIGAN SLOANE, *LIFE OF NAPOLEON BONAPARTE* 382 (1894).

⁶³ INT'L ORG. OF SEC. COMM'NS (IOSCO), *OBJECTIVES AND PRINCIPLES OF SECURITIES REGULATION* 4 (2010) [hereinafter *IOSCO*], available at <http://www.compliance-exchange>.

The securities authority should consist of officials who act through majority vote and who sever their ties to the industry to avoid conflicts of interest. Ensuring that final agency action, such as enforcement actions, are authorized by a majority vote by the securities authority as an institutional body, rather than by an individual officer or chairman, helps insulate staff and officials and eliminates pressure points that render the securities authority vulnerable to undue influence.

5. *Accountability*

Independence must, of course, be balanced with accountability to the public and to the law. There must always be a higher authority. Typically, securities authorities are subject to oversight by a legislative committee, which is necessary and appropriate so long as it avoids undue political influence over agency operational decision making. Proposed rules and regulations should be published to provide the industry and the public a formal comment period, and comments received should be considered by the securities authority before finalizing regulations. All *final* actions and decisions by the regulator, including enforcement actions, should be transparent, public, and subject to judicial oversight and review. However, judicial review should involve some deference to the expertise of the securities authority, and the degree of deference should correlate to the quality of the administrative and deliberative process at the agency level. The securities law can prohibit courts from substituting their judgment for that of the securities authority and from overturning the agency's decisions in absence of arbitrary application or abuse of discretion granted under the securities law statute.⁶⁴

6. *Immunity for Staff*

No employee or official of a securities authority should be exposed to personal liability so long as he or she is acting within the scope of his or her statutory responsibilities. Such exposure has the potential of significantly limiting staff initiative and discouraging them from aggressively performing investigations. This is of particular concern in cases where the subject(s)

com/governance/library/ioscoprinciples2010.pdf.

⁶⁴ See, e.g., *Chevron U.S.A. Inc. v. Natural Resources Defense Council, Inc.*, 467 U.S. 837 (1984) (granting administrative deference to the agency's interpretation of the statute it administers).

under investigation for potential securities law violations might be wealthy, powerful, or otherwise politically connected individuals who are in a position to influence or stop an investigation by intimidation and threats of legal action.

There should also be a provision for the defense of staff accused of wrongdoing or improper motives in discharging their official duties pending a finding on the merits. Obviously, any such defense would not extend to actions such as taking bribes, stealing, misusing confidential information, and other actions taken outside the scope of their statutory responsibilities. If the employee is exonerated, he or she should suffer no pecuniary or non-pecuniary impact.

The problem of threats and intimidation may be particularly complex and compounded in smaller markets because the market participants and regulators typically know each other. Market participants tend to be the wealthy, powerful, and politically connected, and it is not uncommon for them to use their position to achieve short-term gain at the unfair expense of others.⁶⁵ Governments must provide backing and cover for the courageous individuals who seek to do public service and reform markets because it will often mean having to go after the rich, entrenched, and powerful.

7. Ethics

A securities authority must set the standards that will serve to guide and, where necessary change, corporate and market culture. This can occur only if the securities authority and its staff are perceived as professionals that are beyond reproach. The regulatory authority should be empowered to hire staff that will carry out their public service duties in a fair, professional, and impartial manner. The staff must be bound by a vigorous ethics program that should be institutionalized and visible. A poster at the airport in Abuja, Nigeria summed it up well: "Corruption Kills a Country." The same can be

⁶⁵ For example, Perfecto Yasay, Chairman of the Philippines SEC from 1995–2000, courageously resisted pressure from the President of the Philippines, Joseph Estrada (who was later impeached), to drop a market manipulation investigation involving one of the President's business associates. Wayne Arnold, *Widening Breach Develops in Philippine Insider Case*, N.Y. TIMES, Mar. 9, 2000, at C8, available at <http://www.nytimes.com/2000/03/09/business/international-business-widening-breach-develops-in-philippine-insider-case.html?src=pm>. More tragically, Andrei Kozlov, Deputy Chairman of Russia's Central Bank, who led the Central Bank's fight against corruption in the banking industry, was assassinated on September 13, 2006. Helene Cooper, *U.S. Releases Rights Report, with an Acknowledgement*, N.Y. TIMES, Mar. 7, 2007, at A6, available at <http://www.nytimes.com/2007/03/07/Washington/07diplo.html>.

said of the effects of corruption on a capital market.⁶⁶ Since ethics is an area that takes ongoing vigilance, every securities authority should have an institutionalized ethics program that is available at all times to staff and officials.⁶⁷

B. Step 2: Build Capacity to Respond to Specific Securities Law Violations

The enforcement program should develop the in-house, standing capacity and expertise to focus on the six primary categories of securities law violations that are endemic to all capital markets:

1. Financial accounting fraud and disclosure violations by stock issuing companies;
2. Insider trading;
3. Market manipulation;
4. Broker-dealer and investment advisor violations, (such as front running, churning, unauthorized transactions, commingling of assets, and compliance failures⁶⁸);
5. Self-regulatory organization violations; and
6. Offering frauds like pyramid schemes, boiler rooms, and other unauthorized securities offerings.⁶⁹

Any one of these frauds and abuses, if left unchecked, has the potential to undermine a capital market and do massive damage to investors.⁷⁰ This

⁶⁶ See generally Kroll, *supra* note 14 (outlining the effect of fraud and corruption on international business decisions).

⁶⁷ An example is the U.S. SEC's ethics program. *Office of the Ethics Counsel*, U.S. SEC. & EXCHANGE COMM'N, <http://www.sec.gov/about/offices/ethics.shtml> (last visited Aug. 20, 2011).

⁶⁸ See, e.g., *Sample Practices That Violate Regulations*, FIN. INDUS. REGULATORY AUTH., <http://www.finra.org/Industry/Compliance/Registration/QualificationsExams/RegisteredReps/Brochure/P009869> (last visited Aug. 20, 2011) (detailing the rules against such practices by broker-dealers).

⁶⁹ See, e.g., *Investor Alerts, Avoiding Investment Scams*, FIN. INDUS. REGULATORY AUTH., <http://www.finra.org/Investors/ProtectYourself/InvestorAlerts/FraudsAndScams/P118010> (last visited Aug. 20, 2011) (describing the various types of investment offering fraud).

⁷⁰ See, e.g., Bashar H. Malkawi & Haitham A. Haloush, *Reflections on the Securities Law of Jordan*, 23 AM. U. INT'L L. REV. 763, 798 (2008) ("The offenses of insider trading and market manipulation are the most detrimental to the creation of investor confidence in the capital market."). It is worth noting that in the U.S. there is one elegantly simple statute that is the foundation for most SEC enforcement actions involving fraud. See Section 10(b) of the Securities and Exchange Act of 1934, 17 C.F.R. § 240.10b-5 (2011), available at <http://www.sec.gov/about/laws/sea34.pdf>. A comparable sample statute would read:

requires training for the enforcement staff on how to handle these cases. Countries with larger markets may want to consider specialized units that cultivate and maintain expertise in each of these areas.⁷¹ Three of these areas are discussed in further detail below.

1. *Financial Disclosure Fraud*

Disclosure is the foundation of the capital market—it facilitates exchange, honesty, confidence, growth, and development.⁷² The mission of securities authorities is to protect investors and promote capital formation, and disclosure is the tool that accomplishes both of these things.⁷³ A securities authority must ensure that issuing companies, and their auditors, accountants, and other “gatekeepers,” are accountable to provide investors with complete, accurate, and timely disclosures of all material information that a reasonable investor would want to know before making an investment decision.⁷⁴ Investors cannot properly assess and manage risk unless they are confident that the information available regarding stock issuing companies is complete,

It shall be unlawful for any person, directly or indirectly, to use or employ, in connection with the purchase or sale of any security, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the securities authority may prescribe as necessary or appropriate in the public interest or for the protection of investors.

⁷¹ The SEC, for example, has taken this approach in its post-Madoff Ponzi scheme reforms, with specialized divisions for different types of fraud. *See Post-Madoff Reforms*, U.S. SEC. & EXCHANGE COMM'N, <http://www.sec.gov/spotlight/secpostmadoffreforms.htm> (last modified Oct. 8, 2010).

⁷² *See* Oren A. Amram, *When Worlds Collide: Transfer Pricing Tax Strategies and the Securities Laws*, 8 U.C. DAVIS BUS. L.J. 324, 332 (2008) (noting that the history of the U.S. disclosure regime is grounded in aims “to achieve transparency in capital markets”); *see also* Preliminary Response of the Commission to the Recommendations of the Advisory Committee on Corporate Disclosure, Securities Act Release No. 5,906, 14 S.E.C. Docket 178 (Feb. 15, 1978) (“The basic objective of the disclosure requirements is to increase investor confidence and to make the securities markets more efficient and as fair and honest as possible.”).

⁷³ *See, e.g.*, Rutheford B. Campbell, Jr., *Regulation A: Small Businesses’ Search for “A Moderate Capital,”* 31 DEL. J. CORP. L. 77, 80 (2006) (“[The SEC], in crafting the disclosures [for a particular regulation] carefully and expertly strikes a balance between reasonable protection of investors and capital formation.”).

⁷⁴ Canada, for example, has a “gatekeeper” regime applicable to material disclosures by “directors, lawyers, auditors, underwriters, credit rating agencies (CRAs), financial analysts, and retail investment advisors (RIAs).” Stephanie Ben-Ishai, *Corporate Gatekeeper Liability in Canada*, 42 TEX. INT’L L.J. 441, 442 (2007).

accurate, and timely.⁷⁵ This means that investors must have access to both good and bad material information about a company, its management, and its financial statements.⁷⁶

To illustrate the potential impact if a disclosure program is ineffective, one may look to the financial reporting fraud crisis in the U.S. Enron imploded in November 2001.⁷⁷ The collapse of WorldCom followed in July 2002, which was characterized by accounting improprieties of unprecedented magnitude and resulted in the largest corporate bankruptcy in history.⁷⁸ The aggregate market value of the Wilshire 5,000 stock index is estimated to have declined \$8.7 trillion from March 2000 to October 2002,⁷⁹ a market capitalization loss of nearly 50%.⁸⁰ The loss of jobs and losses to investors were devastating to the U.S. economy and society.⁸¹ The lesson from this analysis is that regulation and enforcement programs that are insufficient to quickly address disclosure failures may have catastrophic results. Conversely, a successful disclosure and enforcement regime may result in doubling of market value!

⁷⁵ See Mitu Gulati, *When Corporate Managers Fear A Good Thing Is Coming to an End: The Case of Interim Nondisclosure*, 46 UCLA L. REV. 675, 729 (1999) (“The more information investors have, the better able they are to make optimal investment choices.”).

⁷⁶ Per the U.S. Securities and Exchange Act of 1934, “[t]he term ‘material,’ when used to qualify a requirement for furnishing of information as to any subject, limits the information required to those matters to which there is a substantial likelihood that a reasonable investor would attach importance in determining whether to buy or sell the securities registered.” 17 C.F.R. § 240.12b-2 (2011) (emphasis added) (implying that material information of both good and bad effect must be provided to investors), available at <http://www.sec.gov/about/laws/sea34.pdf>.

⁷⁷ Enron filed for bankruptcy in November 2001. See Douglas M. Branson, *Enron—When All Systems Fail: Creative Destruction or Roadmap to Corporate Governance Reform?*, 48 VILL. L. REV. 989, 1018 (2003).

⁷⁸ See David Teather, *Corporate America’s Path to a Very Public Humbling*, GUARDIAN (U.K.), Dec. 19, 2002, available at 2002 WLNR 15182204 (“WorldCom . . . became the largest ever bankruptcy in July [2002] after being discovered operating the largest alleged fraud.”).

⁷⁹ Tom Walker, *Market Mauling Now 41% Erased*, ATLANTA J.-CONST., Dec. 2, 2003, at D1, available at 2003 WLNR 6234154 (“At its worst point, investors had lost \$8.7 trillion in market value between March 24, 2000, when the Wilshire peaked, and Oct. 9, 2002.”).

⁸⁰ The S&P Index declined over 45% from the high of March 2000 to June 2002. See Alex Berenson, *The Nation: Scream!; Hold on for a Wild Ride*, N.Y. TIMES, July 21, 2002, available at <http://www.nytimes.com/2002/07/21/weekinreview/21BERE.html>.

⁸¹ Beth Piskora, *Wall Street Anticipates a Week of Watching*, N.Y. POST, Nov. 4, 2002, at 31, available at 2002 WLNR 12311057 (detailing the extreme loss of jobs and investor uneasiness during the 2002 downturn in the U.S.).

2. *Insider Trading*

Insider trading is unfair buying or selling of a company's stock "while in possession of material, non-public information" about the company or stock.⁸² Many markets are characterized by pervasive insider trading, which is unfortunate because it raises the cost of capital.⁸³ However, in general, there are comparatively few instances of successful prosecution of insider trading outside the U.S.⁸⁴ In contrast, the U.S. SEC successfully prosecutes about fifty civil insider trading cases each year, which routinely result in the defendants disgorging all of their profits (or losses avoided) *and* paying a penalty "up to three times the amount of profit gained, or loss avoided."⁸⁵ This disparity may be attributable to the SEC's use of non-criminal remedies and powerful investigative tools, which will be discussed in more detail in *Step 4* below.

Insider trading is difficult to investigate and prosecute under both a civil "preponderance of the evidence" or the criminal "beyond a reasonable doubt" standard.⁸⁶ One of my colleagues had the idea of a strict liability standard to address the difficulties in investigating and proving insider trading cases. Under such a legal standard, gains (or losses avoided) by insiders would be disgorged in circumstances where it was simply demonstrated that the trader traded while in possession of inside information.⁸⁷ That is, no finding of intent to engage in wrongdoing would be necessary.⁸⁸ This approach involves a substantially reduced burden of

⁸² *Insider Trading*, U.S. SEC. & EXCHANGE COMM'N, <http://www.sec.gov/answers/insider.htm> (last modified Apr. 19, 2001).

⁸³ See Utpal Bhattacharya & Hazem Daouk, *The World Price of Insider Trading*, 57 J. FIN. 75 (2002), available at http://faculty.fuqua.duke.edu/~charvey/Teaching/BA453_2004/B D_The_world.pdf (finding the "cost of equity is reduced by roughly 5% . . . if insider trading regulations are enforced").

⁸⁴ Thomas C. Pearson, *When Hedge Funds Betray a Creditor Committee's Fiduciary Role: New Twists on Insider Trading in the International Financial Markets*, 28 REV. BANKING & FIN. L. 165, 212 (2008) (noting the lack of international enforcement of securities laws, including insider trading regulations).

⁸⁵ REPORT PURSUANT TO SECTION 308(C) OF THE SARBANES OXLEY ACT OF 2002, U.S. SEC. & EXCHANGE COMM'N 4 (Jan. 24, 2003), <http://www.sec.gov/news/studies/sox308creport.pdf>.

⁸⁶ See Helen A. Garten, *Insider Trading in the Corporate Interest*, 1987 WIS. L. REV. 573, 639-40.

⁸⁷ See Karen Schoen, *Insider Trading: The "Possession Versus Use" Debate*, 148 U. PA. L. REV. 239, 249-57, 278-85 (1999) (finding strong support for the "having possession" standard in U.S. case law).

⁸⁸ See *SEC v. Adler*, 137 F.3d 1325, 1332 (11th Cir. 1998) (explaining the SEC's argument that simple knowing possession of insider information would carry liability).

proof, albeit coupled with a light sanction in the form of simple disgorgement, absent aggravating circumstances.⁸⁹ Presumably, this approach would result in more certain instances of “prosecution” of insider trading, albeit with light penalties, which may be preferable to fewer prosecutions albeit with heavy penalties. The bottom line is that securities authorities should identify the most cost-effective approach to reducing the incidence of insider trading by creating the perception and reality that insider trading is not profitable.

3. Pyramid and Ponzi Schemes

A pyramid or Ponzi scheme arises any time new investor funds are used to pay old investors.⁹⁰ The pretense is that the returns are from a real investment, when there have been no such returns and often no such investment.⁹¹ Pyramid schemes are *always* and inevitably destined to collapse, resulting in nearly complete losses to a vast majority of the investors.⁹² They are frauds by definition.⁹³ Pyramid schemes are most often perpetrated by unregulated persons,⁹⁴ but increasingly authorities must be vigilant to ensure that regulated persons, particularly those facing financial difficulties, are not operating pyramid schemes such as that perpetrated by Bernard Madoff.

Numerous jurisdictions have had, and continue to have, their share of problems with pyramid schemes. Pyramid schemes brought the government of Albania to its knees in 1997;⁹⁵ the MMM Investment scheme in Russia lost \$1.5 billion in the 1990s;⁹⁶ unregistered fraudulent offerings (UFOs) plagued Jamaica’s financial markets culminating in the Jamaica Financial

⁸⁹ See *id.* at 1337–38 (finding that a law giving the SEC the right to receive treble damages in a civil case for insider trading suggested the knowing possession standard was inappropriate).

⁹⁰ See Clarence L. Pozza, Jr. et al., *A Review of Recent Investor Issues in the Madoff, Stanford and Forte Ponzi Scheme Cases*, 10 J. BUS. SEC. L. 113, 116–17 (2010).

⁹¹ *Id.*

⁹² R. Alexander Pilmer & Mark T. Cramer, *Swindler’s List*, L.A. LAW., June 2009, at 22, 24 (“[T]he ultimate failure of a Ponzi Scheme is certain.”).

⁹³ See Pozza et al., *supra* note 90, at 116.

⁹⁴ See Sergio Pareja, *Sales Gone Wild: Will the FTC’s Business Opportunity Rule Put an End to Pyramid Marketing Schemes?*, 39 MCGEORGE L. REV. 83, 87–88 (2008).

⁹⁵ See Celestine Bohlen, *In a Poor Land, a Classic Swindle Leaves Rage and Emptier Pockets*, N.Y. TIMES, Feb. 1, 1997, at A5.

⁹⁶ See William R. White, Note, *Taming the Markets—The New Russian Securities Law and the Protection of Shareholder Rights*, 37 COLUM. J. TRANSNAT’L L. 125, 141–42 (1998).

Services Authority's shut down of Olint Investment in 2006;⁹⁷ Colombia declared a state of emergency in 2008 after the collapse of a large Ponzi scheme;⁹⁸ Nigeria struggles with hundreds of "wonder banks";⁹⁹ and Bernard Madoff managed to conduct a long running and enormously destructive pyramid scheme in the United States.¹⁰⁰ One would think that both perpetrators and investors would have learned their lesson from the Madoff matter, but the SEC has shut down nearly 100 Ponzi schemes *since* Madoff.¹⁰¹ They can only be addressed through eternal vigilance and strong enforcement.

The most important government response to any pyramid scheme is to shut it down by injunctive orders and asset restraints as soon as it is detected.¹⁰² Every day that a pyramid scheme is allowed to continue results in more damage and losses to investors.

The issue often arises as to why a securities authority, as opposed to a banking authority or criminal authorities, should be responsible for shutting down pyramid schemes.¹⁰³ Pyramid schemes are not just "deposit taking" enterprises as they may purport to be.¹⁰⁴ Many offer securities, at least within the definition of security under U.S. law,¹⁰⁵ typically in the form of an "investment contract."¹⁰⁶ Since the SEC has jurisdiction to pursue fraud in

⁹⁷ See *Olint Boss Pleads Guilty, Sent to Prison in TCI*, JAMAICAN OBSERVER, Sept. 24, 2010; Julian Richardson, *Olin Anger*, JAMAICAN OBSERVER, Feb. 9, 2010.

⁹⁸ Carlos Fradique-Méndez, *The Recent Evolution of Columbia's Financial Market*, ASPATORE, Aug. 2009, at 4, available at 2009 WL 2511991.

⁹⁹ Ismail Mudashir, *Kaduna – Storm Over "Wonder Banks"*, DAILY TR. (Nig.) (Sept. 6, 2010), http://www.dailytrust.com.ng/index.php?option=com_content&view=article&id=2271:kaduna-storm-over-wonder-banks&catid=24:star-feature&Itemid=208; *Resurgence of "Wonder Banks"*, DAILY TR. (Nig.) (July 16, 2010), http://www.dailytrust.com.ng/index.php?option=com_content&view=article&id=85:resurgence-of-wonder-banks&catid=17:editorial&Itemid=9.

¹⁰⁰ Christine Hurt, *Evil Has a New Name (and a New Narrative): Bernard Madoff*, 2009 MICH. ST. L. REV. 947, 951–58.

¹⁰¹ Robert Khuzami, Dir., Div. of Enforcement, SEC, My First 100 Days as Director of Enforcement, Remarks Before the New York City Bar (Aug. 5, 2009), available at <http://www.sec.gov/news/speech/2009/spch080509rk.htm> (noting that over forty Ponzi scheme investigations began during Mr. Khuzami's first 100 days).

¹⁰² C.R. Bowles, Jr. et al., *Dirty Rotten Scoundrels: Ponzi Schemes in Bankruptcy Cases*, AM. BANKR. INST. J. 28, 28 (Mar. 28, 2009).

¹⁰³ Jayne W. Barnard, *Evolutionary Enforcement at the Securities and Exchange Commission*, 71 U. PITT. L. REV. 403, 403–04 (2010).

¹⁰⁴ See *infra* note 106.

¹⁰⁵ See Securities Act of 1933, § 2(a)(1), 15 U.S.C. § 77b(a)(1) (2011), Securities and Exchange Act of 1934, § 3(a)(10), 15 U.S.C.A. § 78c(a)(10) (West 2011).

¹⁰⁶ See SEC v. W.J. Howey Co., 328 U.S. 293, 298 (1946) (defining investment contract as a security); see also *Reves v. Ernst & Young*, 494 U.S. 56, 63–64 (1990) (crafting a four factor

the purchase and sale of *any* security,¹⁰⁷ the SEC has jurisdiction over pyramid schemes,¹⁰⁸ and has shut down hundreds of them in the last several years. Securities authorities, central banks, and criminal authorities must ensure that there are cooperative mechanisms in place to deal quickly and effectively with pyramid schemes.¹⁰⁹ If the securities authority is to assume an increasing, or primary role, then it should evaluate whether it needs legal amendments to broaden the definition of a “security.” It will also need the investigative and prosecutorial tools described throughout this Article.

C. Step 3: Empower the Capital Market Authority with Comprehensive Compulsory Investigative Authority

A modern capital market authority must have, and routinely use, full compulsory authority to require production of any information, from *any* person, that is relevant to conducting a complete and thorough investigation.¹¹⁰ Investigators must have the tools to follow the facts wherever they may lead.¹¹¹ The essential importance of this broad

“family resemblance” test for determining whether a “note” is a security).

¹⁰⁷ *Reves*, 494 U.S. at 61.

¹⁰⁸ Mark Frederick Hoffman, Note, *Decreasing the Costs of Jurisdictional Gridlock: Merger of the Securities and Exchange Commission and the Commodity Futures Trading Commission*, 28 U. MICH. J.L. REFORM 681, 682 (1995).

¹⁰⁹ For another set of proffered reforms, see Barnard, *supra* note 103.

¹¹⁰ See generally 15 U.S.C. 78u(a)(1) (West 2011); *SEC v. Wall St. Transcript Corp.*, 422 F.2d 1371, 1375 (2d Cir. 1970). Model statutory language providing such authority could read as follows:

The securities authority may, in its discretion, make such investigations as it deems necessary to determine whether any person has violated, is violating, or is about to violate any provision of the Securities Laws, the rules or regulations thereunder. The securities authority is authorized in its discretion, to investigate any facts, practices, or matters which it may deem necessary or proper to aid in the enforcement of such provisions, in the prescribing of rules and regulations under this law, or in securing information to serve as a basis for recommending further legislation concerning the matters to which this law relates.

¹¹¹ See generally Securities and Exchange Act of 1934, 15 U.S.C.A. § 21(b) (West 2011). Model statutory language could read as follows:

For the purpose of any investigation, or any other proceeding under this law, any member of the securities authority, or any officer designated by it, is empowered to administer oaths, summon witnesses, take statements and other testimonial evidence, and require the production of any books, papers, correspondence, memoranda, or other records (whether paper or electronic) which the securities authority deems relevant or material to the investigation or proceeding.

compulsory authority cannot be overstressed. Fraudsters manipulate markets using their laptop computers. Insider traders pass information through email, phone calls and text messages. Securities frauds often involve secreting illegal proceeds through the banking system, often in accounts held by corporations or trusts, necessitating routine access to bank records and other beneficial ownership information. Even regulated persons, such as brokers and their affiliates, use third parties and personal communication devices to perpetrate their schemes. Witnesses' testimony is also an essential component of building the evidentiary record to successfully stop market fraud. These are just a few examples of the wide range of information that must be accessible by a modern securities authority through compulsory process if they are to effectively police their market and protect investors. Moreover, this authority must be backed up by criminal penalties for refusal to produce evidence, destruction of or tampering with evidence, and for lying to examiners and investigators.¹¹²

1. Why the Ability to Obtain Bank Records Is Essential for Securities Authorities

Securities fraud is *always* motivated by money. Routine access to bank records is essential to successfully pursue market manipulation and insider trading cases because the movement of money through bank accounts is a primary source of evidence connecting parties to a fraudulent scheme, as well as to each other. The ability to easily obtain bank records is a core international standard, recognized in the IOSCO Principles,¹¹³ and is a requirement of the IOSCO Multilateral Memorandum of Understanding

¹¹² See generally *id.* § 78u(c) (providing for criminal penalties for refusal to obey an SEC subpoena for documents or testimony). Statutory language providing for such penalties could read substantially similar to the following:

In case of refusal to obey a securities authority summons issued to any person, the securities authority may invoke the aid of the appropriate court or tribunal to require the attendance and testimony of witnesses and the production of books, papers, correspondence, and other records. Such court or tribunal may issue an order requiring such person to appear before the securities authority or any member or officer designated by the securities authority, to produce records or to give statements or testimony relating to the matter under investigation. Any failure to obey such order of the court may be punished by such court as a contempt thereof.

¹¹³ IOSCO, *supra* note 63, at 6.

(MMOU).¹¹⁴ The U.S. SEC routinely seeks bank records in its securities fraud investigations.

Securities authorities must set up strict guidelines for its staff as to how to request and handle bank records. The request must be made in the course of a legitimate investigation and the information must be held confidential.¹¹⁵ Misuse of bank records and other non-public information by staff or officials should be an offense punishable by termination and/or prosecution. This being said, the securities authority should resist any effort requiring permission of a court or of the banking authorities before obtaining bank records. If every routine request for bank records required a judicial hearing, the resulting delay often would be prejudicial to an investigation. Similarly, requiring approval from the banking authorities would diminish the independence of the securities authorities and would allow the banking authorities to exert potentially inappropriate influence over securities investigations.

a. A Note on Customer Notification

Securities authorities seek bank records in investigations because the staff is trying to determine whether the account holder has committed securities fraud or whether the proceeds are in an account that they control. Some securities authorities have anti-tipping provisions, as do most financial intelligence units.¹¹⁶ Unfortunately, in the U.S. the Right to Financial Privacy Act (RFPA) mandates that the SEC give notice to the customer and an opportunity to object (which objection is rarely successful).¹¹⁷ This notice carries the danger that it will tip off a fraudster that an SEC investigation is ongoing, often sooner than the staff would prefer to surface in an

¹¹⁴ Int'l Org. of Sec. Commissions (IOSCO), Multilateral Memorandum of Understanding, art. 7(b)(ii) (May 2002) [hereinafter IOSCO MMOU], *available at* <http://www.iosco.org/library/pubdocs/pdf/ioscopd126.pdf>.

¹¹⁵ For example, the U.S. SEC uses standard forms that are provided to every witness requested or compelled to provide information. These forms explain the rights of the parties and the routine uses to which the information provided may be used, including use in enforcement actions or in cooperation with domestic or foreign authorities. *See* SUPPLEMENTAL INFORMATION FOR PERSONS REQUESTED TO SUPPLY INFORMATION VOLUNTARILY OR DIRECTED TO SUPPLY INFORMATION PURSUANT TO A COMMISSION SUBPOENA (FORM 1662) (Sept. 1, 2011), *available at* <http://www.sec.gov/about/forms/sec1662.pdf>.

¹¹⁶ *See* Financial Action Task Force, FAFT 40 Recommendations, at 5 (Oct. 2003), *available at* <http://www.fatf-gafi.org/dataoecd/7/40/34849567.PDF>.

¹¹⁷ Right to Financial Privacy Act of 1978, 12 U.S.C.A. § 3404 (West 2011) [hereinafter RFPA], *available at* <http://www.federalreserve.gov/boarddocs/supmanual/cch/priv.pdf>.

investigation. If staff is investigating someone for financial fraud, the last thing they want to do is to notify the person that they are seeking bank records before having a chance to look at those records to determine whether the person has other accounts that may be used to hide the proceeds of fraud. Laws like the RFPA that require law enforcement authorities investigating financial fraud to provide customer notice and an opportunity to protest access to their financial records are an unnecessary and inappropriate impediment to law enforcement.¹¹⁸ As one of my colleagues so eloquently put the issue:

While privacy concerns are of profound significance and must be accorded their proper sway, nonetheless so too is it also of profound social significance that fraudsters do not dominate the capital markets, destroy other people's hard earned wealth and, indeed, reduce the level of economic growth through their malfeasance and thievery.¹¹⁹

Foreign authorities should fight hard for anti-tipping provisions to ensure that they may conduct and complete their investigations without undue interference or delay.

2. Why Access to Telephone Records, Emails, Internet Service Provider Records, and Other Forms of Electronic Communications Are Essential for Securities Authorities

Securities authorities must have the authority to compel production of telephone records if they want to adequately police insider trading and market manipulation. These records can establish whether two parties knew each other and had conversations at key times during an event relevant to the investigation.¹²⁰ This is typically the key evidence necessary to prove insider

¹¹⁸ While there is a provision in the RFPA that a court order may be sought for a temporary exemption from the notice requirement, *id.* § 3409, it creates substantial delay and burden to require investigatory staff in the heat of juggling multiple investigations to go to court to complete their investigations.

¹¹⁹ Dr. Robert M. Fisher, Deputy Dir., Office of Int'l Affairs, U.S. SEC.

¹²⁰ Telephone records are not transcripts of telephone conversations. Rather, these are records that show the date and time telephone calls are placed; the numbers called; the duration of the calls; and subscriber information, such as the name, address, and payment information of the owner of the telephone number.

trading and market manipulation cases.¹²¹ The U.S. Eleventh Circuit Court of Appeals noted that “[t]he temporal proximity of a phone conversation between the trader and one with insider knowledge provides a reasonable basis for inferring that the basis of the trader’s belief was the inside information.”¹²² I estimate that phone records are relied on in well over half of SEC’s successful insider trading prosecutions. As a corollary, I would assume that the inability to obtain phone records probably reduces a securities authority’s ability to investigate successfully and prosecute insider trading by at least half.

Securities authorities must also have the authority to obtain emails, hard drives, and ISP records. With the ever-increasing use of electronic communications and web-based marketing and information distribution tools, the ability to obtain email communications and ISP records, which can provide the name, address, and billing information for subscribers to email accounts or web pages, is increasingly important for effective securities investigations. This is most recently illustrated by the U.S. SEC enforcement action against two Canadians who used Facebook, Twitter, and their website to allegedly manipulate stocks.¹²³ Accordingly, as with telephone records, securities commissions should actively pursue the statutory authority to obtain email, ISP records, and other electronic communications.

3. *Why Compulsory Witness Statements?*

Witness statements play a critical role in an investigation. Securities authorities must have the authority to compel witnesses, including non-regulated persons, to appear and testify before their staff in the course of an investigation. There must also be consequences for lying to the staff.¹²⁴

¹²¹ L. HILTON FOSTER, INSIDER TRADING INVESTIGATIONS 3 (2000) (“Telephone records frequently provide this circumstantial evidence in ‘tipping’ cases.”), *available at* http://www.sec.gov/about/offices/oia/oia_enforce/foster.pdf.

¹²² SEC v. Ginsburg, 362 F.3d 1292, 1299 (11th Cir. 2004).

¹²³ See Press Release, SEC, Court Enters Default Judgments of Permanent Injunction and Other Relief Against Defendants Carol McKeown, Daniel F. Ryan and Their Companies Downshire Capital Inc. and Meadow Vista Financial Corp. (Feb. 9, 2011), *available at* <http://www.sec.gov/litigation/litreleases/2011/lr21847.htm>.

¹²⁴ See, e.g., Press Release, SEC, Teresa Fernandez Sentenced to 41 Months in Prison for Making False Statements to the SEC and Probation Officers (Jan. 27, 2006), *available at* <http://www.sec.gov/litigation/litreleases/lr19545.htm>.

D. Step 4: Empower the Securities Authority with Efficient, Effective, and Flexible Civil Remedies

A capital market's regulator should be empowered with a broad range of remedies at its disposal that are designed to protect investors, deter illegal conduct, and remediate market abuses. A broad range of remedies enables a regulator to tailor each specific remedy to the particular abuse that is being addressed.

A number of countries have attempted to build up a criminal response to market frauds at the expense of civil enforcement programs. This is the wrong approach and unsustainable. The criminal process is not well suited to take the lead role in dealing with most securities law violations. Prosecutors are busy and securities cases are complex. The criminal process takes enormous resources, and the conviction rate for securities fraud all over the world is very low because the criminal burden of proof—beyond a reasonable doubt—is difficult to meet.¹²⁵ Criminal cases, and the moral stigma they represent, should be reserved for the most egregious cases—the premeditated frauds that result in the destruction of life savings and that involve market-destroying conduct. Where this line is drawn in any particular case will depend on many factors, but, in my view, no more than 10% of securities law violations in a market need be dealt with criminally.¹²⁶

In contrast, civil tools are much more flexible, efficient, certain, and effective at stopping and remedying securities fraud and market abuse.¹²⁷ A

¹²⁵ See, e.g., Regina F. Burch, "Unfit to Serve" *Post-Enron*, 42 VAL. U. L. REV. 1081, 1085 (2008) ("[U.S.] [f]ederal criminal trials for violations of federal securities laws are lengthy, involve large resource expenditures by government prosecutors, require sifting through thousands of pages of corporate documents, and involve many corporate employees and other individuals. [The government] must show that the defendant acted willfully or knowingly and must establish its case by proof beyond a reasonable doubt.").

¹²⁶ For example, in many jurisdictions, insider trading can only be prosecuted criminally, which means that the securities authority refers the matter to criminal authorities for prosecution. Now, while insider trading is always bad for markets, there is a long continuum of behavior involved. For example, a CEO may reveal inside information to his barber while getting a haircut; the barber just cannot resist the good fortune that has fallen into his lap, and he goes out and trades. On the other hand, there are the investment bankers working on mergers deals who are sworn to secrecy and sign agreements not to trade, yet they abuse their professional positions by secretly trading through overseas accounts held by nominee-owned corporations that they secretly control. In my view, criminal resources are best spent on the latter situation.

¹²⁷ The U.S. Securities and Exchange Act of 1934 contains a remarkably flexible provision that says that "the [SEC] may seek, and any Federal court may grant, any equitable relief that may be appropriate or necessary for the benefit of investors." 15 U.S.C.A. § 78u(d)(5) (West

comprehensive range of remedies includes: trading suspensions, disgorgement of illegal profits, officer and director bars, civil monetary penalties, injunctive orders to stop present and future violations, appointment of a corporate monitor or receiver, and asset freezes. These remedies can be mixed, matched, and tailored to neatly fit the specific violation. Civil injunctive actions can also be backed by the court's authority to enforce its orders, including incarceration for contempt, ensuring that these orders have teeth.¹²⁸

Moreover, the prophylactic and deterrent effect of public exposure of wrongdoing should not be underestimated, particularly in an industry that thrives on reputation. Indeed, this is a leverage point that the securities authority should fully exploit. Enforcement actions should serve as a forum to send a message by exposing the wrongdoer and explaining the nature of the violation, the harm caused, and the remedial action being taken to correct the problem to protect investors and the market.

The U.S. has developed what is characterized as a "parallel" system, whereby the SEC can prosecute a case civilly without precluding a parallel criminal case by the Department of Justice for the same conduct.¹²⁹ Many have questioned why this parallel system does not result in a constitutional double jeopardy violation. However, the system has survived judicial scrutiny because the agency's penalties and other relief are designed to be remedial in nature, and not punishment for double jeopardy purposes.¹³⁰

2011).

¹²⁸ See, e.g., Press Release, SEC, Sec Files Second Contempt Motion Against Roc Hatfield and Global Diamond Fund, Inc. (Sept. 26, 2002), available at <http://www.sec.gov/litigation/litrelases/lr17747.htm> (describing the SEC's contempt action for failure to file a sworn accounting that had been ordered by the judge).

¹²⁹ See Thomas C. Newkirk, Assoc. Dir., Div. of Enforcement, and Ira L. Brandriss, Staff Attorney, Div. of Enforcement, SEC, The Advantages of a Dual System: Parallel Streams of Civil and Criminal Enforcement of the U.S. Securities Laws, Remarks at the 16th International Symposium on Economic Crime (Sept. 19, 1998) (marking on the advantages offered by the U.S. system of both civil and criminal enforcement mechanisms), available at <http://www.sec.gov/news/speech/speecharchive/1998/spch222.htm>.

¹³⁰ See *Hudson v. United States*, 522 U.S. 105 (1997) (holding that the federal government's administrative proceedings imposing monetary penalties against petitioners for violations of banking statutes did not bar the subsequent criminal proceedings for the same conduct because the administrative proceedings were civil actions for the purposes of the Double Jeopardy Clause).

1. Disgorging Illegal Proceeds of Securities Fraud: Show Me the Money!

Securities frauds are financial crimes and, as such, are all about the money. Securities frauds are particularly tempting because people can quickly make millions of dollars with well-timed insider trading, by participating in a scheme to pump up stock prices while secretly selling into the hype, or by looting their company through undisclosed deals with secretly controlled companies. Indeed, numerous SEC enforcement actions involve securities fraudsters who have funded their “lavish lifestyles” with ill-gotten investors’ funds.¹³¹ The temptation is high, the opportunities abound, and the payoff is large. Securities authorities must be empowered to remove these profits or the frauds will continue.

Remedies that focus on removing the profit incentive through disgorgement and penalties are extremely effective in reducing and deterring financial crime.¹³² If we could disgorge all proceeds of securities fraud, we would eliminate fraud and misconduct from our markets. Confiscation of all profits made from financial crime should be certain, automatic, and the *minimum* sanction available.

Under no circumstances should an individual be permitted to keep the proceeds of his securities law violation. Examples of disgorgement in the context of various securities frauds would include:

- Financial Fraud: officer’s bonus, stock options, salaries where company financial results have been misrepresented, and trading profits;
- Offering Fraud: money misappropriated from the investor funds raised;
- Broker Dealer Fraud: commissions earned on fraudulent transactions;
- Insider Trading: profits made or losses avoided from insider trading; and
- Manipulation: profits from manipulative trading and sales.

¹³¹ *Search SEC Documents*, U.S. SEC. & EXCHANGE COMM’N, <http://www.sec.gov/search/search.htm> (search “lavish lifestyle”) (last modified July 30, 2009).

¹³² *See Rules on Fair Fund and Disgorgement Plans*, 17 C.F.R. § 201.1100 (2006), *available at* <http://www.sec.gov/about/rulesprac2006.pdf> (stating SEC disgorgement rules relating to enforcement actions).

2. Penalties

Penalties are defined as the fines assessed above and beyond the profits made by the wrongdoer.¹³³ If all the profits from market abuse and fraud were disgorged in *every* instance of fraud, the incentive for such fraud and abuse would be eliminated. It is because we cannot detect and prosecute every instance of fraud and abuse that we need penalties in addition to disgorgement of ill-gotten gains to serve as a deterrent. Penalties should have some meaningful correlation to the amount of the gain made from the fraud and should be adjusted based on other factors, such as the harm to the market, harm to investors, willfulness of the fraud, recidivism, the need to create additional deterrence for the particular conduct, and other traditional factors for assessing penalties. For example, if a person makes \$1 million from insider trading, and there is a one in four chance of catching that person, then the penalty to achieve optimal deterrence (i.e., to ensure that wrongdoing does not “pay” on average) should be \$3 million, for a total payment (disgorgement and penalty) of \$4 million. Countries should be careful about laws that provide a fixed amount of penalties for certain violations, as the specified amount can quickly become obsolete and represent a mere cost of business for the fraudster.

E. Step 5: Securities Authorities Need to Develop a Partnership with Criminal Authorities

While I have argued that the vast majority of securities law violations can and should be handled by a non-criminal process, there are always some securities frauds that are so damaging to innocent investors’ lives, so destructive to the market, and so calculated to steal from others, that the perpetrators should go to jail. Securities law violations may also be associated with other crimes, such as money laundering, mail fraud, wire fraud, and conspiracy. This means the securities authority should develop a good working relationship with the Attorney General or other criminal authority to help ensure that the most egregious securities law violations are prosecuted.¹³⁴

¹³³ See, e.g., Press Release, SEC, Statement of the Securities and Exchange Commission Concerning Financial Penalties (Jan. 4, 2006), available at <http://www.sec.gov/news/press/2006-4.htm> (explaining the SEC’s position concerning financial penalties).

¹³⁴ See Newkirk & Brandriss, *supra* note 129 (discussing best practices in coordinating between civil and criminal authorities).

F. Step 6: Securities Authorities Must Have Tools to Engage in Real-Time Enforcement

It is not uncommon for a securities authority to learn of ongoing frauds that, if not shut down immediately, can do irreparable harm to investors and the market. These emergency situations can be expected to constitute 3% to 5% of a securities authority's case load, if the U.S. SEC's experience is any guide.¹³⁵ The point is that securities frauds *will* happen, and the earlier in their life cycle they can be detected and stopped, the less damage they will do. The lesson is that the securities authority should have the tools, the standing authority, and the capacity to address these emergency situations as they arise.

Some of the more effective emergency tools include injunctive orders,¹³⁶ asset freezes, orders preventing destructions of documents, "accountings,"¹³⁷ expedited discovery, repatriation orders, and surrender of passports.¹³⁸ This also means that when issuing companies fall below their disclosure or listing standards the trading in their stocks may need to cease until they clarify their disclosures. When brokerage firms fall below capital requirements, they need to be addressed and resolved immediately. Leaving insolvent firms open creates an environment that is extremely likely to produce fraud and Ponzi scheme activity as the firm desperately searches for assets to fill, or hide, their capital deficiencies. Insolvent firms that are allowed to continue

¹³⁵ See U.S. SEC. & EXCHANGE COMM'N, FY 2010 PERFORMANCE AND ACCOUNTABILITY REPORT 31 (2010) (noting 3.26% of all enforcement investigations are deemed "high impact"), available at <http://www.sec.gov/about/secpar/secpar2010.pdf#mda>.

¹³⁶ See, e.g., Securities and Exchange Act of 1934, 15 U.S.C.A. § 78u(d)(1) (West 2011), available at <http://www.sec.gov/about/laws/sea34.pdf>. Legislation providing for injunctive orders could read substantially similar to the following:

Whenever it shall appear to the securities authority that any person is engaged or is about to engage in acts or practices constituting a violation of any provision of the securities laws or regulations thereunder, it may in its discretion bring an action in the appropriate court or tribunal to enjoin such acts or practices, and upon a proper showing a permanent or temporary injunction or restraining order shall be granted.

¹³⁷ See BLACK'S LAW DICTIONARY 18 (9th ed. 2009) (noting that an "accounting" typically involves an order to produce books and records, sworn financial statements, and the location of assets).

¹³⁸ For an example of the powerful remedies available in a temporary restraining order, see, e.g., Press Release, SEC, Securities and Exchange Commission Obtains Emergency Asset Freeze Against Additional Defendants Who Purchased Call Options for TXU Corp. Stock Prior to Acquisition Announcement (Mar. 30, 2007), available at <http://www.sec.gov/litigation/litreleases/2007/lr20063.htm>.

almost invariably lead to trouble, and, in general, should be cleared out of the market.

1. Asset Freezes

When a fraud is in progress, it is often essential to get a freeze over all the defendant's assets "wherever they may be located" *before* the fraudster learns of the investigation. Otherwise the first thing he tends to do is dissipate his assets. To understand the urgency, stocks typically settle in three days, which means that after three days the fraudster can wire the proceeds to overseas bank accounts in the name of nominee owners, or the proceeds will be used to buy diamonds, mansions, cars, or other items to fuel their "lavish lifestyle."¹³⁹ For these situations, the securities authorities must have a means to freeze assets before they are dissipated.

In the U.S., the SEC must get a court order before it can freeze assets on an emergency basis (often without notice to the owner of the assets). The court will issue the order if the SEC can establish a *prima facie*¹⁴⁰ case and a strong likelihood that it will prevail at trial on the merits of the case. The SEC must also establish that the defendant, directly or indirectly, has engaged in and, unless restrained and enjoined by an order of the court, will continue to engage in acts, practices, and courses of business constituting violations of the securities laws.¹⁴¹ Should the SEC meet this standard, the court will impose a temporary freeze lasting ten days.¹⁴² Prior to the expiration of the ten days, the court will hold a second hearing to determine whether it should maintain the freeze for the duration of the litigation. The SEC must give notice of this hearing to the owner of the assets, who can appear and challenge the freeze order. Unless the owner of the assets can persuade the court that the SEC is not likely to succeed on the merits, or that the frozen assets are not a reasonable approximation of the proceeds of the alleged fraud, the court will issue an order continuing the freeze until after a

¹³⁹ *Search SEC Documents, supra* note 131.

¹⁴⁰ *Prima facie* is Latin for "on its face." See BLACK'S LAW DICTIONARY 1805 (9th ed. 2009). A *prima facie case* is one that at first glance presents sufficient evidence for the plaintiff to win. *Id.*

¹⁴¹ *SEC v. Cavanagh*, 155 F.3d 129, 132 (2d Cir. 1998). These circumstances could include: likely and significant dissipation or conversion of assets, significant harm to investors, flight from prosecution, destruction of or tampering with evidence, transfer of assets or records outside the country, or other immediate and substantial harm to the public interest.

¹⁴² *Id.* ("An asset freeze requires a lesser showing; the SEC must establish only that is likely to succeed on the merits.").

trial.¹⁴³ Once the funds are wired out of the country, or otherwise dissipated, they are difficult to recover. Seizing the proceeds of fraud provides tremendous leverage over the defendants in financial crimes cases and will be a key component in a securities authority's ability to protect investors and the market from securities fraud and abuse.

2. *Financial Intelligence Units*

Proceeds of securities fraud can be wired around the world at the click of a mouse. Tracing such proceeds through traditional evidence-gathering mechanisms, such as memorandum of understanding and mutual legal assistance treaties, may take six months to obtain the records, only to find that the funds had already been wired off to the next offshore jurisdiction five months earlier. This is no way to conduct investigations in today's world. Securities fraud is a predicate offense to money laundering, which means that any time the proceeds of securities fraud are being secreted away through the banking system there is a potential money laundering offense.¹⁴⁴

Increasingly, it makes sense for securities authorities to seek assistance from financial intelligence units.¹⁴⁵ Many financial intelligence units (FIUs) have the capacity to quickly:

- identify the beneficial ownership of accounts at issue;
- determine whether the funds are still in the account;
- work with financial institutions to conduct surveillance over accounts and notify appropriate authorities of customer attempts to withdraw or remove such funds; and
- determine the disposition or destination of any funds that have been withdrawn, wired, or moved.¹⁴⁶

¹⁴³ See *SEC v. Fife*, 311 F.3d 1, 11 (1st Cir. 2002) (explaining that an asset freeze was reasonable because of the high risk that funds would be further depleted without the freeze); *SEC v. ETS Payphones*, 408 F.3d 727, 735 (11th Cir. 2005) (holding that the SEC's approximation of defendant's "ill-gotten gains" were reasonable and so the freeze could continue).

¹⁴⁴ See Kathleen L. Casey, Comm'r, SEC, Opening Remarks at Joint Regulatory Anti-Money Laundering Training (Apr. 23, 2008), available at <http://www.sec.gov/news/speech/2008/spch042308klc.htm>.

¹⁴⁵ See INT'L MONETARY FUND, FINANCIAL INTELLIGENCE UNITS (2004), available at http://www.apgml.org/issues/docs/19/fiu%20handbook_english.pdf (explaining FIUs and their function in market regulation).

A number of financial intelligence units also have the capacity to assist with obtaining asset restraints either prior to or concurrently with an imminent emergency enforcement action.¹⁴⁷ FIUs have assisted the U.S. SEC in securing millions of dollars in proceeds of fraud located in overseas accounts. Securities authorities and FIUs must continue to develop their capacity to work with each other.

G. Step 7: Securities Authorities Should Have the Ability to Settle Cases

Settlements are a valuable tool for building an enforcement program, but only in a system where the regulator has sufficient authority to conduct thorough investigations and apply meaningful sanctions against the wrongdoers, and where it has the reputation for having the will, resources, and skill to successfully prosecute the matter if it is not settled. Specifically, wrongdoers must believe that if they do not settle, the securities authority is ready and willing to prosecute an enforcement action against them and that it will likely be successful in such proceedings.

Some authorities have expressed distaste for settlements, arguing that they represent a compromise of justice. However, if properly structured, settlements can achieve all the goals of an enforcement program. Enforcement cases should not be settled unless the terms result in meaningful relief that is sufficient to remedy the particular violation, protect investors, and have a deterrent effect. Settlements must also result in penalties and other relief that is closely comparable to those that would be obtained if the case were litigated. The bottom line is that, if a settlement does not result in the fundamental enforcement goals of deterrence, disgorgement, investor protection, industry bars, prevention of ongoing fraud, and improvement of investor confidence, then a settlement is counterproductive and should not be accepted.

The settlement process should ensure that settlements result in recourse by the securities authority if the defendant breaches the terms. In the U.S., settlements result in a consented court order, and breaches amount to contempt of the court's order, ensuring that settlements have "teeth." It should be noted here that the higher the quality of the investigation, the higher the quality of the settlement, and the better the securities authority can deter wrongful conduct and protect investors and the market. A properly

¹⁴⁶ See generally *id.* (outlining the role of FIUs).

¹⁴⁷ *Id.* at 14.

structured settlement process can be fair and accountable, while allowing the securities regulator to take action against the individual or entity, get its message out to the public in a meaningful way, and collect penalties and fines, while saving valuable public resources in the time and money it would take to litigate a case to full completion in the courts.

The process should allow settlement negotiations at various times in the investigation process, with appropriate safeguards to ensure that undue pressure is not exerted to extract fines where a violation could not otherwise be proven in court. Most serious settlement discussions should not occur until late in the investigative process, ideally after the investigation is complete and a preliminary determination has been made about the nature of the violations. This will ensure that settlements are comprehensive and that the full evidentiary record and corresponding violations are fully considered in reaching the appropriate settlement. Negotiated settlements should be considered and approved or rejected by the securities authority as an institutional body, rather than by an individual officer. Lastly, final settlement agreements must be transparent and public.

H. Step 8: Capital Markets Must Have Recourse to an Effective Judiciary

An effective modern financial market must have swift resolution of disputes and regulatory enforcement actions, including the ability to grant emergency relief to stop ongoing securities frauds. Capital locked up in disputes is not available to grow an economy. This means that the securities authority, and other capital market operators, must have recourse to an effective judiciary to ensure that disputes are resolved quickly and effectively to help unleash a modern capital market.¹⁴⁸

1. Specialized Tribunals

The establishment of a specialized tribunal appears to be an attractive option that should be considered by many capital markets. Traditional court systems all too often do not offer a sufficiently timely and efficient adjudication mechanism by which the securities authorities, or the securities industry, can seek recourse for final resolution of disputes or enforcement matters. Ideally, the tribunal should be empowered to hear not only appeals

¹⁴⁸ The U.S. SEC uses independent administrative law judges to hear over 50% of its enforcement cases. See *Office of Administrative Law Judges*, U.S. SEC. & EXCHANGE COMM'N, <http://www.sec.gov/alj.shtml> (last modified Apr. 19, 2010) (describing the role of that office).

from administrative actions and orders by the securities authority but also enforcement actions filed by the authority in the first instance. Preferably, the tribunal would have capacity to issue binding injunctive orders, freeze assets, issue industry bars, order accountings, and order production of documents and testimony. To grow the market and establish confidence, the securities authority must have a tribunal available to it that has capacity to remedy the variety of abuses that it will inevitably face as the market grows and develops, including prosecutions for insider trading, market manipulation, financial accounting and disclosure violations by issuing companies, abuse of customers by broker dealers and investment advisors, and pyramid schemes. Indeed, countries should consider a specialized tribunal that would have original jurisdiction to hear all capital markets-related matters, including disputes among investors and brokers and disciplinary matters relating to the Exchange, as well as have jurisdiction to hear securities authority enforcement proceedings. This may be particularly important given the studies that suggest that private enforcement is also a key element in market development.¹⁴⁹

There are a number of models already being employed in various countries, and those appear to be working well. Specialized tribunals are efficient and can be set up to resolve cases in well under a year. The expenses of establishing a specialized tribunal are likely far outweighed in many markets by the potential dividends toward capital market development.

I. Step 9: Securities Authorities Must Have a Robust Compliance and Inspection Program

The securities authority's examination and inspection program should work to reduce the incidence of customer abuse by market intermediaries before they become serious violations. Programs for the inspection of broker-dealers, investment advisors, and other regulated persons should be separated from the enforcement program. Inspections are a non-adversarial cooperative dialogue with the industry that typically result in nonpublic deficiency letters;¹⁵⁰ whereas an enforcement program is adversarial,

¹⁴⁹ See Simeon Djankov et al., *The Law and Economics of Self-Dealing*, 106 J. POL. ECON. 1113 (2008) (exploring the regulation of self-dealing on market development, primarily through private enforcement mechanisms to prevent diversion of corporate wealth from investors to management).

¹⁵⁰ A deficiency letter is provided by the regulator to the firm and identifies the problems, asks the registrant to take remedial steps, and requests that the registrant provide a written response.

compulsory and results in public enforcement actions. This “good cop — bad cop” system has numerous advantages that mutually reinforce each other.

A securities regulator should have a competent staff of examiners that are well-trained to perform complete, comprehensive, and discreet examinations of all market participants. Unlike many other functions of the regulator, the examinations of market participants, and resulting examination reports, should be confidential. Problems and deficiencies identified within firms should be handled informally where possible, but securities examiners should have authority to and not hesitate to refer the most serious securities law violations found during examinations to enforcement staff where appropriate.

1. Compliance Programs

One powerful way a securities authority can cultivate a culture of compliance is to mandate an industry compliance program that requires firms to establish a Chief Compliance Officer, compliance policies and procedures, an annual self-assessment, access for the Chief Compliance Officer to the firm's senior-level executives, and internal codes of ethics.¹⁵¹ The regulator can build a hierarchy whereby the individual firms are responsible for their own representatives, the self-regulatory organizations are responsible for their own firms, and the regulator oversees the entire structure. Such a regime can be strongly reinforced by an enforcement program. For example, a securities authority may sanction not only individual representatives for recommending unsuitable investments, but also the employing firms for failure to supervise their employees. “Failure to supervise” cases send a strong message to the firms that they are responsible for having effective compliance programs that will avoid, deter, and detect improprieties by their employees and that they will be held accountable for deficiencies in such programs. One solid enforcement case against a brokerage firm for a compliance failure, or “failure to supervise,” will send a message to every other firm in the market that, if the firm allows such conduct to happen on its watch, it will be held accountable. Notably, an affirmative defense in these

See EXAMINATIONS BY THE SECURITIES AND EXCHANGE COMMISSION'S OFFICE OF COMPLIANCE INSPECTIONS AND EXAMINATIONS, U.S. SEC. & EXCHANGE COMM'N 24 (2011), *available at* <http://www.sec.gov/about/offices/ocie/ocieoverview.pdf> (describing its examination process).

¹⁵¹ For an excellent article by the architect of such a program, see John H. Walsh, *Institution-Based Financial Regulation: A Third Paradigm*, 49 HARV. INT'L L.J. 381 (2008).

cases is having a compliance program that is reasonably designed to detect and remedy the wrongdoing. This serves to empower compliance officers, as well as examiners, with the clout they need to insist on changes in a firm's conduct, culture, and procedure.

Morality has been defined as what a person does when nobody else is looking. While a majority of people do not seek to unfairly profit at the expense of others, there will always be a minority that will abuse the system. The challenge for a securities authority is to create a transparent environment where the perception is that everyone *is* looking—compliance officers, investors, regulatory authorities, examiners, lawyers, accountants, and other gatekeepers.

J. Step 10: Securities Authorities Must Develop a Partnership with the Industry: The Self-Regulatory Model and Other Incentives to Cooperate with the Government

Unfortunately, numerous securities authorities have not established an effective partnership with their industry for sharing the burden associated with monitoring, compliance, supervision, and disciplinary actions. The government's role is to ensure that the private sector thrives, and the private sector should have every incentive to partner with the government in taking the necessary steps toward this goal. Those in the private sector that are taking the long-term view will support a fully empowered securities authority with a vigorous enforcement program for this is no threat to legitimate business. On the contrary, it is designed to protect and grow the markets. The securities authority should watch for every opportunity to leverage the resources and self-interest of the industry to the maximum extent possible to be a partner in policing the securities market. The regulatory structure should be characterized by a working partnership with the industry at every level possible, albeit at "arms length" to avoid "regulatory capture."

1. Self-Regulatory Organization Structure

Self-regulatory structures are highly efficient and work well where the regulator has full authority to require the industry to police its own members, conduct surveillance, and report and remedy fraud and abuse. Self-regulatory organizations (SROs) are well-positioned to assume this role because they are able to exercise "contractual" control over their

membership. Requiring the industry to police itself also conserves substantial public resources. The SRO's ability to revoke membership is an extraordinarily effective, albeit non-governmental tool that provides leverage for ensuring that members follow the rules. Remarkably, in the U.S., SROs conduct about twice as many examinations and enforcement actions as the SEC. Absent this division of labor, the SEC would likely need to triple its staff and budget. This approach takes a huge burden off of the public resources of a securities authority and frees it up to assume a more appropriate role as an "APEX" regulator. Delegated authority, however, also must come with responsibility and accountability. Moreover, if the SRO does not adequately carry out its responsibilities, the securities authority must use its enforcement powers to correct the situation.¹⁵² As they say: "trust, but verify."

Securities regulators may also seek to cultivate a culture of cooperation within the industry. Again, this is often accomplished by appealing to the industry's self-interest. The securities authority may want to consider implementing a package of incentives to regulated persons for self-policing, self-remediating, and cooperating with investigations. This program can include both intermediaries and stock-issuing companies, as well as whistleblowers and others that come forward with actionable information.¹⁵³ Simply put, if a regulated person or other "gatekeeper" cooperates with an investigation they may be provided with corresponding favorable treatment in the form of lower penalties in any enforcement cases that the securities authority may ultimately bring. Likewise, failure to cooperate may result in correspondingly higher penalties and other sanctions. Industry cooperation with inspections and investigations can substantially improve the responsiveness and capacity of the securities authority's enforcement program. All credit for cooperation should be transparent and approved by

¹⁵² See, e.g., Sodano, Case No. 3-12596 (SEC Mar. 22, 2007), available at <http://www.sec.gov/litigation/admin/2007/34-55509-o.pdf> (discussing charges against CEO of American Stock Exchange for inadequate surveillance, investigatory, enforcement, and compliance programs).

¹⁵³ The U.S. SEC has published a list of considerations to help educate the industry about the benefits of cooperating, and the corresponding penalties for lack of cooperation. See Report of Investigation Pursuant to Section 21(a) & the Relationship of Cooperation to Agency Enforcement Decisions, Exchange Act Release No. 34-44969 (Oct. 23, 2001), available at <http://www.sec.gov/litigation/investreport/34-44969.htm>. This program has worked well and companies coming forward to self-report problems in their organization is a significant source of enforcement cases. See also *Enforcement Cooperation Initiative*, U.S. SEC. & EXCHANGE COMM'N, available at <http://www.sec.gov/spotlight/enfcoopinitiative.shtml> (last modified Nov. 2, 2011) (describing a series of measures to encourage cooperation by both individuals and companies with SEC investigations and enforcement actions).

the securities authority as an institutional body to ensure consistency with programmatic goals and avoid unfair preferential treatment.

K. Step 11: The Securities Authority Must Maximize Its Capacity to Engage in International Cooperation

With the globalization of capital markets, securities authorities must have capacity to work with international regulatory and law enforcement partners to protect their market and investors, and to provide reciprocal assistance when requested. The capacity of a securities authority to protect its market is increasingly dependent on the quality of regulatory authorities in other markets. Securities fraud and abuse is not constrained by geographic borders, but the authority of a securities authority ends at the border. Market abuses that damage investors can originate from anywhere in the world, and domestic market abuses often involve the proceeds of the scheme being wired outside of the country. International boiler rooms¹⁵⁴ and pyramid schemes are examples that further illustrate this point. These international frauds involve unscrupulous salesmen that sell securities from one jurisdiction, often where there is lax enforcement. They sell securities from companies from a second jurisdiction. The victims are in a third set of jurisdictions, who wire their funds to offshore accounts in a fourth set of jurisdictions, and the whole scheme is masterminded by fraudsters who could be located anywhere. Unsuspecting investors, often vulnerable and elderly, are devastated daily by these frauds. These are truly international schemes designed to exploit the jurisdictional limitations of law enforcement that will require new international techniques and cooperation.

The IOSCO MMOU is a magnificent achievement in international enforcement cooperation. The MMOU provides a standardized framework for sharing enforcement-related information and a gradually expanding network of participating regulatory agencies.¹⁵⁵ Approximately eighty countries are now signatories,¹⁵⁶ many after working to obtain the legislative

¹⁵⁴ See generally *Boiler Room*, U.S. SEC. & EXCHANGE COMM'N, <http://www.sec.gov/answers/boiler.htm> (last modified May 25, 2000) (describing boiler room frauds).

¹⁵⁵ See *Multilateral Memorandum of Understanding Concerning Consultation and Cooperation and the Exchange of Information (MMoU)*, OICU-IOSCO, http://www.iosco.org/library/index.cfm?section=mou_main (last visited Aug. 20, 2011) (featuring the text of MMOU).

¹⁵⁶ See *List of Signatories to the IOSCO Multilateral Memorandum of Understanding Concerning Consultation and Cooperation and the Exchange of Information – 80*, OICU-IOSCO, http://www.iosco.org/library/index.cfm?section=mou_siglist (last visited Aug. 20,

capacity to compel bank records and other beneficial ownership information and to share the information with their counterparts.¹⁵⁷ The MMOU allows its signatories to help each other properly police their securities markets and shut down international frauds that may adversely affect capital markets and their investors, creating a seamless enforcement network among its membership.

As great as the IOSCO MMOU is, however, it is only the beginning. First, international agreements to cooperate are only as effective as the regulatory authorities who must give them effect, and many still lack basic powers. Second, as discussed throughout this Article, securities authorities cannot properly police their markets without access to phone records, ISP records, emails, hard-drives, testimony, asset freezes, and provisions for enforcement of judgments, none of which are mandated in the MMOU. The U.K. courts have recently rendered an extraordinarily helpful decision to facilitate an international freeze order and international enforcement of judgment.¹⁵⁸ Someday, these issues will also need to be comprehensively addressed by the IOSCO community. Until that time, securities fraudsters will continue to exploit the gaps in international cooperation.

L. Step 12: Securities Authorities Must Develop Surveillance and Intelligence Capacity

There are many sources that a securities authority should cultivate to ensure that it receives timely intelligence on market conditions, including fraud and abuse. These will include customer complaints, market surveillance programs, examinations of market intermediaries, referrals from other domestic and foreign authorities, whistleblowers, and the financial

2011).

¹⁵⁷ See generally *International Enforcement Assistance*, U.S. SEC. & EXCHANGE COMM'N, http://www.sec.gov/about/offices/oia/oia_crossborder.shtml (last modified Jan. 20, 2010) (explaining memorandum of understanding and mutual legal assistance treaties and their current roles in the SEC regulation framework).

¹⁵⁸ The High Court of Justice in London issued an order freezing assets held in the United Kingdom by a citizen of the United Kingdom who was a defendant in a pending SEC enforcement action in the United States. *U.S. Securities & Exchange Commission v. Manterfield*, (2008) EWHC 1349 (QB), available at 2008 WL 3819582. The *Manterfield* case is summarized in an SEC Press Release. Press Release, SEC, Securities and Exchange Commission v. Lydia Capital, LLC et al. & United Kingdom Court of Appeal Upholds SEC Asset Freeze Order Against Defendant in SEC Case Alleging Fraud by a Hedge Fund Manager (Jan. 28, 2009), <http://www.sec.gov/litigation/litreleases/2009/lr20872.htm>.

press. Securities authorities must have a comprehensive system for intake, analysis, and tracking of surveillance, complaints, tips, and referrals.

A computerized automated surveillance program is essential for most modern capital markets to detect market manipulation and insider trading. The surveillance systems are typically located at the securities authority, stock exchange, or both. The general concept is fairly simple: the program must detect unusual trading spikes in either volume or price in a particular security. Then, public records need to be checked to see if the trading was in advance of significant corporate announcements (typically these include mergers, acquisitions, product development, earnings announcements, or regulatory approvals). If so, this generates an alert indicating possible insider trading that should be investigated. The investigator must determine whether the persons trading have an explanation for their unusual trading other than that they possessed non-public material information. In market manipulation cases, the surveillance will also seek to identify unusual trading spikes, but, unlike insider trading, there may not be any public announcement or other press that would otherwise explain the anomalous trading.

The stock exchanges should be in regular contact with securities authorities to discuss alerts or sudden movements and make appropriate and timely referrals of suspicious trading. The securities authority must ensure that the exchange is using the proper parameters to obtain the maximum efficiency from the electronic surveillance system.

M. Step 13: Securities Authorities Should Maintain the Confidentiality of Investigations

The securities authority must maintain the confidentiality of the investigative process to protect the integrity of the investigation and the privacy and reputation of those being investigated. Investigations should not be construed as an indication of wrongdoing by any person, unless and until the investigation is complete and the regulatory authority authorizes the filing of charges. Any concerns about the securities authority's ability to compel information that is private and confidential should be tempered by requirements that staff maintain the confidentiality of the information, but not by restrictions to the securities authority's access to the information in the first instance. Once an enforcement proceeding commences, the authority should notify the public of the charges, the violations involved, and the regulator's rationale for bringing the action.

N. Step 14: Securities Authorities Should Serve As the "Investor's Advocate"

William O. Douglas, the U.S. SEC's third Chairman from 1937–1939 and the longest serving U.S. Supreme Court Justice, said that the SEC is the "investor's advocate."¹⁵⁹ This philosophy has been the bedrock that has seen the SEC through seventy-five years of market growth and innovation, and it is a primary reason that nearly 60% of U.S. households are confident enough to invest their retirements and children's education in the capital markets. These are productive assets available to build and rebuild the economy. The regulatory structure must be designed to protect their interests and give them the confidence that their funds are not going to be stolen, that the books are accurate, and that the system is not rife with insider traders and market manipulators. Investors will assume the risk of business and economic cycles, but they will not readily assume the risk that their investment will be stolen or diminished by securities fraud. Being the investor's advocate means that the individual investor, not the large industry firms or corporate issuers, should be treated as the ultimate client of the securities authority.¹⁶⁰

So what specific actions can a securities authority take to be the investor's advocate? Investors must see that the regulator is taking appropriate regulatory and enforcement actions for their benefit. In general, this requirement can be met by bringing enforcement cases that will serve to protect the interest of investors, including recovery of assets for defrauded investors.¹⁶¹ Additionally, the securities laws should require, and the regulators should ensure, that investors have access to quality information from issuing companies and the brokerage firms. If a securities authority focuses its efforts on leveling the playing field for the individuals and small players, then most market development and regulatory goals will fall into

¹⁵⁹ Troy A. Paredes, Comm'r, SEC, Remarks at the SEC Speaks in 2011 (Feb. 4, 2011), available at <http://www.sec.gov/news/speech/2011/spch020411tap.htm>.

¹⁶⁰ This does not mean that the securities authority serves as private counsel to individual investors, but rather that it uses its enforcement program to benefit investors as a whole. Even so, many SEC cases result in the collateral benefit of recovery for the harmed investors.

¹⁶¹ See, e.g., *The Investor's Advocate: How the SEC Protects Investors, Maintains Market Integrity, and Facilitates Capital Formation*, U.S. SEC. & EXCHANGE COMM'N, <http://www.sec.gov/about/whatwedo.shtml> (last modified Feb. 28, 2011) ("Common violations that may lead to SEC investigations include: misrepresentation or omission of important information about securities; manipulating the market prices of securities; stealing customers' funds or securities; violating broker-dealers' responsibility to treat customers fairly; insider trading (violating a trust relationship by trading on material, non-public information about a security); and selling unregistered securities.").

place. A capital market regulator should ask this fundamental question in connection with every regulatory and enforcement action: “How is this action we are considering today going to benefit investors?”

VI. CONCLUSION

Regulators can never keep up with the dynamic innovation of a well-functioning capital market, and perhaps this is as it should be. They must, however, keep up with the frauds and abuses on the market. While the key elements that have been identified in this Article may be some of the best available today, of overriding importance is to give a securities authority a broad mandate and flexible tools that it can use to adapt to ever-changing market conditions and to deal with the increasing sophistication of those who abuse the market and investors. The government authorities and the securities industry share the same fundamental goals, which are to attract investors, lower the cost of capital, and develop the market. Getting this formula right can unleash the fullest potential of the capital markets, which will create jobs, eliminate poverty, and increase the standard of living for future generations.