

## “The SEC Speaks” 2014 — SEC Reveals Regulatory and Litigation DNA Now Includes Economic Analysis and Technology

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The Securities and Exchange Commission is incorporating economic and technology-based data analytics and statistical analyses to support its regulatory functions, SEC Chair Mary Jo White revealed at the 43<sup>rd</sup> annual “The SEC Speaks” conference in Washington D.C. on February 21 and 22.

The use of economic and technology analytics will enhance all of the agency’s functions, from examinations, to investigations, to enforcement actions and administrative proceedings, White said during her opening remarks. This economic and data-driven focus became even more apparent in the following panel programs where SEC division leaders provided scores of data-laden charts and graphs illustrating the SEC’s use of “quantitative and predicative analytics” in its mission.

Using pointed and politically charged language, SEC Commissioner Daniel Gallagher in his remarks criticized Congress for the timing and substance of the Dodd Frank Act, describing it as a “monstrosity untethered to the cause of the crisis,” and a “purely political response to the real regulatory emergency” that exists in our financial and capital markets. Mark Cuban, the outspoken owner of the Dallas Mavericks basketball franchise who was recently exonerated of SEC insider trading charges, attended “The SEC Speaks” conference and tweeted his own compliments and criticisms of the positions taken by the SEC at the conference.

“The SEC Speaks” is an annual conference where the SEC commissioners and division leaders address legal and business issues affecting securities markets, principals, and investors. Miller Canfield securities compliance and enforcement lawyer Matt Allen attended the conference.

The first panel to speak after White was from the SEC Division of Economic and Risk Analyses (DERA). The DERA leaders discussed in detail how economic and data analytics are used in all phases of its mission – from economic analysis of proposed SEC rules to the way market data and identifying statistical performance outliers are collected and used to determine examination and investigation targets and scope. Leaders from DERA’s Office of Litigation Economics explained how economic analysis and testimony are used to establish securities violations and obtain injunctions and asset freezes. The Office of Litigation Economics speakers also illustrated how they use economic analyses and court-room illustrative exhibits to rebut expert economist reports submitted by defendants in support of their positions.

### **‘21<sup>st</sup> century tools to address 21<sup>st</sup> century risks’**

The second day began with a panel from the SEC Office of Compliance Inspections and Examinations (OCIE), who introduced “revolutionary” technology tools that will require the industry to “raise the bar to keep up with us.” The primary tool discussed was the National Examination Analytics Tool (NEAT), which is capable of collecting and analyzing years of voluminous trading and other data and in minutes converting it to information that examiners can use to ask questions of examination targets. Quantitative analysts from OCIE will join examination teams to help use this vast amount of data to make SEC exams more effective and efficient. The panel said NEAT helps them “find the right questions to ask,” not to find answers. The parameters into which NEAT can organize and produce information and reports include:

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- Trading reports
- Insider trading reports
- Trade profitability
- Trade allocation
- Account profitability
- Suspicious activity / outliers

Other software projects developed or being developed by the SEC include: 1) an anti-money laundering activity prototype; 2) Machine Analyzed Risk Scoring (MARS); and 3) High Frequency Analytics Lab (HAL).

White confirmed that the SEC is committed to “using 21<sup>st</sup> century tools to address 21<sup>st</sup> century risks.” But, she said, the increased use of technology and data in the capital and financial markets makes them more vulnerable to cyber-attacks and disruptions. So White and other commissioners emphasized the need for increased vigilance on cyber security for all market participants and investors. The other theme running through “The SEC Speaks” conference this year is the Commission’s professed need for increased funding from Congress. Without it, the SEC argues that it will not be able to as effectively protect investors and ensure proper functioning and oversight of the markets.

Finally, leaders from the SEC Division of Enforcement provided interesting insight into the factors that they now consider when determining whether to file an enforcement action in court versus an SEC administrative proceeding, which have evolved after some changes wrought by Dodd Frank.

SEC Chair White and each of the other four SEC Commissioners provided remarks, the high points of which are summarized below:

### **Remarks of SEC Chair Mary Jo White**

White outlined three priorities for 2014: 1) Implement the Dodd Frank and JOBS Acts; 2) Intensify efforts to optimize equity market functions; and 3) Strengthen the SEC enforcement program. She acknowledged the unprecedented rulemaking mandates from Congress in the Dodd Frank and JOBS Acts. But while these historic regulatory mandates challenge the limited resources of the SEC, White said the commission must not allow this to drown out or detract from other pressing rulemakings, duties, and priorities of the SEC, including but not limited to:

- Continuing an examination of the roles and duties of broker dealers and investment advisers
- More oversight over broker dealers
- Engaging domestic and international regulators to identify and address systemic risk to the financial systems
- Continue development of the consolidated audit trail rule
- Increase resilience of systems used by market exchanges and participants in order to reduce risk of disruptions.
- Conduct SEC Roundtable on March 26, 2014 to discuss cyber security of market systems

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White also touted the SEC's new program to require admissions by some defendants settling SEC charges, which she said achieves a greater measure of public accountability, which in turn bolsters public confidence in the markets. She said securities market participants and practitioners can look to the body of cases where the SEC has sought and obtained admissions to determine the types of cases in which the SEC will seek admissions by defendants as a condition of settling charges.

While the JOBS Act rules will offer alternatives for raising capital in the private markets, public markets still offer attractive access to capital, White said, promising that the SEC will work to improve the transparency and liquidity of the public markets and broaden the access to capital in those markets. She also announced an effort by the commission's Corporation Finance Division to update and improve disclosure rules for public companies, including asking investors what they want to see in public company disclosures.

### **Remarks of SEC Commissioner Daniel M. Gallagher**

Using pointed and politically charged language, Daniel Gallagher read an "open letter to the SEC Staff," wherein he extolled the staff for their exceptional service and response to the significant challenges presented by the 2008 financial crisis., while lamenting the "miserable" employee satisfaction and morale of the SEC Staff, which he said stems from unfair political attacks on the SEC by Congress and other policy leaders.

Gallagher indicated that there has "never been a true and honest debate" about the SEC's role in the financial crisis and the blame he says was unfairly heaped upon the SEC in the fallout from that crisis. Gallagher criticized the Dodd Frank Act as a "monstrosity untethered to the cause of the crisis," and a "purely political response to the real regulatory emergency" that exists in our financial and capital markets. He noted that the Dodd Frank Act, thousands of pages long, was hastily written and enacted before any critical and measured congressional findings, contrasting that process with the thorough findings that were made before the 1934 Exchange Act was passed in the wake of the Great Depression. Gallagher said that the financial crisis was the result of "massive congressional policy failures," not the SEC. He did however note the lessons learned by the SEC as a result of the Bernie Madoff fraud.

Finally, Gallagher concluded with a request that the SEC "push back on false narratives" about the SEC raised by "politicians." If the SEC is required to complete all of the rules required by Dodd Frank, he said, it will take at least five years and will leave the SEC "a shell of its former self." Gallagher suggested the SEC address low staff moral because it is a threat to a "mission-driven agency like the SEC."

### **Remarks of SEC Commissioner Luis A. Aguilar**

Aguilar's remarks focused on two issues: 1) the SEC's need to identify and address cyber threats to capital markets and their participants; and 2) the role and SEC regulation of transfer agents. Aguilar observed how significantly our capital markets and their participants rely upon technology, and how that reliance makes the entire global financial system vulnerable to cyber-attacks and malfunctions, which have become more frequent and sophisticated. Mr. Aguilar lauded White for approving a Cyber Security Roundtable at the SEC, scheduled for March 26, 2014, to address these issues. He also suggested that the SEC needs to revisit rules governing transfer agents and their important gatekeeping role in the financial markets.

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## **Remarks of SEC Commissioner Michael S. Piowar**

As the only economist on the Commission, Piowar discussed the enhanced role of economic analysis at the SEC. He emphasized that economic analysis is not the same thing as cost-benefit analysis. Cost-benefit analysis is only one of four parts of a full economic analysis, newly defined by the SEC as studying and answering the following inquiries:

1. Justification – Why is the SEC regulating in this particular area?
2. Base line – What does the market look like without this regulatory action?
3. Alternatives – Are there other ways to address the problem that is the focus of the proposed rule?
4. Economic consequences (cost-benefit analysis) – What are the costs and benefits of the proposed rule?

Piowar reported that economists are now involved at the earliest stages of examinations and investigations. He also said that the SEC will spend more time conducting more thorough economic analysis and testing on the front end of its rulemaking process so that the process becomes more robust, efficient, and better able to withstand judicial challenge.

## **Remarks of SEC Commissioner Kara M. Stein**

Commissioner Stein highlighted various initiatives upon which she thinks the SEC should focus, including:

- Limiting the grant of waiver requests from bad actor provisions that operate to disqualify certain defined “bad actors” from relying upon registration exemptions in the securities laws
- Finalizing rules on executive compensation
- Addressing conflicts of interest in credit ratings
- “Dusting ourselves off” and re-writing rules after courts reject SEC rulemakings
- Working on rules that will prevent runs on money market funds and addressing systemic risks those funds present
- Draft comprehensive consolidated audit trail rules

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