

LET THE SECURITIES AND EXCHANGE  
COMMISSION OUTSOURCE ENFORCEMENT BY  
LITIGATION: A PROPOSAL

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The stories of Stanford's suspected Ponzi scheme, and Madoff's proven scheme, as well as the Securities and Exchange Commission's lenient settlements with very large suspected violators, and its focus on the numerous, small accused, have raised questions about the Commission's enforcement resources. This Article suggests that the Commission outsource civil cases against very large defendants when the examination of the defendant finds signs of wrongdoing under the securities acts. The Commission already outsources two types of legal services and the United States government practices extensive outsourcing. This article suggests that with appropriate limitations and controls outsourcing of enforcement litigation against powerful and wealthy defendants may serve the country well.

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## I. INTRODUCTION

As the story appeared in the newspapers, the examiners of the Securities and Exchange Commission (SEC) visited millionaire Allen Stanford's offices in Texas a number of times and each time reported a strong scent of a Ponzi scheme. Each time the SEC Enforcement group in Texas failed to conduct a serious probe.<sup>1</sup> In the case of Bernie Madoff, the suspicion of a Ponzi scheme was raised by an outsider, who backed his opinion with a fairly significant analysis and data. Yet, the matter was shuffled from the SEC offices in Boston to the New York offices and fell between the cracks.<sup>2</sup> When the SEC brought an action against Bank of America and Citigroup, the actions ended quickly in settlements. Both settlements were disapproved by the courts as too lenient.<sup>3</sup> In the Citibank case, the court noted with surprise that the two defendants were not high-level officials in the bank.<sup>4</sup> In the case of Goldman Sachs, everyone "oohed and aahed" at the large amount of the settlement although it seems to have hardly made a dent in the investment banker's management benefits, bonuses, and whatever it collects under whatever name.<sup>5</sup> In contrast to actions against these large accused institutions and their top level management, the SEC has brought about 300 cases against small organizations on allegations of Ponzi schemes during the past few years.<sup>6</sup>

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1. Zachary A. Goldfarb, *SEC Knew of Stanford's Ponzi Scheme 12 Years Earlier*, WASH. POST, Apr. 17, 2010, at A10. See also OFFICE OF INSPECTOR GEN., SEC. & EXCH. COMM'N, CASE NO. OIG-526, INVESTIGATION OF THE SEC'S RESPONSE TO CONCERNS REGARDING ROBERT ALLEN STANFORD'S ALLEGED PONZI SCHEME (Mar. 31, 2010), available at <http://www.sec.gov/news/studies/2010/oig-526.pdf> (noting that enforcement staff opened and closed investigations).

2. The Bernard Madoff scheme lasted many years and cost investors billions of dollars. *The Madoff Investment Securities Fraud: Regulatory and Oversight Concerns and the Need for Reform: Hearing Before the S. Comm. on Banking, Hous., and Urban Affairs*, 111th Cong. 67, 69 (2009) (statement of Linda C. Thomsen, Director, Div. of Enforcement, SEC).

3. SEC v. Bank of Am. Corp., 653 F. Supp. 2d 507, 512 (S.D.N.Y. 2009); Colin Barr, *Judge Rejects SEC's Citi Settlement*, CNN STREET SWAP (Aug. 16, 2010), <http://finance.fortune.cnn.com/2010/08/16/judge-rejects-secs-citi-settlement> (noting both Citigroup and Bank of America settlements).

4. Colin Barr, *Judge Rejects SEC's Citi Settlement*, CNN STREET SWAP (Aug. 16, 2010), <http://finance.fortune.cnn.com/2010/08/16/judge-rejects-secs-citi-settlement>; see also Lori A. Richards & John H. Walsh, *Compliance Inspections and Examinations by the Securities and Exchange Commission*, 52 BUS. LAW. 119 (1996). See generally Danné L. Johnson, *SEC Settlement: Agency Self-Interest or Public Interest*, 12 FORDHAM J. CORP. & FIN. L. 627 (2007).

5. Daniel Gross, *Goldman's Best Trade Ever*, SLATE, July 16, 2010, <http://www.slate.com/id/2260784>.

6. JAN LARSEN & PAUL HINTON, NERA ECONOMIC CONSULTING, SEC SETTLEMENTS IN PONZI SCHEME CASES: PUTTING MADOFF AND STANFORD IN CONTEXT 2 (Mar. 13, 2009), available at [http://www.nera.com/extImage/PUB\\_Ponzi\\_Schemes3\\_0309\\_final.pdf](http://www.nera.com/extImage/PUB_Ponzi_Schemes3_0309_final.pdf) ("In the last six-and-a-half years, the SEC has settled with more than 300

Thus, the too big to fail and their management were also too big to be prosecuted.

There are a number of explanations for the enforcement performance of the SEC. First, small cases settle fast, cost less, but show larger settlement or conviction numbers than one large case that is likely to bring about a tough fight with well-endowed large law firms and would last far longer. Thus, if success for the Enforcement division is measured by the number of cases, convictions, or settlements, incentives would lead to avoid the large costly complicated cases and focus on the small ones.

Second, large powerful actors are more likely to bring political pressures, and the Commission is, after all, a political body both by its composition and government by Congress.<sup>7</sup> In times of prosperity there is a tendency not to attack the big financial institutions, even though they might be more likely to damage the financial system than the small ones. Thus, political pressure may thwart accusations of large organizations and renowned defendants.<sup>8</sup>

A third consideration involves the enforcement stage at which the issues arise. A decision to settle and even the amount of the settlement may be determined not after bringing the action but during the investigation period.<sup>9</sup> That is, when the parties meet, the defendants are examined under

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defendants alleged to have operated or otherwise been involved in Ponzi schemes. However, the amounts involved in these cases are generally tiny in comparison to those in the Stanford and Madoff cases. Sixty-two of the settlements have related to 12 cases where the alleged Ponzi scheme raised at least \$50 million.” (footnote omitted)).

7. As one commentator put it:

The problems the SEC experienced over the past few years in fulfilling its obligation to police the financial markets are traceable at least in part to pressure from Congress, the White House, and Wall Street to cut back on vigorous enforcement of the securities laws, especially the antifraud provisions. Furthermore, the agency has to police the very people it seeks out for advice and counsel in crafting its rules.

Peter J. Henning, *Should the SEC Spin Off the Enforcement Division?*, 11 TRANSACTIONS: TENN. J. BUS. L. 121, 122 (2009).

8. Targets of prosecutions of financial frauds are “mostly minor players” in the scheme, “such as real-estate agents, mortgage brokers, borrowers and . . . low-level bank employees,” while “[n]o senior executives at large financial institutions [have] face[d] criminal charges”; even banks that reported themselves would blame others, including borrowers and mortgage brokers. David Heath, *Too Big to Jail? Executives Unscathed as Regulators Let Banks Report Criminal Fraud*, HUFFINGTON POST (May 4, 2010), [http://www.huffingtonpost.com/2010/05/03/too-big-to-jail-executive\\_n\\_561961.html](http://www.huffingtonpost.com/2010/05/03/too-big-to-jail-executive_n_561961.html); Onnig H. Dombalagian, *Requiem for the Bulge Bracket?: Revisiting Investment Bank Regulation*, 85 IND. L. J. 777, 795 n.88 (2010) (suggesting that SEC’s “dependence on Congressional funding” and other factors “contribute to a risk of extreme political sensitivity—if not regulatory capture—by Wall Street firms wielding influence on Capitol Hill”).

9. 17 C.F.R. § 201.240(a) (2010) (“Any person who is notified that a proceeding may, or will be instituted against him or her, or any party to a proceeding already instituted, may, at any time, propose in writing an offer of settlement.”).

oath, and the lawyers on both sides evaluate their chance in court. That is also the period in which the defendants might seek to influence the decision by resorting to political and public relationship pressures.

There are personal issues that can surface in any organization, and the SEC is no exception.<sup>10</sup> There are issues of a “revolving door” in which the high level officials at the SEC are hired away by defendants.<sup>11</sup> Some of the pressures on the SEC cannot be eliminated. But, perhaps one pressure—the financial pressure—can be significantly reduced, at no cost or very little cost, to the taxpayers.<sup>12</sup> In addition, this proposed solution can create a better counterweight against political pressures and personal incentives within the SEC.

One proposal to strengthen the SEC enforcement is to spin the enforcement function off the SEC altogether.<sup>13</sup> I do not go that far. I doubt that a stand-alone enforcement or any police force for that matter can be effective and can overcome the problems that the SEC faces today.

This proposal suggests that the SEC outsource cases against very large defendants in civil cases, when the examination of the defendant finds signs of wrongdoing under the securities acts. To be sure, each and every factor must be defined. But luckily, there are many examples of outsourcing on which to draw, including two examples of outsourcing that the SEC has been practicing for some time.

This Article is organized as follows: Section One briefly outlines the authority of the SEC in enforcing the laws under its jurisdiction and the internal process that the SEC follows in its enforcement. Section Two describes two types of outsourcing which the SEC is currently using and the rules that govern these outsourcings. Section Three describes some of the outsourcing practiced by the United States government: outsourcing the management, control of prisons, and accounting services. Section Four outlines the suggested outsourcing of enforcement litigation by the SEC starting at the investigation stage, the possible settlements, the court adjudications and the settlement at the courts’ adjudications. Outsourcing of this sort should be governed by rules concerning the choice of the law firms or lawyers, the limitations on the private sector enforcers, the control

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10. See Tom McGinty, *Staffer One Day, Opponent the Next*, WALL ST. J., Apr. 5, 2010, at C1, available at FACTIVA, Doc. No. J000000020100405e6450001u.

11. *Id.*; see also Olufunmilayo B. Arewa, *Risky Business: The Credit Crisis and Failure (Part III)*, 104 NW. U. L. REV. 441, 449-50 (2010) (suggesting “[c]oncerns about future career opportunities” influenced SEC head of enforcement in Fort Worth office who failed to pursue enforcement action in Stanford case, and “later sought to represent Stanford, and . . . did so”).

12. See Cyrus Sanati, *Support Voiced for Plan to Increase S.E.C. Budget*, N.Y. TIMES, Apr. 15, 2010, available at <http://dealbook.nytimes.com/2010/04/15/support-voiced-for-plan-to-increase-s-e-c-budget> (noting proposal that would allow the SEC to keep fees it collects).

13. Henning, *supra* note 7, at 122.

of the process, and the courts' control over the private sector fees. Section Five suggests the advantages and disadvantages of this type of outsourcing in this case and the arguments for its adoption subject to rules that would limit the possible disadvantages. The time has come to show that the institutions that are too big to fail and their management are not immune from the law that applies to those who are small enough to fail.

## II. A BRIEF OUTLINE OF THE AUTHORITY OF THE SEC AND FINANCING OF ENFORCING THE LAWS UNDER ITS JURISDICTION, AND THE INTERNAL PROCESS WHICH THE SEC FOLLOWS IN ITS ENFORCEMENT

The SEC has authority to bring civil actions against violators of the securities acts, including investment companies and other advisers,<sup>14</sup> and to bargain for settlements, including money payment.<sup>15</sup> However, the payments extracted in settlements or imposed by the SEC or by the courts generally inure to the Treasury.<sup>16</sup> Regardless of how much money the SEC collects by enforcement, the SEC continues to receive its budget from Congress.<sup>17</sup> Thus, the SEC's budget is fixed regardless of the amounts that the SEC may win in court or by settlement. Arguably, the resources necessary to fight a battery of experienced lawyers with a significant amount of assistance are unavailable to the SEC.<sup>18</sup>

## III. TWO TYPES OF OUTSOURCING WHICH THE SEC IS CURRENTLY PRACTICING AND THE RULES THAT GOVERN THESE OUTSOURCINGS

The SEC has been practicing outsourcing in a number of situations. Its litigators have hired expert witnesses, including academics, to offer

14. 15 U.S.C. §§ 77t(d)(1), 78u(d)(3)(A), 80a-41(e)(1), 80b-9(e)(1) (2006).

15. 17 C.F.R. § 201.240 (2010); *see, e.g.*, Press Release, Sec. & Exch. Comm'n, Statement of the Securities and Exchange Commission Concerning Financial Penalties, No. 2006-4 (Jan. 4, 2006) (on file with author), *available at* <http://www.sec.gov/news/press/2006-4.htm> (noting recent settlement in which company will pay civil money penalty).

16. 15 U.S.C. §§ 77t(d)(3)(a), 78u(d)(3)(C), 80a-41(e)(3)(A), 80b-9(e)(3)(A) (2006). Under the Sarbanes-Oxley Act, as amended, the SEC may add a civil penalty to a disgorgement fund for victims. *See* Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 929B (2010) (to be codified as amended at 15 U.S.C. § 7246(a), (b)) (amending the Sarbanes-Oxley Act of 2002, 15 U.S.C. § 7246 (2002)).

17. The SEC, unlike the Federal Reserve Board, is not self-funded, and consequently must receive funding from Congress. *See* Joel Seligman, *Self-Funding for the Securities and Exchange Commission*, 28 NOVA L. REV. 233, 255-56 (2004). Its funding must be "authorized" and "appropriated" by the respective committees in both houses of Congress. 3 CHARLES H. KOCH, JR., ADMINISTRATIVE LAW AND PRACTICE § 7.22(b), at 23-24 (3d ed. 2010).

18. *See, e.g.*, U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-02-302, SEC OPERATIONS: INCREASED WORKLOAD CREATES CHALLENGES 11-13, 25 (2002), *quoted in* Seligman, *supra* note 17, at 247 (noting impact of SEC's limited resources on its enforcement activities).

expert testimony.<sup>19</sup> In addition, the SEC may, and does, hire attorneys to work at the SEC under contract.<sup>20</sup> Contract employees are generally not subject to the conflict of interest prohibitions and other restrictions imposed on government employees.<sup>21</sup> For example, the “revolving door” prohibitions that apply to government employees who leave the government employment<sup>22</sup> do not apply to these attorneys.<sup>23</sup> Finally, bounty hunters have been rewarded for information that led to convictions.<sup>24</sup>

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19. See, e.g., Bruce Kelly, *SEC Takes Strict View on Client Data*, INV. NEWS, Jan. 14, 2008, at 1, available at FACTIVA, Doc. No. INVN000020080119e41e0000p (noting that in many cases SEC has expert witnesses); *SEC v. Johnson*, 525 F. Supp. 2d 70 (D.D.C. 2007) (granting in part motion to exclude expert testimony). Expert witnesses are not considered employees. Faust F. Rossi, *Evidence*, 48 SYRACUSE L. REV. 659, 709 (1998) (“It is difficult to claim that an expert witness is really under anyone’s control. An expert is not an employee or agent of the party calling him.”).

20. See, e.g., John W. Cox, *Bixby Knolls, Calif. Shopping Center Goes on the Market*, PRESS-TELEGRAM (Long Beach, Ca.), June 17, 2000, available at 2000 WLNR 7807684. Cf. Patrick McFadden, Note, *The First Thing We Do, Let’s Outsource All the Lawyers: An Essay*, 33 PUB. CONT. L.J. 443 (2004) (supporting the outsourcing of government legal services).

21. Richard W. Painter, *Bailouts: An Essay on Conflicts of Interest and Ethics when Government Pays the Tab*, 41 MCGEORGE L. REV. 131, 142 n.22 (2009).

22. See 18 U.S.C. § 207(a)(1)-(2) (2006) (restrictions on former employees of executive and legislative branches, including “[p]ermanent restrictions on representation on particular matters . . . in which the person participated personally and substantially” as a government employee and “[t]wo-year restrictions concerning particular matters under official responsibility”); Adoption of Supplemental Standards of Ethical Conduct for Members and Employees of the SEC and Revisions to the Commission’s Ethics Rules, 75 Fed. Reg. 42,270, 42,277 (July 20, 2010) (to be codified at 17 C.F.R. pt 200) (governing practice by former SEC employees); 17 C.F.R. § 200.735-8(d) (2010) (disqualifying partners or associates of person disqualified in a particular matter unless waiver is obtained; waiver ordinarily granted when disqualified person is isolated from matter); cf. MODEL RULES OF PROF’L CONDUCT 1.11 (2010). Despite these restrictions, there are concerns that former SEC employees work for the industries they policed and use their SEC training and expertise against the agency. See also McGinty, *supra* note 10.

23. Memorandum from Stephen D. Potts, Dir., Office of Gov’t Ethics, to Designated Agency Ethics Officials, Gen. Counsels and Inspectors Gen. 4 (Feb. 15, 2000), available at 2000 OGE LEXIS 80 (“True independent contractors are not employees because they are not subject to the supervision or operational control . . . that is necessary to create an ‘employer-employee relationship’ with the Government.”); McGinty, *supra* note 10 (“Employees who aren’t covered by the restrictions can legally represent clients before the commission the day they leave . . .”).

24. Diane Francis, *SEC and Bounty Hunters*, HUFFINGTON POST, Aug. 11, 2010, available at [http://www.huffingtonpost.com/diane-francis/sec-and-bounty-hunters\\_b\\_676696.html](http://www.huffingtonpost.com/diane-francis/sec-and-bounty-hunters_b_676696.html). In addition, the Dodd-Frank Wall Street Reform and Consumer Protection Act provides for payments to whistleblowers in certain SEC judicial or administrative actions. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, sec. 922(a), § 21F (2010) (to be codified at 15 U.S.C. § 78u-6)).

IV. SOME OUTSOURCING EXAMPLES PRACTICED BY THE UNITED STATES  
GOVERNMENT: THE MANAGEMENT AND CONTROL OF PRISONS, AND  
ACCOUNTING SERVICES

Outsourcing government claims has been authorized by Congress and has been upheld by the courts at least since 1863 in the False Claims Act.<sup>25</sup> In one respect the Act is narrower than outsourcing the SEC's authority to sue offenders. The Act delegates to private persons the right to sue for violations *against the United States*. In contrast, the SEC's authority involves the right to sue for injury to the public and the financial system. However, the use of private prosecutors for government claims, for more than 100 years, suggests that the proposed outsourcing of SEC claims against violators of the law is not an outlandish, drastic proposal.

"The [False Claims Act], which Congress originally enacted in 1863, is the government's 'primary litigative tool for combating fraud' against the federal government."<sup>26</sup> "The Act authorizes both the Attorney General and private persons to bring civil actions to enforce the Act."<sup>27</sup> "Congress amended the FCA in 1986 to increase the financial and other incentives for private individuals to bring suits under the Act and thereby to enlist the aid of the citizenry in combatting [*sic*] the rising problem of 'sophisticated and widespread fraud.'"<sup>28</sup>

The legislative history indicates that Congress sought to encourage more private enforcement of the FCA because "[d]etecting fraud is usually very difficult without the cooperation of individuals who are either close observers or otherwise involved in the fraudulent activity. Yet in the area of Government fraud, there appears to be a great unwillingness to expose illegalities."<sup>29</sup>

Ann Taylor Schwing, in her book on California affirmative defenses, describes the process of *qui tam* as follows:

A local prosecutor who brings a false claims action is required to serve a copy of the complaint on the Attorney General on the same date the complaint is filed. A private person who files a false claims action must concurrently serve a copy on the Attorney General along with written disclosure of substantially all material evidence and information the person . . . possess[es]. The Attorney General may elect in either case to proceed with the action or, if only local funds are involved, to

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25. 31 U.S.C. § 3730 (2006) (amended 2010).

26. United States *ex rel.* Kelly v. Boeing Co., 9 F.3d 743, 745 (9th Cir. 1993) (quoting S. REP. No. 99-345, at 2 (1986), *reprinted in* 1986 U.S.C.C.A.N. 5266). For an extensive discussion of the False Claims Act, see *Minn. Ass'n of Nurse Anesthetists v. Allina Health Sys. Corp.*, 276 F.3d 1032 (8th Cir. 2002).

27. United States *ex rel.* Kelly, 9 F.3d at 745 (citing 31 U.S.C. § 3730 (1988)).

28. *Id.* (quoting S. REP. No. 99-345, at 2, 23-24 (1986), *reprinted in* 1986 U.S.C.C.A.N. 5266, 5267, 5288-89).

29. *Id.* n.2 (quoting S. REP. No. 99-345, at 4 (1986), *reprinted in* 1986 U.S.C.C.A.N. 5266, 5269).

refer the matter to the prosecuting attorney for the local subdivision who may decide to proceed, to dismiss or to permit the private plaintiff to proceed.<sup>30</sup>

Similarly, any person may enforce the California campaign contributions provisions. The person must first notify the civil prosecutor, who may elect to sue; if the civil prosecutor does not, the person may do so.<sup>31</sup> In addition, in certain cases involving civil rights laws, appellate briefs must be served on the State Solicitor General at the Office of the Attorney General,<sup>32</sup> and the Attorney General may elect to file a brief.<sup>33</sup>

Thus, while in *qui tam* the process starts with the private prosecutor's initiative and grants the attorney representing the government the power to adopt the claim, in the proposed process the converse is suggested. It is the government that initiates the outsourcing. At the same time, the process of outsourcing starts not in the courts but during the investigation, which is initiated by the government.

There are many other facts that support outsourcing. The Federal government has been described as the largest employer in the United States.<sup>34</sup> Yet as of 2007 "more people work under contracts than are directly employed by the government."<sup>35</sup> This includes its outsourcing of many governmental functions.<sup>36</sup> In March 2010, Tholons, an advisory investment research facility, noted that the government sector has transformed public service with outsourced IT services. It demonstrated the

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30. 1 ANN TAYLOR SCHWING, CALIFORNIA AFFIRMATIVE DEFENSES § 12:6 (2010), available at Westlaw CAAFDEF (footnotes omitted). For discussion of the *qui tam* process see, for example, Anna Mae Walsh Burke, *Qui Tam: Blowing the Whistle for Uncle Sam*, 21 NOVA L. REV. 869 (1997).

31. SCHWING, *supra* note 30.

32. CAL. CIV. CODE §§ 51.1, 55.2 (West 2007); CAL. GOV'T CODE § 4461 (West 2008); CAL. HEALTH & SAFETY CODE §§ 19954.5, 19959.5 (West 2006).

33. SCHWING, *supra* note 30. Federal laws require notice to appropriate state officials in proposals for federal class action settlements and bankruptcy proceedings for authority for store closings or "going-out-of-business sales." *Id.* (citing 11 U.S.C. §§ 101 et seq. (2006)); Robin Miller, Annotation, *Construction and Application of Class Action Fairness Act of 2005*, 18 A.L.R. Fed. 2d 223 (2007).

34. See, e.g., *Achieving National Security Through Sustainable Spending: Hearing Before the Subcomm. on National Security and Foreign Affairs of the H. Comm. on Oversight and Government Reform*, 111th Cong. (2010), LEXIS, News Library, Curnws File (statement of Todd Harrison, Senior Fellow, Ctr. for Strategic and Budgetary Assessments) (stating that Department of Defense alone is United States' largest employer, "accounting for 51 percent of federal workers and employing more people than Wal-Mart and the Post Office combined . . .").

35. Scott Shane & Ron Nixon, *In Washington, Contractors Take on Biggest Role Ever*, N.Y. TIMES, Feb. 4, 2007, available at <http://www.nytimes.com/2007/02/04/washington/04contract.html>.

36. See Diana Simpson, *Privatization and Outsourcing in the Armed Forces*, AIR UNIVERSITY (2001), <http://www.au.af.mil/au/aul/bibs/priv/privat2.htm> (last visited Sept. 21, 2010) (bibliography of authorities discussing outsourcing in military).



benefits of such outsourcing.<sup>37</sup> Prisons have been privatized as well.<sup>38</sup> So has enforcement, including tax collection.<sup>39</sup>

The Army has been outsourcing an enormous amount of services and in 1996 suggested that the process should continue.

Deputy Secretary of Defense John P. White addressed the [Army's] need to outsource additional government functions currently performed by in-house federal civil servants or military. During hearings before the Senate Armed Services Subcommittee on Readiness on April 17, 1996, he stated that "The central focus of the outsourcing initiative is to maintain and improve our combat effectiveness. Outsourcing offers the opportunity to achieve that goal by generating savings for modernization, sustaining readiness, and improving the quality and efficiency of support to the warfighters."<sup>40</sup>

#### V. SUGGESTED OUTSOURCING OF ENFORCEMENT BY THE SEC (INVESTIGATION, POSSIBLE SETTLEMENTS, COURT ADJUDICATIONS AND SETTLEMENT AT THE COURTS' ADJUDICATIONS)

Outsourcing of this sort should be governed by rules concerning the choice of the law firms or lawyers, the limitations on the private sector enforcers, the control of the process, and the courts' control over the private sector fees.

The choice of lawyers should be governed by quantifiable rules. For example, qualification should depend on: the number of lawyers and experts in the area; the past performance of the law firm in this area; whether they worked at the SEC, and if so, when (and limit those who worked at the SEC

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37. JHOANA MUTIANGPILI, THOLONS, GOVERNMENT SECTOR OUTSOURCING: TRANSFORMING PUBLIC SERVICE WITH OUTSOURCED IT SERVICES (Mar. 2010), available at [http://www.tholons.com/nl\\_pdf/Government\\_Outsourcing.pdf](http://www.tholons.com/nl_pdf/Government_Outsourcing.pdf).

38. See, e.g., Daniel Taub, *As Funds Grow Scarce, Some Turn to Privately Run Prisons*, STAR-LEDGER (Newark, N.J.), May 16, 2010, at 005.

39. E.g., David Cay Johnston, *I.R.S. Enlists Outside Help in Collecting Delinquent Taxes, Despite the Higher Costs*, N.Y. TIMES, Aug. 20, 2006, available at <http://query.nytimes.com/gst/fullpage.html?res=9A01E7D8153EF933A1575BC0A9609C8B63>.

40. Susan J. Harvey, *Outsourcing Government Functions — A New Look at an Old Challenge*, PROGRAM MANAGER, Nov.-Dec. 1996, at 40 (quoting *Department of Defense Authorization of Appropriations for Fiscal Year 1997 and the Future Years Defense Program: Hearings Before the Senate Armed Services Subcomm. on Readiness Services*, 104th Cong. 321, 323 (1996) (statement of John P. White, Deputy Secretary of Defense)). However, the article noted conditions which may make outsourcing unattractive. These conditions include: (1) statutory or regulatory constraints that may discourage outsourcing a function; (2) similar services by the private sector that may be more costly; and (3) the fact that "[s]ome agencies may not have the capability to offer centralized contract control to ensure effective quality management, to develop staff expertise and oversight capability, or to provide consistency." *Id.* at 41 (noting also, in the outsourcing of Army transition services, "the extensive effort in delving into the myriad of legal issues to meet the formidable regulatory requirements necessary to outsource").

most recently); any conflicts of interests they might have; and the percentage of contingent fees that they seek.

Each such item might be given a value, and overall, the SEC might have some limited discretion. In addition, the head of the office of Enforcement, together with the head of the office of Examinations, should be responsible for the decision to start the Investigation process. The time limit for deciding whether to investigate must be determined by internal rules. If the two cannot agree on the action to be taken, the matter must be brought to the Commission.

There should be a rule concerning who at the SEC may approve the choice and a time limit on that decision-maker. Further, no one except the bidding law firm may represent it in bidding or negotiations with the SEC's representative.

Because negotiations on settlement between the SEC and the defendants are conducted at the investigation stage, the chosen lawyers or law firm should be involved in the proceedings at this stage. That is, together with a Wells notice,<sup>41</sup> the SEC should announce an offer to outsource the case.

Different law firms may have different incentives to compete for contracts to litigate or avoid competing. On the litigator side, the litigation may be easier. There will be no effort to contest class actions, as in the usual cases. And perhaps discovery will be easier, and some standing issues can be avoided. On the other hand, not all law firms would be interested in this type of practice. Further, law firms that have a large plaintiff litigation department and those who do not cater to large defendants and would like to develop their litigation departments may be interested in bidding for the litigation rights. On the other hand, law firms that have large potential defendant clients are likely to avoid the invitation to litigate.

#### VI. ADVANTAGES AND DISADVANTAGES OF SEC ENFORCEMENT OUTSOURCING AND THE ARGUMENTS FOR ITS ADOPTION

There are pluses and minuses to this proposal. However, regulations and rules can reduce the minuses (if not eliminate them entirely) and enhance the pluses. The time has come to show that the institutions that are too big to fail and their managements are not immune from the law that applies to those who are small enough to fail. The following is a list of

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41. "The term 'Wells notice,' like 'Wells submission,' is commonly used by the securities bar and the SEC to refer to this invitation to file a Wells submission." Joshua A. Naftalis, *"Wells Submissions" to the SEC as Offers of Settlement Under Federal Rule of Evidence 408 and Their Protection from Third-Party Discovery*, 102 COLUM. L. REV. 1912, 1918 n.30 (2002). A Wells submission is a party's statement to the SEC "setting forth [its] interests and position in regard to the subject matter of the investigation." 17 C.F.R. § 202.5(c) (2010); Naftalis, *supra*, at 1912-13.

objections to the proposal, suggested limitations to the disadvantages on which the objections are based, and counter-advantages to the proposal. I believe that these advantages trump the objections, subject to the proposed rules.

One objection to the proposal may be that the government has never outsourced an enforcement litigation function. Such an outsourcing might lead to outsourcing litigation on criminal offenses. In both cases there are significant public interest issues that private litigants are not considering. Delegating these decisions to private litigants may endanger the entire financial system. Private litigators may be too lenient or too harsh in their litigation and settlement decisions, and thereby endanger the financial system both ways. After all, the private litigators will have only one aim in sight: to maximize their earning and minimize their expenses. These cost-benefit calculations may not be compatible with the cost-benefit analysis of the public's interest.

These arguments, however, were debated and settled many years ago. Both *qui tam* and other outsourcing areas have been practiced in this country for years. The encouragement of private parties to enforce the law in the interest of the population at large is also part of the American tradition, as described above. And if the SEC continues to supervise private enforcement, this condition renders the proposal far less drastic than the current practices today. In addition, a cost-benefit analysis is currently being practiced by the staff of the SEC. Budgetary and political calculations affect these decisions. In fact, there are rules that require the SEC to account for the costs and benefits of their regulation to the system as a whole.<sup>42</sup> Thus, even under the current law, the cost to investors is to be balanced against the costs to the financial intermediaries, which I call professions (and others may call businesses). Payment to private law firms for enforcing the rules for the benefit of investors and the system seems to exceed the benefit as compared to the cost.

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42. See 15 U.S.C. § 77b(b) (2006) ("Whenever pursuant to [the Securities Act of 1933] the Commission is engaged in rulemaking and is required to consider or determine whether an action is necessary or appropriate in the public interest, the Commission shall also consider, in addition to the protection of investors, whether the action will promote efficiency, competition, and capital formation."); *id.* § 78c(f) (Securities Exchange Act of 1934); *id.* § 80a-2(c) (Investment Company Act of 1940); *id.* § 80b-2(c) (Investment Advisers Act of 1940); OFFICE OF MGMT. & BUDGET, EXEC. OFFICE OF THE PRESIDENT, CIRCULAR A-4 (Sept. 17, 2003), available at [http://www.whitehouse.gov/omb/circulars\\_a004\\_a-4/](http://www.whitehouse.gov/omb/circulars_a004_a-4/) (providing guidance to regulatory agencies on development of regulatory analysis; urging that major rulemakings be supported by benefit-cost analysis); see also, e.g., Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 417(a)(2)(A), 124 Stat. 1376, 1579 (2010) (requiring SEC division to conduct study of feasibility, benefits, and costs of requiring real time reporting of short sale positions of publicly listed securities).

Arguably, the amount that private litigators collect will be deducted from the amounts that the treasury could collect. Hence, the outsourcing of litigation might be costly to the taxpayer. In addition, litigation and higher fine payments will also deplete the defendants and weaken the financial system, especially since some of the potential defendants, and especially the big ones, form the foundations of our financial system. Therefore, we cannot on the one hand fine them and on the other hand support them (especially with taxpayers' money).

However, by hiring private law firms, there are greater chances of collecting more money from the defendants. Most importantly, payment of fines should be imposed on those institutions and their managers that caused the violations, especially if the managers knew of and encouraged the violations. To be sure, managers are covered by insurance and indemnities. However, the coverage is effective only if there is no verdict to condemn them. That is one reason why the managers, especially of large institutions, press hard for settlements.<sup>43</sup> Thus, settlements against the *large institutions*, which are in fact paid by their shareholders and perhaps their creditors, should be settled. Claims against their managers should be far less frequently settled and only if there are good reasons for doing so.

Arguably, involving a private law firm in enforcement allows private firms to gain information that was gleaned in examinations by government agents. This process may violate the defendants' right of privacy; this process can be viewed as abuse of power by the government examiners. Examiners were granted the power to force involuntary subjects to provide information. In fact, the SEC is attempting to induce the examined subjects to cooperate and offer information, even of violations, if these have been solved and significantly reduced.<sup>44</sup>

And yet, the purpose for which the information is provided has not been changed by outsourcing the enforcement. The defendants are not entitled to privacy in the investigation process. Under oath, they must answer questions or seek the shelter of the Fifth Amendment. This shelter will be available to them under any investigation, and with any investigator. In addition, if the law empowers the SEC to outsource its activities, the private enforcers have the same powers as the public ones. Besides, the defendants do not have the right to choose their prosecutors any more than

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43. E.g., James Bohn & Stephen Choi, *Fraud in the New-Issues Market: Empirical Evidence on Securities Class Actions*, 144 U. PA. L. REV. 903, 920-21 (1996).

44. See SEC. & EXCH. COMM'N, REPORT OF INVESTIGATION PURSUANT TO SECTION 21(a) OF THE SECURITIES EXCHANGE ACT OF 1934 AND COMMISSION STATEMENT ON THE RELATIONSHIP OF COOPERATION TO AGENCY ENFORCEMENT DECISIONS, Sec. Exch. Act Release No. 44969, Accounting & Auditing Enforcement Release No. 1470, 76 SEC Docket 220 (Oct. 23, 2001), available at <http://www.sec.gov/litigation/investreport/34-44969.htm>; Press Release, Sec. & Exch. Comm'n, SEC Announces Initiative to Encourage Individuals and Companies to Cooperate and Assist in Investigations, No. 2010-6 (Jan. 13, 2010), available at <http://www.sec.gov/news/press/2010/2010-6.htm> (last visited Sept. 21, 2010).

they have the right to choose the personnel of the SEC Enforcement Division. So long as the enforcers are legally authorized and abide by the restrictions imposed on them, their identity is not subject to the defendants' objection. The important principles are that the SEC may delegate its functions if authorized by law. The delegation of its power must be subject to the same constraints as the other personnel of the SEC or to constraints that would achieve the same results as those imposed on the SEC's personnel.

Arguably, outsourcing prosecutorial powers can invite corruption. Private firms might extort payments to recommend settlements or entice payments to prosecute competitors. And yet, this danger exists and has always existed regardless of whether the prosecutors are government employees or private sector lawyers in an outsourcing process. It is difficult to generally evaluate which of the two groups is subject to stronger temptations. Perhaps private lawyers who have an opportunity for significant gains by winning an outsourcing position may be less tempted to sell their settlement influence than government employees who are paid a fixed and far lower salary. The culture of the SEC and the culture of the private sector firms may be a strong determinant in this case. The prestige of being a private-public prosecutor, if developed, can be the best controlling factor against corruption.

The Madoff case has uncovered indirect influence by a member of the family.<sup>45</sup> A recent case of hiring of an influential SEC member by a private firm that is subject to investigation on the particular activities of the SEC's member's expertise may be subject to questions as well.<sup>46</sup> Political influence may play a role in the decision of the SEC personnel and its Commissioners.<sup>47</sup>

In contrast, a private firm in a position to earn significant amounts of money may be less eager to curry favors with a potential defendant. In fact, the interests of such a firm may mute the pressures to avoid investigations or invite trivial settlement. If one wished to create a greater pressure for litigation against low settlements, one may grant the outsourced law firm a

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45. Rosie Lavan, *New SEC Chief Gave Bernard Madoff's Son a Job*, TIMES ONLINE (London) (Dec. 18, 2008), [http://business.timesonline.co.uk/tol/business/industry\\_sectors/banking\\_and\\_finance/article5364345.ece](http://business.timesonline.co.uk/tol/business/industry_sectors/banking_and_finance/article5364345.ece).

46. Tom McGinty, *SEC 'Revolving Door' Under Review*, WALL ST. J., Jun. 16, 2010, at C1, available at <http://online.wsj.com/article/SB10001424052748703280004575309061471494980.html>

47. See, e.g., Judith Burns & Kara Scannell, *SEC Brings Fewer Enforcement Cases*, WALL ST. J., Oct. 27, 2006, at C3, available at FACTIVA, Doc. No. J000000020061027e2ar0002z (noting former SEC attorney Gary Aguirre's allegations that he was fired after seeking to take the testimony of former Wall Street chief executive John Mack; Aguirre said "his supervisors refused to allow him to take Mr. Mack's testimony because of his political connections and clout"; Mack "was a major fund-raiser for President Bush . . .").

lower contingency fee as a percentage of a settlement amount than of a verdict amount.

It is true that many cases are settled by private litigators because they have to invest the cost of the litigation and would prefer to settle after they have won the preliminary stage, recognizing their standing and representation of a class. Thus, if the pressure to litigate instead of settling should be higher, there are ways to structure contingent fees accordingly. However, if the pressure is too high, firms will avoid bidding for litigation work except when the prospects of winning are very high. Thus, a rule could be designed to (a) either give the firm the right to determine whether and what the minimum amount of the settlement must be, or (b) grant such decision-making power jointly to the SEC and the firm. In addition, when the case has gone to trial and settlement is subject to the court's decision, the court should consider the fees issue, similar to the courts' decisions concerning fees in bankruptcy cases.<sup>48</sup>

It should be noted that under the False Claims Act, private litigants may collect up to 30% of the judgment.<sup>49</sup> To be sure, the Act is designed to encourage the discovery of information about defrauding of the government while the proposal here is to encourage private litigators to invest in the litigation on defrauding investors and destroying the financial system. Nonetheless, the Act demonstrates the readiness of Congress to reward private citizens that undertake government enforcement action.

Public policy considerations might raise other problems: One example is the problem raised by the creation of the Special Prosecutor status. The office became highly politicized and lost its credibility. And yet, this proposal imposes limits on political pressures in a number of ways. First, it is subject to courts' control as of the start. Most importantly, the process is subject and continues to be subject to SEC personnel's involvement. No investigation, settlement, or action can be conducted without the supervised consent of the SEC's personnel, and as to some aspects of the process – the consent of the Commission. The process should also contain both confidentiality agreements and prohibition on publicity, unless permitted by the SEC personnel.

Most importantly, the incentive of the law firms is fundamentally money-based and in most cases only secondarily politically-based. The investigations and the actions are indeed subject to public disclosure, but

48. See 11 U.S.C. § 328(a) (2006) (governing compensation of professional persons employed by bankruptcy trustee or creditors' or equity security holders' committee); *Midland Mut. Life Ins. Co. v. Masnorth Corp.* (*In re Masnorth Corp.*), 28 B.R. 892 (Bankr. N.D. Ga. 1993) (creditor was entitled to reasonable attorney fees and costs arising out of cure of default and reinstatement of mortgage; however, ruling on amount of such fees and costs was reserved pending evidentiary hearing).

49. *Minn. Ass'n of Nurse Anesthetists v. Allina Health Sys. Corp.*, 276 F.3d 1032, 1041 n.4 (8th Cir. 2002) ("Under the current statute the size of the bounty varies, but can be as high as thirty percent of the proceeds of the suit." (citing 31 U.S.C. § 3730(d) (1994))).

these are no different from the procedures conducted by the SEC, which must be disclosed by the investigated firm if material.<sup>50</sup> Court proceedings are public, no matter who appears before the judge.<sup>51</sup> And the publicity interests of the SEC prosecutors who appear are about similar to those of the law firm.

It has been noted that in some other contexts “agencies may not have the capability to offer centralized contract control to ensure effective quality management, to develop staff expertise and oversight capability, or to provide consistency.”<sup>52</sup> Yet, it may be difficult to write requirements with sufficient controls over quality. Program managers may not have the time for studying outsourcing as an alternative or the time for a lengthy procurement process. These and other obstacles have to be overcome to initiate a successful outsourcing program.

Yet, in this case, the agency has the talent and the ability to supervise the quality of the law firms’ performance. The agency also has the ability to find the right contract terms for the engagement whose services were outsourced. The supervision of the outsourced law firms’ performance is continuous. The problem of conflict of interest can be avoided by prohibiting the staff from being engaged in any way by the litigating firms for a period of 5 years or more.

Even though the list is far from closed, there are many arguments for choosing the outsourcing alternative, and it is worth a try.

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50. See William R. McLucas et al., *A Practitioner’s Guide to the SEC’s Investigative and Enforcement Process*, 70 TEMP. L. REV. 53, 105-06 (1997) (“Applying a general materiality analysis, disclosure of the existence of a Commission investigation may or may not be required in a particular situation; disclosure of the facts and circumstances giving rise to the investigation, however, very well may be required.”); see also David M. Stuart & David A. Wilson, *Disclosure Obligations Under the Federal Securities Laws in Government Investigations*, 64 BUS. LAW. 973, 974 (2009) (stating that although there is no legal duty under statute, regulation or case law to disclose an SEC investigation, “the federal securities laws provide rules and regulations that impose a duty to disclose specific events that may arise during an investigation.”). Regulation S-K requires disclosure of “material pending legal proceedings,” and where any such “proceeding is ‘known to be contemplated’ by a government authority” and certain other matters that may arise in an investigation. *Id.*

51. See, e.g., FED. R. CIV. P. 77(b) (“Every trial on the merits must be conducted in open court and, so far as convenient, in a regular courtroom.”). The First Amendment to the U.S. Constitution guarantees the public a right to attend criminal trials. *Richmond Newspapers, Inc. v. Virginia*, 448 U.S. 555, 580 (1980); see also *Globe Newspaper Co. v. Superior Court*, 457 U.S. 596, 603 (1982). Courts have also found a right of access to civil trials. See, e.g., *Brown & Williamson Tobacco Corp. v. FTC*, 710 F.2d 1165, 1177-79 (6th Cir. 1983).

52. Harvey, *supra* note 40, at 41; see Mike Billington, *Report: Agencies Must Reform the Way They Hire Lawyers*, SUN-SENTINEL (S. Fla.), Jan. 30, 1992, [http://articles.sun-sentinel.com/1992-01-30/news/9201050877\\_1\\_private-lawyers-butterworth-government-lawyers](http://articles.sun-sentinel.com/1992-01-30/news/9201050877_1_private-lawyers-butterworth-government-lawyers) (quoting Florida Attorney General urging that state and local government agencies oversee the work of private lawyers doing government work and suggesting guidelines for hiring them and a standard contract limited to one year).

## VII. CONCLUSION

The SEC's ability to outsource enforcement litigation could increase its effectiveness. It might reduce incidents such as those of Madoff, Stanford, Enron, and others that are still unknown. Outsourcing of the litigation may change the balance of incentives. It may reduce the political pressures on the SEC staff and the Commission in favor of the financial returns that it might bring. Outsourcing may also reduce the pressure on large law firms to please large potential clients, by adding to their clients the Enforcement Division of the SEC. None of these measures will completely resolve the issues involved in the SEC's enforcement. Specific rules and assured perfect enforcement can be our aim. It is doubtful whether we will attain it. But outsourcing enforcement in the manner described above may be a small step in this direction of meeting the ultimate goal.