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# The revolving door and the SEC's enforcement outcomes: Initial evidence from civil litigation<sup>☆</sup>

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## ABSTRACT

We investigate the consequences of the “revolving door” for trial lawyers at the SEC’s enforcement division. If future job opportunities motivate SEC lawyers to develop and/or showcase their enforcement expertise, then the revolving door phenomenon will promote more aggressive regulatory activity (the “human capital” hypothesis). In contrast, SEC lawyers can relax enforcement efforts in order to develop networking skills and/or curry favor with prospective employers at private law firms (the “rent seeking” hypothesis). We collect data on the career paths of 336 SEC lawyers that span 284 SEC civil cases against accounting misrepresentation over the period 1990–2007. Our overall evidence is consistent with the “human capital” hypothesis. However, we find some evidence of “rent seeking” when SEC lawyers are based in Washington DC and when defense firms employ more former SEC lawyers. The revolving door likely impacts numerous aspects of SEC regulation setting and enforcement. This study examines accounting-related civil cases and is not able to study administrative or non-accounting enforcement cases. Further, the study does not address the choice of which cases to pursue, the incentives of employees other than trial lawyers, or how the revolving door affects rule making. Subject to these caveats, our study provides an important first look into the effects of revolving door incentives on the SEC’s enforcement process and lays the groundwork for future research.

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**“At a minimum, the revolving door has undermined the integrity of the SEC’s oversight on numerous occasions, and the SEC isn’t policing as aggressively as it should,”** said Nick Schwellenbach, POGO’s director of investigations, quoted in Hilzenrath (2011).

## 1. Introduction

In this paper, we provide an initial examination of whether revolving doors are associated with compromised regulatory oversight by the SEC. In particular, we investigate whether civil cases against accounting misrepresentation are influenced by the past and future job prospects of prosecuting SEC lawyers. The media, members of Congress, academics, former employees of the SEC and investors have raised questions about the impact of the revolving door on the SEC’s efficacy and independence. Indeed, ex-SEC chairwoman, Mary Schapiro (US Senate, 2009, p. 28), testified that the SEC must seek to avoid conflicts created by employees “walking out the door and going to a firm and leaving everybody to wonder whether they showed some favor to that firm during their time at the SEC.” A GAO report (2011) contends that even the mere appearance of a conflict of interest could undermine confidence in the enforcement process at the SEC, and a report from the SEC watchdog, Project on Government Oversight (2011), discusses individual cases where revolving door incentives likely undermined SEC enforcement. Despite the inherent importance of the SEC’s revolving door phenomenon, there is surprisingly little systematic evidence on the topic. Our paper attempts to provide initial evidence by examining whether SEC trial lawyers’ career prospects are associated with their enforcement efforts, while at the SEC.

Revolving doors lead to both the SEC hiring lawyers from firms that they regulate as well as SEC officials leaving to work for firms that are regulated.<sup>1</sup> Revolving doors are natural in that the SEC needs industry specific expertise to monitor and regulate effectively, and regulated firms need experience and knowledge of complex regulations to minimize the cost of compliance. However, revolving doors can undermine enforcement if SEC lawyers are captured by past or future private employers. Specifically, revolving doors raise concerns that: (i) prior experience in industry makes SEC personnel unduly sympathetic to industry’s interests; or (ii) SEC personnel go easier on violations to curry favor with future employers. Crucial to whether revolving doors enhance or compromise regulatory effort is the reason why the regulator is being hired by industry. If the SEC official is being hired primarily for his knowledge of the complex regulatory environment and technical expertise, he will have an incentive to invest in and/or demonstrate his human capital skills while at the regulatory agency to increase his future prospects in industry, which, in turn, will make him enforce regulations more aggressively (see Che, 1995; Salant, 1995). We predict aggressive enforcement for both “average” SEC lawyers who want to develop skills to ensure good future job prospects, as well as for highly talented SEC lawyers who want to demonstrate their competence to prospective employers. We label these arguments as the “human capital hypothesis.” In contrast, if the SEC official is being hired primarily for his ability to lobby and influence decision makers at the agency, he is likely to under-emphasize or even compromise enforcement outcomes to curry favor with prospective employers (the “rent-seeking hypothesis”).

In this paper, we provide initial evidence to discriminate between these two hypotheses by investigating whether and how job opportunities influence the outcomes of SEC civil litigation of accounting misrepresentation cases. We hand-collect data on future employers of a sample of SEC lawyers that prosecuted cases between 1990 and 2007.<sup>2</sup> The rent-seeking hypothesis implies that lawyers that leave the SEC to work for a private law firm, hereafter referred to as “revolvers,” will be associated with lenient or lax enforcement while at the SEC. In contrast, the human-capital hypothesis implies that revolvers will be associated with aggressive enforcement while at the SEC.

We use three proxies for aggressive enforcement effort. The first is the monetary value of the damages collected by the SEC. The second outcome is whether, in addition to prosecuting his own civil charges, the SEC lawyer refers the case to the Department of Justice (DOJ) for simultaneous criminal proceedings. The third outcome is whether the SEC lawyer pursues individual charges against the CEO of the firm. Charging the CEO is considered aggressive because: (i) naming individual officers antagonizes influential people who might hinder the SEC lawyers’ future employment prospects; and (ii) individuals are likely to defend their case more vigorously relative to when only their company is named (Eagelsham, 2011).

We obtain case dockets for all available SEC civil litigation of accounting misrepresentations filed between the years 1990–2007. We then search through Bloomberg Law databases, supplemented with LexisNexis Court Link, to collect data on the names of the SEC lawyers prosecuting each case, the defendant law firms, the parties charged, the monetary damages, and the outcome of the case. We rely on the LexisNexis Academic database, the Martindale Company’s database, Freedom of Information Act requests, and general web searches to gather data on the age, education, and the identity of the pre- and post-SEC employers of each SEC lawyer identified above. Our final sample includes 336 unique lawyers that worked on 284 SEC enforcement cases over the sample period.

<sup>1</sup> For instance, Peter H. Bresnan, a former Deputy Director in the SEC’s Division of Enforcement, resigned in December 2007 and joined the law firm of Simpson Thacher & Bartlett LLP. In November 2009, Mr. Bresnan filed a statement advising the SEC that he had been “retained to represent a client [name redacted] in connection with *SEC v. Bank of America Corp.* (09-Civ-6892 (JSR)) (S.D.N.Y.).” A reverse example relates to the recent appointment of Mary Jo White, chair of the litigation department at the law firm of Debevoise & Plimpton, as the chairwoman of the SEC.

<sup>2</sup> Revolving door concerns also apply to other SEC employees such as accountants, economists, and Commissioners. We focus on lawyers because case dockets allow us to match lawyers with specific SEC enforcement. Moreover, detailed resumes, necessary to trace career paths, are easier to obtain for lawyers as compared to other professionals.

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