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OVERSIGHT OF THE SECURITIES AND EXCHANGE COMMISSION'S FAILURE TO IDENTIFY THE BERNARD L. MADOFF PONZI SCHEME AND HOW TO IMPROVE SEC PERFORMANCE

HEARING

BEFORE THE

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS UNITED STATES SENATE

ONE HUNDRED ELEVENTH CONGRESS

FIRST SESSION

ON

ANALYZING THE SEC'S OVERSIGHT AND EXAMINATION OF THE ACTIVITIES OF BERNARD L. MADOFF AND BERNARD L. MADOFF INVESTMENT SECURITIES, LLC AND WHY IT FAILED TO IDENTIFY THE PONZI SCHEME, AND TO ASSESS RECOMMENDATIONS FOR HOW TO IMPROVE THE REGULATORY PERFORMANCE OF THE SEC

SEPTEMBER 10, 2009

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OVERSIGHT OF THE SECURITIES AND EXCHANGE COMMISSION'S FAILURE TO IDENTIFY THE BERNARD L. MADOFF PONZI SCHEME AND HOW TO IMPROVE SEC PERFORMANCE

THURSDAY, SEPTEMBER 10, 2009

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, DC.

The Committee met at 2:33 p.m., in room SD–538, Dirksen Senate Office Building, Senator Christopher J. Dodd (Chairman of the Committee) presiding.

OPENING STATEMENT OF CHAIRMAN CHRISTOPHER J. DODD

Chairman DODD. The Committee will come to order, and let me thank all of our guests here today in the Banking Committee, my colleagues and staff. Today's hearing is entitled "Oversight of the SEC's Failure to Identify the Bernard L. Madoff Ponzi Scheme and How to Improve SEC Performance." Let me thank the staff and others for the work they have done on this issue and the follow-on we will need to do as well, not that this one hearing is going to complete the examination of this question, because obviously the significance of it Americans are well aware of, including the most recent reports about taped conversations between Mr. Madoff and others in which his contempt for the process, the SEC, and the American people is quite evident. Obviously, as he says, "First of all, this conversation never took place, OK?" Some indication of what we are—the individual, the psychopathic individual we are dealing with on these issues.

I am going to make some brief opening comments, and then I will turn to Senator Shelby for opening comments, and following the Bob Corker rule, there will be no statements made by any other member of the Committee until the opening round.

[Laughter.]

Chairman DODD. This way we can get through this thing and make sure we get two rounds in. I tease Bob Corker about his preference.

Senator MENENDEZ. Mr. Chairman, is that who we have to be thankful to?

Chairman DODD. I do not know. Ask Bob Corker about that rule.

[Laughter.]

Chairman DODD. I have teased him about it along the way. And, again, if anyone feels absolutely compelled that they would like to

say something, obviously I try to accommodate my colleagues' requests. But if it would be all right, we would like to move along and cover the ground.

Let me begin. Bernie Madoff stole $50 billion, and maybe more. He stole from individuals, he stole from pensions funds, he stole from charities and municipalities, communities like Fairfield in my home State of Connecticut. He stole more than money. He stole the retirement savings and the economic security of families and individuals, organizations, and charities all across the United States. And the very agency charged with the responsibility of policing Mr. Madoff, the Securities and Exchange Commission, did not stop him. There can be no excuse for that colossal failure. But I demand, as my colleagues do here, Democrats and Republicans, that victims of this fraud—some of whom hail from my home State and many, of course, all across the country that have testified before this Committee, as some have, also demand an explanation. How did this happen? What went on? Who was on the beat? What was going on that allowed this colossal—colossal—thievery to occur?

And so today we hold our third hearing on Ponzi schemes, and our second on the Madoff fraud, in particular, to find out how this could possibly have happened and what we need to do as a Government, as an Exchange Commission, as well as the Congress of the United States, to minimize this ever occurring again.

Incredibly, it emerged late last year that the SEC staff had received multiple complaints over a period of 16 years—16 years, from 1992 to 2008—that Bernie Madoff's business was not legitimate, but had not taken any effective action. To his credit, then-Chairman Christopher Cox directed the SEC Inspector General to conduct a full investigation of why these credible reports had been ignored. The Inspector General released a report last week, and it is deeply disturbing, to put it mildly.

As the report indicates, the SEC received, and I am quoting:

> more than ample information in the form of detailed and substantive complaints, but a thorough and competent investigation or examination was never performed.

The report goes on to describe an embarrassing series of internal failures at the SEC.

One, incompetent supervisors directed their offices to look only for the types of fraud they understood and failed to recognize the type actually being committed in the Madoff case.

Number two, inexperienced SEC staff simply accepted Mr. Madoff's claims without making the single phone call or sending the single letter that it would have taken to verify the information they were given.

Number three, no one ever thought it merited a closer look when Mr. Madoff said he traded in Europe with a firm that reported there was no activity—when a firm that reported there was no activity in the account.

And, fourthly, divisions and offices failed to coordinate or share information.

This is ugly stuff, to put it mildly. Beginning in 1992, 16 years ago, 17 years ago, the SEC received information that should have led to the quick end of Bernie Madoff's Ponzi scheme. But because the task of following up on that information was assigned to junior

staff or supervisors with insufficient experience in the securities market, because that staff failed to ask obvious questions or take simple steps to verify what Mr. Madoff told them, and because their supervisors actually discouraged in some cases further investigation—in short, because the SEC failed to do its job, Bernie Madoff stole $50 billion.

Today we are going to hear from the Inspector General about his report. We will hear from Harry Markopolos, an individual we have talked about on this Committee, who early, early on sent the warning signals in detailed information about what he determined was a Ponzi scheme. Mr. Markopolos is an investment analyst who continually attempted to get the SEC's attention with regard to the Madoff fraud about his ideas for improving the organization. And we will hear from the heads of the Office of Compliance Inspections and Examinations and the Division of Enforcement about what the SEC has done in light of the Madoff revelations and about what Chairman Schapiro intends to do going forward.

There are several clear steps that I believe—and I hope my colleagues and others would agree—that need to be taken. One, the SEC staff should be trained in markets and investment strategies so they can know fraud when they see it, and the SEC should hire staff with real-world experience. The very culture needs to be reformed to encourage aggressive oversight. Staff should verify self-serving statements of facts made by targets of investigations. And coordination between the SEC's offices and divisions must be improved, and that is a point, by the way, that I am going to come back to over and over again, this idea of coordinating activities so we do not have these kind of stovepiped problems. And the SEC is not the only organization that suffers from a stovepipe mentality. That was all across Government, for that matter, but particularly here where divisions within the organization are required to communicate with each other, so you share information and knowledge arriving at decisions as to whether or not to go forward in matters like this. And, last, there should be a more rigorous system of evaluating outside tips and allegations, including articles in the financial press.

Well, like many Americans who have obviously been following this event since last fall, I am stunned and angry, as many people are in this country, that this fraud was allowed to happen. But I also believe that the SEC can do better.

Let me say as well, because obviously we are going to talk today about the SEC, a lot of people work there. And this is not part of my prepared remarks. I have a high regard for the many, many people who work at the SEC and do a terrific job every day. And so I do not want this to be seen as some sweeping indictment of everybody who works at this organization. Far from it. I have a high regard for people who dedicate their lives, work long hours to ferret out problems that exist. And so this is really trying to find out where we go from here, obviously how this happened, and how we can step forward. And I am pretty confident I speak for all of us up here to reflect the respect we have for the literally hundreds of people who dedicate their lives at this agency. And I thank you personally for the kind of work you do. And we are just going to

ask you to help us to make sure that we minimize if not prohibit and stop forever this kind of an event ever occurring again.

I literally get emails every day, almost every day from constituents of mine in Connecticut. These are not wealthy people. These are people who work every day, work hard every day to save and retire to provide some security for themselves. They have been ruined, at least in their minds, by what has happened here. They have been wiped out by what has happened.

Dr. Backe, who was a constituent of mine, testified in January before this very Committee about what happened to him and the people in his medical practice in Connecticut. These people have literally been devastated by what has occurred. And I do not know if there is any way we can compensate them adequately. SIPC does not seem to be able to require us to be able to do much about it. I would like to hear my colleagues' thoughts on what we might do, or the SEC. But we have got to make sure this does not happen again. But I do not want every individual working at the SEC to feel somehow this is an indictment across the spectrum of everyone there. Hardly from it. But, clearly, we have got to do a better job, and this is infuriating, what happened in this case.

With that, let me turn to Senator Shelby.

STATEMENT OF SENATOR RICHARD C. SHELBY

Senator SHELBY. Thank you, Mr. Chairman.

Last January, right here in this room, a little more than 1 month after Bernard Madoff confessed to running a $50 billion multi-decade Ponzi scheme, this Committee held a hearing to try to understand how a fraud of that magnitude could go undetected by the Securities and Exchange Commission for so many years. Unfortunately, that hearing yielded few answers.

In the intervening 7 months since, the SEC's Inspector General, who is with us today, has been piecing together what really happened. His report sets out a chronology that tracks 15 years of missed opportunities and considerable incompetence. The IG found that the Office of Compliance Inspections and Examinations and the Division of Enforcement at the Securities and Exchange Commission were made aware at least six times that there might be something wrong in Madoff's firm. Potentially fruitful leads were not pursued, while significant staff resources were devoted to running down clearly unproductive avenues.

Investigations were unfocused, understaffed, and improperly documented. Communication across the SEC offices was so badly flawed that Madoff himself had to alert the New York examiners that their counterparts in the Washington office of the SEC had been looking at similar issues.

The IG determined that the SEC culture and organizational structure discouraged employees at the SEC from reaching out to one another to share market intelligence, obtain expert advice, or to compare notes about their cases. The Securities and Exchange employees did not give weight to colleagues' recommendations, so a tip found credible by one group of staffers would be dismissed hastily by another.

The report also documents that Mr. Madoff, despite his persistent misrepresentations to the Securities and Exchange Commis-

sion, received greater deference by the staff at the SEC than the tippers who spotted his fraud. Ultimately, in each case the report indicates that the lingering questions and concerns of the SEC employees was swept under the rug by impatient and inflexible supervisors at the SEC who concluded that asking the logical next question would take too long or would be outside the scope of the examination. How absurd.

In the aftermath of the botched Madoff investigation, the SEC has claimed that more funding will address its failures? Will it? The report, however, clearly describes an agency that does not know how to use the information and resources it already has. Fixing the SEC will not merely involve more resources. It is going to take much more. The Commission is going to have to make a broad-based change if it hopes to become a smarter, more flexible, more productive, and ultimately accountable organization.

I am hopeful that the SEC will learn from its failures and seize this opportunity to reform itself from within. If it refuses to do so, Congress will do it for them.

Thank you, Mr. Chairman.

Chairman DODD. Thank you very much, Senator.

I will now introduce our panelists, and these introductions are a little bit longer than I normally give, but I think it is important to note that these are some very, very talented people who have recently joined the SEC to come on board, and I think knowing a bit about their backgrounds in a public setting like this will hopefully be a source of some encouragement to people about steps that have already been taken under the leadership of the SEC.

First of all, I welcome David Kotz, who is not with the SEC but, rather, is the Inspector General of the SEC. He joined the SEC in December of 2007 and previously had served as Inspector General for the Peace Corps. Having been a former Peace Corps volunteer when Thomas Jefferson was President of the United States, going back a number of years—it seems that long.

[Laughter.]

Chairman DODD. I welcome your previous experience in covering the Peace Corps. Prior to that, he worked at the U.S. Agency for International Development and in private law firms, and he prepared the extensive report we are examining today. And he will be our first witness.

In the second panel, you have already heard me talk about Harry Markopolos who spoke with and met with and gave detailed analysis to the SEC staff raising questions about whether Bernie Madoff was violating securities laws such as by operating a Ponzi scheme from 2000 to 2008, over an 8-year period. Mr. Markopolos holds professional certifications as a chartered financial analyst and as a certified fraud examiner. He is a past president of the Boston Security Analysts Society. He currently works as an independent fraud investigator with attorneys pursuing actions under the False Claims Act and other statutes. From 1991 to 2004, he worked with Rampart Investment Management Company where he became its chief investment officer.

John Walsh was appointed the Acting Director of the Office of Compliance Inspections and Examinations at the SEC in August of 2009, just a few weeks ago. He has served at the SEC for 20 years,

including service in the Office of General Counsel, the Division of Enforcement, and the Special Counsel to Chairman Arthur Levitt. He has been a member of the OCIE staff since its creation in 1995.

Robert Khuzami—and I hope I pronounced that correctly—was appointed as Director of the SEC Division of Enforcement in February of 2009 and came to the SEC from Deutsche Bank where he had served as general counsel for the Americas since 2004, earlier as global head of litigation and regulatory investigations, and prior to this, Mr. Khuzami served as a Federal prosecutor for 11 years with the U.S. Attorney's Office for the Southern District of New York prosecuting complex securities and white-collar criminal matters, including insider trading, Ponzi schemes, and accounting fraud—obviously an extensive background.

We thank all of our witnesses today for being with us. Mr. Kotz, we will begin with you. I am going to have the lights on here to watch your time. We do not want to cut you too short, but we would like you to move along as well to get to the questions. So thank you again for the tremendous work you have done and that of your staff in preparing this report.

STATEMENT OF H. DAVID KOTZ, ESQ., INSPECTOR GENERAL, SECURITIES AND EXCHANGE COMMISSION

Mr. KOTZ. Thank you for the opportunity to testify today before this Committee as Inspector General of the Securities and Exchange Commission. In my testimony, I am representing the Office of Inspector General, and the views that I express are those of my office and do not necessarily reflect the views of the Commission.

Immediately after Bernard Madoff confessed to operating a multi-billion-dollar Ponzi scheme, my office commenced an investigation into why the SEC had failed to discover this scheme. On December 17, 2003, we issued an agency-wide document preservation notice and submitted requests for email records from the SEC's Office of Information Technology. Over the course of the investigation, we saw emails from over 70 current and former SEC employees for various time periods relevant to the investigation, ranging from 1999 to 2009. In all, we estimate that we obtained and searched approximately 3.7 million emails.

During the investigation we also reviewed work papers and examination files of the SEC examinations of Madoff from 1990 to December 11, 2008, and sought documentation from third parties, such as FINRA and DTC, to undertake our own analysis of Madoff's trading records.

To assist us in the investigation, we retained two sets of outside consultants. In February 2009, we retained FTI Consulting, Inc. to aid with the review of the examinations of Madoff that were conducted by the SEC. In June 2009, we retained First Advantage Litigation Consulting Services to assist us in the restoration and production of additional Madoff-related emails that the SEC had been unable to provide due to gaps in electronic data.

We also conducted 140 testimonies under oath or interviews of 122 individuals with knowledge of facts or circumstances surrounding the SEC's examinations and/or investigations of Madoff. I would like to acknowledge the extraordinary efforts of the OIG investigative team that I have been honored to lead in conducting

this important investigation. These included Deputy Inspector General Noelle Frangipane, Assistant Inspector General for Investigations David Fielder, and Senior Counsels Heidi Steiber, David Witherspoon, and Christopher Wilson, as well as my assistant, Roberta Raftovich. Without their incredible devotion and exceptional work, we would not have been able to complete the investigation and present a thorough and comprehensive report within such a short period of time.

On August 31, 2009, we issued to the SEC Chairman a comprehensive report of investigation in the Madoff matter containing over 450 pages of analysis. In our report, we found that between June 1992 and December 2008 when Madoff confessed, the SEC received six substantive complaints that raised significant red flags concerning Madoff's investment adviser operations and should have led to questions about whether Madoff was actually engaged in trading. We also found that the SEC was aware of two articles regarding Madoff's investment operations that appeared in reputable publications in 2001 and questioned Madoff's unusually consistent investment returns.

Our report concluded that notwithstanding these six complaints and two articles, the SEC never conducted a competent and thorough examination or investigation of Madoff for operating a Ponzi scheme and that, had such a proper examination or investigation been conducted, the SEC would have been able to uncover the fraud.

The first complaint, which was received by the SEC in 1992, alleged that an unregistered investment company was offering 100-percent safe investments with high and extremely consistent rates of return over significant periods of time to special customers.

The second complaint was very specific, and different versions of it were provided to the SEC in May 2000, March 2001, and October 2005. The complaint submitted in 2005, entitled "The World's Largest Hedge Fund is a Fraud," detailed approximately 30 red flags indicating that Madoff was operating a Ponzi scheme, a scenario it described as "highly likely."

In May 2003, the SEC received a third complaint from a respected hedge fund manager identifying numerous concerns about Madoff's strategy and purported returns. Specifically, the complaint questioned whether Madoff was actually trading options in the volume he claimed and noted that Madoff's strategy and purported returns had no correlation to the overall equity markets in over 10 years. According to an SEC manager, the complaint laid out issues that were "indicia of a Ponzi scheme."

The fourth complaint was part of a series of internal emails of another registrant that the SEC discovered in April 2004. The emails described the red flags that a registrant's employees had identified while performing due diligence on their own Madoff investment using widely available information. These red flags identified included Madoff's incredible and highly unusual fills for equity trades, his misrepresentation of his options trading, and his unusually consistent, non-volatile returns over several years. One of the internal emails provided a clear, step-by-step analysis of why Madoff must be misrepresenting his options trading. The SEC ex-

aminers who initially discovered the emails viewed them as indicating "some suspicion as to whether Madoff is trading at all."

The SEC received the fifth complaint in October 2005 from an anonymous informant, which stated:

> I know that Madoff's company is very secretive about their operations and they refuse to disclose anything. If my suspicions are true, then they are running a highly sophisticated scheme on a massive scale. And they have been doing it for a long time.

The sixth complaint was sent to the SEC by a "concerned citizen" in December 2006 and advised the SEC to look into Madoff and his firm, referencing a potential scandal of major proportion which was executed by the investment firm Bernard L. Madoff.

In March 2008, the SEC Chairman's office received another copy of the 2006 complaint, with the additional information that Madoff kept two sets of records and implying that a false set of records were kept on Madoff's computer.

These complaints all contained specific information and could not have been fully and adequately resolved without a thorough examination and investigation of Madoff for operating a Ponzi scheme.

According to our FTI experts, the most critical step in examining or investigating a potential Ponzi scheme is to verify the subject's trading through an independent third party. We found that the SEC conducted two investigations and three examinations related to Madoff's investment adviser business based on the detailed and credible complaints that raised the possibility that Madoff could have been operating a Ponzi scheme. Yet at no time did the SEC ever verify Madoff's trading through an independent third party and never actually conducted a Ponzi scheme examination or investigation of Madoff.

In the first examination and investigation conducted in 1992 based on suspicions that a Madoff associate had been operating a Ponzi scheme, the SEC focused its efforts on Madoff's associate and never thoroughly scrutinized Madoff's operations even after learning that Madoff made all the investment decisions and claimed to achieve remarkably consistent returns over a period of numerous years with a very basic trading strategy. The SEC seemed not to have considered the possibility that Madoff could have taken the money that he used to pay the associate's customers back from other brokerage clients.

In 2004 and 2005, the SEC's examination unit, OCIE, conducted two parallel cause examinations of Madoff. The exams were similarly flawed. There were significant delays in the commencement of the examinations, notwithstanding the urgency of the complaints, and the teams assembled were relatively inexperienced. The scopes of the exams were in both cases too narrowly focused on the possibility of front-running, with no significant attempts made to analyze the numerous red flags about Madoff's trading and returns.

During both these examinations, the exam team discovered suspicious information and evidence and caught Madoff in contradictions and inconsistencies. However, they either disregarded these concerns or simply asked Madoff about them and accepted his seemingly implausible answers at face value.

Astoundingly, both examinations were open at the same time in different offices without either office knowing the other one was conducting a virtually identical investigation. In fact, it was Madoff himself who informed one of the exam teams that the other team had already received the information being sought from him.

Both examinations failed to follow up with outside entities. In the first examination, the examiners drafted a letter to the NASD seeking independent trade data, but never sent the letter, claiming it would have been too time-consuming to review the data they would have obtained. Our expert opined that had this letter been sent, the data collected would have provided the information necessary to reveal Madoff's Ponzi scheme.

In the second examination, the OCIE Assistant Director obtained information from a financial institution that Madoff claimed he used to clear his trades, indicating there was no transaction activity in Madoff's account for a specified time period, but failed to conduct any follow-up or even share this information with the exam team. The investigation that arose from a complaint that explicitly stated it was highly likely that Madoff was operating a Ponzi scheme never really investigated the possibility of a Ponzi scheme. The Enforcement staff failed to appreciate the significance of the analysis in the complaint and directed most of their investigation at determining whether Madoff should register as an investment adviser.

The Enforcement staff again almost immediately caught Madoff in lies and misrepresentations, but failed to follow up on inconsistencies. In fact, when Madoff provided evasive or contradictory answers to important questions in testimony, the staff simply accepted his explanations as plausible.

Although the Enforcement staff attempted to seek information from independent third parties, they failed to follow up. For example, when they received a report from the NASD that Madoff had no option positions on a certain date, they did not take any further steps. Further, Enforcement drafted, but decided not to send, a letter seeking documentation from European counterparties. Had any of these efforts been fully executed, they would have led to Madoff's Ponzi scheme being uncovered.

We have recommended that the Chairman carefully review our report and share with OCIE and Enforcement management the portions of this report that relate to performance failures by those employees who still work at the SEC so that appropriate action is taken on an employee-by-employee basis. My office also plans to issue three additional reports relating to the SEC's failures regarding Madoff. Because of the systematic breakdowns we found in our investigation, we plan to issue two separate audit reports providing the SEC with specific and concrete recommendations to improve the operations of both OCIE and Enforcement. FTI is finalizing a report that will describe its analysis of OCIE's exam process and provide numerous "lessons learned," with specific and concrete recommendations to improve nearly every aspect of OCIE's operations. These recommendations, which are currently in draft status, are detailed in my written testimony.

We are also finalizing a report that analyzes "lessons learned" from the Enforcement investigations of Madoff and prescribes con-

crete recommendations for improvement within Enforcement. The Enforcement-related recommendations we are currently considering are also detailed in my written statement.

Both reports containing recommendations to OCIE and Enforcement will be finalized and issued within the next few weeks. We also plan to issue an additional report in November 2009 analyzing the reasons why OCIE's investment adviser unit did not conduct an examination of Madoff after he was forced to register as an investment adviser.

My office is committed to following up on all the recommendations that we will be making to ensure that significant changes and improvements are made in the SEC's operations as a result of our findings. We are confident that under Chairman Schapiro's leadership the SEC will take the appropriate steps to implement our recommendations and ensure that fundamental changes are made in the SEC's operations so that the errors and failings we found in our investigation are properly remedied and not repeated.

Thank you.

Chairman DODD. Thank you very much for the very comprehensive work you and your staff have done, and we appreciate it.

I am going to ask the Clerk to keep on about 7 or 8 minutes here for the first round, because we have a second panel to go to and I know several colleagues have other oversight hearings and responsibilities. They will be coming in and out. And I am going to leave the record open, by the way, for questions, as well, if they are unable to make it here, so they have a chance to make sure their questions will be answered, and I would appreciate, to the extent you have got a lot of work in front of you and recommendations, if you would also respond to these questions as soon as possible. I would make that similar request for our second panel. In fact, I am making it now, so they can hear that, as well.

Let me just quickly, if I can, jump in. The report describes a number of very critical instances in which the SEC staff failed to see information—you have just enumerated these in your testimony—getting information from third parties to verify Mr. Madoff's claims about his trades. Steps as simple as sending a letter that was already drafted, in fact, in one case, a drafted letter just needed to be sent that might have brought an end to this thing years ago, or making a single phone call to the Depository Trust Corporation or the National Association of Securities, NASD. Just a single phone call, is that what you are saying, a single letter being sent, a single phone call having been made, in your view, could have brought this to a screeching halt and exposed it for what it was?

Mr. KOTZ. Senator, that is right. The concern was that they would get tremendous amounts of information that would take a long time to peruse. But, in fact, of course, since Madoff wasn't engaged in trading, they would have received very little information and immediately they would have seen that on certain days that Madoff was claiming in customer statements he had $2 billion in options, for example, there are no records of those.

Chairman DODD. He made no trades?

Mr. KOTZ. That is right. I mean, he had a broker-dealer operation and he had firm trades, but it was in very different amounts. It was certainly—we actually—during the course of our investiga-

tion, we went to DTC and we got specific dates, for example, the date that Madoff testified before the SEC, and we compared the documents, the customer statements, with the documents from the DTC and immediately we saw that there was no question that Madoff wasn't making anywhere near the volume that he said he was, and with respect to the NASD, as well. I mean, there are entities that clear trades. Those are independent entities. Madoff can't give them documents. Those documents are independent. And had they done that, they would have uncovered this scheme.

Chairman DODD. So a single phone call, a single letter, would have exposed this for what this was——

Mr. KOTZ. Yes, that is right.

Chairman DODD. That is your testimony. To what do you attribute—again, and this is a broad question, but try and be brief in your answer—the lack of follow-through? I mean, is it agency culture? Lack of staff commitment? Staff not wanting to antagonize powerful people within the industry? The Office of Compliance Investigations, Examination, and Enforcement, do they employ trusting people? I presume they do, but I raise the question with you here. What should the SEC do, in your view, as a general matter to address this issue?

Mr. KOTZ. Well, I think there are a couple of reasons. One, they were too trusting of Madoff. I think a lot of people just simply didn't believe that Madoff could be operating a Ponzi scheme, notwithstanding the fact that they got complaints that gave indicia of that Ponzi scheme.

I think also they set the scope of their examinations and investigations too narrowly. So when the junior folks wanted to continue, the senior people said, that is not within the scope.

I think that there was too much of an emphasis on numbers, how many exams were going to get done that year. And there was a certain time period where the examiners were at Madoff's firm conducting an examination. They wanted to continue and their supervisor said, time is up, we have to move on to the next one, without really going back to ensure that you did a full and thorough job on that one.

I think skepticism is very important, no matter who it is. I mean, Madoff certainly used the fact that he was the sole contact for many of the examinations, particularly involving junior examiners. They sat with Bernie Madoff for hours a day. He told them stories about how he was on the short list to be the next SEC Chairman and gave them information, dropped a lot of names. And there wasn't sufficient support from the senior-level people. You cannot allow a junior-level person to be put in that position.

Madoff was very aggressive when they would ask for information that he didn't want to provide and they didn't get enough support and back-up from their senior-level people. Madoff tried to focus them toward front running, toward these limited areas so they would not get to the real issues, and he was successful in doing that.

Chairman DODD. There are 41 recommendations, by my count, that you make in your report. I know you are going to make some—there is a follow-on you are going to be doing with some recommendations. But the 41 I have counted—this is a hard question

to ask you, but I would like you to try anyway—how do you prioritize these? In the recommendations, which are the ones that you believe are deserving of immediate attention to minimize, if not entirely stop, this kind of example from happening again?

Mr. KOTZ. Yes. I mean, I think there are specific things that have to be done within particularly the examination program in terms of ensuring that when a complaint comes in, all aspects of the complaint are reviewed. They have to ensure that the planning memorandum are done appropriately. They have to ensure that the conduct of the exam is done sufficiently. They have to go to independent third parties. I think those are very important areas.

I think you mentioned earlier about coordination among staff. I think that is one that has to be addressed right away. You cannot have a situation where one side of the SEC doesn't know what the other side is doing. I mean, in that examination, the examiners were ready to confront Madoff with some misrepresentations, inconsistencies. When they confronted him, he pushed back at them by saying, "I already provided this to your colleagues." They were embarrassed. They were taken aback. And it is difficult to continue that momentum in an examination when it seems as though the individual you are examining knows more than you do. So that is one, I think, that has to be remedied right away.

I mean, the fact is that the SEC as a whole got numerous complaints over the years, but nobody kind of counted it up to see, hey, wait a minute. We have got this complaint and this complaint and this complaint, and taking it all in, there must be more to it than just simply front running. So that is something, I think, that must be addressed right away.

Chairman DODD. Steven Pearlstein writes for the Washington Post—and I agree writes a good column—wrote a column recently in which he suggested there is a culture at the SEC—and I am not going to quote him exactly, I don't remember the exact words he used—that minimizes the following on of tips, that there is sort of a rejection of the tips coming in as just not really worthy of follow-on. Do you agree with that?

Mr. KOTZ. Certainly, in the case of Harry Markopolos's complaint, the enforcement investigators felt that he wasn't an insider and immediately discounted his complaint. And we asked them when we did the investigation, what else could Harry Markopolos have provided other than perhaps, "Bernie Madoff told me he was operating a Ponzi scheme," and if he had provided that, then we wouldn't need the SEC.

So there was that case, that unless it is an insider, that they had concerns about Harry Markopolos because he made reference to a bounty, that he is only out for money, and they discounted him based on that, when in fact, if you look carefully at his complaint, he had two scenarios. One was a Ponzi scheme, which he viewed as highly likely. One was front running, which he viewed as unlikely. Front running was the one that he could potentially get a bounty, not for the Ponzi scheme. So if he was really out for a bounty, he would have pushed the other one, not the Ponzi scheme.

But yes, there was definitely a sense, particularly in the investigations that we looked at, of them not taking seriously enough complaints like Harry Markopolos's complaint because that person

was an insider, because the information wasn't given to them wrapped up in a bow. And clearly, the SEC got sufficient information to then move the ball—I mean, that was one of our concerns about the entire process. The SEC got detailed complaints. They never really took it anywhere from where the complaints were, notwithstanding the fact that they spent significant time. And as you say, doing other things, for example, contacting independent third parties, would have immediately moved the ball.

Chairman DODD. Yes. How about, just in terms of you have the Boston office, the New York office. These things kind of go on. Are there jealousies within offices, who initiates an investigation, who gets it, who gets credit? Is that a problem? Did you encounter that?

Mr. KOTZ. You know, it is interesting, because the Boston office was very impressed with Harry Markopolos's complaint, understood Harry Markopolos's complaint——

Chairman DODD. They wanted an investigation.

Mr. KOTZ. They wanted an investigation.

Chairman DODD. They sent it down to New York.

Mr. KOTZ. Right. At that time, there was a concern in the agency that offices were hoarding cases, and so, rightly so, the Boston office felt they shouldn't hoard this case. They should send it to New York where Madoff was. It didn't make sense for Boston to do it.

But when the heads of the Boston office sent it to New York, they made special efforts. They had the head of the Boston office email the head of the New York office directly to make sure that they understood this is not a complaint we just want to give you because we want to take the good ones. This was a very significant complaint. Then they followed a couple——

Chairman DODD. Was that an extraordinary kind of communication?

Mr. KOTZ. Yes, it was, absolutely. And then they followed up a couple weeks later to make sure that someone was assigned to that case, even after the first follow-up. So they did what they could to ensure that New York was doing it appropriately. Ironically, had they hoarded the case, as was the case and was a concern within the agency, they would have likely taken the appropriate steps to uncover the Ponzi scheme.

Chairman DODD. Last, and my time is up, but I want to raise the silo problem that you have already addressed to some degree. And I say, this is not a unique problem. I mean, this—we see this, I think, in private organizations as well as public ones, this kind of approach where there is not the kind of communication between divisions for a variety of reasons. How serious a problem is this, and what do you recommend be done about it?

Mr. KOTZ. Yes. I mean, I think on the examination side, it was a concern. You had broker-dealer examiners conducting the examinations who didn't understand the investment manager side. I do believe, and John Walsh will talk about that later, that that issue has been rectified and now they are doing exams with the joint groups. So I think that that is on its way to being resolved.

On the enforcement side, the concern was Madoff would say that his trading was in Europe. Well, we have an Office of International Affairs. If you have questions about trading in Europe, you go to the Office of International Affairs. That is their purpose. The En-

forcement Division didn't do that, and I think that is something that needs to be encouraged among enforcement attorneys. If they don't understand particular issues, they need to seek assistance in the agency. There are people in the agency who do understand it, but they need to seek assistance from them so that they can properly conduct these investigations.

Chairman DODD. Is there anything as simple as an interagency task force that sits down periodically with each other to talk about various cases to determine whether or not there ought to be some cross-pollination in their efforts?

Mr. KOTZ. I think that is a good idea. I think where you have an investigation that involves foreign issues, I think that there should be some recording that efforts were made by the enforcement investigators, almost like a check list, that they checked off that they spoke to this office. So you force people—there wasn't sufficient planning. When they first got this complaint, they didn't sit down and say, how do we go about investigating a Ponzi scheme, because if they had done that, the first thing they would have said was, let us go to independent third parties. They need to have that process in place. They need to have the experience to understand and they need to be required to take certain steps, and a step involving European trading would be asking questions of our international folks.

Chairman DODD. My time is long since up, but I just want to make sure as you get these reports and the further examination of recommendations, whether or not we actually hold another hearing on this or not, but I want to maintain that we get that information right away from you, and obviously we will follow up with it. But I want you to keep very much in contact with this Committee on these recommendations, and specifically if there are any statutory recommendations.[1] I am not recommending there be any at this point, but I would like to know whether or not you think there needs to be, whether or not this Committee has to take some action beyond holding hearings as to whether or not—whether it is additional resources for the SEC to do a job or anything else. I think all of us would like to know whether or not you are making any recommendations ich would require the action by the Congress. I want to know that, OK?

Mr. KOTZ. Absolutely.

Chairman DODD. Thank you.

Senator Shelby.

Senator SHELBY. Thank you. Mr. Kotz, would just simply providing more resources without other structural changes address the problems you have identified at the SEC?

Mr. KOTZ. Yes, I think it is more than just resources.

Senator SHELBY. Absolutely.

Mr. KOTZ. Yes.

Senator SHELBY. It is structure, too, isn't it, and leadership?

Mr. KOTZ. Yes. Yes. Because while resources was a factor in that they didn't have a branch chief on certain examinations, at the end

[1] H. David Kotz's additional recommendations sent to Chairman Dodd are available in Committee files.

of the day, the SEC spent years examining and investigating Madoff

Senator SHELBY. And found nothing.

Mr. KOTZ.——but didn't do the appropriate things. So additional people, if they are not going to do the appropriate things, will not solve the problem.

Senator SHELBY. Just waste resources?

Mr. KOTZ. Yes.

Senator SHELBY. In your report, and it is very lengthy and thorough and we appreciate what you have done, it noted that some investors viewed the fact that the SEC had inspected the Madoff firm as a sort of regulatory seal of approval for the firm. What steps can be taken, in your judgment, to help investors understand that the fact that a firm registered with or inspected by the Securities and Exchange Commission does not mean that the firm is legitimate or guarantee that it is operating in full compliance with the law? How do we thread that needle there?

Mr. KOTZ. Yes. I think there has to be a better educational process, without a doubt, because that was a significant issue. We found folks who reinvested with Madoff based on their feeling that the SEC had checked out Madoff. I had a very sophisticated hedge fund individual say to me he knew for sure that Madoff wasn't running a Ponzi scheme because he had seen Harry Markopolos's complaint and he knew that the SEC would look at that carefully and there is no way they wouldn't have caught the Ponzi scheme.

So part of that means the SEC needs to do a better job in its investigations, but they also need to explain to the public and investors out there exactly what it means when they close an investigation. It doesn't mean they are doing everything right, and Bernie Madoff certainly used that fact, constantly referring to the SEC just being in here, which they were, as a way to convince people who were perhaps hesitant about investing with him.

Senator SHELBY. Your report also describes a series of failures at the SEC that enabled Mr. Madoff to continue to swindle the investors for decades. Given that failures occurred repeatedly and throughout different part of the Securities and Exchange Commission, can we assume that other similar frauds are likely occurring or have occurred without detection?

Mr. KOTZ. Well, I mean, we haven't looked at other specific matters——

Senator SHELBY. I know that.

Mr. KOTZ.——but yes, it was a concern that the same pattern seemed to take place across the spectrum. If you look at the examinations and investigations from 1992 until the present, it was very similar—limited focus, not enough aggressiveness in the investigations and examinations, inexperienced junior people not being supported by supervisors. So it is a great concern.

Obviously, we spent a lot of time analyzing the Madoff situation and issued a very long report, but we don't know what else is out there and it is a great concern that these seem to be systematic issues. And I think the agency needs to address those issues in a systematic way.

Senator SHELBY. In some of your recommended reforms in your report, you offer a number of recommendations at the end of your

report to improve the process by which matters are handled. Very important. One of the examiners you talked to, however, lamented the fact that, and I will quote, "the typical SEC examiner walks into a room where there are a bunch of dead bodies lying around and they notice that the clocks are 10 minutes fast." In other words, they notice the wrong thing.

Are you concerned that even if your recommendations are implemented, we hope, that the culture of the SEC is such that examiners will be rewarded for focusing only on technical violations of the securities laws rather than the real substance, looking behind compliance check lists and identifying more serious problems such as this massive fraud?

Mr. KOTZ. Yes. I mean, that is a concern. We devote an entire section of the report to many interviews we had with folks outside in the private sector who conducted due diligence and we tried to compare the methods that they used when they conducted due diligence to what the SEC used. And what we found was exactly that. They take a more holistic approach. They look at larger issues rather than kind of a check list approach. Did you file this form? Was this signed? Are the clocks on time? *Et cetera.* And so it is a concern.

I think that the way to resolve that is to get more input from these private sector folks. There are a lot of very smart people in the private sector who make very good decisions about investments, folks who looked at Madoff and immediately realized that there was something wrong with his returns. The SEC can get—have educational opportunities for training from these outside entities, and I think that will help them to focus more on big picture issues rather than have a check list and go by and not notice the fraud in the corner of the room.

Senator SHELBY. You also noted in your report, you spoke with private entities that had conducted due diligence that you have alluded to and concluded that Madoff's purported returns were not legitimate. In other words, they raised concern. Given that there seem to have been many people who suspected something was wrong at the Madoff firm, why do you think that more whistleblowers did not come forward to the SEC, or were there enough whistleblowers but not enough diligence at the SEC?

Mr. KOTZ. I mean, I think that there were sufficient complaints. I think that there were a lot of people who were skeptical about Madoff's returns. He was using what even the SEC examiners called a plain vanilla trading strategy. There was no magic in his split-strike conversion strategy.

I don't think that there were a lot of people who did due diligence who necessarily assumed it was a Ponzi scheme. Many people thought he was doing perhaps something else illegal, but not necessarily a Ponzi scheme. So that may be a reason why there wasn't more people——

Senator SHELBY. But had reason to believe that something was not right, didn't they?

Mr. KOTZ. Yes. Yes. And people told us that they are nervous about coming forward. I mean, I think one of the other issues to look at is to encourage people to come forward.

Senator SHELBY. Absolutely.

Mr. KOTZ. People are nervous to come forward. One of the individuals who came forward came forward anonymously, asked us to keep his name anonymous in this report. Many of the people we talked to about due diligence asked specifically not to have their name reported. When the report came out, even though we took out their names, they called and said, "Are you sure there is no way that our name is anywhere in the report?" I mean, there is a concern out there about bringing information forward.

So when you have somebody like Harry Markopolos who is willing to come forward, you have to take that and do the appropriate investigation. But I think something has to be done to look at how to encourage more people to file complaints, because the folks out in private industry, they have a good sense of what is going on.

Senator SHELBY. Is it mind boggling to you, as you did your research and investigation here, that a fraud of such magnitude, $50 billion or more—I assume one of the largest the SEC has ever dealt with or failed to deal with—how could it have happened, right?

Mr. KOTZ. Absolutely. Absolutely. And certainly, Bernie Madoff had a very good reputation, and I think that played a part in this whole issue, which is no one really believed that Bernie Madoff could be operating a Ponzi scheme. And I think that that is a reason why many investors continued to invest with him.

My position would be, after doing this investigation, that if you get a complaint that says Bernie Madoff is operating a Ponzi scheme, you need to be able to believe it in order to conduct an appropriate investigation. At that point, you need to allow for the possibility that it is happening and check it out. And when you start checking it out and you see Bernie Madoff saying things that are contradictory, you need to keep going.

Senator SHELBY. He not only fooled the investors, he fooled the SEC big time, didn't he?

Mr. KOTZ. Yes, he did.

Senator SHELBY. Thank you.

Chairman DODD. Thank you very much, Senator.

The Chairman of the Securities Subcommittee, Jack Reed.

Senator REED. Thank you, Mr. Chairman.

Thank you, Mr. Kotz, for an extraordinarily insightful and informative report. We appreciate it very much, your efforts.

Approximately how many tips, complaints, accusations, do you think the SEC gets a year?

Mr. KOTZ. Oh, thousands. I wouldn't know the exact number, but yes, quite a number.

Senator REED. Which they are not of the order of specificity and detail of Mr. Markopolos's, clearly, but——

Mr. KOTZ. Yes. Yes.

Senator REED. But clearly, going forward, are you confident that there is a triage system, for want of a better term, in place to separate those that are not on, at least first inspection, compelling and identify the compelling ones?

Mr. KOTZ. Yes. Well, one thing the SEC is definitely doing is revamping that entire system. So they have made great efforts, and the SEC folks can talk about it in more detail, but there has been a major effort led by Chairman Schapiro to revamp that entire process. I think there were some concerns about the triage system,

but they are certainly exerting a great deal of energy to fix that system so that there is a good triage system in place.

Senator REED. Let me turn to another area going forward. That is the data and the systems that the SEC has. Everyone has alluded to it, the Chairman and Senator Shelby, about the stovepiping. You have indicated very clearly two groups going in, one being played off against the other by Madoff. Is the plan, or is the capability there today to basically go to a terminal and be able to call up all the information relative to a particular individual, a particular case?

Mr. KOTZ. Yes. I mean, I think that there needs to be some improvements in that area. I mean, ironically, the exam program actually had a system for putting examinations into a data base. The problem was two-fold. One, the folks who did the exam didn't put them in, and the folks who looked, who were doing another exam, didn't check. So in this case, the two exams were operating at the same time, but the exam wasn't in the system and the other entity didn't check to see if the exam was in the system anyway. So when you have those data bases, they have to be used. I think that the SEC is making renewed efforts to ensure that they put information into the data bases so that people know what the other side is doing.

Senator REED. That is kind of surprising. I would assume that entering the data was a basic requirement of the investigative team, and they failed to do that?

Mr. KOTZ. Yes, that is right.

Senator REED. And was there any—is that routine, or is that an exception in this case?

Mr. KOTZ. At that time, we understood it was not uncommon for people not to put their exams in the data base. I believe that things have changed since then——

Senator REED. Yes.

Mr. KOTZ.——but at that time, we were told in our investigation that it wasn't uncommon at all.

Senator REED. Was Madoff aware of the structural and cultural shortcomings which allowed him to operate so successfully? I mean, did he have better intel than the SEC?

Mr. KOTZ. Well, I mean, he was certainly aware that the SEC was conducting two examinations of him at the same time. And certainly, he used his knowledge generally in the industry to impress the examiners. So in many ways, he knew which buttons to push. He knew how to impress the examiners and he knew how to get them off the track that would have disclosed the Ponzi scheme.

Senator REED. Again, this whole area, this has been extraordinarily shocking to all of us and your report has been extremely helpful and useful. There are changes that you have alluded to with respect to technology, with respect to entering cases, different enforcement policies. I presume, but I don't want to put a conclusion forward without your comment, that at least the SEC seems to be headed in the right direction now.

Mr. KOTZ. Absolutely. I mean, this thing has really affected the SEC greatly, and Chairman Schapiro understands the importance of changing things. I have met with her many times on these issues. We are going to make many, many recommendations. A lot

of things have been begun. Even before our report came out, I was asked to provide briefings along the way so they could understand how the process would work. We will follow up with two reports in the next few weeks that will make 50-some-odd recommendations that we will ensure are implemented. So the SEC understands, I believe, that things need to be done and are taking actions.

Senator REED. This is my final question. The more I sort of look at institutions and different aspects, both here in the United States and across the globe, culture plays a huge role in how people operate, how institutions operate. Can you make any comments upon the culture then of the SEC and the culture now? Are there variables that you would sort of point to in terms of that have to be changed that aren't strictly resource, that aren't strictly sort of organizational charts?

Mr. KOTZ. Yes, I think there are a couple. I think, historically, the Enforcement Division, in my opinion, has been very resistant to changes in general. There is a new Director, Mr. Khuzami, who is undergoing a major restructuring and there will be significant changes in the Enforcement Division, which is something that I think is unique to his leadership. I think that is something that may not have happened that much in the past. So that is an area where I think things are going to be different today than they were previously.

Senator REED. Thank you very much. Thank you.

Chairman DODD. Thank you very much, Senator.

Senator Johanns.

Senator JOHANNS. Mr. Chairman, thank you.

Let me just express my appreciation for the Chairman and the Ranking Member following up on this. I think it is enormously important.

Since this story broke, we have all had an opportunity, I am sure, to watch the victims interviewed, and the tragic stories, I mean, just make you want to weep for them, people who are in their senior years who just have no chance of making this money back. I mean, they are not going to live long enough.

I read your report and I reach the obvious conclusion: The Federal Government blew it. What is their remedy? Where do they go from here?

Mr. KOTZ. Yes; I do not know. There are, I guess, legal issues about what victims can do. Through the course of our investigation, we met victims as well, and they were not—you know, as Senator Dodd said, they were not real rich people. They were not people who lost $100 million and have $100 million left. You know, I talked to people who said for them December 11th was their 9/11. December 11th was like September 11th for them. Their lives were devastated. And there is no question that we in the Federal Government must do better.

Senator JOHANNS. I do not want to necessarily draw you into a political debate because that is not the purpose of this hearing, but so many things are happening these days, big, huge, Federal Government programs—health care and on and on. And I read something like this, and I just wonder. Tell me something that will assure me that the Federal Government can handle what it is setting out to embrace when it does this so poorly.

Mr. KOTZ. Well, I cannot speak for the health care system, but, I mean, it is a concern, at least on the SEC level, that there were so many opportunities, it seemed relatively easy to uncover this, and it was not done. So I can understand why there is a concern about the operation of a Government agency.

I do think, however, that the SEC can improve its operations so that it gets better and it is able to do its job in the long run.

Senator JOHANNS. You know, that is the other part that I take away from your report, that, boy, this was, when you really came down to it, kind of a no-brainer. You say that very, very easy to scratch into this even a little bit below the surface, and you are kind of in the midst of this enormous Ponzi scheme going on.

Did you find any evidence of undue influence being placed upon the examiner or the investigator? Was there anything that caused you to believe that there was more to the story here than just sloppy work?

Mr. KOTZ. When we started the investigation, we also came to that kind of conclusion. There is no way in the world this was not some type of corruption. There has to be something happening. This many people could not have missed this much. And we followed up on numerous leads in that area, and we retraced every examination and investigation, reading all the emails, as I said, 3.7 million emails, reviewing all the emails, and we found that there was no evidence of improper influence from the top. We looked very carefully into the allegations about Eric Swanson, who married Shana Madoff; we found there was no evidence that that relationship had any impact.

We did find that Madoff was able to use his stature to impress the junior examiners, so in that way, Madoff was able to use his influence. But there was nothing that we found that was direct, and we looked very hard, followed up on a lot of leads in that area, and there was just no evidence that it happened.

And if you talk to the examiners and you go through the documents, you can see exactly how it happened, and there was no point in time where, you know, something switched or they were about to get something and somebody pulled them off. There was just no evidence of anything from the top or improper influence.

Senator JOHANNS. You know, and I do not know if I should be reassured by that or not, because what you have just described for me is massive, complete, total bureaucratic incompetence. You know, they were not even doing it because they were on the take or being bought off. They just simply were incompetent.

Mr. KOTZ. And, in fact, many of the examiners and investigators, particularly the junior ones, actually worked very hard on these examinations and investigations. They spent a lot of time. They were not lazy and, you know, just filing out at 4 o'clock. They spent a lot of time working on it. But they were not going in the right direction. They were not doing the right thing. They spent a lot of time spinning their wheels when if they had just gone to an independent third party, it would have come out.

Senator JOHANNS. Let me ask you this, and let me lay a little ground work for this. Fifty-billion dollars plus got out the back door before this thing collapsed, and, you know, the reality is I do not know if we caught up with it so much as it just collapsed. You have

got statements being published every month or on whatever periodic basis. You have got investigators in there turning things inside and out, trying to figure out this and that and the next thing. You have got an organization that apparently is claiming it is doing trades and it is not doing trades. You have got customers that are calling in and saying, "What is going on here?" For intents and purposes, it is acting like it is actually doing something, when actually what it really is doing is getting the money out the back door. And I appreciate the importance of this question, but it is a question that needs to be asked.

Do you believe that Bernie Madoff, with all of that going on, acted alone?

Mr. KOTZ. I am really not in a position to be able to know. We really did not look into that aspect of the operations. We focused on the SEC. So I do not know that I could give an educated answer on that question.

It seems to me to have been——

Chairman DODD. Why don't you give an uneducated answer?

[Laughter.]

Mr. KOTZ. I can give an uneducated answer on any question, I guess.

It seems to me it was a pretty large enterprise, that it would be difficult even for Bernie Madoff to pull off himself. But that is not based on information that I found during the investigation, just based on kind of some understanding of how this worked.

Senator JOHANNS. You know, what I am driving at here is this: You probably have people in the hearing room who are victims. You have certainly got people who are watching this on TV who are victims. Their lawyers and probably themselves are trying to figure out where does this tangled web lead to, and if we follow in this direction, there may be assets out there that we have not yet tapped into. And although people, I think sadly, are only going to get pennies on the dollar by pursuing that, that is still something. And that is why I think that question is enormously important, because if we have any role here, it is to protect the public. And I think you are saying beyond any shadow of a doubt, the Federal Government, with this agency that is supposed to protect the public, failed miserably.

So help me try to figure out how this Committee embraces this very difficult issue and picks up the mantle for these poor people and helps them do what we should have done years ago, which is protect them.

Mr. KOTZ. One thing I can say, you know, in the course of our investigation, we had communications with Federal prosecutors who are working on the prosecution of folks related to the Madoff Ponzi scheme. And I can tell you that they are working very earnestly to ensure that if there are people out there who worked with Bernie Madoff, that they come to justice. So I can assure you that a lot of actions are being taken in that respect.

And then, you know, there are obviously questions about how to refund the investors the money, but we are not specifically involved with that. But as I said, I heard heart-wrenching stories myself about people whose lives were destroyed because of what happened, and through no fault of their own. You know, I talk to peo-

ple about, "Well, weren't your surprised that you kept getting these solid returns when everybody else was losing money in the market?" One person said to me, "You know, I was very concerned about it. But 3 days before Madoff confessed, I got a statement, and the statement showed that I still had money in it." He said, "When you get a bank statement, do you go to the bank to see if the cash is still in there?" He believed that the money was there. He did not have any reason to think it was not. He was concerned about it. But he saw that he had a statement. Why would he believe that it was all made up?

Senator JOHANNS. Let me just ask one last question, if the Chairman will permit me. As you know, in another life I worked with an Inspector General—I was Secretary of the Department of Agriculture—and grew to really respect the work of our Inspector General. I cannot always say I celebrated those briefings that I would get, but I grew to respect their work.

Do you find it shocking, flabbergasting, that, you know, you have got a whistleblower, you have got a road map that pretty well lays out a Ponzi scheme, that you folks were not brought into this earlier? I think if I would have gotten a letter like that, I would have, first of all, fainted and, once revived, I would have called my Inspector General, my General Counsel, my Deputy, and the White House and everybody else under the sun to say, "We have got to do something about this."

Mr. KOTZ. Yes, I mean, it is interesting because one of the things we found in the investigation is that all of these complaints were kept at relatively low levels. Our office was not involved. It was not even at the highest level of the Enforcement Division or the Compliance Office. It was relatively junior and mid-level folks that made the decisions to look into it and close the case. And, really, the Commission was never informed about the Markopolos complaint. Our office was never—and it was really dealt with at more of a junior level.

Senator JOHANNS. Thank you, Mr. Chairman.

Chairman DODD. Well, Senator, those are great questions. I thank Senator Johanns immensely. Very important. And I think all of us share those questions as well, and this Committee is going to take a look at the victims and the compensation issue to some degree. I am not encouraged by some of the answers I have received already, but certainly pursuing, for whatever it is worth—in my mind, this could never have been a one-man operation, in my view. You do not steal $50 billion and engage in phony transactions over a period of time of this length and do it by yourself. That just defies logic, in my view. So I welcome the fact that there is a serious investigation being pursued, and that may offer some opportunity to provide some compensation to victims, as Senator Johanns has pointed out. But there may be other means as well, and we need to examine that possibility to deal with this. But it is a flabbergasting case, and so we are very interested in other recommendations you would make.

Let me turn to Senator Menendez. Let me just inform my colleagues, there is a vote that is going to occur in about 4 minutes, 5 minutes, and what I would like to recommend is that Senator Menendez go forward with his questions, and that those of us go

and cast votes. We will recess after your questions and come right back and finish up. Senator Merkley has questions, I know, and others may come back, and then we will try to get to that second panel very quickly.

But, Senator Menendez, why don't you go ahead?

Senator MENENDEZ. Well, thank you, Mr. Chairman. I appreciate that.

Let me just make a comment. I was listening to our colleague, Senator Johanns, at the beginning of his questioning, and I appreciate it. I have the same dismay he has about how the Securities and Exchange Commission worked in this regard. And I know you raised the question as to whether if we cannot have a successful agency do this, how do we have a successful agency do something else?

I come to a different point of view on that. It is how we correct this. It is similar to the consequences of, before you were the Secretary of Agriculture, the discrimination that black and Hispanic farmers faced in the Department of Agriculture that has been recognized most recently in $1 billion settlement. And so the question is: Do we have less of a Department of Agriculture or do we correct what was wrong? In this case, do we correct what is wrong with the SEC? And so I look at it in that vein.

I clearly believe the SEC staff was, from everything I have read of your report, grossly untrained, uncoordinated, and lazy in their investigations. One SEC team consisted only of lawyers without any traders in it, thus lacking the expertise to do, I think, a lot of the critical analysis and questions that were necessary to do the job.

You mentioned the lack of coordination between New York and Washington offices, independently conducting investigations and finding that out only through Madoff, who used that against them, repeatedly not sending documents for third-party verification of transactions that Madoff made or supposedly made, because they believed that the volumes of documents they would get back would be too voluminous for them to review.

Now, it does not take a fraud investigator or a rocket scientist to figure out that verifying information with third parties is necessary to find out if someone's veracity is legitimate or not. It is pretty amazing to me. I am a lawyer by training, but I do not even think it takes a lawyer to understand that third-party veracity is important.

So my question is: Who is held accountable for this grossly incompetent performance?

Mr. KOTZ. Well, I think the entire SEC should be held accountable for what happened. Clearly, there are systemic problems, and for that reason we are having reports with recommendations to deal with the systemic issues. I also recommend that my report be shared, to the extent that there are current SEC employees who are still here, with the supervisors of those SEC employees to make a determination on an employee-by-employee basis about what to do about those specific situations.

Senator MENENDEZ. How many people who worked at the SEC made mistakes in the course of these five severely botched investigations?

Mr. KOTZ. I would say over 20.

Senator MENENDEZ. Over 20. And of those 20 people, to your knowledge, how many have been fired because of this gross incompetence?

Mr. KOTZ. Well, I do not believe anybody has been fired specifically related to this investigation report.

Senator MENENDEZ. Well, I have to tell you, it seems to me that you could not run a company and you cannot conduct a Government service in which you have gross incompetence and those people are allowed to stay at their jobs. So we will look forward to seeing what the SEC is going to do here, because the first thing you have to do is clean house. If there is a culture of incompetence, you have to change that culture, at the end of the day.

You know, it seems to me—let me ask you, when the 2005 investigation revealed that Madoff misled the SEC about the strategy he used for customer accounts, withheld information about the accounts and violated SEC rules by operating as an unregistered investment adviser, why didn't the SEC use its subpoena power to collect information from both Madoff and independent third parties rather than just rely on Madoff's work?

Mr. KOTZ. Well, the information that we received from the investigators who handled the matter was that Madoff responded to their document request. They would ask for documents; he would produce documents. So at least in the enforcement investigation, they did not feel subpoena power was necessary.

The truth is they could have gone to the independent third parties without subpoenas. The SEC certainly has the ability to get records from NASD, now FINRA. The SEC oversees them, and the SEC can get DTC records as well. When we did our investigation, we went to DTC, we asked them for records, they provided them. It was no problem.

So there was no question that they could have received the information, even without a subpoena.

Senator MENENDEZ. So it was not a denial of information. It was their gross incompetence in even pursuing the information.

Mr. KOTZ. Right. They never asked for the right information. They never either asked for it in the first place or followed through on their requests.

Senator MENENDEZ. Now, Mr. Kotz, I understand you were not the Inspector General during this period of time, so let me preface my question there. I appreciate the work you have done here. But who at the SEC is responsible for overseeing that investigations are done properly and that leads are followed up on?

Mr. KOTZ. Well, I would say the heads of the Enforcement Division are responsible for ensuring that investigations within that Division are conducted appropriately.

Senator MENENDEZ. And I agree with you. But didn't we Inspector Generals of the department during this period of time? Where were they?

Mr. KOTZ. There was an Inspector General who came in prior to me, yes.

Senator MENENDEZ. And where were they?

Mr. KOTZ. Well——

Senator MENENDEZ. I mean, we had a 16-year period here from 1992 to 2008. Where was the Inspector General?

Mr. KOTZ. There was no complaint ever brought to the Inspector General's attention. I mean, no one ever brought any complaint to the Inspector General. The Inspector General's office was not aware of any issue. And, in fact, an Office of Inspector General cannot go out and do a Ponzi scheme investigation.

Senator MENENDEZ. So you have reviewed this, and in the 16 years there was not one complaint at the Inspector General's office about what Madoff was doing?

Mr. KOTZ. That is correct.

Senator MENENDEZ. OK. That is critically important.

Let me ask you one last question. Isn't it something to consider that an effective and objective audit of Madoff would have quickly revealed his scheme? Since Madoff's Funds was non-public, he was not required to have an audit from the PCAOB. Doesn't this scandal show the need to more closely monitor private firms as well as public companies?

Mr. KOTZ. I think that that is correct. I think that that would have assisted in this process. To the extent the SEC did not catch it, you would have had another avenue to catch it. So I agree with that.

Senator MENENDEZ. And one final question. In your opinion, based upon what you have found in terms of this incompetence and negligence here—those are my words, not yours, but certainly I believe they are incompetent and negligent—should other SEC investigations be reopened based on the incompetence in this case?

Mr. KOTZ. Well, if there is certainly information leading them to believe that the same circumstances occurred, then I would say yes.

Senator MENENDEZ. Thank you very much.

We stand in recess until the call of the Chair. Thank you.

[Recess.]

STATEMENT OF SENATOR CHARLES E. SCHUMER

Senator SCHUMER. [Presiding.] The hearing will come to order. Senator Dodd had another pressing engagement, so he asked me to chair the second part of this hearing. So what we are going to do, since I am the last questioner of the Inspector General, I will give a brief opening statement, ask the Inspector General a few questions, and then we will get right along to the second panel. Oh, there will be one other person coming back to ask questions when I am finished.

So first, Inspector General, I want to thank you for testifying and conducting this investigation of the SEC's failure to ferret out Bernie Madoff's decades-long fraud. With everything we already know about the scope and the scale of Madoff's fraud, I was still stunned by the details of your report. In fact, I am starting to believe the only thing more amazing than the size of his Ponzi scheme was the failure of the SEC to catch him. Like the old saying goes, the SEC apparently couldn't hit the broad side of a barn if you gave them a shotgun and directions. And, in fact, we will see later from Mr. Markopolos, I read what he sent to the SEC. It was almost like color-by-numbers. All they had to do was take the No. 6 pencil and

color in the No. 6 little lines and they would have found the whole thing. It is just utterly amazing.

As you absolutely made clear, there were so many warnings and inconsistencies, you would think the Madoff file would have been one giant red flag. And yet time and time again, tips were ignored, inquiries were waylaid. He was able to bully the agency into submission before full investigations were even started. Just breathtaking.

And I worry not only about the SEC's ability to catch the next swindler, but also about its ability to do its most basic job, which is to oversee the capital markets. One thing that has become clear to me is that as our markets have evolved, the SEC has simply not kept pace. While the financial world has only gotten more and more sophisticated, the agency has at best stood still, if not gone backward in terms of staffing, resources, and sophistication.

I have great confidence in the work of Chairman Schapiro and the changes she is trying to bring to the agency, but frankly, the SEC is outgunned. The SEC staff of 3,650 oversees 35,000 entities. The sheriff of Wall Street is trying to police a town full of Howitzers with a six-shooter.

The SEC clearly needs more resources, but it is only one of two financial regulators that must go begging to Congress every year for appropriations, even though it brings millions more in fees than Congress allows it to spend. This leaves the SEC without a stable source of funding that would allow them to invest in the personnel and technology they need to keep pace with the markets they are supposed to police.

That is why I plan to introduce legislation allowing the SEC to keep all of the transaction and registration fees it collects from public companies so it can attract and retain the kind of expertise required to catch sophisticated thieves and invest in the technology required to monitor today's rapidly expanding and increasingly complex markets.

The bottom line is, while the SEC may need new laws and new tools, they had all the laws necessary on the books to catch Madoff. They didn't have the personnel, the expertise, the sophistication, the organization. They need better people, more of them, better paid, and people who are paid enough that they stay a long period of time, they don't just come for 3 years and then leave and go to a hedge fund, because a lot of this is simple experience and the SEC people didn't have it.

Now, I have a few quick questions for you, because I know my colleague, Jeff Merkley, has been waiting patiently, and he always is very patient, but very good. So let me ask you these questions.

First, if you had to assign a letter grade to the SEC for its performance in the six Madoff investigations, what would it be, from A to F?

Mr. KOTZ. F.

Senator SCHUMER. If you could go lower, would you give them a lower grade than that?

Mr. KOTZ. Perhaps.

Senator SCHUMER. Yes, F and left back, or I don't know what. OK.

Your report highlights the inexperience and lack of resources as important causes of the SEC's failures in this case. So would you support the concept—I am not asking you the language, but the concept of the bill I plan to introduce that would result in millions more dollars in funding for the SEC by allowing the fees to go directly to funding the SEC as it used to be and would allow them to invest in better and more qualified personnel?

Mr. KOTZ. Well, I think, certainly, resources was something that we saw that had an impact in the different examinations and investigations that were conducted. For example, in one of the major examinations, there was no branch chief on the exam. So the junior examiners were left kind of to their own devices, didn't get enough support. That was because they didn't have an available person. Another examination was moving forward, making some progress, and they decided to put it on the back burner in favor of another matter. That was an issue, also, that relates to resources.

The limited focus decisions perhaps also relate to resources in that they decided that they had the manpower to look at a discrete issue rather than looking at larger issues. There was the request for documents, but they were concerned with obtaining mountains of documents which they didn't feel they had resources to look at. So there is no question that there were aspects of what I found that relates to a lack of resources.

Senator SCHUMER. All right. Senator Merkley?

Senator MERKLEY. Thank you very much, Mr. Chair, and thank you for your testimony.

Earlier this year, we had the chance to take a little bit of a look at this and it is nice to revisit now with your report. Your report emphasizes very starkly the number of investigations over a span of 16 years, six investigations, and the fact that there were both sophisticated and very straightforward measures that should have caused a real interest on the part of the SEC.

On the sophisticated side, we have this extraordinary report from Mr. Markopolos with 29 red flags. I read this earlier this year and I asked the question of another SEC member, how often do you get such a sophisticated critique as opposed to just a simple tip that maybe there is something wrong somewhere? So I want to ask you the same question. Is this quite an unusual document, for someone to lay out such a sophisticated analysis of a firm and 29 red flags?

Mr. KOTZ. We asked that question to many people in our investigation and the answer was almost uniform. It was very unusual. There were people who told us, even people who dealt with complaints directly who had never seen such a detailed complaint.

Senator MERKLEY. So on the one hand, we have this very sophisticated point, and then we have many people with simpler observations, that there was no evidence of counterparties, that a standard consistent return on a hedge fund doesn't match the experience of any hedge fund anywhere under the sun, under varying market conditions, that there wasn't evidence of corresponding trades, *et cetera, et cetera,* and so forth, just very simple.

So I look at this and I think even a novice investigator—even a novice investigator seeing such a sophisticated report on the one hand, or simple, basic, how can this possibly square, ought to be intrigued and say there is something here to look after. I just sim-

ply can't accept that it is simply a case of inexperience or a case of resources. Was there a general culture of lack of curiosity, lack of wanting to inconvenience big players, a lack of reward to investigators who had hard-hitting investigations? Did it damage their career paths? What are the managerial issues? I really didn't see in your report any kind of real sign of the culture that generated such failure.

Mr. KOTZ. There was certainly concern about the focus being on finishing the investigation and moving on to the next matter, and so for that reason, they didn't want necessarily to look at the larger issues. They would stick to the more limited issues, which were easier to deal with, which were resolved quickly.

We were surprised, as well, that the enforcement investigators simply didn't understand how unusual Madoff's investments were, and they asked Madoff in the testimony how—he said that he had an amazing gut feel for the market. His gut feel was based on standing on the trading floor. He could feel when the market would move. And Madoff was able—he had perfect timing. He was able to get in and out every day in nearly the exact right point. And we asked them, how did you believe Madoff's explanation, and they simply didn't understand that it was so unusual to have such consistent returns over a long period of time that no one else was able to duplicate.

Senator MERKLEY. Does this raise serious questions about the type of training that the investigators receive?

Mr. KOTZ. Yes. I think, absolutely, and that is one of the things, I think, that Enforcement is now looking to change. I think in the past, the SEC Enforcement lawyers were generalists. They were very smart, hard-working individuals, but they didn't have a particular specialized experience in an area, and I don't think that in this case that was sufficient. You could be a very smart person, but if you don't understand options or trading, you are not capable of doing that type of investigation.

So I think that there is a move toward specialization, which will allow people who really understand how to operate a case, to take an investigation. One of our recommendations that we are considering is to require at least a certain number of individuals on every investigation that had done a Ponzi scheme investigation before. None of the people in the enforcement investigation had ever done a Ponzi scheme. None of them really knew how to do a Ponzi scheme. You cannot do a Ponzi scheme investigation without understanding how to do it. Just being a smart person who is a generalist, I don't think is sufficient.

Senator MERKLEY. How could, in the face of such a comprehensive report like Mr. Markopolos compiled, how could the investigative team not include an experienced investigator who would have knowledge of Ponzi schemes?

Mr. KOTZ. That is a very good question. At no point in time was there anybody on the case who had done a Ponzi scheme investigation before. At no point in time did they go and sit down and say, let us see, how does one do a Ponzi scheme investigation? If we don't know, because we haven't had experience, let us go to our many colleagues who know. They didn't. They didn't know the in-

formation that was needed and they didn't seek out that information from others in order to know it themselves.

Senator MERKLEY. Did you happen to ask the investigators an awkward question, but the awkward question would be along this line. Were you concerned that if you pushed and prodded, that complaints would be made to your superiors and your career might be damaged?

Mr. KOTZ. We did ask those questions to all the major players in all the examinations and investigations and they said no. We did not find that they were concerned that they would attack Bernie Madoff or make allegations of Bernie Madoff and their careers would be affected. I think there are some Enforcement lawyers who would like to bring a case against somebody like Bernie Madoff. But they simply didn't have the skills to be able to match up with him.

Senator MERKLEY. Did the SEC routinely bring in consultants, folks who might have a career knowledge, sophisticated knowledge, to come in for 2 hours to review a case or provide advice or direction or any type of assistance?

Mr. KOTZ. We weren't aware of that happening in the course of these examinations and investigations, and when we spoke to folks from the outside, they said they would be willing to do it, if asked. And that is one of the areas that we are looking at toward recommendations, to encourage private sector folks to explain to the SEC individuals how to go about and conduct this due diligence.

Senator MERKLEY. The investigations occurred over this 16-year period, so that is an extensive length of time with many, many different folks involved, and so I don't direct this toward any one individual, but we did have from 2005 to 2008 Christopher Cox, who had this management philosophy of light-touch regulation. Was there any sort of equivalent in the investigative branch of being kind of light-touch investigators for fear of, I don't know, discouraging, inappropriately interfering with firms, or so on and so forth?

Mr. KOTZ. I didn't find that that was happening, at least in connection with the Madoff investigations and examinations.

Senator MERKLEY. Well, I appreciate your report very much and the series of recommendations. I am not completely satisfied, because there has to be a factor of a culture of management that affects what type of investigators you hire, whether you hire consultants, whether you press folks to really get to the bottom, whether you ask common-sense questions about what seems out of sync, whether there are mentors in the department you can consult with, *et cetera.* I just feel like if we are going to have a very successful team in the future, that management philosophy is going to be critical to putting us back on track.

Mr. KOTZ. Yes, I agree with that. Absolutely.

Senator SCHUMER. Thank you, Senator Merkley. Thank you, Mr. Kotz.

We are now going to call our next panel forward, Harry Markopolos, John Walsh, Robert Khuzami. Please come forward.

[Pause.]

Senator SCHUMER. OK. Let us get started. I know that Senator Dodd has already introduced the witnesses, so we are not going to do that again. Each of you has a limit, Mr. Markopolos—seven, Mr.

Walsh and Mr. Khuzami—five each. Please, so we have some time for questions, try to keep your statements within those limits. There is a little clock up there. Your entire statement will be read into the record, so it will be part of the record.

Mr. Markopolos, you may begin.

STATEMENT OF HARRY MARKOPOLOS, CHARTERED FINANCIAL ANALYST AND CERTIFIED FRAUD EXAMINER

Mr. MARKOPOLOS. Thank you, Mr. Chairman. Thank you, Ranking Member. Thank you, Members of the Committee.

I was responsible for approximately one-third of the Inspector General's 477-page report, either directly or indirectly, so I can speak to that one-third of the report. I did submit three different complaints to the SEC in May of 2000, March of 2001, and in the fall of 2005.

If the Inspector General's report was falsified, inaccurate, or a whitewash, I would be denouncing it before you today. But I find this report to be extremely accurate, exceptionally well written, phenomenally well researched. It is very comprehensive. It is hard hitting. It gets right to the fact of the matter. In a nutshell, the SEC staff was not capable of finding ice cream at a Dairy Queen.

But I never at any point in time saw any criminal activity by any member of the Securities and Exchange Commission. I do not believe that such criminal activity occurred. I know that the Inspector General was very comprehensive in his investigation. He went down all avenues. He was looking—he was asking pointed questions, asking if there was any inappropriate behavior by SEC staff at the highest levels of the organization, at the lowest levels of the organization, mainly at the teams and branch chief levels, and at all levels in between, and he never determined that such activity occurred. I suspect that he would have found it. He was digging as hard as he could.

Certainly, it would have been far less damaging to the reputation of the SEC if criminal activity had been found and it could blame one or two bad apples in the bunch and say it was their fault and they were going to prison. They were trying very hard to make that criminal case. I do not believe that such a case existed. They certainly never found one. I doubt that there was any criminal activity.

The report was so well done. The Inspector General went down every avenue. And when you do an investigation, you have to go down every avenue, and most of those will be dead ends. This was a typical investigation except that it was exceptionally well performed and I commend it to you. It is great reading. For the victims out there, and I know you are watching, you definitely want to read all 477 pages. It is hard hitting. It is like watching a train wreck in slow motion from 477 different angles and it has the same tragic ending on each page.

It is unbelievable. Sadly, it is true. It is a true report. Keep in mind that the Madoff case was the "Twilight Zone" of all fraud cases. There was nothing about this case that was ever believable. The scope—Mr. Madoff was in 40 different countries. He had over 339 fund of funds feeding him in new victims. Over 59 different management companies were involved with Mr. Madoff, in over 40

nations. He had a lot of help. This is perhaps the biggest international conspiracy of modern times. It is a record-breaker of cases.

I think it shows that the SEC is currently not functional at present, but they are on the right track. The SEC prior to December 11 was not in the fight versus fraudsters. Fraudsters are winning on all fronts. They are winning the battle. None of this Nation's financial regulators did their jobs. Basically, our financial regulators—all of them—stole their paychecks from the taxpayers.

White collar fraud is a cancer on this Nation's soul. It is the white collar fraudsters that cause the most damage. It is not the violent criminals. It is not the bank robbers. It is not the armed robbers. It is not the drug dealers. It is the white collar fraudsters. They have the best resumes. They went to the best schools, live in the nicest homes, in the finest neighborhoods. And yet they cause the most damage. They are the ones that bankrupt our companies, destroy pensions, destroy life savings of victims.

And let me tell you how this report affected me personally. I had lost faith in all government prior to December 11, and it wasn't until I met Mr. Kotz and saw the investigation that he underwent that restored my faith. Mr. Kotz and the entire Inspector General's team reaffirmed my faith in government. This hard-hitting report is as honest as the day is long. It is a great report.

I have three young sons, all aged six or under, at home watching today. And when they grow up, I hope that they will turn out to be like David Kotz. That is how much I think of the Inspector General. It is a hard-hitting report. I don't think there has ever been a finer report released. I commend it to everybody.

I want to thank Mary Schapiro for her moral courage and leadership in allowing this report to be written and released to the public, knowing how damaging it would be to the reputation of the SEC. But before you can recover, you have to hit rock bottom, and I think this report takes the SEC to rock bottom. But they have made tremendous improvements since February 4, and I have seen a lot of those improvements. I am impressed.

The pace of reform at the SEC, it is certainly not taking place at the speed of government. Mary Schapiro likes to tell her staff that she wants them to act like her hair is on fire. I think she actually misstates the case. I think she has been on fire lately. The pace of reforms is rapid, but it needs to keep that same pace going forward. The job is far from done. You have to crawl before you can walk, and you have to walk before you can run. And right now, the SEC is learning how to crawl all over again.

They are heading in the right direction. They have probably been out of the fraud fight for about two decades and they need to get back into the fight. Thank you, Mr. Chairman.

Senator SCHUMER. Thank you, Mr. Markopolos, not just for your testimony, but for your persistence and courage. I think when the chapters are written on how this happened and how it is corrected, you deservedly will play a large and stellar role.

Mr. Walsh.

STATEMENT OF JOHN WALSH, ACTING DIRECTOR, OFFICE OF COMPLIANCE INSPECTIONS AND EXAMINATIONS, SECURITIES AND EXCHANGE COMMISSION

Mr. WALSH. Chairman Dodd, Ranking Member Shelby, Senator Schumer, and Members of the Committee, I appreciate the opportunity to appear before the Committee today to testify on behalf of the Securities and Exchange Commission. My name is John Walsh and I am the Acting Director of the Office of Compliance Inspections and Examinations at the SEC.

First, let me say without qualification that we all sincerely regret that we did not detect the Madoff fraud. As I believe I speak here for everyone in the Examination program, we view the Madoff case as a terribly unfortunate example of what happens when we fail in our mission. The type of fraud perpetrated by Mr. Madoff is the kind of misconduct we spend our days trying to uncover. That is why we feel the way we do, and that is why we are working so diligently to address the problems that contributed to this failure.

Let me assure you, we have not been sitting idly by awaiting the Inspector General's report. Indeed, from the time that we first learned of Madoff's fraud, we have been working hard to revamp the way that we operate. Since being appointed Acting Director last month, my most important goal has been to continue to reshape the Examination program.

For example, we are actively recruiting staff with specialized industry experience. We are enhancing our training programs, including widespread participation in outside courses, such as the Certified Fraud Examiner Program. We are requiring examiners to routinely reach out to counterparties, custodians, and customers to verify that assets actually exist. We are integrating broker-dealer and investment adviser examinations to make sure that the right expertise is being deployed in every examination. We are considering new risk assessment techniques to more proactively identify areas of risk to investors. We are ensuring that examiners know they have management's support as they follow the facts, wherever the facts lead.

But we know more can be done. So like others in the agency, we are carefully studying the Inspector General's report and will continue to do so. The report shows that some examiners asked the right questions, but it also shows we did not pursue all the answers. The report shows that some examiners were moving forward on the right path, but we did not take all necessary steps. To put it bluntly, the report shows that we simply didn't do what we needed to do and investors have suffered.

Going forward, you have our commitment that we will continue to learn from our mistakes and we will continue to assess how we can improve our examinations. Thank you.

Senator SCHUMER. Thank you, Mr. Walsh, for your candor.

Mr. Khuzami.

STATEMENT OF ROBERT KHUZAMI, DIRECTOR, DIVISION OF ENFORCEMENT, SECURITIES AND EXCHANGE COMMISSION

Mr. KHUZAMI. Chairman Dodd, Ranking Member Shelby, Members of the Committee, thank you for this opportunity to testify on behalf of the Securities and Exchange Commission.

Having read the Inspector General's report and its litany of missed opportunities, it is clear that no one can or should defend, excuse, or deflect responsibility for the SEC's handling of the Madoff matter. Simply stated, in this case, we failed in our fundamental mission to protect investors and we must continue vigorously to reform the way we operate.

We have read the letters from harmed investors that were filed with the court in connection with Madoff's sentencing. It is a sobering and humbling experience. I am here to commit to you and to investors across the country that we will carefully study the findings of the Inspector General's report and any forthcoming audits and that we will implement the changes necessary to strengthen our Enforcement and Examinations Program.

I am also here to personally pledge my unwavering commitment and unconditional efforts toward revitalizing the Enforcement Division and firmly reestablishing the trust and respect of the investors whom we are charged to protect. I know that my colleagues from the Office of Compliance Inspections and Examinations share this commitment.

As you may know, even before the Inspector General's report was issued, this agency had already begun to institute extensive reforms. These include hiring additional staff with expertise, streamlining its management, expanding training, restructuring our processes to better share information, leveraging the knowledge of third parties, eliminating unnecessary process and procedure, and revamping the way we handle the hundreds and thousands of tips and complaints and referrals that we receive each year.

Despite these changes, we recognize that more needs to be done. We intend to learn every lesson we can to help buildupon the reforms we have already put into place.

With respect to the Division of Enforcement, almost immediately after beginning my tenure as Director of the Division on March 30 of this year, I, together with other Enforcement staff, commenced a top-to-bottom self-assessment of our operations. The marching orders were, think creatively and there are no sacred cows. That self-assessment resulted in numerous changes we are now implementing. Collectively, they have been described as the biggest reorganization in at least three decades of the Division of Enforcement.

These changes, which will begin to address some of the issues raised by the Inspector General, include creating five specialized investigative units, national in scope, where we will combine expertise, training, and industry and investigative know-how to conduct smarter and more proactive investigations.

To reduce management levels by almost 40 percent and deploy those experienced investigators back full-time to the critical work of conducting front-line investigations.

And establishing an Office of Market Intelligence, a single unit within the Enforcement Division armed with enhanced technology where we will collect, analyze, prioritize, and monitor the more than 700,000 tips and complaints the agency receives annually.

Over the past year, the criticisms surrounding the SEC in the Madoff fraud has been sharp and steady. We have taken the lessons to heart and we are in the process of implementing a far-reaching program of change and improvement. There has been no

complacency. It is not business as usual. There is an institution-wide commitment to heightened levels of tenacity and professionalism.

Criticism of the SEC arising from the Madoff fraud, however, should not obscure the 75-year tradition of vigorous enforcement resulting from the dedicated efforts of thousands of public servants who work tirelessly every day, and with impressive results, to protect the investing public. These staff members continue to vigorously investigate wide ranges of activities, cases relating to the credit crisis, market abuse, accounting and financial fraud, structured products, and fraud involving hedge funds and investment advisors.

To take just one example, since Chairman Schapiro took leadership in January, the SEC has filed 45 separate enforcement actions involving Ponzi schemes, substantially more than the same period in 2008.

Our mission is investor protection and the Madoff case serves as a terrible reminder to each of us of the consequences of not getting the job done properly. It is a lesson we will not and should not forget. Our job is to protect investors from wrong-doers and to hold those wrong-doers accountable for their actions.

We recognize that as we hold others accountable, we must also be ready to accept responsibility for our failures. We stand ready to do so. And again, on behalf of the Commission, we pledge our commitment to do everything in our power to regain your confidence and the confidence of the investing public. Thank you for your time.

Senator SCHUMER. Thank you, Mr. Khuzami.

I have a whole bunch of questions here, but first, I just want to ask Mr. Walsh—he was there at the time. Still, when you read Mr. Kotz's report, when you see Mr. Markopolos' complaint, it is just astounding. I mean, this was not just a mistake. This was not just saying we regret it. Even Mr. Khuzami says, "I am not going to mar the 75-year tradition of the agency."

Well, you know, when I got to Congress in 1980, the SEC was one of the premier civil service organizations in the Government, a little like the Justice Department. And, wow, has it gone downhill. It is just amazing. Of course it will mar it.

So my first question—you can speak from, you know, reassociated a little—how the heck did this happen? Markopolos, who is a man of great integrity, says he could not find any fraud. Kotz, who is a man of integrity, says he cannot find any fraud. It was just sheer incompetence. But the incompetence, when you read the IG report, I mean, you did not have to have any training as an investigator to do the kinds of follow-up that might have revealed this to happen. All you had to do was have an IQ of about 100 and even a semi-desire to find out what happened. You did not have to have a burning desire. You did not have to turn over every stone.

So please share with us—because I am still befuddled, and maybe, Mr. Khuzami, because you have had to think about this a lot. Markopolos has spoken on this, and we have his articles and things like that. Just share with us how the heck this happened. Because most people, if they just read what happened, they would say there has got to be fraud. You know, somebody had to delib-

erately do some of these things to let Madoff escape. Now, we have no evidence of that, and it is unfair to leap to that conclusion, and I do not. But I am just totally befuddled. The most rudimentary—in other words, if you sent a 15-year-old, you know, a sophomore in high school, and said here is what is going on, figure out, you know, just follow it through, as a homework assignment, they would know to do some of these things.

Tell me, what was going on here? Was there an attitude that we should not look, you know, this soft touch, whatever it is called, investigating? Just, you know—and I do not cast any shadow on your integrity at all, Mr. Walsh, but just I need to know, we need to know, America needs to know. It is just too confounding to accept an answer, "Well, gee, it was a mistake, a very bad mistake, we are sorry."

By the way—and this will be my next question to all of you. It makes you think there must be 30 more of these, maybe not of the scope of Madoff, but there has got to be more of them. We were in the go-go 2000s. Other people had to be thinking of this. I just read about some Brooklyn Ponzi scheme uncovered yesterday. There must be scores more of these if the investigating ability was so rudimentary and so flawed.

Go ahead, Mr. Walsh.

Mr. WALSH. Well, Senator, I attribute it to two primary causes, and both of these were highlighted by the Inspector General, and I agree with him.

One I think was the failure to obtain third-party verification of the information that Madoff was giving them, and this was very unfortunate.

Senator SCHUMER. Did the SEC fail to get third-party verification routinely on just about everything?

Mr. WALSH. At the time these examinations were done, third-party verification was used as the examiners believed appropriate. We have changed that. We now require third-party verification as a routine part of our examinations. We provided detailed training to examiners to make sure they understand how they——

Senator SCHUMER. Look, I am not asking you how you have corrected it.

Mr. WALSH. Yes, sir.

Senator SCHUMER. I understand that. I am asking, because you have got to know the whole—so there was, almost never, was there third-party verification?

Mr. WALSH. It was done occasionally, but as we saw here, sir, too many people decided it was not needed in their particular examination. So I believe that was the first——

Senator SCHUMER. Would the SEC—you have been there 20 years. Would the SEC, the year you first came in, do more third-party verification than they did in your 18th year?

Mr. WALSH. It is difficult for me to say, to quantify, and to be honest, I am really not sure. Probably we do so much more in 2009 than we have ever done before. It is hard to say, sir. I have only been an examiner for some years, and actually I am the in-house lawyer for the——

Senator SCHUMER. You are trying to catch somebody who might be fraudulent, and you have some allegations, pretty serious ones, like Markopolos——

Mr. WALSH. I can tell you—I am sorry.

Senator SCHUMER. Again, you do not have to be Albert Einstein to figure out you ought to get some third-party verification and not accept the potential defrauder at their word.

Mr. WALSH. Yes, sir, you are absolutely correct.

Senator SCHUMER. Markopolos, what do you think about this?

Mr. MARKOPOLOS. Trained fraud examiners know that you never go to the person that you suspect of a fraud first. You go to that person last.

Senator SCHUMER. Exactly.

Mr. MARKOPOLOS. You go to all the other people in the organization.

Senator SCHUMER. Right.

Mr. MARKOPOLOS. You question them. You build a chain of documents, and you verify everything. And here the examiners found and caught Mr. Madoff in numerous lies, and yet they had no professional——

Senator SCHUMER. Why do you think? It is just befuddling.

Mr. MARKOPOLOS. They had no professional skepticism. They had no formal fraud examination training. And so they took the lies, and they did not dig deeper, and they did not increase the scope of their examination. They did not request more resources. It was a failure of Fraud Examination 101, it was a failure of Audit 101, and it was a failure of Finance 101.

Senator SCHUMER. It almost seems they had an attitude that they did not want to find things. Is that fair to say?

Mr. MARKOPOLOS. They lacked any kind of regulatory zeal. They were not compensated or measured on the quality of the exams or the amount of fraud caught. They were measured and rewarded through promotions basically on the number of exams conducted, which is a meaningless statistic.

Senator SCHUMER. Of course.

Mr. MARKOPOLOS. We should care about the number of frauds caught and the number of frauds that we deterred and the amount of damages that we recovered for an investor, so they were measuring the wrong things and promoting based upon the wrong measurements.

Senator SCHUMER. So you are saying that the basic system of incentives probably was not just neutral, but pushed people away from doing a thorough investigation.

Mr. MARKOPOLOS. That is correct.

Senator SCHUMER. Mr. Khuzami, do you agree with that?

Mr. KHUZAMI. Well, Senator, I guess I would start slightly differently, certainly on the enforcement side. What we know is that, look, the Enforcement Division recently and during the time of these events has brought numerous cases based on vague complaints, based on press articles. The IG testified earlier they did not find any evidence that the investigative folks were lazy or not committed. So we know that the investigators know how to do the job, and there is a long history of cases to underscore that. So the question really for me was this appeared to be, to use an overused

term, a perfect storm; that a confluence of events, including a lack of experience by the individuals, a lack of going to sources of competence to get advice, perhaps some personality conflicts, a lack of rigorous supervision, and a number of other factors meant that—and perhaps Mr. Madoff himself, who, while there was a finding that there was not undue influence, you know, it takes a little while for you to wrap your mind around the fact, I suspect, if you are not careful, that someone like Mr. Madoff may be running a $50 billion Ponzi scheme. There are lots of indicia of legitimacy that he had, from the nature of his institutional investors to his stature to other factors.

So I think, unfortunately—and this was the terrible result—all these factors came together to lead to the conclusion that we missed this. But it was not for reasons that I think you can draw significantly greater lessons across the entire Division.

Senator SCHUMER. I used to watch "Dragnet" when I was a kid. I watch "Law and Order." I mean, I am not an investigator. I know that especially if someone brings up a complaint three or four times, you go check with someone else.

Mr. KHUZAMI. That is correct. And there was consultation that was made——

Senator SCHUMER. No, no, no, but you look for third-party—you go out and——

Mr. KHUZAMI. Absolutely right.

Senator SCHUMER. And they would have caught him cold, right?

Mr. KHUZAMI. Absolutely right, and we do that across whole categories of our investigations. Third-party verification, not just in the investment adviser context, but in every case.

Senator SCHUMER. You are a starting policeman in the investigator's unit. You know to do third-party verification.

Mr. KHUZAMI. That is correct.

Mr. WALSH. Yes, sir, I agree, with examinations as well, and we are emphasizing that very strongly to make sure people do that.

Senator SCHUMER. So let me ask all three of you: It seems to me almost a certainty, given how bad things were with Madoff, that there are probably other Ponzi schemes—I do not know how large—that they have not uncovered yet. What do you have to say about that? Markopolos first.

Mr. MARKOPOLOS. Certainly, there are. There is always fraud present. The fraudsters are very smart. This past year helped collapse a lot of the Ponzi schemes because you always need new money coming in, and investors are very gun-shy these days, and rightly so. So we are seeing a lot more of them collapse, and that is why you are reading about so many. So I am sure there are more out there and more fraudsters to be caught.

Senator SCHUMER. Would you guys agree—Walsh, Khuzami—that there are probably more?

Mr. WALSH. We are actively looking for more. We have gone out very vigorously and conducted examinations of entities that have——

Senator SCHUMER. I take it there is third-party verification now.

Mr. WALSH. Yes, sir, absolutely.

Senator SCHUMER. And do you think there are more?

Mr. WALSH. We have actually encountered problems. We have referred some to the Division of Enforcement for further action.

Senator SCHUMER. What do you think the likelihood is there are more?

Mr. WALSH. We are looking for them, yes, sir.

Senator SCHUMER. Mr. Khuzami?

Mr. KHUZAMI. There is always more, Senator.

Senator SCHUMER. Would any of them be, you know, in the billion or tens of—you know, Madoff was $50 billion. Stanford was, what, $8 to $10 billion or something?

Mr. KHUZAMI. That is correct.

Senator SCHUMER. Could they be in the billion-dollar range, or those would have been uncovered already?

Mr. KHUZAMI. There is no guarantee that there is not, but I agree with Mr. Markopolos that the economic cycle has shaken out a lot of the schemes that would otherwise exist, and that is why we have been able to bring, along with concerted effort, 45 this year alone.

Senator SCHUMER. Right. The other thing that worries me related to this is, you know, with new technology and increasingly dark markets, it is harder to uncover some of these things, and it makes it more difficult. Do you agree with that? Do all of you agree that it would be more difficult given we have less transparency in the markets these days rather than more?

Mr. KHUZAMI. Absolutely right, Senator. More complex products and less transparency equals a greater possibility of fraud and wrongdoing.

Senator SCHUMER. And it would be one of the arguments, at least from the fraud point of view, that we ought to lighten up these dark markets, or at least shine some light into them, right?

Mr. KHUZAMI. I think that is correct.

Senator SCHUMER. Do you agree, Mr. Walsh?

Mr. WALSH. Yes, sir, absolutely.

Senator SCHUMER. Mr. Markopolos?

Mr. MARKOPOLOS. The cockroaches always head for the dark rooms. We need to shed light in there.

Senator SCHUMER. My father was an exterminator, so I may not be an investigator.

[Laughter.]

Senator SCHUMER. But I know that much.

OK. Now, let me ask you this. I mean, Markopolos has mentioned, as has Mr. Kotz, some of the skills, the skills an investigator needs. Do the personnel at the SEC have those skills?

Mr. KHUZAMI. Senator, they either have the skills, they have the capacity to develop them, and together with some of the reforms that we have undertaken, we will get to the place that we need to be in order to be ready to fulfill our mission.

Senator SCHUMER. Are you able and willing to fire people who just are not up to the job?

Mr. KHUZAMI. Well, Senator, there are various restrictions on what we are able to do in that regard, but we can get to where we need to be through a variety of methods. We, for example, are creating specialized units which will really, through repeated investigations of the same nature, additional training, and hiring spe-

cialists who are focused in these areas, go a long way toward creating the kind of expertise that we need.

Senator SCHUMER. All right. One example. SEC has a lot of lawyers, sort of lawyer-heavy. I think in the Division of Enforcement most of the people are general litigators. I am a lawyer. Being a lawyer does not necessarily make you good with numbers, and that is what you need to know to figure these things out.

So my question—and this is to Mr. Khuzami and Mr. Walsh: Who in the Enforcement or Compliance Inspections Divisions has the ability to do the necessary analysis and forensic accounting investigations in this world of very complex structured products, quantitative trading, and a lot of it hidden? You know, not hidden for a nefarious purpose. They do not like their trades to be revealed. What percentage of people at the Enforcement and Compliance Divisions have real experience working in the markets, trading these products, making quantitative models, developing trading technology systems, versus, say, the percentage of people who are lawyers?

Mr. KHUZAMI. Well, look, Senator, we are clearly not where we need to be in terms of the acquisition of individuals with some of those skills. That is why these specialized units and the additional hiring will help very much. We are not going to get to a point in the near future where large numbers of our staff have the kind of skills that you are talking about. But that does not mean we will be handicapped by any means, because what you really need is centers of competence, places where people know they can go to get the advice and the expertise that they need. And that can exist within the Division of Enforcement, that can exist in the sister divisions of the agency, and that can exist through training programs.

So while my hiring goals may not allow me to have the kind of——

Senator SCHUMER. How many new people have you hired since you have come in?

Mr. KHUZAMI. Well, we received a re-appropriation that allowed us to hire approximately 25 in 2009, and we have——

Senator SCHUMER. I helped get you that appropriation.

Mr. KHUZAMI. You did, and we are very thankful for that, Senator.

Senator SCHUMER. Yes, but it is not close to enough.

Mr. KHUZAMI. I agree. I agree. We have additional requests for fiscal year 2010 and a significant request for 2011.

Senator SCHUMER. What do you think of the proposal, all three of you, that I made, which is that the SEC should be able to use the fees that it gets—registration, and other things? I mean, right now it is about $1.5 billion and they only get about $800 million of it.

Mr. KHUZAMI. Senator, I think from my perspective, it is a very good idea, not only for the amount of the funding but for the predictability of it. We cannot even budget long term for certain kinds of projects that—we cannot go into the out-years because we do not know for certain whether or not the funds will be there. So things like IT budgets, which by definition are long-term projects, suffer.

Senator SCHUMER. Right. And I suppose even personnel. If personnel knows there is going to be a growing revenue stream and they are likely, if they are good, to be promoted, get salary increases, they will stay longer. Because isn't one of your problems lack of experience?

Mr. KHUZAMI. That is correct, and also being able to react quickly. Some of the banking regulators can hire immediately when they are facing an imminent crisis. They can bring large numbers of people on with specialties. We cannot do that.

Senator SCHUMER. Well, they are funded the way—we would not have to get you this special little appropriation for a smaller number of people.

What do you have to say about those kind of funding things, Markopolos?

Mr. MARKOPOLOS. I definitely concur. You need to increase the funding in the industry, and I was a member of the industry for 17 years. We paid those SEC fees. And yet the money was diverted to the general Treasury and it was not diverted——

Senator SCHUMER. So you would support the proposal I made.

Mr. MARKOPOLOS. I support it 100 percent. Thank you.

Senator SCHUMER. How about you, Mr. Walsh?

Mr. WALSH. Absolutely. We are seeking to attract greater expertise to the program, hiring more senior staff who can come in from the industry and bring their knowledge with them. And I believe the proposal you are suggesting, sir, would really help us do that.

Senator SCHUMER. Right. You know, on tapes that were revealed by the media today, here is what Madoff said when he coached his employees who were coming in. You may have heard this. It came out today. He said to those who were going to be interviewed by the SEC, "You do not have to be too brilliant with these guys"—this is his quote—"because you know they work for 5 years at the Commission, then they become a compliance manager at a hedge fund now." That is the problem. They are there a short time, and then they go away.

Do you agree with—I mean, Madoff's analysis, as crooked as he was, was correct in this area. Right?

Mr. KHUZAMI. Certainly, we would like to retain our best talent for as long as we can. You know, turnover is not always a bad thing. As you may know, Senator, I——

Senator SCHUMER. It depends who turns over.

Mr. KHUZAMI. It depends on who turns over. I worked in an office as a prosecutor where turnover was in the 5- to 7-year range, but it did not stop it from being one of the premier law enforcement offices in the country.

Senator SCHUMER. All right. Well, I was glad one of the people turned over in your office and came and worked for me.

Mr. Walsh, is turnover greater today than it was 20 years ago at the SEC when you started?

Mr. WALSH. Turnover has gone up and down, usually because of what is happening out in the marketplace. We have had a period of time where it has been relatively low. I think——

Senator SCHUMER. Since the market crashed.

Mr. WALSH. Yes, sir.

Senator SCHUMER. But before that, was it up higher than it——

Mr. WALSH. Yes, it was much higher, and we also have the same problem my colleague has described, that hanging onto the people we want to keep, it is always a challenge.

Senator SCHUMER. OK. Let us see here. I have a few more questions, but Senator Merkley has been waiting patiently, so I am going to reserve a second round for me and turn it over to Senator Merkley.

Senator MERKLEY. Thank you very much, Mr. Chair.

I want to start, Mr. Markopolos, you said that your three sons were watching at home. I just want them to know what a courageous thing you did in reporting your belief that there was fraud at this firm. When I first read your 29 red flags report, you began it by asking for confidentiality, very limited circulation of who you were because of concerns for your safety and the safety of your family, and I think when you are taking on a multi-billion-dollar enterprise, those concerns were very legitimate, but you put the interest of our nation and our finances first, took some personal risk, and I applaud you for it.

Mr. MARKOPOLOS. Thank you, Senator.

Senator MERKLEY. I keep coming back to try and understand the cultural factor, because I simply can't believe that the capable folks coming out of—even if they came relatively freshly out of college—weren't able to see the basic, simple elements involved. And sometimes one gives the benefit of the doubt, and in some cases, one gives a massive benefit of the doubt, and there are cultural factors as to why that occurs.

I want to get some sense, is there any kind of regular socializing that goes on between the SEC team and the financial world where people know each other, know each other individually, are invited to parties, are invited to go to see shows together? Do invitations come from the financial community to the investigators? Is there any kind of that kind of mixing that makes people more friends than adversaries?

Mr. WALSH. Sir, we are very concerned about excessive fraternization because we feel it could create a conflict of interest and dull people's judgment and the vigor of their work. We have ethical rules where if someone wants to socialize, it must be a widely attended gathering. They should come in for ethics approval in advance. We take that very seriously. So I would hope that if there is that level of fraternization that a conflict of interest has arisen, someone who was engaging in that will certainly be recused from any future work relating to that firm.

Senator MERKLEY. So the industry doesn't invite people to conferences in Hawaii?

Mr. WALSH. Well, they do invite people to conferences and they can be very valuable for gathering intelligence and picking up on risks and trends and sometimes just the chatter in the background in the industry. But again, that goes through a very careful review and approval process to makes sure that the people that go to those conferences don't suffer from conflicts of interest while they are there.

Senator MERKLEY. Does anyone else want to comment on that?

Mr. KHUZAMI. Well, it is perhaps less of a problem in enforcement, because we by definition have an adversarial or potentially

adversarial relationships with the institutions and individuals that we regulate. On the other hand, there is some value in that kind of outreach and participation because we are able to inform the investing community and the institutions of what we think is wrong and where we think they should clean up their act. And as long as you maintain a proper distance, I think those kind of arrangements can be beneficial.

Mr. MARKOPOLOS. I would definitely like to comment. I don't think the SEC staff is out there enough with industry professionals at the conferences. They do not allow time off for staff members to attend security analyst meetings, to attend Economic Club meetings, to attend CPA Society meetings. They need to get out there and mingle with industry participants. And they also need to have something very simple that I carry with me, a business card, and the SEC doesn't even provide their own staff with business cards.

So how are you going to get a fraud referral if you go to an industry event, which they typically don't go anyway? How are you going to find out what is going on if you are not out there? And how are you going to be educated upon the new products that are coming out every day, every week, every month, if you are not attending industry events, and they typically do not fund those or allow the time off.

So I think they need to get out there more. You don't need to fraternize. That would be bad. But you need to at least show up, and they don't even show up.

Senator MERKLEY. Is that something you are all taking a look at, in terms of staying up with understanding these exotic financial vehicles and so forth?

Mr. KHUZAMI. Certainly. In terms of training and education, absolutely right. Through our specialization efforts and through enhanced training, we are clearly moving in the direction of acquiring greater knowledge and greater exposure in those areas.

Mr. WALSH. Yes, sir, I would agree.

Senator MERKLEY. Another challenge, and I think it was referred to by Senator Schumer, is that folks might come to your organization looking down the road and seeing the possibility of much higher-paying jobs in private industry, the same industry that they are regulating. Is the revolving door and the potential for much better remuneration down the road a problem in folks not wanting to be kind of too hard hitting in their investigations or offending key power brokers in the industry?

Mr. KHUZAMI. Senator, this is an issue that came up when I was with the Department of Justice and continues to come up now. My general view is, if you want to attract good talent, then there is always that risk. There is no getting away from it, particularly for individuals who work in cities with high cost of living. That is just a risk. But the alternative, which is to accept people who find themselves less marketable, I don't think is palatable, either.

But at the same time, my view is that the way that an individual makes themselves potentially marketable for future employment is by no means to pull your punches or somehow not conduct vigorous investigations. If anything, it is the opposite, that enforcement attorneys and prosecutors are very interested in significant cases, thorough investigations, cutting areas of the law, and even some-

times high-profile cases in order to later enhance their employment opportunities. Those are all good things. And employers, on the other hand, are not interested in hiring, in my experience, people who are willing to not conduct those kinds of investigations or not respected by their colleagues and peers and don't have influence within the community.

So I recognize the problem in the abstract. I don't think it is as big a problem in reality.

Mr. WALSH. Sir, I would add, if I could, we have a procedure where when someone is leaving, we take a look back over their work over a period of time before they left, a year, and if there is any conflict that we can see between where they are going and the work they have done over that period of time, we take it out and we make sure that, in fact, they weren't pulling punches and they weren't doing things they shouldn't have done.

Senator MERKLEY. I see I am over my time. Can I ask one last question here?

Senator SCHUMER. Please.

Senator MERKLEY. One of the issues that came up in the Madoff situation is about the firm's auditor. So does the SEC review information about who a firm's auditor is, whether the auditor's firm's capability reflects competence, a track record elsewhere? Is there a change of practice in this area? And am I right in thinking that had the inadequacy of the auditing function been looked into, that this might have been a real clue to the situation?

Mr. WALSH. Certainly, sir, we are looking at it much more actively today. And, in fact, that is one of the high-risk elements that we are now considering as we sift through the community to see if there are, in fact, other problems lurking out there. Absolutely, it is getting a lot more attention today.

Senator MERKLEY. I will just close by noting that I think the SEC's incompetent examinations actually greatly served Mr. Madoff because it suggested to folks rumors of the investigations, the fact he could say he had been investigated and cleared said to people, this firm is credible and gave them greater confidence in investing and it just points out how incredibly important this function is to the correct functioning of our markets and the protection of the public. I understand that you are doing everything in your power to put the SEC back on course and I thank you for it.

Senator SCHUMER. OK. I have a few more questions and then we will finish up.

Mr. Markopolos, you make 14 recommendations to the SEC based on your experience. If you had to choose, tell me the two you consider the most important.

Mr. MARKOPOLOS. The best tool that the SEC could use, in my opinion, is the pink slip. It is a piece of paper that every employee could understand. There need to be a number of them. I suspect about half the staff, or perhaps more——

Senator SCHUMER. Explain to everybody who might be listening to this what the pink slip is.

Mr. MARKOPOLOS. The pink slip is when you get called into account and you get fired for doing a bad job or not being competent on the job. I think many of the examiners and many of the enforcement attorneys lack confidence at the basic skill levels. There

needs to be a skill inventory conducted of the staff. They need to take multiple choice exams. Those that don't cut the mustard, let them go. Everybody's performance needs to be closely reviewed and they basically need to start weeding out staff.

Senator SCHUMER. Now, there are limitations on the ability to weed out staff. Would you, Mr. Khuzami, or you, Mr. Walsh, comment on those, and does the SEC need to change the rules? Are these rules? Are they statutes? Do they get in the way? Could you just generally comment on Mr. Markopolos's suggestion of pink slipping people?

Mr. KHUZAMI. Well, Senator, I guess I can't let the comment pass without responding to the substance of it first, which would be that certainly in my experience, in the 5 months I have been with the Division, I would not agree by any stretch of the imagination of the numbers of people that Mr. Markopolos suggests are deserving of pink slips. I have seen the performance of these people. They are committed. They are hard working. They are excellent at what they do. And if there is something that we need to do, it is to train them better and to provide them opportunities for greater expertise

Senator SCHUMER. But the question just leaps out. If that is the case, how did they miss Madoff?

Mr. KHUZAMI. Senator, as I explained——

Senator SCHUMER. If they are so confident——

Mr. KHUZAMI. I can't—Senator, as I said, there are a number of variables that came together to cause this terrible consequence. My only point is that it is not emblematic of the entire Division.

Senator SCHUMER. OK. But how about the ability to get rid of people who aren't good? We can disagree as to how many there might be.

Mr. KHUZAMI. Well, Senator——

Senator SCHUMER. Are your hands too tied in that regard?

Mr. KHUZAMI. Senator, we are doing more in respect to—we are adopting, for example, in 2010 an enhanced Performance Management System which will allow us to better evaluate set objectives and evaluate the performance of individual attorneys. The ability to impose discipline or to terminate lawyers is not, in my view, is not an impediment to achieving where it is that we need to get.

Senator SCHUMER. Mr. Walsh?

Mr. WALSH. I would agree. I think, certainly, we have a very skilled staff. To me, as I read the Inspector General's report, one of the truly heartbreaking elements is that there was expertise on the staff. There were people who could have played the proper role in solving the problem and they just weren't brought to bear on the particular problem, on the particular issue.

Senator SCHUMER. You know, this is just so confounding. You are saying your staff was competent. They have the tools. They have this. And it just didn't happen. It is just not going to add up to people.

Mr. Markopolos, do you want to comment?

Mr. MARKOPOLOS. Yes. I think it is very hard to soar like an eagle when you are surrounded by turkeys, and there are a lot of turkeys that need to be let go.

Senator SCHUMER. OK, but Mr. Khuzami and Walsh are saying there are many more eagles than turkeys. They just happened to miss this thing.

Mr. MARKOPOLOS. A lot of these—most of these attorneys at the SEC, honestly, I don't think they could find steak at an Outback.

Senator SCHUMER. Well, here is what I want to ask you, Mr. Markopolos. Make believe there is a wall between Walsh and Khuzami, OK, because they seem like decent people and have very good reputations. Do you think they are just doing this because that is the job of somebody, to defend their employees, and maybe deep down inside them, they realize there needs to be a whole lot more competence?

Mr. MARKOPOLOS. I think so. I think it is the institution talking, not the men. At least, I hope not. I think there needs to be a different model of compensation. It needs to be results-based. It needs to be salaries—better salaries. If you pay peanuts, then you shouldn't wonder why you end up with monkeys. You need to increase the salary and give these people the bonuses that they probably deserve, make them success-based, make them revenue-based for bringing in the big cases.

Senator SCHUMER. That relates to a second question. There are salary caps, limits. Do you think, Mr. Khuzami and Mr. Walsh, that they interfere with the ability to get the best people and retain the best people? Would it be better if the compensation levels were changed so you could pay more, at least to some of the top people? I don't just mean the senior advisors, but maybe you need ten really cracker-jack investigators who get paid more than others, and you can't do that given the present rules. Is it possible the pay scales, way of promoting, seniority and all that need to be changed in an agency like this?

Mr. KHUZAMI. Senator, I think that greater flexibility in both the ability and the amount that we could pay people would be very helpful, particularly as we recruit market specialists, structurers, traders, others who came from Wall Street who, although may have a difficult finding a job now, may soon find themselves in demand and making many multiples of that.

Senator SCHUMER. Right. So you would say that you need more flexibility. Do the top salaries have to be raised, or what you can pay for some certain key people have to be raised?

Mr. KHUZAMI. I agree completely, Senator.

Senator SCHUMER. Mr. Walsh?

Mr. WALSH. Yes, sir. That would really help us attract the talent we need. We are constantly competing with Wall Street to draw in people who have the skills we need to regulate Wall Street.

Senator SCHUMER. Obviously. OK. That was your first—I asked you for two, Mr. Markopolos. Give me the second.

Mr. MARKOPOLOS. The second, almost as important, would be to minimize, if not eliminate, the influence and the over-lawyering at this agency. Put people with capital market——

Senator SCHUMER. I didn't hear that. Minimize the influence of what?

Mr. MARKOPOLOS. Of the attorneys at the SEC. There are too many—the attorneys are running the show and they have failed miserably. It is time to give people with capital markets experience

a chance. I have to think we can do better. We understand the frauds of the 21st century. We know these instruments. We know the structured product. We know the math. We know the derivative. We know how they are put together again. The law—there are too many lawyers and the law is too low of a bar for behavior. Securities law is down here. The behavior we need to shoot for is way up here and it is called good ethics, it is called good transparency, and open——

Senator SCHUMER. That is two separate issues. One is making the standard higher. That has to be done statutorily or that could be done administratively?

Mr. MARKOPOLOS. I think administratively. You would have to—the lawyers only look at the low bar, the law. You need to raise that.

Senator SCHUMER. One is lawyers versus investigators. I asked them about that, but we will come back to that. But the first one is, do you think the actual standard of criminality has to be changed or at least of what fraud is?

Mr. MARKOPOLOS. Yes. You need to increase the bar and make it more expansive, give these guys more tools.

Senator SCHUMER. OK. Do you gentlemen agree with that? You need some statutory or regulatory changes in defining what fraud is?

Mr. KHUZAMI. Senator, I don't think it is so much the definition

Senator SCHUMER. And I don't just mean fraud. I mean the other crimes, too, whatever they are——

Mr. KHUZAMI. We generally don't lack for statutory vehicles to charge individuals. There are issues, as you know, with respect to our ability to have jurisdiction over security-based swaps agreements and hedge funds, for example, which would greatly aid our investigations, as would the requirement that hedge funds and others have standard audit trail information so that we can more quickly analyze their trading patterns.

Senator SCHUMER. Right. Mr. Walsh, do you have anything to add?

Mr. WALSH. No, I agree with my colleague on that.

Senator SCHUMER. And what about the second comment? Mr. Markopolos's comments were really two. The second was, too many lawyers, not enough market experienced people. I sort of asked you that before.

Mr. WALSH. Well, as—I am sorry. Go ahead, please.

Mr. KHUZAMI. Look, we are all about increasing our specialization. That is the thrust behind so many of the reforms we have implemented. I will say at the same time, there are astounding examples of work in complicated capital markets areas that the staff has done. Just to take an example, in the New York office, one of our flagship offices, many of the same groups that were involved in this case did the sham finite reinsurance cases involving AIG, RenaissanceRe, and others, highly complicated, structured transactions in which no risk was being transferred, transactions done solely to augment balance sheets and earnings. We did those cases and we did them well, $800 million worth of disgorgement and penalties that went back to investors, 24 enforcement actions, criminal

convictions. We have that capability. We can do a lot more with some specialized expertise.

Senator SCHUMER. OK.

Mr. WALSH. The examination program actually has relatively few lawyers. I am the lawyer for the program, but there are only 13 percent of us. Most examiners are accountants. Many of them are very fine forensic accountants. But I believe where we really need to grow, and I believe I agree with you on this, is to have more financial analysts, to have more trading specialists, people who understand difficult valuation issues, and that is really—

Senator SCHUMER. Very logical.

Mr. WALSH. Yes, sir.

Senator SCHUMER. You don't have the resources to do that right now, do you?

Mr. KHUZAMI. No, we do not.

Senator SCHUMER. OK. And so just to reiterate, the kind of legislation I have introduced is really very much needed, really if you are going to stop all these futures schemes as the markets get more complicated. Do you agree, Mr. Khuzami?

Mr. KHUZAMI. That may be the single best thing that you could do, Senator.

Senator SCHUMER. Mr. Walsh?

Mr. WALSH. Yes, sir.

Senator SCHUMER. Mr. Markopolos?

Mr. MARKOPOLOS. Yes, Senator.

Senator SCHUMER. Good. Last question. The Inspector General's report states, on a conference call about two Madoff exams, quote:

> a senior-level Washington, D.C. examiner reminded the junior examiners that Madoff, quote, 'was a very well-connected, powerful person,' which one of the New York examiners interpreted to raise a concern for them pushing Madoff too hard.

Mr. Markopolos, did you feel that Mr. Madoff's stature in the investment community was an impediment to the SEC uncovering his Ponzi scheme?

Mr. MARKOPOLOS. Yes, Senator, I do. I feel there is a protective species on Wall Street where the biggest and most powerful firms are given a free pass or a "get out of jail" card and they go after the small fry.

Senator SCHUMER. Mr. Walsh, could that have been true?

Mr. WALSH. Well, sir, it is very difficult. I think the Inspector General concluded that while there was no direct interference in the examination by supervisors, he did, I believe, conclude that it could have been a secondary effect in what happened. We are taking this very seriously. We have established an internal hotline, so SEC examiners anywhere around the country, as soon as they believe they are being intimidated or a firm is acting unreasonably or inappropriately, they can call the hotline and it will ring on the desk, my desk and the desk of a number of senior people who work with me. We are moving very quickly to make sure that this type of intimidation——

Senator SCHUMER. But I think what they are saying here is you wouldn't call a hotline. What Mr. Markopolos is agreeing with and what the Inspector General was saying was, because he was a pow-

erful person, they sort of instinctively might not have been as tough as if he was a less powerful, less well-connected person——

Mr. WALSH. Well, we are all——

Senator SCHUMER.——not a hotline that is going to change that.

Mr. WALSH. Well, sir, I——

Senator SCHUMER. Let me ask Mr. Khuzami

Mr. WALSH. Sorry.

Senator SCHUMER.——what are you doing to deal with the issue that both the Inspector General and Mr. Markopolos had pointed out, to try to get into these sort of psychological barriers?

Mr. KHUZAMI. Senator, I think the way to deal with something like that is tone at the top and communication and involved supervision, supervisors and managers who recognize the situations where perhaps a more junior person may be susceptible to that kind of influence, and that supervisor intervenes and closely monitors to make sure that that is not happening.

Senator SCHUMER. OK. Good. Does anyone want to add anything, because if not, we will close the hearing and thank you for your time. But do you have any more comments, Mr. Markopolos?

Mr. MARKOPOLOS. No, I do not. Thank you, Senator.

Senator SCHUMER. Any more metaphors? You are pretty good with those.

[Laughter.]

Mr. MARKOPOLOS. No. Thank you.

Senator SCHUMER. OK. Mr. Khuzami or Mr. Walsh, any comments?

Mr. KHUZAMI. No——

Senator SCHUMER. You are not big on the metaphors.

Mr. KHUZAMI. No, too many metaphors.

Senator SCHUMER. Right. OK.

Mr. WALSH. Thank you.

Senator SCHUMER. I like metaphors, as people know.

I thank all of you for coming, and the hearing is closed.

[Whereupon, at 5:12 p.m., the hearing was adjourned.]

[Prepared statements and responses to written questions follow:]

PREPARED STATEMENT OF CHAIRMAN CHRISTOPHER J. DODD

Bernard Madoff stole $50 billion.

He stole from individuals and pension funds and charities and municipalities like Fairfield in my home state. He stole more than money. He stole the retirement savings and the economic security of families across the country.

And the Securities and Exchange Commission didn't stop him.

There can be no excuse for that colossal failure. But I demand—the victims of this fraud, some of whom hail from my state and have testified before this Committee, demand—an explanation. And so today, we hold our third hearing on Ponzi schemes—and our second on the Madoff fraud in particular—to find out how this could possibly have happened, and what we need to do to make sure it can never happen again.

Incredibly, it emerged late last year that SEC staff had received multiple complaints over a period of sixteen years that Madoff's business was not legitimate, but hadn't taken any effective action. To his credit, then-Chairman Christopher Cox directed the SEC Inspector General to conduct a full investigation of why these credible reports had been ignored.

The Inspector General released a report last week, and it is deeply disturbing. As the report indicates, "The SEC received more than ample information in the form of detailed and substantive complaints," but "a thorough and competent investigation or examination was never performed."

The report goes on to describe an embarrassing series of internal failures at the SEC:

- Incompetent supervisors directed their offices to look only for the types of fraud they understood and failed to recognize the type actually being committed in the Madoff case.
- Inexperienced SEC staff simply accepted Madoff's claims without making the single phone call or sending the single letter that it would have taken to verify his information.
- No one ever thought it merited a closer look when Madoff said he traded in Europe with a firm that reported there was no activity in the account.
- Divisions and offices failed to coordinate or share information.

It is ugly stuff. Beginning in 1992—1992!—the SEC received information that should have led to a quick end for Bernie Madoff's Ponzi scheme.

But because the task of following up on that information was assigned to junior staff or supervisors with insufficient experience in the securities market, because that staff failed to ask obvious questions or take simple steps to verify what Madoff told them, because their supervisors actually discouraged further investigation—in short, because the SEC failed to do its job, Madoff stole $50 billion.

Today, we will hear from the Inspector General about his report. We will hear from Harry Markopolos, an investment analyst who continually attempted to get the SEC's attention with regards to the Madoff fraud about his ideas for improving the organization. And we will hear from the heads of the Office of Compliance, Inspections, and Examinations and the Division of Enforcement about what the SEC has done in light of the Madoff revelations, and about what Chairman Schapiro intends to do going forward.

There are several clear steps that should be taken:

- SEC staff should be trained in markets and investment strategies so they can know fraud when they see it, and the SEC should hire staff with real world experience.
- The very culture needs to be reformed to encourage aggressive oversight.
- Staff should verify self-serving statements of facts made by targets of investigations.
- Coordination among the SEC's offices and divisions must be improved.
- There should be a more rigorous system for evaluating outside tips and allegations, including articles in the financial press.

Like many Americans, I am stunned and angry that this fraud was allowed to happen. But I also believe that the SEC can do better. And I look forward to discussing how in today's hearing.

PREPARED STATEMENT OF SENATOR RICHARD C. SHELBY

Thank you, Mr. Chairman.

Last January, a little more than 1 month after Bernard Madoff confessed to running a $50 billion multi-decade Ponzi scheme, this Committee held a hearing to try to understand how a fraud of that magnitude could go undetected by the Securities and Exchange Commission for so many years.

Unfortunately, that hearing yielded few answers.

In the intervening 7 months, the SEC's Inspector General has been piecing together what really happened. His report sets out a chronology that tracks fifteen years of missed opportunities and considerable incompetence.

The IG found that the Office of Compliance Inspections and Examinations and the Division of Enforcement were made aware at least six times that there might be something wrong at Madoff's firm.

Potentially fruitful leads were not pursued while significant staff resources were devoted to running down clearly unproductive avenues.

Investigations were unfocused, understaffed, and improperly documented. Communication across SEC offices was so badly flawed that Madoff himself had to alert the New York examiners that their counterparts in the Washington office had been looking at similar issues.

The IG determined that SEC culture and organizational structure discouraged employees from reaching out to one another to share market intelligence, obtain expert advice, or compare notes about their cases.

SEC employees did not give weight to colleagues' recommendations, so a tip found credible by one group of staffers would be dismissed hastily by another.

The report also documents that Mr. Madoff, despite his persistent misrepresentations to the SEC, received greater deference by the staff than the tippers who spotted his fraud.

Ultimately, in each case, the report indicates that the lingering questions and concerns of SEC employees were swept under the rug by impatient and inflexible supervisors who concluded that asking the logical next questions would take too long or would be outside the scope of the examination.

In the aftermath of the botched Madoff investigation, the SEC has claimed that more funding will address its failures. The report however, clearly describes an agency that does not know how to use the information and resources it already has. Fixing the SEC will not merely involve more resources.

The Commission is going to have to make broad-based changes if it hopes to become a smarter, more flexible, more productive and ultimately more accountable organization.

I am hopeful that the SEC will learn from its failures and seize this opportunity to reform itself from within. If it refuses to do so, Congress will do it for them.

Thank you Mr. Chairman.

PREPARED STATEMENT OF SENATOR TIM JOHNSON

Thank you Chairman Dodd for holding today's hearing. Following the recent release of the SEC's Inspector General's "Investigation of Failure of the SEC to uncover Bernard Madoff's Ponzi scheme," I think it is crucial that this Committee continues its oversight role of the SEC. The report highlights the numerous mistakes the agency made, the red flags that were missed, and a too narrow examination focus that prevented the agency from taking a "big picture" look at the business Bernard Madoff was running. These grave mistakes call into question the job the SEC was doing, and more importantly cost some American investors their life savings.

I applaud Chairman Schapiro for the efforts she has made to reform how the SEC regulates markets and protect investors. It is the role of this Committee to help determine if the changes that were made are the right changes to prevent fraud, like that which was perpetrated by Bernard Madoff, from happening again. While massive cases like the Madoff ponzi scheme rightfully grab headlines, we must also focus on smaller fraudulent schemes which also hurt investors.

It is my goal to ensure that the SEC has the right tools and appropriate resources; that investors have access, information, and protection, and that industry participants have certainty and rules that allow them to compete fairly both at home and abroad. I look forward to hearing more from today's witnesses, and I look forward to working with members of this Committee as we consider how to better regulate the securities industry and reassure investors that our markets are safe.

PREPARED STATEMENT OF SENATOR JACK REED

The Securities and Exchange Commission's handling of the Madoff case is shocking, and reveals fundamental problems with the agency's operations, organization, and culture. The cop on the beat missed dozens of clues while Madoff robbed charities, families, and investors. Between 1992 and 2008, the SEC ignored red flags from six detailed complaints, and two studies that sounded alarm bells. The SEC also conducted five separate reviews during the decade and a half that Madoff ran his operations, but failed to take basic steps that would have uncovered the fraud. How did so many examiners and so many investigations fail to close the loop on this Ponzi scheme? How did they fail to complete the minimal follow-up and third-party verification that would have brought down a multi-billion dollar scam artist?

At a Securities Subcommittee hearing I chaired back in May, we took a close look at the SEC's Enforcement Division and heard from the Government Accountability Office about how resource problems and policy changes undermined the Agency's ability to bring enforcement actions. But I am afraid the Inspector General's findings illuminate much deeper issues than scarce resources and changes in policy, and raise questions about examiner competence and agency culture.

I have consistently fought to give the SEC the robust resources and authority it needs to aggressively fight fraud and other abuses in the securities markets. And I will continue to do so. But I hope today's hearing helps us to continue to identify the underlying issues and problems at the agency that led to this preventable travesty. This hearing should help provide further transparency and accountability, and allow Congress to identify concrete steps to rebuild the agency, including steps beyond simply adding resources and authority.

I want to close by saying that while the SEC is currently suffering from a very tarnished reputation, one that it deserves based on its failures in recent years, the agency historically has been a symbol of strength and toughness in the markets for decades, thanks in large part to its dedicated staff. I believe under its new leadership and under the attention of Congress, the SEC can once again become the aggressive watchdog it once was and restore confidence in our securities markets.

PREPARED STATEMENT OF H. DAVID KOTZ

INSPECTOR GENERAL, SECURITIES AND EXCHANGE COMMISSION

SEPTEMBER 10, 2009

Introduction

Good afternoon. Thank you for the opportunity to testify today before this Committee on the subject of "Oversight of the SEC's Failure to Identify the Bernard L. Madoff Ponzi Scheme and How to Improve SEC Performance" as the Inspector General of the Securities and Exchange Commission (SEC). I appreciate the interest of the Chairman, as well as the other members of the Committee, in the SEC and the Office of Inspector General (OIG). In my testimony today, I am representing the OIG, and the views that I express are those of my Office, and do not necessarily reflect the views of the Commission or any Commissioners.

Since being appointed as the Inspector General of the SEC in December 2007, my Office has issued numerous audit and investigative reports involving issues critical to SEC operations and the investing public. These have included comprehensive audit reports on important topics such as the factors that led to the collapse of Bear Stearns, the Division of Enforcement's (Enforcement) efforts pertaining to complaints about naked short selling, and the SEC's oversight of credit rating agencies. We have also issued investigative reports regarding a wide range of allegations including claims of improper securities trading by SEC employees, preferential treatment given to high-level securities industry officials, retaliatory termination, Enforcement's failure to vigorously pursue an investigation, and perjury by supervisory Commission attorneys.

Request To Undertake Madoff Investigation

On the late evening of December 16, 2008, former SEC Chairman Christopher Cox contacted me and asked my Office to undertake an investigation into allegations made to the SEC regarding Bernard L. Madoff (Madoff), who had just confessed to operating a multi-billion dollar Ponzi scheme, and the reasons why the SEC had found these allegations to be not credible.

Commencement of our Madoff Investigation

We began our investigation immediately. On December 18, 2008, we issued a document preservation notice to the entire SEC, stating that the OIG had initiated an

investigation regarding all Commission examinations, investigations or inquiries involving Madoff, and/or any related individuals or entities. We formally requested that each SEC employee and contractor preserve all electronically stored information and paper records related to Madoff in their original format.

We also took immediate steps to begin gathering evidence. On December 17, 2008, we initiated our first request for email records from the SEC's Office of Information Technology (OIT). Over the course of the investigation, the OIG made numerous requests from OIT for emails, including: (1) all emails of former Office of Compliance Inspections and Examinations (OCIE) employee Eric Swanson during his tenure with the SEC; (2) all emails of six staff members who were involved in the SEC's investigation of the Madoff firm that was initiated in 2006 for the period from January 2006 through January 2008; (3) all emails for SEC Headquarters, New York Regional Office (NYRO) and Boston Regional Office (BRO) staff members from January 1, 1999, through December 11, 2008, that contained the word "Madoff"; (4) additional emails for approximately 68 current and former SEC employees for various time periods relevant to the investigation, ranging from 1999 to 2009. In all, we estimate that we obtained and searched approximately 3.7 million emails during the course of our investigation.

On December 24, 2008, we sent comprehensive document requests to both Enforcement and OCIE, specifying the documents and records we required to be produced for the investigation. We followed up with memoranda to OCIE in April, May and June of 2009. We also had follow-up communications with Enforcement on January 21, 2009 and July 22, 2009. We further had numerous email and telephonic communications with both OCIE and Enforcement regarding the scope and timing of the document requests and responses, as well as meetings to clarify and expand the document requests as necessary. We collected all the information produced in response to our document production request. We then carefully reviewed and analyzed the investigative records of all SEC investigations conducted relating to Madoff, the Madoff firm, members of Madoff's family, and Madoff's associates from 1975 to the present.

During the investigation, we also reviewed the workpapers and examination files of nine SEC examinations of Madoff's firms from 1990 to December 11, 2008. Where documents from the examinations were not available, we sought testimony and conducted interviews of current and former SEC personnel who had worked on the examinations.

We also sought information and documentation from third parties in order to undertake our own analysis of Madoff's trading records. During the course of the OIG investigation, we requested and obtained records from: (1) the Depository Trust Company (DTC) relating to position reports for Madoff's firm; (2) the National Securities Clearing Corporation (NSCC) relating to clearing data records for executions effected by Madoff's firm; and (3) the Financial Industry Regulatory Authority (FINRA) Order Audit Trail System data (OATS) submitted by Madoff's firm for six National Association of Securities Dealers Automated Quotations (NASDAQ)-listed stocks and the NASDAQ Automated Confirmation of Transactions (ACT) data base for a trading period in March of 2005.

Retention of Experts

In order to assist us in the Madoff investigation, we retained two sets of outside consultants. In February 2009, we retained FTI Consulting, Inc. (FTI engagement team) to assist with the review of the examinations of Madoff and his firms that were conducted by the SEC. Members of the FTI engagement team engaged by the OIG included Charles R. Lundelis, Jr., Senior Managing Director, Forensic and Litigation Consulting; Simon Wu, Managing Director, Forensic and Litigation Consulting; John C. Crittenden III, Managing Director, Corporate Finance Group; and James Conversano, Director, Forensic and Litigation Consulting. Each individual member of the FTI engagement team brought a unique and specialized experience to the analyses that FTI engagement team conducted, including expertise in complex financial fraud investigations, securities-related inspections and examinations, hedge fund operations, cash-flow analysis and valuations, market regulation rules, market structure issues, accounting fraud, investment suitability, the underwriting process and compliance and due diligence practices.

At our direction, the FTI engagement team conducted a thorough review of all relevant workpapers and documents associated with the OCIE examinations of Madoff's firm, scrutinized the conduct of the Madoff-related SEC examinations and investigations, and analyzed whether the SEC examiners overlooked red flags that could have led to the discovery of Madoff's Ponzi scheme. The FTI engagement team also replicated aspects of the OCIE cause examinations of Madoff to determine

whether the SEC sought the appropriate information in the examinations and analyzed that information correctly.

In addition, OIT advised us during the course of our investigation that there were substantial gaps in the emails we were seeking to review as part of our investigation because of failures to back up tapes, hardware or software failures during the backup process, and/or lost, mislabeled or corrupted tapes. In order to ensure that we were able to conduct a thorough and comprehensive investigation, in June 2009, we retained the services of First Advantage Litigation Consulting Services (First Advantage) to assist us in the restoration and production of relevant electronic data. First Advantage's team had significant experience in leading numerous large-scale electronic discovery consulting projects, as well as assisting with highly sensitive and confidential investigations for corporations and the Federal Bureau of Investigation.

In connection with its retention on the Madoff investigation, First Advantage provided consulting and technical support to the OIG and the SEC, and was able to successfully preserve and restore potentially relevant data within the universe of electronic data we had requested from OIT. As a result, we were able to review additional Madoff-related emails that were pertinent to our investigation.

Testimony and Interviews Conducted in the Madoff Investigation

We also conducted 140 testimonies under oath or interviews of 122 individuals with knowledge of facts or circumstances surrounding the SEC's examinations and/or investigations of Madoff and his firms. We interviewed all current or former SEC employees who had played any significant role in the SEC's significant examinations and investigations of Madoff and his firms over a period spanning approximately 20 years.

The OIG's Investigative Team

I think it appropriate to acknowledge the extraordinary efforts of the OIG Investigative team that I have been honored to lead in conducting this important investigation. These included Deputy Inspector General Noelle Frangipane, Assistant Inspector General for Investigations David Fielder, and Senior Counsels Heidi Steiber, David Witherspoon and Christopher Wilson. Additional assistance was provided to this investigation by my Assistant, Roberta Raftovich, in coordinating many of the administrative aspects of compiling the report. Without the incredible devotion and exceptional work of these individuals, we would not have been able to complete this investigation and present a thorough and comprehensive report within such a short period of time.

Issuance of Comprehensive Report of Investigation

On August 31, 2009, we issued to the Chairman of the SEC a comprehensive report of investigation (ROI) in the Madoff matter containing over 450 pages of analysis. The ROI detailed the SEC's response to all complaints it received regarding the activities of Madoff and his firms, and traced the path of these complaints through the Commission from their inception, reviewing what, if any, investigative or examination work was conducted with respect to the allegations. Further, the ROI assessed the conduct of examinations and/or investigations of Madoff and his firm by the SEC and analyzed whether the SEC examiners or investigators overlooked red flags (which other entities conducting due diligence may have been identified) that could have led to a more comprehensive examination or investigation and possibly the discovery of Madoff's Ponzi scheme.

Our ROI also analyzed the allegations of conflicts of interest arising from relationships between any SEC officials or staff and members of the Madoff family. This included an examination of the role that former SEC OCIE Assistant Director Eric Swanson (Swanson), who eventually married Madoff's niece Shana Madoff, may have played in the examination or other work conducted by the SEC with respect to Madoff or related entities, and whether such role or relationship in any way affected the manner in which the SEC conducted its regulatory oversight of Madoff and any related entities.

We have also considered the extent to which the reputation and status of Madoff and the fact that he served on SEC Advisory Committees, participated on securities industry boards and panels, and had social and professional relationships with SEC officials, may have affected Commission decisions regarding investigations, examinations and inspections of his firm.

Results of the Madoff Investigation

The OIG investigation found that between June 1992 and December 2008 when Madoff confessed, the SEC received six substantive complaints that raised significant red flags concerning Madoff's investment adviser operations and should have

led to questions about whether Madoff was actually engaged in trading. We also found that the SEC was aware of two articles regarding Madoff's investment operations that appeared in reputable publications in 2001 and questioned Madoff's unusually consistent investment returns.

Our report concluded that notwithstanding these six complaints and two articles, the SEC never conducted a competent and thorough examination or investigation of Madoff for operating a Ponzi scheme and that, had such a proper examination or investigation been conducted, the SEC would have been able to uncover the fraud.

The first complaint, which was brought to the SEC's attention in 1992, related to allegations that an unregistered investment company was offering "100 percent" safe investments with high and extremely consistent rates of return over significant periods of time to "special" customers. The SEC actually suspected the investment company was operating a Ponzi scheme and learned in its investigation that all of the investments were placed entirely through Madoff and consistent returns were claimed to have been achieved for numerous years without a single loss.

The second complaint was very specific, and different versions of it were provided to the SEC in May 2000, March 2001 and October 2005. The complaint submitted in 2005 was entitled, "The World's Largest Hedge Fund is a Fraud," and detailed approximately 30 red flags indicating that Madoff was operating a Ponzi scheme, a scenario it described as "highly likely." These red flags included the impossibility of Madoff's returns, particularly the consistency of those returns and the unrealistic volume of options Madoff represented to have traded.

In May 2003, the SEC received a third complaint from a respected hedge fund manager identifying numerous concerns about Madoff's strategy and purported returns. Specifically, the complaint questioned whether Madoff was actually trading options in the volume he claimed, noted that Madoff's strategy and purported returns were not duplicable by anyone else, and stated that Madoff's strategy had no correlation to the overall equity markets in over 10 years. According to an SEC manager, the hedge fund manager's complaint laid out issues that were "indicia of a Ponzi scheme."

The fourth complaint was part of a series of internal emails of another registrant that the SEC discovered in April 2004. The emails described the red flags that a registrant's employees had identified while performing due diligence on their own Madoff investment using publicly available information. The red flags identified included Madoff's incredible and highly unusual fills for equity trades, his misrepresentation of his options trading, and his unusually consistent, non-volatile returns over several years. One of the internal emails provided a step-by-step analysis of why Madoff must be misrepresenting his options trading. The email clearly explained that Madoff could not be trading on an options exchange because of insufficient volume and could not be trading options over-the-counter because it was inconceivable that he could find a counterparty for the trading. The SEC examiners who initially discovered the emails viewed them as indicating "some suspicion as to whether Madoff is trading at all."

The SEC received the fifth complaint in October 2005 from an anonymous informant. This complaint stated, "I know that Madoff [sic] company is very secretive about their operations and they refuse to disclose anything. If my suspicions are true, then they are running a highly sophisticated scheme on a massive scale. And they have been doing it for a long time." The informant also stated, "After a short period of time, I decided to withdraw all my money (over $5 million)."

The sixth complaint was sent to the SEC by a "concerned citizen" in December 2006, and advised the SEC to look into Madoff and his firm as follows:

> Your attention is directed to a scandal of major proportion which was executed by the investment firm Bernard L. Madoff . . . Assets well in excess of $10 Billion owned by the late [investor], an ultra-wealthy long time client of the Madoff firm have been 'co-mingled' with funds controlled by the Madoff company with gains thereon retained by Madoff.

In March 2008, the SEC Chairman's Office received a second copy of the previous complaint, with additional information from the same source regarding Madoff's involvement with the investor's money, as follows:

> It may be of interest to you to that Mr. Bernard Madoff keeps two (2) sets of records. The most interesting of which is on his computer which is always on his person.

The two 2001 journal articles also raised significant questions about Madoff's unusually consistent returns. One of the articles noted his "astonishing ability to time the market and move to cash in the underlying securities before market conditions

turn negative and the related ability to buy and sell the underlying stocks without noticeably affecting the market." This article also observed that "experts ask why no one has been able to duplicate similar returns using [Madoff's] strategy." The second article quoted a former Madoff investor as saying, "Anybody who's a seasoned hedge-fund investor knows the split-strike conversion is not the whole story. To take it at face value is a bit naive."

The complaints all contained specific information and could not have been fully and adequately resolved without a thorough examination and investigation of Madoff for operating a Ponzi scheme. The journal articles should have reinforced the concerns expressed in the complaints about how Madoff could have been achieving such unusually high returns.

According to the FTI engagement team, the most critical step in examining or investigating a potential Ponzi scheme is to verify the subject's trading through an independent third party. The OIG investigation found that the SEC conducted two investigations and three examinations related to Madoff's investment adviser business based upon the detailed and credible complaints that raised the possibility that Madoff was misrepresenting his trading and could have been operating a Ponzi scheme. Yet, at no time did the SEC ever verify Madoff's trading through an independent third party and, in fact, SEC staff never actually conducted a Ponzi scheme examination or investigation of Madoff.

The first examination and first Enforcement investigation involving Madoff were conducted in 1992 after the SEC received information that led it to suspect that a Madoff associate had been conducting a Ponzi scheme. Yet, the SEC focused its efforts on Madoff's associate and never thoroughly scrutinized Madoff's operations even after learning that Madoff made all the investment decisions and being apprised of the remarkably consistent returns Madoff had claimed to achieve over a period of numerous years with a basic trading strategy. While the SEC ensured that all of Madoff's associate's customers received their money back, it took no steps to investigate Madoff. The SEC focused its investigation too narrowly and seemed not to have considered the possibility that Madoff could have taken the money that was used to pay back his associate's customers from other clients for which Madoff may have had held discretionary brokerage accounts. In the examination of Madoff, although the SEC did seek records maintained by DTC (an independent third party), they obtained those DTC records from Madoff rather than going to DTC itself to verify if trading occurred. Had the SEC sought records from DTC, there is an excellent chance it would have uncovered Madoff's Ponzi scheme in 1992.

In 2004 and 2005, the SEC's examination unit, OCIE, conducted two parallel cause examinations of Madoff based upon the hedge fund manager's complaint and the series of internal emails the SEC had discovered. The examinations were remarkably similar in nature. There were initial significant delays in the commencement of the examinations, notwithstanding the urgency of the complaints. The teams assembled were relatively inexperienced, and there was insufficient planning for the examinations. The scopes of the examination were in both cases too narrowly focused on the possibility of front-running, with no significant attempts made to analyze the numerous red flags about Madoff's trading and returns.

During the course of both these examinations, the examination teams discovered suspicious information and evidence and caught Madoff in contradictions and inconsistencies. However, they either disregarded these concerns or simply asked Madoff about them. Even when Madoff's answers were seemingly implausible, the SEC examiners accepted them at face value.

In both examinations, the examiners made the surprising discovery that Madoff's mysterious hedge fund business was making significantly more money than his well-known market-making operation. However, none of the examiners identified this revelation as a cause for concern.

Astoundingly, both examinations were open at the same time in different offices without either office knowing the other one was conducting a virtually identical examination. In fact, it was Madoff himself who informed one of the examination teams that the other examination team had already received the information being sought from him.

In the first of the two OCIE examinations, the examiners drafted a letter to the National Association of Securities Dealers (NASD) (another independent third party) seeking independent trade data, but they never sent the letter, claiming that it would have been too time-consuming to review the data they would have obtained. The OIG's expert opined that had the letter to the NASD been sent, the data collected would have provided the information necessary to reveal Madoff's Ponzi scheme. In the second examination, the OCIE Assistant Director sent a document request to a financial institution that Madoff claimed he used to clear his trades, requesting trading done by or on behalf of particular Madoff feeder funds during a

specific time period, and received a response that there was no transaction activity in Madoff's account for that period. However, the Assistant Director did not determine that the response required any follow-up and the examiners working under the Assistant Director testified that the response was not shared with them.

Both examinations concluded with numerous unresolved questions and without any significant attempt to examine the possibility that Madoff was misrepresenting his trading and operating a Ponzi scheme.

The investigation that arose from the most detailed complaint provided to the SEC, which explicitly stated it was "highly likely" that "Madoff was operating a Ponzi scheme," never really investigated the possibility of a Ponzi scheme. The relatively inexperienced Enforcement staff failed to appreciate the significance of the analysis in the complaint, and almost immediately expressed skepticism and disbelief about the complaint. Most of the investigation was directed at determining whether Madoff should register as an investment adviser or whether Madoff's hedge fund investors' disclosures were adequate.

As with the examinations, the Enforcement staff almost immediately caught Madoff in lies and misrepresentations, but failed to follow up on inconsistencies. They rebuffed offers of additional evidence from the complainant, and were confused about certain critical and fundamental aspects of Madoff's operations. When Madoff provided evasive or contradictory answers to important questions in testimony, the staff simply accepted his explanations as plausible. Although the Enforcement staff made attempts to seek information from independent third parties, they failed to follow up on these requests. They reached out to the NASD and asked for information on whether Madoff had options positions on a certain date. However, when they received a report that there were in fact no options positions on that date, they did not take any further steps. An Enforcement staff attorney made several attempts to obtain documentation from European counterparties (another independent third party) and, although a letter was drafted, the Enforcement staff decided not to send it. Had any of these efforts been fully executed, they would have led to Madoff's Ponzi scheme being uncovered.

The OIG also found that numerous private entities conducted basic due diligence of Madoff's operations and, without regulatory authority to compel information, came to the conclusion that an investment with Madoff was unwise. Specifically, Madoff's description of both his equity and options trading practices immediately led to suspicions about his operations. With respect to his purported trading strategy, many private entities simply did not believe that it was possible for Madoff to achieve his stated level of returns using a strategy described by some industry leaders as common and unsophisticated. In addition, there was a great deal of suspicion about Madoff's purported options trading, with several entities not believing that Madoff could be trading options in such high volumes where there was no evidence that any counterparties had been trading options with Madoff.

The private entities' conclusions were drawn from the same red flags regarding Madoff's operations that the SEC considered in its examinations and investigations, but ultimately dismissed.

We also found that investors who may have been uncertain about whether to invest with Madoff were reassured by the fact that the SEC had investigated and/or examined Madoff, or entities that did business with Madoff, and found no evidence of fraud. Moreover, we found that Madoff proactively informed potential investors that the SEC had examined his operations. When potential investors expressed hesitation about investing with Madoff, he cited the prior SEC examinations to establish credibility and allay suspicions or investor doubts that may have arisen while due diligence was being conducted. Thus, the fact the SEC had conducted examinations and investigations and did not detect the fraud lent credibility to Madoff's operations and had the effect of encouraging additional individuals and entities to invest with him.

We did not, however, find evidence that any SEC personnel who worked on an SEC examination or investigation of Madoff or his firms had any financial or other inappropriate connection with Madoff or the Madoff family that influenced the conduct of the examination or investigatory work. We also did not find that former SEC Assistant Director Eric Swanson's romantic relationship with Bernard Madoff's niece, Shana Madoff, influenced the conduct of the SEC examinations of Madoff and his firm. We further did not find that senior officials at the SEC directly attempted to influence examinations or investigations of Madoff or the Madoff firm, nor was there evidence any senior SEC official interfered with the staff's ability to perform its work.

As I discussed earlier, we did find that despite numerous credible and detailed complaints, the SEC never properly examined or investigated Madoff's trading and never took the necessary, but basic, steps to determine if Madoff was operating a

Ponzi scheme. Had these efforts been made with appropriate follow-up at any time beginning in June 1992 until December 2008, the SEC could have uncovered the Ponzi scheme before Madoff confessed.

As a result of our findings, we have recommended that the Chairman carefully review our report and share with OCIE and Enforcement management the portions of this report that relate to performance failures by those employees who still work at the SEC, so that appropriate action (which may include performance-based action) is taken, on an employee-by-employee basis, to ensure that future examinations and investigations are conducted in a more appropriate manner and the mistakes and failures outlined in this report are not repeated.

Additional OIG Reports

While the report we issued to the Chairman on August 31st describes in detail the factual circumstances surrounding the Madoff-related complaints received by the SEC and the SEC's examinations and investigations of Madoff over the years, my Office plans to issue three additional reports relating to these matters. Because our investigation identified systematic breakdowns in the manner in which the SEC conducted its examinations and investigations, we plan to issue two separate audit reports providing the SEC with specific and concrete recommendations to improve the operations of both OCIE and Enforcement.

With respect to recommendations concerning OCIE, our expert, FTI, has conducted extensive fieldwork to analyze further the adequacy of OCIE's examinations of Madoff. The FTI engagement team reviewed our August 31, 2009 Report of Investigation, as well as related findings, exhibits, witness testimony and other supporting documentation (*i.e.,* OCIE examination staff work papers), and interviewed over a dozen key personnel representing OCIE's broker-dealer, investment adviser and risk assessment programs. In addition, the FTI Engagement Team reviewed OCIE's policies and procedures with regard to its examination processes and other third party records, including FINRA order and execution data and DTC and NSCC records.

The FTI Engagement Team also was granted access to OCIE's various Intranet sites, including the Broker-Dealer, Investment Adviser/Investment Company, Office of Market Oversight, and Training Branch sites, in order to view its examination policies and procedures. The FTI engagement team is currently finalizing a report that will describe its analysis of OCIE's examination process and provide numerous "lessons learned" arising from its analysis, with specific recommendations to improve OCIE's operations. While these recommendations are currently in draft status, I can report that the recommendations we are considering include the following:

- Establishing a protocol for SEC examiners to identify relevant information from industry news articles and other sources outside of the agency;
- Establishing a protocol that explains how to identify red flags and potential violations of securities law based on an evaluation of information found in industry news articles and other relevant industry sources;
- The implementation of an OCIE-related collection system that adequately captures information relating to the nature and source of each tip or complaint and also chronicles the vetting process to document why each tip or complaint was or was not acted upon and who made that determination;
- Mandating procedures for review of credible and compelling tips and complaints;
- Mandating timelines for the vetting of tips and complaints, as well as for the commencement of cause examinations;
- Requiring proper procedures for the use of scope memoranda to ensure that examinations conducted in response to tips and complaints that are received are not too narrowly focused;
- Establishing procedures for the timely modification of scope memoranda when significant new facts and issues emerge;
- Ensuring the appropriate review and analysis of planning memoranda for cause examinations to ensure that cause examinations are thoroughly planned based upon the tip or complaint that triggered the examination;
- Creating procedures to ensure that all steps of the examination methodology, as stated in the planning memorandum, are completed before the examination is closed;
- Requiring the documentation of all substantive interviews conducted by OCIE of registrants and third parties during OCIE's pre-examination activities and during the course of an examination;

- Prescribing procedures for the preparation of workpapers for an OCIE examination to ensure sufficient detail to provide a clear understanding of its purpose, source, and the conclusions reached;
- Establishing, reviewing and testing procedures for logging all OCIE examinations into an examination tracking system;
- Ensuring that the focus of an examination is determined in an appropriate and thoughtful manner, and not simply based upon on the availability or the skills of a particular group of examiners;
- Ensuring that personnel with the appropriate skills and expertise are assigned to cause examinations with unique or discrete needs;
- Requiring that a Branch Chief, or a similarly designated lead manager, be assigned to every substantive project including all cause examinations;
- Requiring the development of a formal plan within OCIE to ensure that OCIE staff and managers are obtaining and maintaining professional designations and/or licenses by industry certification programs that are relevant to their examination activities;
- Recommending the development and implementation of interactive exercises to be administered by OCIE training staff or an independent third party and reviewed prior to hiring new OCIE employees in order to evaluate the relevant skills necessary to perform examinations;
- The training of OCIE examiners in the mechanics of securities settlement, both in the United States and in major foreign markets;
- The training of OCIE examiners in methods to access the expertise of foreign regulators, such as the United Kingdom's Financial Services Authority, as well as foreign securities exchanges and foreign clearing and settlement entities;
- Requiring OCIE examination staff to verify a test sample of trading or balance data with counterparties and other independent third parties such as FINRA, DTC, or NSCC whenever there are specific allegations of fraud involved in an examination;
- Recommending the training of OCIE examiners jointly with the Office of Economic Analysis economists by FINRA, other self-regulatory organizations (SROs) and exchange staff in understanding trading data bases, regional exchanges, option exchanges, and DTC/NSCC, *etc.;*
- Ensuring that OCIE staff have direct access to certain data bases maintained by SROs or other similar entities in order to allow examiners to access necessary data for verification or analysis of registrant data;
- Mandating procedures to ensure that when an examination team is pulled off an examination for a project of higher priority, the examination team return to the previous examination upon completion of the other project and bring the prior examination to a conclusion;
- Implementing procedures for tracking the progress of all cause examinations, including the number of cause examinations opened, the number ongoing and the number closed for each month; and
- Requesting OCIE management provide express support to their examiners regarding the examiners' pursuit of evidence in the course of an examination, even if pursuing that evidence requires contacting customers or clients of the target of that examination.

We are also finalizing a report that analyzes "lessons learned" from the investigations conducted by the SEC's Enforcement Division of Madoff and prescribes concrete recommendations for improvement within Enforcement. For this analysis, we launched an extensive survey questionnaire to Enforcement staff and management in both headquarters and the regional offices. This survey was designed to obtain feedback from Enforcement staff on numerous topics, such as allocation of resources, performance measurement, case management procedures, communication, adequacy of policies and procedures, employee morale, and management efficiency and effectiveness.

The Enforcement-related recommendations that we are currently considering include the following:

- Establishing formal guidance for evaluating various types of complaints (*e.g.,* Ponzi schemes) and training of appropriate staff on the use of such guidance;
- Ensuring that the SEC's tip and complaint handling system provides for data capture of relevant information relating to the vetting process to document why a complaint was or was not acted upon and who made that determination;

- Requiring tips and complaints to be reviewed by individuals experienced in the subject matter to which the complaint or tip relates, prior to a decision not to take further action;
- Establishing guidance to require that all complaints that appear on the surface to be credible and compelling be probed further by in-depth interviews with the sources to assess the complaints' validity and to determine what issues need to be investigated;
- The training of staff to ensure they are aware of the guidelines contained in Section 3 of the Enforcement Manual and Title 17 of the Code of Federal Regulations, Section 202.10, for obtaining information from outside sources;
- Requiring annual review and testing of the effectiveness of Enforcement's policies and procedures with regard to its tip and complaint handling system;
- Implementing procedures to ensure that investigations are assigned to teams comprised of individuals who have sufficient knowledge of the pertinent subject matter (*e.g.* Ponzi schemes);
- The training of staff on what resources and information are available within the Commission, including how and when assistance from internal units should be requested;
- Mandating that planning memoranda be prepared at the beginning of an investigation and that the plan include a section identifying what type of expertise or assistance is needed from others within and outside the Commission;
- Requiring that after the planning memorandum is drafted, it be circulated to all team members assigned to the investigation, and all team members then meet to discuss the investigation approach, methodology and any concerns team members wish to raise;
- Conducting periodic internal reviews of any newly implemented policies and procedures related to information sharing with divisions and offices outside of Enforcement to ensure they are operating efficiently and effectively and necessary changes are made;
- Requiring that the planning memoranda and associated scope, methodology and timeframes be routinely reviewed by an investigator's immediate supervisor to ensure investigations remain on track and to determine whether adjustments in scope, *etc.,* are necessary;
- Ensuring that sufficient resources, both supervisory and support, are dedicated to investigations up front to provide for adequate and thorough supervision of cases and effective handling of administrative tasks;
- Establishing policies and procedures to ensure staff have an understanding of what types of information should be validated during investigations with independent parties such as FINRA, DTC and the Chicago Board Options Exchange;
- Updating Enforcement's complaint handling procedures to ensure complaints received are properly vetted even if an investigation is pending closure; and
- Conducting periodic internal reviews to ensure that Matters Under Inquiry (MUIs) are opened in accordance with any newly developed Commission guidance and examining ways to streamline the case closing process.

Both of these reports containing recommendations to OCIE and Enforcement will be finalized and issued within the next few weeks. We also plan to issue an additional report analyzing the reasons that OCIE's investment adviser unit did not conduct an examination of Madoff after he was forced to register as an investment adviser in 2006, and prescribing recommendations as appropriate to improve this process. We plan to issue this report by the end of November 2009.

My Office is committed to following up with respect to all the recommendations that we will be making to ensure that significant changes and improvements are made in the SEC's operations as a result of our findings in the Madoff investigation. We are aware that improvements have already been begun under the direction of Chairman Schapiro even prior to our report being issued. We are confident that under Chairman Schapiro's leadership, the SEC will carefully review our analyses and reports and take the appropriate steps to implement our recommendations and ensure that fundamental changes are made in the SEC's operations so that the errors and failings we found in our investigation are properly remedied and not repeated in the future.

Conclusion

In conclusion, we appreciate the Chairman's and the Committee's interest in the SEC and our Office and, in particular, in the facts and circumstances pertinent to

the Madoff Ponzi scheme. I believe that the Committee's and Congress's continued involvement with the SEC is helpful in strengthening the accountability and effectiveness of the Commission. Thank you.

PREPARED STATEMENT OF HARRY MARKOPOLOS

CFA, CFE, CHARTERED FINANCIAL ANALYST AND CERTIFIED FRAUD EXAMINER

SEPTEMBER 10, 2009

Introduction

I would like to thank Chairman Dodd and Ranking Member Shelby for inviting me to submit written and oral testimony to the Senate Banking, Housing and Urban Affairs Committee today. I appreciate your invitation to testify on my experiences with the SEC with regard to the Bernard Madoff scandal, the SEC Inspector General's Report and recommendations, along with my own recommendations on regulatory reform.

The Current Situation

The current situation is dire. The cost to this nation's capital markets due to criminal acts by white-collar fraudsters is still being totaled up but easily runs into the trillions of dollars. The only question is: how many trillions will be required to clean up the banking system, the insurance companies, and the shadow financial institutions and rid their balance sheets of toxic debt? We still don't know and won't know for several more years.

White collar crime is a cancer on this nation's soul and our tolerance of it speaks volumes about where we need to go as a nation if we are to survive the current economic troubles we find ourselves facing. These troubles were of our own making and due solely to unchecked, unregulated greed. We, as a nation, get the government and regulators that we deserve, so let us be sure to hold not only our government and our regulators accountable, but also ourselves, as citizens, for permitting these situations to occur.

Far too much attention and money has been paid to violent crime and drug offenses while white-collar fraudsters have been allowed to roam freely and openly without fear of getting caught. For example, too many FBI agents were assigned to chase down bank robbers who dared hold-up bank tellers at bank branches and steal small amounts of money in the mere thousands. Bank robberies are better left to state and local police while Federal resources are targeted to attack the high-level white collar frauds originating in the C-level suite. Meanwhile the true banksters were the top officials of our nation's largest financial institutions who looted millions and hundreds of millions in unmerited bonus payments from these financial institutions while apparently no FBI agents were investigating the white-collar frauds these fraudsters were perpetrating.

White-collar criminals cause far more economic harm to this nation than armed robbers, drug dealers, car thieves, and other assorted miscreants put together. These fraudsters steal approximately 5 percent of business revenues annually, dwarfing the economic losses due to violent crime, yet not nearly enough Federal law enforcement resources are devoted to catching them. White-collar criminals have the best resumes, have attended good universities and many of them hold graduate degrees. They live in the nicest neighborhoods and have the best reputations—until they get caught. But the worst whitecollar criminals cause far more damage to the Nation than common criminals because they wipe out pensions, bankrupt companies, throw thousands of out work, and destroy investor confidence.

Sub-prime loans, liar loans, option-arms, collateralized debt obligations (CDO's), credit default swaps (CDS's), collateralized loan obligations (CLO's), and other toxic structured products were the evidence of their crimes but so far, all too few have been brought to justice. An entire criminal class consisting of corrupt real estate agents, property appraisers, mortgage lenders, ratings agencies, and Wall Street investment banks openly colluded to originate, package and sell toxic debt securities to pension funds, individuals and other unsuspecting victims. And all of these crimes occurred right under the noses of our nation's incompetent financial regulators who saw nothing, said nothing and did nothing, in effect they stole their government paychecks. So here we are today with a regulatory system that is beyond broken.

Bernard Madoff is merely the poster child for what went so horribly wrong with our financial system. His fraud destroyed the lives of thousands of direct investors. Entire generations of families went from riches to rags literally overnight. Some victims cannot pay for medical care while others have seen their children's college edu-

cation funds wiped out. Charities, schools and endowments have shut down or seen their operations curtailed. The millions of indirect victims of the Madoff fraud are those individuals and organizations that received services, scholarships or grants from the direct victims.

The reputation of the U.S. capital markets as a desirable place to invest is also a victim. No foreign government or investor holding U.S. securities thinks our capital markets are properly regulated. Some foreign investors will be adding an "American Fraud Risk Premium" to their expected rates of return which increases the cost to American businesses which need access to affordable capital. This raises the cost to all Americans. Each one of us will be paying higher fees and higher interest rates to our foreign creditors as a result of our failure to properly regulate our markets.

The mess in which we find ourselves took decades to manifest itself and it will take a considerable number of years to repair the damage to our nation's balance sheet and to our nation's reputation as a safe place to invest.

My Comments on the SEC IG's Madoff Report

I realize that the Committee invited me here today to verify that the SEC IG Madoff Report was both truthful and accurate. The 477-page IG Report contains an accurate depiction of what transpired during my dealings with the SEC. I have seen no discrepancies between what I saw and heard and what the SEC IG has reported. If there was a cover-up or a white-wash, I would have spotted it and vehemently refuted all discrepancies in my testimony today.

I am impressed beyond my ability to express myself by how open, honest, transparent and how exceptionally well researched and well written the SEC Inspector General's report is. As a key figure who probably accounts for approximately a third of the report's length either directly or indirectly, I was at ground zero of the Madoff fraud investigation for 8 1/2 years. Tragically, what the SEC IG depicts in his report fits with my experiences with the SEC during the time period 2000 to the present.

I have to thank H. David Kotz, the SEC's Inspector General (the "IG") for his team's tireless efforts while under great stress to write this report. My counsel, Dr. Gaytri Kachroo, Esq. (LL.L, LL.B, LLM, SJD) and I have worked closely in assisting the IG's team with the portions of the report that are relevant to my team's investigation and others. Thanks also to my investigative team members, Frank Casey, Neil Chelo, and Michael Ocrant for cooperating with the IG team.

I have read many government inspector generals' reports and, all too often, they have been nothing but white-washed, cover-up jobs. This IG report is different because this IG is different. If you go back and read the SEC's IG reports since Mr. Kotz became the IG, you'll see that all of his reports are hard-hitting and very embarrassing to the agency. They also contain coherent and constructive recommendations on fixing the problems. The Madoff IG Report is consistent with the high quality of work that I have seen from his office. With these kinds of reports the SEC cannot help but get better faster and Lord knows we need them to get better faster.

I would be remiss if I didn't also thank the key individual who allowed this report to be written in an open and transparent manner. Mary Shapiro, the SEC Chairman, supported her IG office's writing and release of this report. I'm sure there are many within the SEC who wished she had scuttled this report or at least heavily censored it. I admire her dedication to the truth, to openness and to transparency. I am sure the internal pressures to censor this report were tremendous but Chairman Shapiro demonstrated superior leadership in allowing the IG write and deliver this hard-hitting report to the American public. This report defines her courage and her leadership of the SEC as it rebuilds itself.

To all Americans who are thinking that the level of incompetence, inexperience and laziness depicted in the full 477-page report just can't be true, sadly, I can assure you it is all true. My February 4, 2009 testimony before the House Capital Markets Sub-Committee details the low regard I held this agency in pre-Madoff and pre-Mary Shapiro. Unfortunately, this IG report is frighteningly accurate. Even a great fiction-writer like Stephen King couldn't have made up the nightmare that the SEC was pre-December 11, 2008. The SEC's actions and inactions during the Madoff investigation were a comedy of horrors.

No doubt it would have been far better for the agency if it turned out that Mr. Madoff had bribed one or more of the SEC staff to waylay investigations of his criminal enterprise. Catching an SEC employee or employees who were paid to look the other way would have resulted in far less embarrassment and turmoil for this agency. It is my opinion that if there was an internal corruption case to be made, the SEC appeared to me to be pulling out all of the stops to make corruption cases against its own employees which I will cover in some detail below. But it wasn't

corruption that led to Madoff operating a multi-decade long Ponzi scheme that went unchecked for so long—it was systemic and structural incompetence.

At no time did I notice criminal activity by SEC staff examiners or enforcement personnel. Clearly, I feared that if the SEC staff were corrupt then one or more of them would have taken money from Bernard Madoff, handed him copies of my SEC submissions and Madoff would have attempted to silence me soon thereafter. That did not happen. My being here refutes the conspiracy theorists who mistakenly think that anyone connected to the SEC's 2006–2008 Madoff investigation related to my November 2005 SEC submission must have been corrupt.

It was clear to me during my first call with the SEC IG in late December 2008 that he was conducting a thorough and wide-ranging investigation of the SEC staff. My first call with him told me a lot about him both as a person and as a professional. He asked me if I would be willing to make a full production of Madoff case documents because he wanted to double-check the document production he was getting internally from the SEC. In other words, he wasn't going to meekly accept whatever documents his own agency was giving him, he wanted an independent third party, namely myself and my counsel, to provide our documents and emails as a check on his own agency's veracity.

When I first met him in person on February 5, 2009, it was also clear that his investigation did encompass possible criminal acts by SEC staffers at all levels. He read my 2005 SEC Submission and must have thought to himself, *"there's no possible way that an SEC enforcement team could miss the Madoff Ponzi scheme with this kind of detailed road map in their hands. It's just not possible, there must be internal corruption involved somewhere."* He asked me pointed questions about high level employees bowing to outside political pressures. He also asked pointed questions about possible corruption at lower levels involving team, branch and regional staff. I can assure you that the IG went down all the proper paths in his questioning of me to thoroughly explore any and all possible criminal acts that might have occurred involving SEC employees. Given my knowledge of what transpired, I never felt any SEC staffers were corrupt and the fact that the IG's investigation asked plenty of questions that were corruption related suggests a proper investigation was conducted.

I am a certified fraud examiner (CFE) and I have been investigating large, half billion dollar and up, white collar fraud cases full-time for over 5 years now. I could tell from Mr. Kotz's questions where his investigation had gone and where it was going. It was as thorough and wide-ranging as it could be. Like all investigations, you are forced to go down every possible path you can identify, most of which turn out to be dead ends, in order to finally arrive at a fair interpretation of the truth. No one is capable of conducting the perfect investigation nor does any report contain a full 100 percent of what transpired—humans and memories are way too fragile for that. Investigators, no matter how good they might be, are incapable of perfectly recreating the past. I am a pretty fair investigator myself and I know for a fact that I could not have done nearly as good a job as Mr. Kotz and his team did. This IG Report is the absolute best inspector general's report I have come across.

In my opinion this IG Report is a fair and accurate depiction of what I experienced. My hat is off to the SEC for conducting a proper and thorough investigation and delivering such a detailed and powerful report. I also commend this agency's leadership for having the moral courage to release it to the American public. If a harder hitting IG Report than this has ever been written, please let me know so that I can obtain a copy and read it.

Where are the other Financial Regulator's Inspector Generals' Reports?

It is a breath of fresh air that the SEC has stepped forward and delivered a comprehensive and transparent report about what transpired during the Madoff crime spree for the sixteen year time period 1992–2008. Now where are the IG Reports for the other financial regulators, namely the Federal Reserve (FED), the Office of the Comptroller of the Currency (OCC), the Federal Deposit Insurance Corporation (FDIC), and the Office of Thrift Supervision (OTS)? These regulators were far more incompetent than the SEC yet they seem intent on lying low in the weeds and avoiding blame.

One can argue that the banking regulators' lapses were far more egregious than the SEC's and that their examiners were even less competent—and that's quite a feat! If the entire SEC staff were seated in Fenway Park for the afternoon and couldn't find 1st base, then I'm not too sure that banking regulators could even find Boston, much less Fenway Park. And at the top levels of these non-functional banking regulators, there are more than a few who I doubt could even find the east coast.

I urge the Committee to task each banking regulator to prepare its own inspector general's report for their agency and to make their reports at least as hard-hitting as the SEC IG's. The bank regulators' failures to regulate have cost the American taxpayers a lot more money and lost reputation than the SEC's failures and it is past time they be taken to the woodshed too. They need to be exposed and held accountable just like the SEC has been exposed in this report and held accountable.

Comments on the SEC's Reforms to Date

Plainly put I have never seen a government agency embrace reforms as rapidly as the SEC has. Of course, I've never seen an agency do such a bad job first-hand like this either. For the SEC it's definitely a case of sink or swim. If this agency fails to right itself and quickly, it is doubtful that they would get included in the new regulatory structure due to be enacted by this Congress. The SEC's very survival depends upon embracing change at a rapid pace in a bid to show they deserve to survive and not have their enforcement powers parceled out to other agencies after they were disbanded.

The Madoff Ponzi scheme exposed this non-functional agency's every wart and took it to its lowest point in its 75-year history. The scandal was so big and all encompassing and took place over such a long timeframe that it called into question the entire agency's structure, staffing, willingness and ability to protect investors and to ensure the safety, soundness and transparency of our nation's capital markets.

When a scandal of these epic proportions hits it is like a 100-year flood—it occurs every century or so. If the Stock Market Crash of 1929 and subsequent Great Depression was last century's 100-year financial flood, then Bernard Madoff and the Panic of 2008 are this century's version of that. The regulatory structures put into place in the wake of the Great Depression are now over three-quarters of a century old and inadequate to police our financial markets. Madoff brought this point home to the SEC and they seem to have gotten religion after their multi-decade long slumber.

By now you've seen the SEC's list of Proposed Post-Madoff Reforms dated June 29, 2009. I support each of these recommendations without exception. There are other much smaller, less newsworthy reforms that are not on this list of which even Mary Shapiro may not be aware because the SEC's regional offices adopted them on their own. They saw a need for change and took the initiative to make the changes within their power to make. I happen to have found out about them either from SEC staffers who are personal friends of mine or professional acquaintances of mine. I would like to share two of these instances with you.

First, one regional office held its own series of internal meetings to discuss changing the way exams are performed. They just knew the current methodology wasn't effective and discussed new methods on their own without being told to do so by their Washington headquarters. Second, another regional office was reviewing a company's restated earnings and discovered an old internal auditor's report that bluntly stated that the company's CEO and CFO were cooking the books. The internal auditor was fired on the spot when he refused to withdraw the report and then mailed it to the Audit Committee Chairman. The SEC went in, found the report in the company's files, and then, several years after the report was written, flew a team out to meet the fired internal auditor to conduct a follow-up investigation. These are only two examples of how the SEC is changing rapidly and for the better. Before Madoff turned himself in, the SEC staff didn't seem to care about anything other than showing up and collecting their paychecks. Nowadays it does seem that the agency is operating with a speed and vigor which it hasn't exhibited in many years.

I would rate the SEC in its current state as still being non-functional but at least they are trying to get better and they are trying at an enviable pace. As they say, you have to crawl before you can walk, and you have to walk before you can run. Right now the SEC is learning to crawl again. It took decades of sloth, abysmal leadership, under-funding and benign neglect to get this bad and realistically it will take them at least a few years to become the effective, efficient cop on the beat that investors expect.

My biggest worry is that the SEC will backslide once their agency is out from under public scrutiny. It is up to Congress to ensure that they keep close watch over the SEC and perform close oversight to ensure that the pace of reform continues and that these reforms are funded. I encourage Congress to write enabling legislation where required to enact and fund the SEC's proposed reforms.

Recommendations for Regulatory Reform

Recommendation # 1: Combine all of the Nation's Financial Regulators under one Umbrella

The SEC IG report details how the Boston, New York, and Washington offices of the SEC were incapable of coordinating the Madoff investigation amongst themselves. Worse, within the New York Regional Office, the Examination team (OCIE) that had just finished an exam of the Madoff operation in 2005 did not coordinate effectively with the Enforcement team (DOE) that started investigating Madoff shortly thereafter. If regional offices from a single agency could not coordinate with each other and if teams within one regional office could not coordinate with each other, what sense does it make to keep FED, OCC, FDIC, SEC and the CFTC as stand alone regulators? Worse, each of the five regulators would have its own computer system and none of them would know what the other regulators were doing with respect to a particular company.

Regulators are facing off against financial institutions magnitudes larger than those that existed back in the 1930s when the current regulatory system was formed. Today, unfortunately we still have gigantic "too big to fail—too big to succeed—too big to regulate" companies like Citigroup, Bank of America, American International Group and others. These ultra-large companies may have subsidiaries operating banks, insurance companies, mortgage lenders, credit card companies, investment-banks and securities broker-dealers not only domestically but also internationally. Sending in several separate regulators to spot problems is akin to tackling the problem peace-meal. If the SEC can't coordinate within its own agency, what hope is there that separate agencies can coordinate effectively? Is it any wonder the three financial institutions I've listed above collapsed last year and needed government rescues to survive?

Our nation has too many financial regulators and this leaves too many gaping holes for financial predators to engage in "regulatory arbitrage" and exploit these regulatory gaps where no regulator is looking or the regulator that may be investigating is trumped by another. I have seen one institution where individuals have two different business cards. One card has their registered investment advisor title (which falls under SEC regulation) and the other has their bank title (which falls under banking regulators). When the FED comes in to question them, they say they're under the SEC's jurisdiction and when the SEC comes in to question them, they say they're under the FED's jurisdiction. But let's assume that both the SEC and FED were to come in and inspect fraud in the company's pension accounts under management, well then the company might say, *"Oh but these are ERISA accounts and they fall under the Department of Labor, so you don't have jurisdiction."* Clearly this situation has to be corrected so firms can't play one regulator off against the others or worse, choose to be regulated by the most incompetent regulator while avoiding the most vigorous and thorough regulators.

The goal needs to be to combine regulatory functions into as few a number as possible to prevent regulatory arbitrage, centralize command and control, ensure unity of effort, eliminate expensive duplication of effort, and minimize the number of regulators to whom American businesses must respond.

I recommend that one super-regulatory department be formed and that it be called the Financial Supervisory Authority (FSA). Under it's command should be the SEC, the FED, a national insurance regulator and some sort of Treasury / DOJ law enforcement function with staffs of dedicated litigators carrying out both criminal and civil enforcement for the SEC, national insurance regulator, and the FED. All banking regulators should be merged into the FED so that only one national banking regulator exists. Pension fund regulation should be moved from the Department of Labor to the SEC. The CFTC should be merged into the SEC so there exists only one capital markets regulator. Cross-functional teams of regulators from the SEC, FED, national insurance regulator and Treasury/DOJ should be sent on audits together whenever possible to prevent regulatory arbitrage. I envision the inspection arms to be the SEC, FED and national insurance regulator while the Treasury/DOJ litigators house the litigation teams that take legal action against defendants. American businesses deserve to have a simpler, easier to understand set of rules to abide by and they also deserve to have competent regulation. Right now financial institutions pay a lot in fees for regulation but they certainly aren't getting their money's worth.

Recommendation # 2: Pass a Sarbannes-Oxley (SOX) Equivalent Law for Government to Hold Agency Heads Accountable to Taxpayers

In the wake of the accounting scandals that felled Enron, WorldCom, Global Crossing, Adelphia and others, Congress passed very strict laws that held corporate

CEO's and CFO's accountable for their company's financial reporting. CEO's and CFO's suddenly became accountable for everything that happened or failed to happen with their company's financial reporting. No longer could they claim *"they didn't know what was happening"* under their watch. If a CEO and CFO signed off on a company's books and it turned out that for whatever reason the books were materially inaccurate, it was a 10-year prison sentence. If the CEO and CFO were willfully cooking the books, it meant a 20-year prison sentence.

I propose that Congress pass similar legislation that holds agency heads just as responsible as we currently hold corporate CEO's and CFO's for their financial reporting. If an agency fails to enforce this nation's laws, as passed by Congress, then a criminal referral to the Justice Department seems in order.

Right now there is no accountability in government. All of this nation's financial regulators failed to regulate the industries they were charged with regulating and they've gotten away scot-free without any punishment. At the SEC a few high-level department heads were allowed to resign "to pursue other growth opportunities" called "pogo-ing out" but how fair is that to taxpayers? It sure would be nice to see a few agency heads sent to prison for their willful blindness in letting our nation's financial system collapse but, unfortunately, there are no laws on the books to help in this regard.

If Congress passes a law, we as taxpayers should want to see it enforced fairly for all. Currently it seems that entire government agencies can remain comatose and let the industries they are charged with regulating commit whatever crimes they wish with impunity. Putting agency heads in prison for willful blindness, malfeasance, and corruption seems like it's long overdue.

SOX for government would also go a long ways toward eliminating "regulatory capture" whereby regulators stop protecting the public because they become beholden to the industries they are charged with regulating. Government is supposed to be representing the public's interests but all too often these government agencies become captive and start representing their industry's interests over those of the citizenry. For instance, the overall goal of the SEC investigation and examinations, as the IG's report iterates time and again, is and was to protect investors, current and future, not deep pocketed and influential industry firms.

Recommendation # 3: Use Congressional Public Censure to Punish Incompetent Government Agencies

One way to light a fire under under-performing or non-performing government agencies that are non-responsive to Congressional oversight is to publicly censure these wayward agencies. For example, Congress could censure an agency by voting into law that for the next X number of months or years, that offending agency be termed *"A national disgrace by Act of Congress dating from today—Month Y."* The censured agency would then have to include this censure in every email sent out by its employees during the time period the censure was in force for. This shaming mechanism is a low-cost but effective means for Congress to express its displeasure over the lack of regulatory zeal by certain agencies, some of whom are repeat offenders. The road toward gaining respect would then be earned through every successful effort by employees, who would in turn be incentivized to work together to improve the entire organization through their individual and team efforts.

Recommendation # 4: Regulate all Over-the-Counter Products, Mandate Centralized Clearing and Wherever Possible Put Them on Exchanges

Over-the-Counter (OTC) is unregulated space. It's where the financial industry's cockroaches congregate because there is no light, only darkness. This is also where the industry's highest margins exist so they will fight like the dickens to protect their profit margins.

Laws should be passed that dictate that U.S. investors cannot trade OTC products offshore and receive government protection in the form of bailouts. In other words, no more trading through unregulated entities such as AIG's London-based Financial Products unit where the risk ends up getting transferred back on-shore domestically and U.S. taxpayers end up footing the bill. If U.S. regulators don't have visibility into an OTC product that's traded off-shore, then strict risk and capital limits should be placed on U.S.-based traded counter-parties in order to avoid systemic risk.

You cannot regulate common sense but some sort of guidelines should be available to investors on the SEC's website that if you don't know how to model an OTC derivative yourself, then you, your company or your municipality should not be trading them. The SEC should closely investigate all disclosures in the OTC municipal derivatives market because this sector of the marketplace is rife with fraud. In many

instances it is still a pay-to-play market with opaque disclosure documents and even more opaque pricing mechanisms which only serve to defraud government entities.

In my own state, Massachusetts, our Turnpike Authority ended upside down on a series of interest rate swaptions they did not understand. The last press account I saw in late 2008 put the amount of fiscal carnage in Massachusetts at $450 million. I can assure you that no one in our state's government knows how to price interest rate swaptions. Our Turnpike Authority was "picked off" by several Wall Street firms because they were lured into these OTC transactions and did not understand either the pricing or the risks. But since you cannot regulate common sense, at least regulate the OTC markets so they don't remain lawless like the Wild Wild West of the late 19th century.

Recommendations for the SEC

Recommendation # 1: A Maximum of One Lawyer on the SEC Commission Itself

Currently the SEC is dominated by lawyers, in fact all five of the current SEC Commissioners are lawyers so is it any wonder the SEC is ineffectual? I have nothing against lawyers but putting them in charge of supervising our capital markets has been an unmitigated disaster. Very few SEC lawyers understand the complex financial instruments of the 21st century and almost none of them have ever sat on a trading desk or worked in the industry other than in a legal capacity. If you want to know how things became so bad at the SEC it's because predominantly most or all of the five SEC Commissioners have been lawyers who haven't a clue as to how the industry really operates.

Putting lawyers in charge of regulating the capital markets makes no sense, something the financial services industry recognizes. Most financial firms are run by businessmen with capital markets or banking expertise—not that this prevented the industry from a near-death experience in 2008 but just about anything is better than being led by lawyers who have no understanding of the finance industry they are governing.

Lawyers within the SEC need to be relegated to back-seat roles and removed from most positions of senior leadership within the agency and replaced by people with the proper backgrounds to understand the markets and institutions being regulated. Yes, the Director of Enforcement should be a lawyer but as for the other departments, very few should be led by lawyers.

Read the SEC IG's report for how the SEC's enforcement lawyers did not have a clue as to what Bernard Madoff was telling them about his trading strategy. They couldn't recognize the obvious lies because none of them had any financial expertise to understand the capital markets. The typical SEC attorney would have trouble finding ice cream at a Dairy Queen so tasking them to uncover financial frauds would be about as fruitful.

The law is the lowest form of acceptable behavior but ethics are a higher standard that the SEC's securities lawyers seem to ignore time and again. For instance, mutual fund market-timing wasn't illegal so the SEC's lawyers ignored it while individual investors lost tens of billions to market-timers and hedge funds engaged in the practice. However, any industry professional with a moral compass could have told you this activity was unethical and needed to be stopped. SEC lawyers are not trained within the industry, and so they have little idea of the ethical dilemmas industry professionals face everyday. Lawyers are trained in the black letter law and regulation instead. This, in a nutshell is why it is better to have industry professionals running the show and not lawyers because securities laws are a very low behavioral bar. Securities laws are outdated as soon as they are passed because new financial instruments are invented to skirt these laws, which is another reason that lawyers shouldn't be running the SEC. We need to raise the bar and insist upon transparent and fair dealings for all which is a standard of behavior that is leaps and bounds higher than merely following existing securities laws. Therefore having lawyers run the show allows too much bad behavior to occur since they have blinders on and can only distinguish between lawful and unlawful behavior. Only finance professionals can keep up with the modern financial instruments of the 21st century. Therefore they should be in positions of authority. It would be very difficult to do a worse job than the securities lawyers have already.

Recommendation # 2: Conduct a Skills Inventory of the Professional Staff and Terminate Those Not Qualified to Hold Their Positions

It's clear that a significant portion of the SEC's professional staff, perhaps 50 percent or more of them, need to be let go because they are not qualified to hold their positions. For example, quite a few of the New York Regional Staff depicted in the SEC IG report should be immediately fired if they haven't already resigned. Fortu-

nately, given the layoffs on Wall Street, plenty of vastly more qualified industry professionals who do understand the capital markets, are available and could be brought on board quickly. The SEC's staff needs to be dramatically upgraded and there's no better economic environment to be in than today's from a hiring standpoint.

Recommendation # 3: Hire Qualified Industry Professionals with Over 10 Years of Experience

Hiring kids right out of college is not the way to detect financial fraud. These greenhorn twenty-something's couldn't find steak at an Outback. For the broker-dealer exam teams, hire experienced brokers with as many years of experience as you can. Send veteran traders and veteran back office personnel in to conduct trading floor exams. For the money management and hedge fund teams, hire experienced portfolio managers, analysts and buy-side back office personnel to conduct asset manager exams. The same goes for hiring experienced accounting professionals to examine required corporate filings. Let me tell you about the following story from Boston. A person I know rather well with over 10 years of industry experience, an under-graduate degree in economics and math, an MBA and a Chartered Financial Analyst designation wanted to leave her job as a senior analyst at a large mutual fund company in order to have another child. She wanted out of the rat race where 70 hour work weeks were common and expected so she applied for a job with the SEC. During her interview she was told that she was 1) overqualified with too much industry experience, 2) over educated and 3) that she wouldn't be happy inspecting paperwork and would likely quit in frustration so the SEC didn't plan on offering her the job. And that's the problem. Since the SEC only hires unqualified, uneducated people without financial industry experience, all they want to do is check pieces of paper to make sure all the paperwork that existing (outdated) securities law requires is being complied with. Is it any wonder, given the current SEC staff, how major financial felonies go unpunished while minor paperwork transgressions are flagged for attention?

I am not sure how many of you have ever undergone an SEC inspection visit. I was a portfolio manager, then chief investment officer, at a multi-billion dollar equity derivatives asset management firm. We were considered "high risk" because we managed derivatives and received SEC inspection visits every 3 years like clockwork, so I've been through these examinations and will tell you about their many obvious flaws. First, the SEC never once was able to send in an examiner with any derivatives knowledge. A good thing my firm was honest because if we weren't we could have pulled a Madoff on them and they would have never been the wiser. Second, the teams are very, very young and they don't have any industry experience. Third, the teams come in with a typed up list of documents and records they wish to examine. They hand this list to the firm's compliance officer (CO). The CO then takes them to a conference room and the firm provides the pile of documents and records which the SEC team inspects diligently. So, if a firm were so inclined, it could keep a second set of falsified but pristine records yet commit the equivalent of mass financial murder and get away with it, just as long as the firm's books and records were in compliance.

Now let's examine what went wrong with the examination process described above. First, the team only interacted with the inspected firm's compliance team, not the traders, not the portfolio managers, not the client service officers, and not top management. The problem with this process is that the SEC examiners only examined paperwork but neglected the tremendous human intelligence gathering opportunities that were sitting right outside the conference room. What these SEC examiners need to be doing is sending one or two people out on the trading floors and into the portfolio manager's offices to ask leading, probing questions. During every single such unscripted interview, the SEC examiner should ask, "Is there anything going on here that is suspicious, unethical or even illegal that I should know about? Are you aware of any suspicious, unethical or even illegal activity at any competing firms that we should be aware of?" And, during that interview, the SEC examiner should be handing out his/her business card, asking that person to call if they ever run across anything the SEC should be looking into either at their firm or any other firm. These are basic internal auditing techniques that every accountant, internal auditor, and fraud examiner uses when conducting audits. But the SEC staff is so untrained, it's almost as if this is advanced rocket science, because the SEC examiners are so inexperienced and unfamiliar with financial concepts they are afraid to interact with real finance industry professionals and choose to remain isolated in conference rooms inspecting pieces of paper.

Right off the bat, the incoming SEC Chair needs to get these examiners to focus on interacting with the industry professionals and querying them on what's going

on in their firms and their competitors' firms. Sitting like ducks getting fed controlled bits of paper by inspected firms isn't getting the job done and the current examination process is an insult to common sense. It also seems like a waste of taxpayers' or investors' money. This also reinforces the need to increase the pay scale and add in incentive compensation such that more qualified people apply for and take SEC jobs. Unless and until the SEC puts real finance professionals on those examination teams, their odds of finding the next Bernie Madoff are miniscule at best.

Recommendation # 4: Adopt the Industry's Compensation Model

The problem is that the SEC pays peanuts and then wonders how it ended up with so many monkeys. Industry pays salary plus bonus and the SEC needs to be competitive in order to attract the best talent. Compensation at the SEC needs to be both increased and shifted to include incentive compensation tied to how much in enforcement revenues each office collects. Of course, the SEC Commissioners would be setting the levels of fines for enforcement actions, but each SEC Regional Office should get back some percentage, and I recommend a 10 percent level initially, toward that office's bonus pool.

Regional enforcement teams that bring in a $100 million case deserve to be compensated for that. And, to prevent taxpayers from having to pony up these multimillion dollar bonuses, I would insist that the fines be triple the amount of actual damages, that the guilty transgressors pay the actual costs of the government's investigation, so that SEC staff bonuses end up being paid for by the guilty transgressors.

In expensive financial centers' like New York and Boston, cost of living adjustments bringing base compensation to the $200,000 level make sense. This would be enough to attract the nation's best, brightest and most experienced industry practitioners. All compensation over and above this amount would need to come from each regional office's bonus pool and be tied directly to the fines (revenues) that each office generates. People who do not perform and bring in good quality cases that settle will get asked to leave and make room for people who can come in and produce solid cases.

Recommendation # 5: Move the SEC's Headquarters to New York

This might be the single best way to quickly upgrade the SEC's talent pool at the highest levels. Move the SEC's headquarters out of Washington because Washington is a political center not a financial center, so you won't find very many qualified finance professionals there. Since New York is the world's largest financial center and Boston is the world's fourth largest financial center, moving the SEC to either New York City, West Chester County, New York or Fairfield County, Connecticut makes a lot of sense. This puts the SEC's headquarters right in the center of the financial industry and offers easy access to both Boston and Washington. If the SEC wants to attract the top talent, relocating its headquarters to somewhere between New York City and Stamford, CT is where this agency will best attract the foxes with industry experience it so desperately needs to be on the right side of the fence.

Recommendation # 6: Administer Competency Exams for Professional Staff Before Hiring

Amazingly, the SEC does not give its employees a simple entrance exam to test their knowledge of the capital markets! Is it any wonder that most SEC staffers, particularly the Staff Attorneys don't know a put from a call, a convertible arbitrage strategy from a municipal bond, or an interest-only from a principle-only fixed income instrument? The Chartered Financial Analysts Level I exam covers the material that I would expect all of the SEC's professional staff to have mastered before being hired. I doubt that even 20 percent of the SEC's current staff would be able to pass this exam. For SEC Staff Attorneys that number would likely be less than 5 percent.

Recommendation # 7: Fund Subscription Budgets

If you walk into any sizable investment industry firm, they'll have a library of professional publications for their staff to use as a resource. Typical journals on hand would be the Journal of Accounting, Journal of Portfolio Management, Financial Anaylsts Journal, Journal of Investing, Journal of Indexing, Journal of Financial Economics, and the list goes on and on. If you walk into an SEC office, you won't see any of these journals nor will you see an investment library. This begs the question: where do SEC staffers actually go to research an investment strategy, find out which formulas to use to determine investment performance, or figure out what a CDO squared is? Apparently all the SEC staff uses is Google and Wikipedia because both are free. Lots of luck figuring out today's complex financial instru-

ments using free web resources. No wonder industry predators run circles around the SEC's staff. It's easy to fool people from an ignorant regulator that makes sure its staff remains uneducated.

Recommendation # 8: Mandate and Fund Business Cards for All SEC Staff

The SEC doesn't provide its staff with business cards. I know, it's hard to believe but it's true. It's sort of hard to get a call back from someone you've met at an industry conference or an employee of a firm that you just asked, *"please give me a call if you ever spot a securities fraud,"* if you haven't handed them a business card. Some SEC staff pay for their own business cards but if private industry provides business cards for its employees then the SEC should also. It's only common sense.

All business cards should also tell what professional credentials each SEC staffer has obtained. Credentials such as CFA, CFE, CFP, CIA, CISA, CPA, JD, Ph.D., and others should appear prominently on all staff business cards. Printed at the bottom of each card should be something like, *"To report a securities fraud please call me."* This would send a message that each SEC staff member is a fraud-fighter first and foremost. Upon receiving calls to report a fraud, each SEC employee will immediately forward the call to competent authority per the SEC's standard operating procedure for handling whistleblower tips. Secretaries and clerks should also have business cards since this is a low cost means of advertising that your employer is in the securities fraud-fighting business.

Recommendation # 9: Change Performance Metrics Away From the Number of Exams Undertaken

Measuring performance by the number of exams a Regional Office conducts each year totally misses the point. The SEC's mission is to protect investors and to find or prevent fraud. As the SEC IG's report has shown, conducting poorly planned and executed exams and then promoting staff based upon the completion of shoddy exams is not a deterrent to fraud. The goal should never be how many pieces of paper were inspected, it must become how much fraud did we catch?

Obvious success metrics which the SEC should start measuring are fine income, dollar damages recovered for investors, dollar damages prevented, and the number of complaints from Congress to the regulators complaining about the severity of the fines or the thoroughness of the government's investigations. Exams catch so little major fraud that they are the least important metric to follow unless one actually believes that catching minor technical violations is a felony deterrent.

Recommendation # 10: Increase the Risk of Fraud Detection by Funding SEC Attendance at Industry Events

The most important thing the SEC can do is increase the risk of detection for securities fraudsters. To do that the SEC needs to put its staff out among the industry's employees wherever and whenever possible. Interacting with industry professionals before and after industry functions is a great way to obtain tips on nascent fraud schemes and stop them before they become Madoff-sized or sub-prime sized.

Large cities with robust financial centers have financial analyst societies, CPA societies, securities traders associations and economic clubs which hold educational meetings of just the sort the SEC staff needs, but the SEC typically doesn't allow its staff time off to attend these meetings nor does it reimburse its staff for attending industry meetings of this nature. Rarely does anyone see SEC staff attending these educational events and we all know it isn't because the SEC has no need for industry knowledge.

Recommendation # 11: Fund Development of an SEC Knowledge Base

Think of how different it would have turned out if the SEC exam and enforcement teams in New York could have turned on their PC's, typed in the word "Ponzi" to an on-line SEC knowledge base and have appear on the screen diagnoses of past Ponzi schemes and a list of checklists on how to most efficiently solve such cases. Unfortunately, the SEC staff did not have such a system and as a result SEC exam and enforcement teams were not able to solve one of the easiest fraud schemes there is, the simple Ponzi scheme. Ponzi schemes are not that hard to figure out because there is no underlying investment product, there is no trading and the assets are being diverted to pay off old investors.

To further increase the SEC's auditing effectiveness, I would organize a "Center for All Lessons Learned (CALL)" similar to what the U.S. Army has been using with great effectiveness for decades. CALL will collate and sort through every fraud that the SEC finds. These frauds would be diagnosed for both common and unique elements that each had so that the odds of future frauds going unchecked are further reduced.

CALL would be a password protected, on-line web based resource for all SEC employees to use and, more importantly, to contribute to themselves. The SEC needs to be able to learn at a faster pace than the bad guys they are fighting, and the only way to increase the SEC's decisionmaking quickly is to demand that all levels of the organization pitch in and contribute their lessons learned. The old top down, command from above approach doesn't work in the modern era and must be abandoned if the SEC is to achieve greatness. The SEC currently has a staff of 3,500 and every single one of those thirty-five hundred brains needs to be turned on and contributing to this knowledge base.

Recommendation # 12: Properly Arm SEC Exam & Enforcement Teams

If the SEC staff in New York had Bloomberg machines and if they knew how to use them, they could have quickly analyzed actual OEX Standard & Poor's 100 index options trades that Bernard Madoff purported to trade on certain dates and proven that no such trades actually occurred. The case would have been cracked open quickly but, of course, the SEC staff doesn't have easy access to Bloomberg machines nor are they trained in how to operate them.

The Bloomberg machine is the key knowledge tool used in the finance industry but it is expensive, costing over $20,000 per machine per year. Industry allocates one Bloomberg machine per trader, analyst and portfolio manager so that they can conduct the business of finance. The SEC is lucky to have one Bloomberg machine per Regional Office! Sending SEC teams into exams and enforcement actions without a Bloomberg is akin to sending unarmed teams to a gunfight and then wondering why they come back to the office hanging their heads in defeat each time.

When a financial analyst is about to analyze a company to determine whether or not to invest in that company's stock, the first thing he/she does is go to a Bloomberg and analyze the firm's capital structure, its financial statements, financial ratios, look up the firm's weighted cost of capital, and start running a horizontal and vertical analysis of the firm's financial statements. The trained analyst will also use the Bloomberg to read all news stories out on a company, look at the firm's SEC filings, and use all of the information collected to build a set of questions he/she needs to answer before investing. The trained analyst will also obtain Wall Street's research reports on the company to see how those analysts approached their analysis to see if there might be something they missed.

Unfortunately, the SEC staff examiner rarely can do this because either they can't get access to a Bloomberg or they are not trained in how to use one. For SEC compliance purposes I don't see how their staff can function effectively without having at least one Bloomberg assigned per exam and enforcement team. Their work, in brief, cannot be done without it. Those Bloomberg machines are the lifeblood of the industry and they contain must of the data that an SEC staffer would need for a basic fraud analysis of a company. Not funding these machines is penny-wise but pound-foolish.

Recommendation # 13: Establish an SEC Office of the Whistleblower

According to the Association of Certified Fraud Examiner's 2008 Report to the Nation (please refer to the attached Appendix II for the relevant portions of this report or you can find it a *www.acfe.com*) whistleblower tips detected 54.1 percent of uncovered fraud schemes in public companies. External auditors, and the SEC exam teams would certainly be considered external auditors, detected a mere 4.1 percent of uncovered fraud schemes. Whistleblower tips were 13 times more effective than external audits, hence my recommendation to the SEC to encourage the submission of whistleblower tips.

Other interesting statistics from the ACFE Report are that employee tips are 57.7 percent of all whistleblower tips received. How easy would it be for SEC enforcement teams if an internal whistleblower came in and presented them with hidden books and records? Customers provided 17.6 percent of whistleblower tips followed by vendors (12.3 percent) and shareholders (9.2 percent).

Recommendation # 14: Authorize an SEC Whistleblower Bounty Program Similar to Those of the Department of Justice and the IRS

The Internal Revenue Service (IRS) started its Office of the Whistleblower in December 2006 and in less than 3 years has grown this office to a staff of 18. The IRS now receives the largest cases with the absolute best quality of evidence in its history. Consider the cost of 18 IRS employees versus the billions in additional tax revenues they will be responsible for bringing into the U.S. Treasury.

The IRS offers bounty payments of 15 percent–30 percent to whistleblowers for cases that lead to successful recoveries for the U.S. Treasury. These bounty payments do not come out of the IRS's budget nor do the taxpayers pay these bounties—all bounty payments are made by the guilty defendants. Therefore this is a

no cost program that funds itself and allows the IRS Staff to cherry-pick from the cases that literally walk in the door, selecting the credible cases for immediate investigation.

I recommend that the SEC expand and reinvigorate its almost never used whistleblower bounty program. Section 21A(e) of the 1934 allows the SEC to pay a bounty of up to 30 percent to whistleblowers but only for insider-trading theory cases. The way this works is, the SEC can fine the guilty defendant triple the amount of its ill-gotten gains or losses avoided for insider trading and can award up to 10 percent (10 percent) of the penalty amount to the whistleblower (triple damages × 10 percent maximum bounty award = 30 percent potential maximum reward).

Unfortunately, unlike the IRS's Whistleblower Program and the False Claims Act, the SEC's reward payments are not mandatory and the SEC can refuse to pay these rewards without explanation. If Congress would expand this program to include all forms of securities violations and make the reward payments mandatory, then my bet is that hundreds of cases would walk in the door each year, and that several dozen of these would be high quality cases that would lead to billions in investor recoveries similar to the billions that the False Claims Act (31 USC Sections 3729–3733) already provides each year.

I recommend that each tip, upon receipt, be logged in, given a case number, and for credible tips with real evidence behind them, the whistleblower and whistleblower's counsel be put in contact with the relevant SEC operating unit that is best able to investigate the complaint. Hopefully, this will prevent a repeat of my experiences during the Madoff Case, where over the years I kept submitting better and more detailed case filings but ran into trouble because Boston's SEC Regional Office believed me but New York's SEC Regional Office apparently did not. Standardizing the treatment of whistleblowers to ensure that they are not ignored or mistreated should be a priority for the SEC. An annual reporting to Congress of whistleblower complaints and the SEC's follow-up actions should be mandatory.

Let me add one more important point, the issue of self-regulation and whistleblowing. Consider that perhaps hundreds of finance professionals around the globe knew that Madoff was a fraudster or at least suspected that he was. How many of these people contacted the SEC with their suspicions and identified themselves? Unfortunately, I may have been the only one.

Getting rid of the shysters, fraudsters and banksters is in everyone's best interest and restoring trust in the U.S. capital markets is imperative if we are to restore our nation's economy to health. If I'm the CEO of an honest firm and I hire new employees who worked across the street at a competitor and then find out from these new employees that my competitor is dishonest, it would be in my economic self-interest and in the interest of good public policy to turn them into the SEC. If self-regulation is ever going to work, we need to find ways to advertise it, reward it, and measure it. Currently, the SEC is doing none of the above.

APPENDIX I

NOTICE OF MISINFORMATION IN THE PRESS AND MEDIA FROM HARRY MARKOPOLOS, CFA, CFE, SEPTEMBER 10, 2009

1. Per a recently released Madoff book, I am not an accountant nor do I hold a B.S. degree in Accounting from Loyola College (now called Loyola University) of Maryland. I do hold a Bachelor of Arts degree in Business Administration from Loyola.

2. Per several news agencies reporting, I am not a Certified Public Accountant (CPA) nor am I an accountant. I am a Chartered Financial Analyst (CFA) and a Certified Fraud Examiner (CFE).

3. Per a major news service's reporting, I am not writing a book entitled, "An Army of One," due for release this fall. First, "An Army of One," is a U.S. Army recruiting slogan. Second, this title would be wholly inappropriate because I led a team of four. Together, we are writing a book but we have not selected a title yet and our anticipated publication date has always been March 2010.

4. Per a major news service's reporting, I did not pay my way through college, my parents did. I did pay my way through graduate school.

5. Per an Internet-only newspaper's reporting, I never commanded a civil affairs unit on active duty for 7 years in Western Europe and Africa. I was a part-time reservist for 17 years, having served first in the Maryland Army National Guard (MDARNG) and then in the U.S. Army Civil Affairs and Psychological Operations Command (USACAPOC). I also never served as a commando of any sort nor did I ever hold a top-secret clearance nor was I ever an Army Intelligence Officer. I have held a secret clearance and I left the reserves in April 1995 so that I could apply for and enter graduate business school at Boston College in September 1995.

6. Per a major news service's reporting, I never said, "The SEC roars like a lion and bites like a flea." I did say, "The SEC roars like a mouse and bites like a flea."

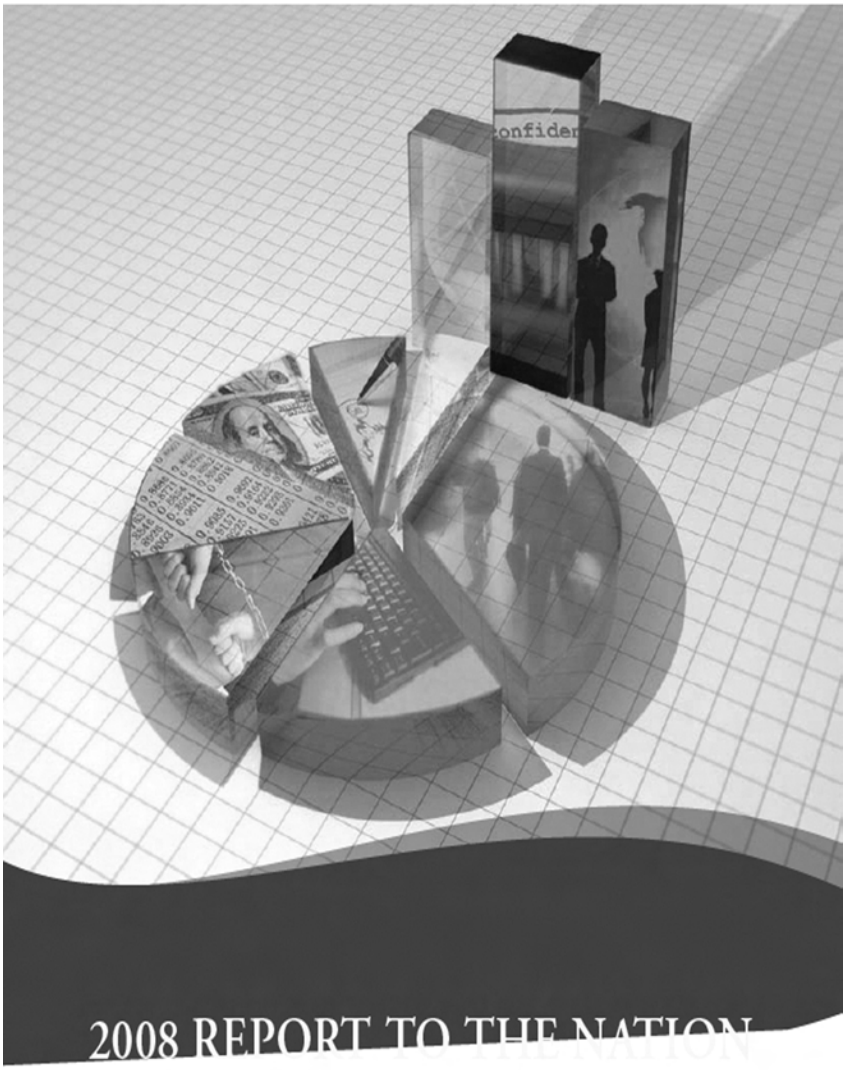
7. Per a major newspaper's gossip column that reportedly quoted me as saying larger fraud schemes than Madoff's were out there, I never said that. An audience member said that during the question & answer period at one of my presentations. I did say that someday way into the future there would be someone who will break Madoff's record for fraud because white collar fraudsters are always getting smarter.

APPENDIX II

2008 ACFE Report to the Nation Excerpts

APPENDIX III

June 2009 Fraud Magazine Interview with Harry Markopolos


2008 REPORT TO THE NATION

Letter from the President

When the Association of Certified Fraud Examiners was founded 20 years ago, we knew that occupational fraud was a significant and largely misunderstood problem for organizations. Our personal experiences, along with a host of anecdotal evidence, indicated that fraud had a massive impact on businesses and agencies in all sectors of the economy. Unfortunately, at that time, very little research had been conducted on occupational fraud so there was no way to know just how big the problem was or to find much useful information about the individuals who committed these crimes or the organizations victimized by them.

ACFE's Chairman and Founder, Joseph T. Wells, conceived of the *Report to the Nation on Occupational Fraud and Abuse* as a way to shed light on the costs and effects of occupational fraud. It is fair to say that over the course of his career Mr. Wells has contributed more to the study of fraud than any other person, and in many ways the *Report to the Nation* represents one of his most significant achievements.

In 1996, when the first *Report to the Nation* was published, it constituted the largest privately funded study ever conducted on fraud. The ACFE has published subsequent editions in 2002, 2004, 2006, and now 2008, and over that time the *Report to the Nation* has come to be regarded as the most authoritative statistical resource available on occupational fraud.

The growth and influence of the *Report to the Nation* are almost entirely due to the efforts of Mr. Wells and his conviction that understanding how fraud works is crucial to effectively combating it. Because of Mr. Wells' contributions, Dr. Gil Geis, the first president of ACFE, originally named this study *The Wells Report*. Though he was too humble to accept that name, each edition of the *Report to the Nation* truly belongs to Joe Wells.

It also belongs to the Certified Fraud Examiners who contribute the raw data from which the *Report to the Nation* is compiled. The 2008 edition of the Report is based on 959 cases of occupational fraud which were reported by the CFEs who investigated and resolved them. Without the information supplied by those CFEs, this Report would not exist. I sincerely thank them for their contributions.

I am pleased to present the *2008 Report to the Nation on Occupational Fraud and Abuse* to practitioners, business and government organizations, academics, the media, and the general public. I hope the information contained in this Report will further the general understanding of occupational fraud and support the efforts of those who work to deter, prevent, detect, and investigate it.

James D. Ratley, CFE
President, Association of Certified Fraud Examiners

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To download the entire Report, visit
www.ACFE.com/documents/2008-rttn.pdf

Executive Summary

This study is based on data compiled from 959 cases of occupational fraud that were investigated between January 2006 and February 2008. All information was provided by the Certified Fraud Examiners (CFEs) who investigated those cases.

One-fourth of the frauds in this Report caused at least $1 million in losses.

- Participants in our survey estimated that U.S. organizations lose 7% of their annual revenues to fraud. Applied to the projected 2008 United States Gross Domestic Product, this 7% figure translates to **approximately $994 billion in fraud losses.**

- **Occupational fraud schemes tend to be extremely costly.** The median loss caused by the occupational frauds in this study was $175,000. More than one-quarter of the frauds involved losses of at least $1 million.

- **Occupational fraud schemes frequently continue for years before they are detected.** The typical fraud in our study lasted two years from the time it began until the time it was caught by the victim organization.

- This Report focuses on 11 distinct categories of occupational fraud. **The most common fraud schemes were corruption, which occurred in 27% of all cases, and fraudulent billing schemes, which occurred in 24%.** Financial statement fraud was the most costly category with a median loss of $2 million among the 99 financial misstatements in this Report.

- Despite increased focus on anti-fraud controls in the wake of Sarbanes-Oxley and mandated consideration of fraud in financial statement audits due to SAS 99, our data shows that **occupational frauds are much more likely to be detected by a tip than by audits, controls or any other means.** Forty-six percent of the cases in this Report were detected by tips from employees, customers, vendors, and other sources. Tips were also the most common means of detection in 2002, 2004, and 2006.

- **The implementation of anti-fraud controls appears to have a measurable impact on an organization's exposure to fraud.** We examined 15 specific anti-fraud controls and measured the median loss in fraud cases depending on whether organizations did or did not have a given control at the time of the fraud. In every comparison, there were significantly lower losses when the controls had been implemented. For example, organizations that conducted surprise audits suffered a median loss of $70,000, while those that did not had a median loss of $207,000. We found similar reductions in fraud losses for organizations that had anonymous fraud hotlines, offered employee support programs, provided fraud training for managers, and had internal audit or fraud examination departments.

- The Report includes frauds that impacted organizations in a number of different industries. The industries most commonly victimized by fraud in our study were banking and financial services (15% of cases), government (12%) and healthcare (8%). **Among industries with at least 50 cases, the largest median losses occurred in manufacturing ($441,000), banking ($250,000), and insurance ($216,000).**

- **Small businesses are especially vulnerable to occupational fraud.** The median loss suffered by organizations with fewer than 100 employees was $200,000. This was higher than the median loss in any other category, including the largest organizations. Small businesses also suffered the largest losses in our 2006 study. Check tampering and fraudulent billing were the most common small business fraud schemes.

- **Lack of adequate internal controls was most commonly cited as the factor that allowed fraud to occur.** Thirty-five percent of respondents cited inadequate internal controls as a primary contributing factor in the frauds they investigated. Lack of management review and override of existing controls were each cited by 17% of respondents.

- **Seventy-eight percent of victim organizations modified their anti-fraud controls after discovering that they had been defrauded.** The most common change was to conduct management review of internal controls, which occurred in 56% of cases. Implementation of surprise audits was the next most common response, followed by fraud training for managers and employees.

- **Occupational frauds were most often committed by the accounting department or upper management.** Twenty-nine percent of frauds in this Report were committed by persons in the accounting department, while 18% were committed by executives or upper management. Frauds committed by executives were particularly costly, resulting in a median loss of $853,000.

- **Occupational fraudsters are generally first-time offenders.** Only 7% of fraud perpetrators in this study had prior convictions and only 12% had been previously terminated by an employer for fraud-related conduct. These results are consistent with our 2004 and 2006 Reports.

- Fraud perpetrators often display behavioral traits that serve as indicators of possible illegal behavior. **The most commonly cited behavioral red flags were perpetrators living beyond their apparent means (39% of cases) or experiencing financial difficulties at the time of the frauds (34%).** In financial statement fraud cases, which tend to be the most costly, excessive organizational pressure to perform was a particularly strong warning sign.

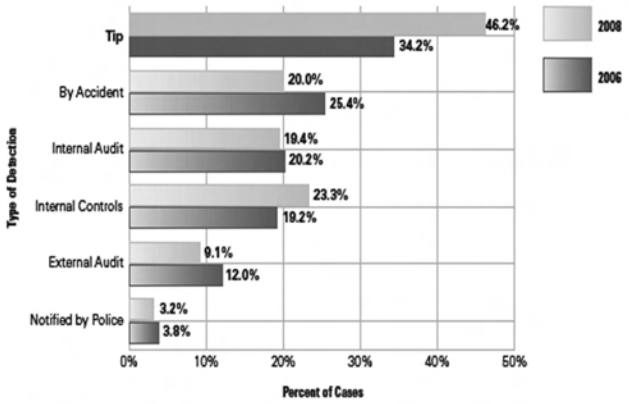
3 Detection of Fraud Schemes

Occupational frauds are much more likely to be detected by tips than by any other method.

Respondents to our survey were asked to identify how the frauds were first discovered. Nearly half of the cases in our 2008 study were uncovered by a tip or complaint from an employee, customer, vendor, or other source.

While tips have historically been the most common means of detection in our surveys, the percentage of fraud discoveries attributed to tips in 2008 is quite a bit greater than in 2006. It is encouraging to note that the percentage of cases discovered by accident was five percent lower than in 2006, while internal controls were credited with catching a slightly larger number of frauds.

Initial Detection of Occupational Frauds[4]

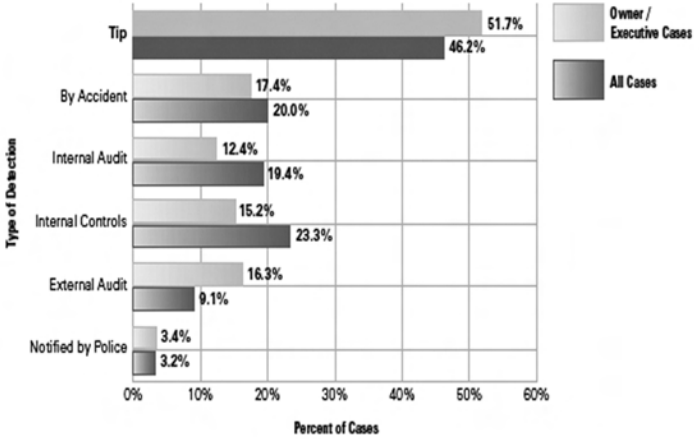


[4]The sum of percentages in this chart exceeds 100 percent because in some cases respondents identified more than one detection method.

Detecting Fraud Committed by Owners and Executives

Tips were by far the most commonly cited detection method in cases that were perpetrated by owners and executives. Not surprisingly, internal controls were not as effective at detecting frauds committed by top-level perpetrators, as these individuals are often uniquely positioned to override even the best-designed controls. In contrast, external audits detected a greater percentage of cases involving owners and executives; this finding underscores the importance of independent assessments and external accountability as well as the need for auditors to be especially vigilant in reviewing transactions involving owners and executives.

Initial Detection of Frauds by Owners/Executives[5]



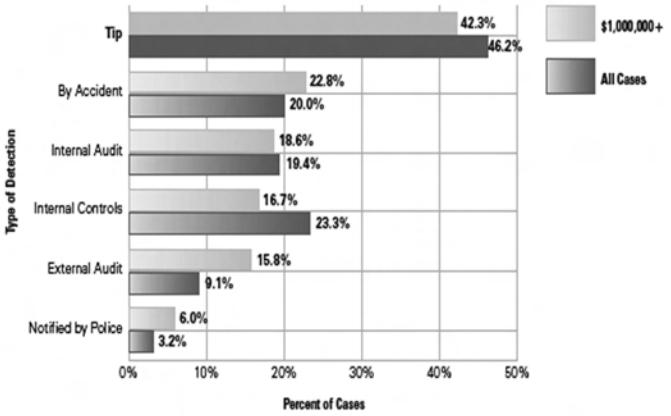
[5]The sum of percentages in this chart exceeds 100 percent because in some cases respondents identified more than one detection method.

3 Detection of Fraud Schemes

Detecting the Largest Frauds

The value of effective independent audits is illustrated by their role in detecting large frauds. Among the 237 cases involving a loss of $1 million or more, external audits were cited as the detection method 16% of the time, as compared to 9% of all cases. Tips were the most common detection method for these cases with 42% of million-dollar frauds being uncovered through a tip or complaint.

Initial Detection Method for Million Dollar Schemes[6]

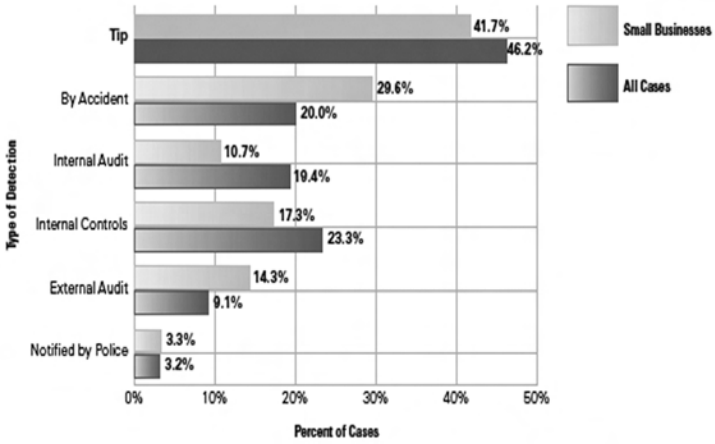


[6]The sum of percentages in this chart exceeds 100 percent because in some cases respondents identified more than one detection method.

Detecting Fraud in Small Businesses

Small businesses (those with less than 100 employees) are typically thought to have fewer or weaker controls in place than their larger counterparts, primarily due to a lack of personnel or financial resources. The results of our survey bear this out, as a lower percentage of frauds in small businesses were caught by internal controls. Additionally, internal audits and tips were cited as the detection method in fewer small business cases than among all cases, while small business frauds were also more likely to be detected by accident. These findings indicate that small organizations have room for improvement in their proactive fraud detection efforts.

Initial Detection of Frauds in Small Businesses[7]



[7]The sum of percentages in this chart exceeds 100 percent because in some cases respondents identified more than one detection method.

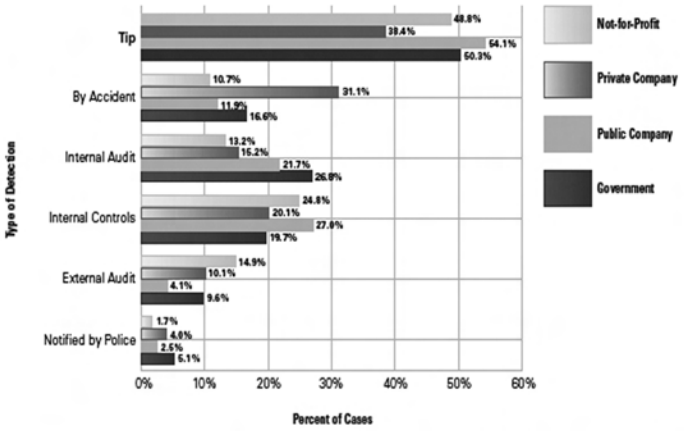
3 Detection of Fraud Schemes

Detection Methods by Organization Type

In comparing detection methods based on the victim's organization type, we see that, with a few exceptions, the relative frequency of initial detection methods is generally consistent across the four categories of organizations. In each category, tips were the most common detection method, generally followed by internal controls and internal audits. The biggest deviation we found was in frauds at privately held companies. In these cases, frauds were initially detected by accident nearly a third of the time, which is a substantially higher rate than in any other organization type. It is not clear exactly why so many frauds at privately held companies were detected by accident as opposed to other methods, but we note that this result is similar to our 2006 Report, in which 35% of frauds in private companies were detected by accident. Private companies also experienced a smaller proportion of cases being reported through a tip or complaint.

Internal audits were the source of detection in over a quarter of the government fraud cases, which exceeded the rate for any other type of organization. Surprisingly, publicly traded companies cited the smallest percentage of fraud detected by external audits even though they are the only organizations among the four categories that are generally required to undergo an independent audit. However, public companies also had the largest percentage of frauds detected through both tips and internal controls; this may reflect the continued impact of the Sarbanes-Oxley Act of 2002, which mandates the establishment of anonymous reporting mechanisms and increases the emphasis on strong internal control systems for publicly traded organizations.

Initial Detection Method by Organization Type*



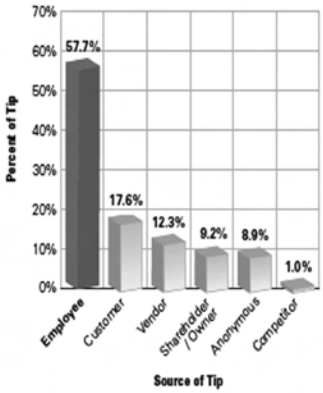
*The sum of percentages for each organization type in this chart exceeds 100 percent because in some cases respondents identified more than one detection method.

Tips

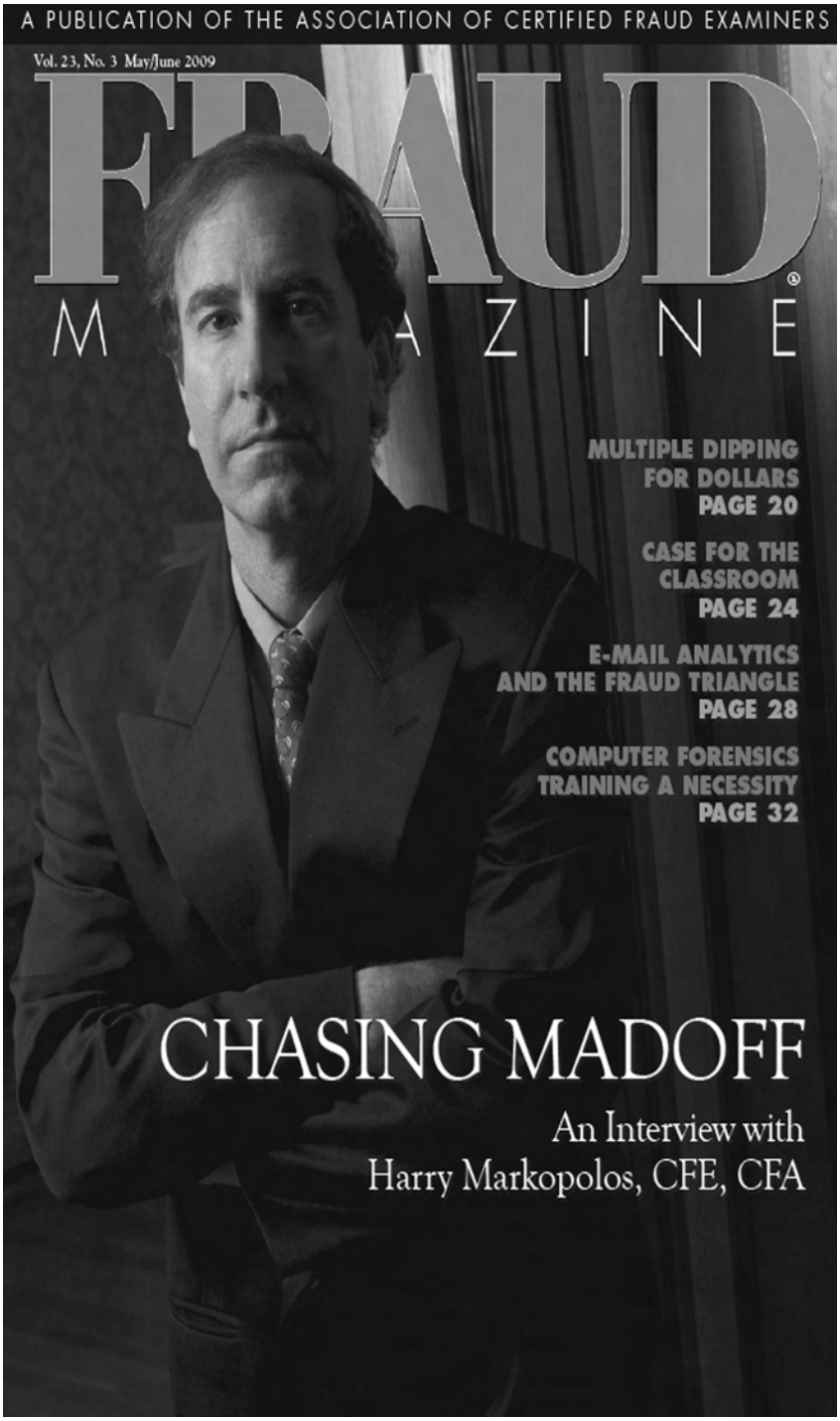
Of the 417 cases in our study in which a tip or complaint was instrumental in the detection of the fraud, 31% were received via a hotline or other formal reporting mechanism. This is a relatively high number considering that less than half of the victim organizations in our survey had a formal reporting mechanism. The fact that tips continue to be the most effective means of detecting fraud suggests that organizations could improve their detection efforts by establishing formal structures to receive reports about possible fraudulent conduct.

By far, the greatest percentage of tips came from employees of the victim organization, which is consistent with our findings in 2006. The fact that over half of all fraud detection tips came from employees suggests that organizations should focus on employee education as a key component of their fraud detection strategies. Employees should be trained to understand what constitutes fraud and how it harms the organization. They should be encouraged to report illegal or suspicious behavior, and they should be reassured that reports may be made confidentially and that the organization prohibits retaliation against whistleblowers. It is also worth noting that over 30% of tips came from external sources. While training and educating employees about reporting fraud is clearly an important step, organizations should also involve these third parties in their fraud detection programs by making them aware of the organization's reporting mechanism and encouraging them to report improper conduct.

Percent of Tips by Source*



*The sum of percentages in this chart exceeds 100 percent because in some cases respondents identified more than one source of the initial tip.


A PUBLICATION OF THE ASSOCIATION OF CERTIFIED FRAUD EXAMINERS
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Harry Markopolos speaks to attendees at ACFE's annual fraud conference.

36 Chasing Madoff: An Interview with Harry Markopolos

By Dick Carozza • Photos by Jodi Hilton

Harry Markopolos, CFE, CPA, couldn't have known that his first fraud examination would last nine years and uncover the largest-ever Ponzi scheme.

FEATURED ARTICLES

20 New York Indie Contractors Rip Off System as 'Employees': Multiple Dipping for Dollars

By Ronald J. Huefner, Ph.D., CPA, CMA, and Sara R. Melendy, Ph.D., CPA

As more and different types of frauds come to light involving public pension systems, CFEs and auditors must be on the lookout for miscast worker/employer relationships and determine if professional service providers actually are independent contractors illegitimately reported as employees.

24 Classroom Case: Something's Fishy at Jones Company

By Martin J. Coe, MBA, ACFE Educator Associate, CPA, CISA; Jeffrey Coussens, MFA; and John Delaney, DBA, ACFE Educator Associate, CPA, CIA

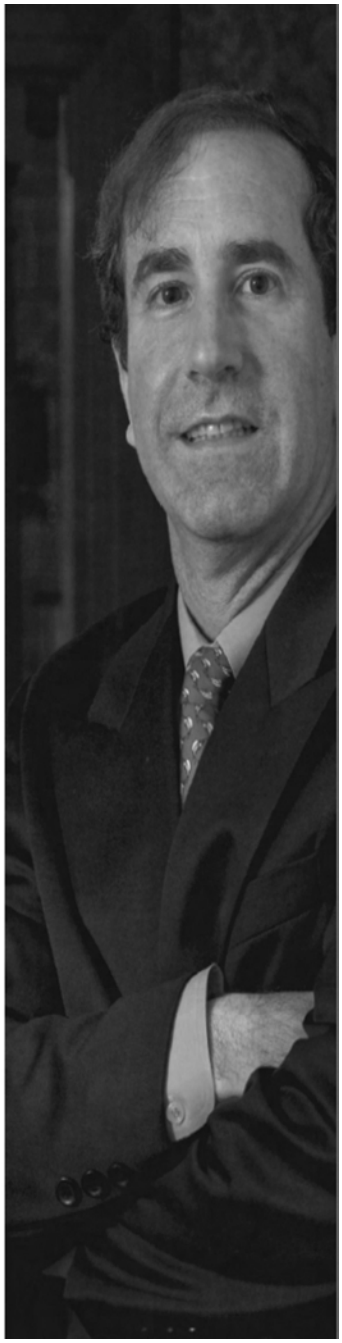
In this fictional case designed for classrooms or seminars, an intrepid seasoned internal audit manager and an inexperienced but willing staff auditor investigate suspicious financial activity at Jones Company. Their discoveries reveal their hunch was right, and they stop the fraud.

An Interview with Harry Markopolos, CFE, CFA

CHASING MADOFF

Harry Markopolos, CFE, CFA, couldn't have known that his first fraud examination would last nine years and uncover the largest-ever Ponzi scheme.

By Dick Carozza • Photos by Jodi Hilton



Finally, after nine years, they listened to Harry Markopolos.

"What hits us the most is that you didn't give up on these efforts," said Rep. Ed Royce, R-Calif., during Harry Markopolos' Feb. 4 Congressional testimony about his investigation of Bernard Madoff's Ponzi scheme. "You tried repeatedly, and you tried to encourage others to look into this in order to protect investors, and not only here but around the world. And for that we want to express our appreciation."

Markopolos' quest began as a simple work assignment; he was a portfolio manager for an equity derivatives asset management firm in Boston when he was asked to analyze Madoff's money-making methods. He quickly discovered that Madoff was running an old-fashioned Ponzi scheme.

"My team and I tried our best to get the Securities and Exchange Commission [SEC] to investigate and shut down the Madoff Ponzi scheme with repeated and credible warnings," Markopolos said during his testimony before the Financial Services Subcommittee on Capital Markets. He said he submitted an eight-page document listing red flags and mathematical proof of a major fraud to the SEC's Boston Regional Office in May 2000.

He resubmitted evidence to SEC offices in 2001, 2005, 2007, and 2008, but to no avail. In 2008, the stock market crumbled, investors rushed in to redeem their investments, and Madoff ran out of cash and turned himself in. After pleading guilty on March 12, he awaits sentencing for a scheme with losses estimated from $10 billion to $65 billion.

Meanwhile, Markopolos is trying to settle his life after the media onslaught and use his fraud examination skills to work on False Claims Act and IRS tax-faud cases in which the U.S. government is the victim.

"I didn't have any fraud examination training [before the Madoff investigation] so I look to the ACFE as my single-most useful professional education provider," he said.

Markopolos will be a keynote speaker at the 20th Annual ACFE Fraud Conference & Exhibition, July 12-17, at the Bellagio, in Las Vegas.

What events led you to investigate Madoff's business?
In late 1999, I was a portfolio manager for a multibillion-dollar equity derivatives asset management firm in Boston's financial district. Frank Casey, a marketing senior vice president for the firm, returned from New York with marketing materials for a high-performing, derivatives-based hedge fund managed by Bernard Madoff. In early 2000, the firm's partners asked me to reverse-engineer the strategy so that we could offer this successful product to our firm's customers.

After I modeled the strategy, I determined that the returns could only be coming from illegal front-running of the Madoff broker/dealer arm's client orders or from fictional returns that were the result of a Ponzi scheme. I went to the firm's partners and jokingly asked if they really wanted to get into that business. They hastily replied, "No way, if that's what he's doing then we don't want to compete in that space."

What tipped you off?
Madoff's name was never on the marketing materials; that was clue No. 1 – I've never seen a product offering where the manager's name wasn't listed up front. The marketing literature described a derivatives-based strategy with 37 moving parts, but I was very familiar with the math, and the strategy as described shouldn't have been able to earn a positive return after fees. He made some very simple portfolio construction errors in that he foolishly retained single-stock price risk that would have led to a lot more down months than he reported to investors. If he had designed the product correctly, he could have avoided this single-stock risk, so I knew that Madoff didn't know the first thing about portfolio construction mathematics. Literally, it took five minutes after reading his strategy paragraph to determine that he wasn't really using the described strategy to earn the returns he said he was. Under existing securities law, if you tell clients that you are using Strategy A to invest their money but, in fact, you use an undisclosed Strategy B to really invest their money, you've committed fraud.

What were the factors that allowed this scheme to continue for so long?
I couldn't possibly cover them all in such a short interview, so I will hit the main factors. The important thing you have to know about Madoff is that he is a brilliant con artist who knew how to prey on human nature like few others.

The main emotion he appealed to was human greed, but he was smart enough to address investors' fears by showing them a strategy that owned stock market index put options [option contracts that give the owners the right, but not the obligation, to sell specified amounts of underlying securities at a specified price within a specified time] such that if the stock market ever crashed they would be protected. He created the illusion of an investment strategy that never hit home runs but instead earned a steady 1 percent a month and also couldn't lose much money because he owned protective stock market put options. If such a product had really existed it would be the Holy Grail of investment products. But Madoff was smart enough to show modest returns that didn't seem overly high so as to avoid suspicion.

In finance there is a term, the Sharpe Ratio, which is a measure of how many units of return you earn for each unit of risk you take. Madoff's Sharpe Ratio was off the charts over a decade-and-a-half time period, ranging between 2.5 to 4.0 for most time frames. Sharpe Ratios this high have existed for shorter time periods but never for 15 years in a row – no one is that good! But investors wanted to believe in the Holy Grail so they suspended their disbelief and acted like moths before a flame.

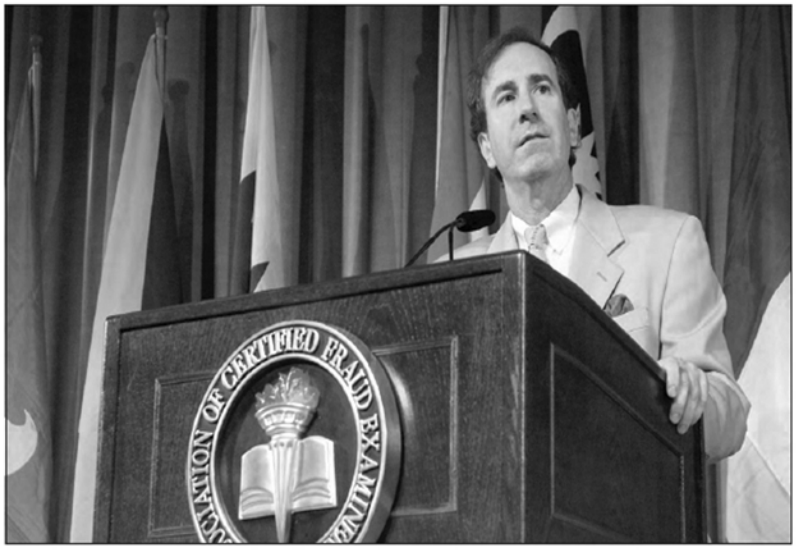
Madoff also used the veil of exclusivity to overcome victims' hesitancy to invest. He would simply lie and tell feeder funds [funds that conduct virtually all of the transactions through other funds called master funds], fund of funds [hedge funds that invest in a diversified basket of other hedge funds], and rich individual investors that he wasn't really taking in new money to manage because he had pretty much all the money he wanted to manage. He would say, *"but because I like you I'll give you special access and allow you, and only you, to invest."* Then he would give them a flattering reason why he considered them to be special, and they'd fall for it hook, line and sinker.

Madoff also owned a prestigious broker/dealer firm, Madoff Securities, which was a major market-maker in over-the-counter and NYSE-listed stocks. At various times Madoff was trading 5 percent to 10 percent of the daily exchange volume. Therefore, he had the patina of respectability. After all, if he owned a successful brokerage firm, why would he need to steal?

And just like any other large-company CEO fraudster, Madoff's résumé was impeccable. He was former chairman of

Markopolos Gives Advice to Aspiring Fraud Examiners

1. Join your local ACFE chapter and attend meetings regularly. Collect fellow members' business cards, and ask about their expertise. Then when you run into what seems like an unsolvable problem, use your Rolodex to reach out and ask for advice.
2. Build a world-class fraud library, one book at a time. The ACFE bookstore and Amazon.com carry a large number of anti-fraud titles that you should be reading as part of your continuing education program.
3. Develop an expertise in a fraud examination specialty to make yourself more valuable. Pick a specialty that's your passion, and master it.
4. Find a mentor who can guide you in making career decisions and teach you the finer points of fraud examination.
5. Follow the one-third rule: for every hour you spend working, spend a third of that time engaged in continuing educational activities or social networking.



Harry Markopolos, CFE, CFA, tells attendees his story at the ACFE's 20th Annual ACFE Fraud Conference and Exhibition held July 12-17, 2009 in Las Vegas, NV. (Mathew Sturtevant)

the NASDAQ and sat on several prominent industry association boards as did his brother and his sons. He gave to charities and donated to politicians. Investors were blinded by the résumé, his perceived wealth, and his lofty status in the community and therefore didn't feel the need to dig beneath the surface when conducting due diligence. Plus they knew that if you asked too many questions and angered him that he'd tell you that he didn't want you as a client. Psychologically, he had designed the perfect fly trap.

You said that Frank Casey, then the senior vice president of marketing for Rampart Investment Management Company Inc., the Boston firm at which you worked at the time, told you that investors he met in New York City considered Madoff the premier hedge fund manager because of his steady return streams with unusually low volatility. Why didn't they realize, as you did, that this was just an old-fashioned Ponzi scheme?

Investors who asked too many questions were told not to invest. If you asked detailed due diligence questions and wanted full transparency and an independent third-party bank to custody assets and clear trades, then Madoff would tell you, "It's a take-it or leave-it black-box strategy. I invented this strategy and if I let third parties see what I'm doing, then they will duplicate the strategy and kill my returns by competing away the market inefficiencies I'm exploiting."

Smart investors would stick to their investment discipline and walk away, refusing to invest in a black-box strategy they did not understand. Greedy investors would fall over themselves to hand Madoff money. He was brilliant in letting smart investors walk away and not being offended by it. He knew his targets were investors who didn't ask too many questions. You don't need to be the smartest man in the world to be a Ponzi artist; you only have to be smarter than your victims.

You've said that Madoff marketed his stocks by saying he would invest them through a complex "split-strike conversion" strategy. Why do you think he used this marketing plan with his customers?

First, it had a basket of 30 to 35 blue-chip stocks that any investor would feel comfortable owning. Second, it appeared to be a diversified basket of stocks so that at least some investors would willingly allocate 100 percent of their savings to him. Third, there were stock market index put options that would protect investors against a severe market decline such as that experienced in 2008, so it seemed like a very safe, diversified strategy – just the type to lure in victims and keep them sleeping soundly at night. Fourth, Madoff knew the SEC didn't have any derivatives experts on staff that would understand the math behind the strategy. Fifth, the strategy had so many moving parts that none of the feeder funds understood the strategy either. The complexity of the strategy worked to perpetuate the fraud.

How could the managers of the feeder funds miss that 45-degree upward angle in the graph of the cumulative performance of Madoff? Do you think they willingly ignored the warning signs because the money kept flowing in?
Madoff masqueraded as a hedge-fund operator but was licensed as a broker-dealer. By the same token, the feeder funds masqueraded as hedge-fund operators, but were nothing more than marketing arms for Madoff. In a normal Wall Street fee-splitting arrangement, the marketing arm would typically take 20 percent of the fees and only very rarely more than 50 percent. But in Madoff's case, I believe he was passing along well over 80 percent of the fees to the feeder funds. Therefore, they had a monetary incentive not to ask too many questions.

I've met some investors who felt Madoff was front-running his broker-dealer arm's order flow. These investors were actually reassured that Madoff's returns were real but were generated illegally. My guess is they figured if Madoff were eventually caught he'd go to prison but that they would be able to keep all the illegally generated returns.

Can you describe your meeting in 2002 with the 14 French and Swiss private-client banks and hedge fund of funds?
I had designed a statistical options arbitrage strategy that could earn better returns than Madoff, but which could lose almost 50 percent in any given month if the market fell more than 8 percent over a 10- to 15-day time span. The firm that was marketing this strategy for my firm also marketed Madoff's strategy and would tell everyone we met that "Harry is just like Madoff only with higher risk and higher return." Of course I would get very frustrated every time this was said, but I knew that if I told the European fund of funds that Madoff was a fraud, then word would get back to him and I would be putting my life in jeopardy.

Of the 14 feeder funds and private-client banks that had Madoff, only two have come forward and admitted their losses. As of February 2009, there were a "dirty dozen" who hadn't yet come forward. Keep in mind that this is almost seven years later, so some may have discovered Madoff was a fraud and gotten out. But I think most of the "dirty dozen" are hiding and for good reason.

I used that European trip to further the investigation and detail Madoff's inroads into the European marketplace. What I discovered was that Madoff was running affinity circles luring in many of Europe's royal families – the high-born, old money families, and the newly rich. Madof used noblemen in Europe to market to and to lure in wealthy victims.

In the United States, Madoff was preying on the Jewish community. Interestingly, Madoff knew that his affinity circle consisted of American Jews, but that by recruiting feeder funds with different customer bases, he could expand the number of affinity circles he could tap into for new victims.

Surprisingly, my team and I never realized that Madoff was accepting separately managed accounts from American Jewish investors. We incorrectly thought that by tracking the institutional feeder funds and fund of funds investing in Madoff, we were tracking all his victims, so we missed this particular category of victims entirely.

Unfortunately, it was this group of individual Jewish investors that was likely hit the hardest, with many of these families experiencing devastating losses because they invested everything they had with Madoff. In retrospect, this was obvious, yet we missed it during our investigation.

Most of the European money was invested through "offshore" accounts so it is doubtful that these European victims will be coming forward and filing loss claims for fear of alerting their host nation tax authorities. So while I believe that the Madoff losses are higher in Europe than in the United States, most of those European losses will never be reported to prove my hypothesis.

After the Boston SEC office sent the Madoff case to the SEC's New York branch, you said the New York office was unresponsive. You said in your testimony before the Congressional subcommittee that "the relationship between the SEC's Boston and New York offices is about as warm and cordial as the Yankees-Red Sox rivalry." Did you ask the Boston office to contact the New York office again to inquire about the inaction? Did the SEC's New York office give you its reasons for not being able to find the fraud?
No, I never asked the Boston office to contact New York. Since the two offices didn't like each other, having Boston challenge New York's competence by asking for status reports would only have hurt matters instead of making them better.

You approached the senior investigative reporter for The Wall Street Journal. Even though he was eager to investigate the story, you said the newspaper's editors never gave their approval. Did you ever discover the reason for this?
No, but I will say that I went to John Wilkie, whom I personally consider to be The Wall Street Journal's best investigative journalist. This reporter has broken many stories. My nickname for him is "front-page Wilkie" for all the scoops he lands on the journal's front page every year. He and I keep in touch, and he's definitely someone I will go to with other cases in the future.

In 2006, the SEC did interview Madoff, his assistant, an official from one of the company's feeder funds, and another employee. Would you have some idea of the results of that investigation?
I cannot possibly answer on behalf of the SEC. The SEC inspector general's report will be out this summer and will answer these questions. One thing I can tell you is that I've spent an entire day giving sworn testimony to the SEC's inspector general team and they impressed me. I was interview No. 60 for them. Their questions were wide-ranging and revealed to me how extensive their investigation is. They know they are writing a widely anticipated IG report that will end up in the history books. This particular IG has written hard-hitting reports in the past that have pulled

HARRY MARKOPOLOS *continued on page 57*

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no punches, and I am expecting to see his team's best work in the upcoming Madoff Report.

When did you first see that Madoff was struggling to keep his Ponzi scheme afloat?
A member of my investigative team, Frank Casey, had a key dinner in June 2005 where he found out from his sources that Madoff was actively trying to borrow money from several European banks. That was our first indication that the scheme was running short of cash.

How did you find out that Madoff was running low on funds in 2007?
In April 2007, a San Francisco-based firm came out with a structured product that had 3:1 leverage to Fairfield Sentry Fund's Madoff returns. For every $1 an investor put in, a European bank would lend you $2 so that $3 was invested with Madoff instead of only $1. Of course, the bank would make a nice interest rate for itself and the San Francisco-based firm would earn three times as much in management fees as would Fairfield Sentry. It was win-win-win for the feeder funds, the banks, and Madoff. To us, this was a sign of desperation that Madoff needed larger and larger amounts of fresh cash to keep the scheme from collapsing.

When and why did you eventually abandon your investigation?
The top three offices at the SEC are in New York, Boston, and Washington. If the three best SEC offices weren't bright enough to figure out such an easy scheme then it was clear to me that the case had no future. By April 2008, I had several False Claims Act cases under seal that were progressing nicely and felt that the Madoff case wasn't going anywhere. Therefore, I decided to concentrate on my winners and cut loose my loser, the Madoff case, which just goes to prove that it is impossible to predict how your cases will turn out! Madoff was in my dead-case-files cabinet, but it arose from the dead like a phoenix.

Why do you think Madoff suddenly turned himself in on Dec. 11, 2008?
The dramatic fall in the worldwide financial markets of October and November 2008 led to panic, resulting in massive investor redemptions from hedge fund of funds. These fund of funds operators felt that Madoff was their best-performing, most-liquid hedge fund manager so they redeemed him first, which led to him not being able to meet all of those redemption requests.

Madoff had taken money from every corner of the globe and he had taken it from some very unsavory characters. That's why he didn't flee; he had nowhere to run and nowhere to hide; so he did the logical thing – he turned himself in.

Of the 29 red flags you identified, which ones were the strongest indicators that a fraud was being perpetrated? Which ones should have made the SEC sit up and take notice?
All of them. But if I had to pick the most important red flag it would be that Madoff's purported options trading size was seven to 65 times the size of the actual market for those derivative instruments at various points in time.

Your investigative team consisted of Neil Chelo, director of research for Benchmark Plus; Frank Casey, formerly of Rampart Inc., the North American president for Fortune Asset Management; and Michael Ocrant, now of the publication, Institutional Investor. Were they working pro bono?
Yes, they knew Madoff was a clear and present danger to the capital markets and to the reputation of the United States. Some things are so important that you just know you have to do them for free and certainly this was one of them.

I'd also like to point out that the two lawyers who helped me prepare for the Congressional testimony, attorney Phil Michael of Troutman Sanders LLP in New York, and Dr. Gayiri Kachroo, JD, LLM, SJD, of McCarter & English LLP in Boston, also worked pro bono in representing me. Thank goodness civic duty and doing the right thing are still prevalent in our nation.

How did your Army Reserve special operations background help you in the investigation?
I was used to leading small, task-oriented teams of functional experts. And I certainly knew how to develop intelligence sources, debrief them, and give them specific and general requests for additional information while letting them figure out how to acquire the information.

When I was in the Army Reserve, the Army's JFK School for Special Warfare hired cross-cultural anthropologists to train us how to communicate across cultural boundaries; this training has always helped me during my investigations. Mirror-imaging the people I am with so that I can find common ground more easily with them, and exchanging information with them more effectively, has been invaluable to me. My unit used to operate in Western Europe so I knew their cultures intimately and was able to make some investigative breakthroughs there rather quickly in 2002.

With me it's always been a two-way street information-wise. I don't come across as "an investigator." The Army trained me to be "a friend who's there to help." As a result, I find large fraud cases in companies in which government regulators have not helped the subjects during their routine inspections. Government investigators all too often are in the "listen-only mode," which is why they don't hear much useful information. You have to reveal information in order to receive it. No one trusts the person who's only there to listen.

What fueled your tenacity during your nine-year investigation of Madoff?
There's a fine line between bravery and foolishness. My team and I definitely crossed that line and were, to some extent, foolish to continue the investigation after it became apparent in 2002 that the SEC was incapable of understanding a derivatives-based Ponzi scheme.

Bernard Madoff walks through the throngs of reporters to the courthouse in New York City for sentencing. He was convicted of running the largest Ponzi scheme to date on March 12. (Photo by David Appleton)

However, because of the immense size of the fraud and the untold damage we felt it would do to the reputation of the United States and our capital markets, we knew that if we did not continue the investigation Madoff would continue to lure in more victims and cause even more damage.

You've said that all the members of your team feared for their lives during your investigation. Did you have any specific threats that made you fear for yours?

The "off-shore" feeder funds were only one step removed from organized crime. If organized crime knew that Madoff was stealing their money, he would have been killed. Therefore, if Madoff had ever found out that he had a team tracking him through Europe and North America and that he risked getting exposed, it was a good bet that he would have had several billion reasons to want us silenced. To compartmentalize the damage, I was the only one who went to the SEC. The SEC never knew I had a team in the field helping me.

New SEC Chairwoman Mary L. Schapiro has said she will streamline some procedures, and she will eliminate the requirement that commissioners approve all enforcement actions before they're elevated from an inquiry to an investigation and before subpoenas go out, according to The New York Times. In a Times interview she said, "This agency did not pursue some critical issues and problems. We need to be transparent about what we missed. We need to learn from these tragedies." What else does she need to do now and in the long term to improve the SEC?

I have written numerous pages containing more than three-dozen recommendations and included them in my written Congressional testimony. I have heard through the grapevine and through press reports that the SEC is actively exploring at least a few of my recommendations and they've done it with such speed that I'm hopeful we will see dramatic improvements. If the SEC does not improve soon, they risk being merged out of existence in the upcoming rewrite of the nation's regulatory scheme.

The SEC's ineptitude and that of the Federal Reserve have brought the nation to the brink of financial collapse, so I am confident that drastic changes will be made in order to restore investor trust in our capital markets. I would rate the Federal Reserve's performance as far worse than that of the SEC. None of the nation's financial regulators did their jobs, which is what allowed this crisis to develop over a period of at least 15 years.

What talents and skills should the perfect SEC investigator have?

First they must understand finance, balance sheets, and financial instruments at least to the level that a Chartered Financial Analyst Level I candidate does. Second, they need to possess a nose for fraud and have a toolbox for investigating fraud, which is why I recommended that the SEC hire Certified Fraud Examiners. Third, having a trading background would be essential for the perfect SEC investigator. Fourth, having a CPA's knowledge of financial statement preparation along with Fortune 1000 experi-

enot would be a must. Of course, the perfect SEC investigator has yet to be born. No fraud investigator is perfect.

You've said the SEC needs to offer incentives to its investigative staff members. Could you explain your reasoning and how that might work?

Wall Street pays employees a base salary of roughly $150,000 to $200,000 per year plus a bonus often tied to 5 percent to 15 percent of the revenues that you bring into the firm during the year. The SEC needs to adopt Wall Street's compensation methods in order to compete with industry for the best available talent. SEC staffers that tackle and solve major securities fraud cases that result in successful settlements for investors should be awarded substantial bonuses for their excellent work, just like they would be in industry. I recommend that for each dollar in actual fraud damages the guilty defendant be fined treble damages along with the cost of the government's investigation. This will ensure that the defrauded investors are made whole and it will ensure that these large SEC bonus checks are paid by the crooked companies that stole the money in the first place.

During your testimony, you recommended the establishment of an Office of the Whistle-blower within the SEC. What should the office look like?

First, it needs a technological filter to winnow through the hundreds of thousands of e-mail complaints received each year to sort through the ones that are specific, credible, and worth following up by a trained investigator. Second, trained investigators who have excellent phone-interviewing skills need to conduct follow-up calls on the most promising leads. Third, these trained investigators have to be able to gain whistle-blowers' trust and develop additional information. Fourth, the whistle-blower program needs to provide a bounty for cases submitted under seal to the SEC that result in a successful recovery by the agency. The Department of Justice and the Internal Revenue Service both pay rewards of 15 to 30 percent for successful cases submitted by whistle-blowers and, as a result, these two agencies receive lots of well-developed, large fraud cases each year. Fifth, a case-tracking system needs to be adopted that tracks cases from start to finish. Sixth, the SEC needs to data mine the complaints for useful data that raises red flags for further analysis about future fraud trends.

You've met with SEC Inspector General David Kotz about some "mini-Madoffs." I know you can't be specific about these cases, but do they involve Ponzi schemes at other investment firms? Were you able to share your concerns about the SEC and suggestions for improvement?

I told the SEC there was one possible mini-Madoff that merited close examination. There is an investment company reporting performance numbers that were even better than Madoff's. I didn't investigate beyond looking at the performance numbers, so it's best that the SEC send a team in to verify that the returns are real.

Looking back through the nine years, would you have done anything differently in communicating your investigation results to the SEC, financial professionals, and others?

Madoff was my first case, which, of course, is the absolute worst case to start one's career as a fraud examiner with! Back then I didn't know what the SEC's organization chart looked like, I didn't know how they functioned, nor did I know how poorly trained, paid, and resourced they are. I didn't know what I didn't know, which actually helped in some ways and hurt in others.

Interested CFEs can look at my SEC submissions and case materials posted on www.house.gov under the archived hearings of the House Financial Services Committee dated Feb. 4, 2009, and judge for themselves what I should have done differently. Were my case submissions clearly written? Did I include enough proof? Were my red flags sufficient? Should the SEC have shut Madoff down based upon those submissions? What did we fail to investigate? What obvious things did we miss?

Things would have gone a lot better if I had joined the ACFE in 1999, networked at local chapter meetings, and obtained advice from seasoned CFEs. If I had done those things then the case would have had better odds of being successful.

In the Army, I was taught that leaders are responsible for everything that happens and fails to happen in their units. Obviously, this is the biggest case failure in history, and I bear responsibility for not leading this case to a successful conclusion. I'll leave it to the historians and my fellow CFEs to judge where I could have done better. I feel as badly about the result as anyone other than the victims.

What do you consider to be the best way to take down a securities Ponzi scheme?

Since a Ponzi scheme never really provides any underlying product or service, these types of frauds shouldn't take more than a few hours to solve in most instances. You simply walk into the suspected Ponzi operator's headquarters unannounced and ask to be taken to the trading desk, which won't exist. If the fraudsters are fast on their feet they'll tell you their trading desk is located at a different, far more remote location to slow you down by a day or two until you can get teams to that location. If there's no trading desk at the firm's headquarters and the firm doesn't list any other offices in its marketing literature, then you can be pretty sure it's a Ponzi.

Next you ask for the trading tickets showing those securities they traded at which prices at which time – again, they probably won't have those either. If they do have trading tickets, all you have to do is call the brokerage firms they purportedly traded through and ask if the trades are real – which they won't be. Or you can simply look at a "time & sales tick data feed" and attempt to locate these trades. Because they won't exist, that won't be too hard. I'd want to load the time & sales tick data onto a laptop so that I could check the suspected Ponzi operator's trades on site and in front of them while a partner observed their reactions to my doing this.

My guess is that for 90 percent of the Ponzi schemes out there, simply asking the principal to take you to his trading desk will

quickly lead to the confessional interview. That the SEC takes years to solve Ponzi schemes is proof that they need to hire examiners with industry experience.

You collected all your investigatory information from public domain documents. What do you venture to guess that investigators might now find in hidden Madoff company documents?
Only the internal company documents will reveal who his helpers were. Seeing the accomplices behind bars is one small measure of justice that I am looking forward to. My fear is that Madoff turned himself in at a time and place of his own choosing so he certainly had plenty of time to destroy the records necessary to implicate his accomplices.

Did you have a press plan?
On day 1, Dec. 12 – one day after Madoff turned himself in – The Wall Street Journal went to press with my name as the whistle-blower. On day 2, I developed a workable press plan that I never had to change – merely execute. I simply picked best-of-breed media outlets to work with and ignored the hundreds of press requests that were pouring in. For TV, I chose 60 Minutes as the best of the best. They probably approached me on day 4 or 5, so I had to be patient and wait for them, but I figured if all their competitors were calling, then they would too. For radio, I chose National Public Radio's Boston affiliate because I knew the news director's wife. For print media, I had been working with The Wall Street Journal for three years already. The only two media outlets I did not choose on day 2 were the Boston Globe and the Boston Examiner – they were added later.

I spent the first six days working with Greg Zuckerman of The Wall Street Journal to get the defining front-page cover story on the case published on day 7. Reporters and television cameras would show up at my front door and at times my home was staked out, but I tried to not let the media pressure get to me.

The press will pounce on you immediately, but you can't possibly do 500 interviews in a week nor should you try. I did one story that first week but made it a good one in a national publication with millions of readers and had it include some key case documents on its Web site for the world to read and use to form their own opinions.

Letting the public form their own opinions based upon the documents you provide to the press will make your case for you, so there's no need to sit for multiple press interviews. Besides, the press will all copy from the few in-depth press interviews you give. It's better to do very few interviews of exceptionally high-quality and let the hundreds of other media outlets copy from that handful of interviews that you sit for.

What can you say to encourage fraud examiners as they doggedly pursue tough cases?
I think I over-pursued this case and took way too many risks. Once I had children, I should have stopped the investigation because I put my family at risk. Realistically, in hindsight, Madoff was too dangerous an individual and too powerful a target for me. So my advice is "know when to quit." But this was my first case and I didn't know any better.

Do you believe that CFEs should have a working knowledge of the trading profession? If so, what are some of the basics they need to know to intelligently discern investing frauds?
No, unless a CFE is working at a trading firm I don't see any reason to spend the years it would take to obtain a working knowledge of the trading profession. It's far easier to hire people with trading and back-office expertise to assist you in securities fraud cases rather than wasting too much time trying to master this complex field.

You've been a securities expert for years. Joseph T. Wells, CFE, CPA, began the ACFE in 1988 to help train fraud examiners to prevent, deter, and detect fraud. How have the seminars and conferences helped you in your investigations?
I didn't have any fraud examination training so I look to the ACFE as my single-most useful professional education provider. I attend as many monthly Boston ACFE Chapter training events as I can. Last year, I attended the ACFE Annual Fraud Conference and Exhibition – the main, pre- and post-conferences – to acquire as much knowledge as inexpensively as I could.

Plus, I would attend all the conference social events; [they are] great times to network and further educate yourself. If a single post-graduate university course is $4,000, then a week attending the ACFE Annual Fraud Conference or a two-day conference is a lot less expensive, and it's more focused toward what I do for a living.

I'd also say that spending a few hours in the exhibition hall speaking to all the vendors is a phenomenal learning experience. At last year's conference, I spent hours with all of the digital forensics vendors. They showed me how to operate their equipment, how to break passwords using rainbow tables, how to mirror image a hard drive and maintain chain of custody, how to snoop on Blackberries and laptops that foolishly had unencrypted Wi-Fi and blue-tooth connections, etc. I didn't learn enough to actually operate the equipment myself, but I learned quite a bit about what's available and made several vendor connections that will come in handy during my career.

You now run an independent fraud investigation firm. What kinds of cases do you work on? How do you receive whistle-blower tips?
I only work on False Claims Act and IRS tax-fraud cases in which the victim is the government. My minimum case size is $500 million and I don't take cases from the outside; I find my own. Whistle-blowers don't find me; I find them. I automatically reject cases that try to find me and rarely respond to e-mails or phone calls from people I don't already know.

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SEPTEMBER 10, 2009

I. Introduction

Chairman Dodd, Ranking Member Shelby, and Members of the Committee, thank you for the opportunity to testify today on behalf of the Securities and Exchange Commission (SEC) regarding the agency's failure to detect the massive fraud perpetrated by Bernard Madoff. We share the Committee's desire to identify and remedy the causes of this failure and appreciate your support for improving the agency's enforcement and examination roles. We are committed to making every change necessary to fulfill our mission.

Before we begin, the Commission would like to recognize the work of the Inspector General and his staff investigating this matter and drafting the report, *Investigation of Failure of the SEC to Uncover Bernard Madoff's Ponzi Scheme* (OIG–509) ("IG Report"). We and others at the Commission are closely studying the report and will continue to analyze and learn from its findings and conclusions.

Having read the IG Report and its litany of missed opportunities, it is clear that no one can or should defend, excuse, or deflect responsibility for the SEC's handling of the Madoff matter. Stated simply, in this case we failed in our fundamental mission to protect investors, and we must continue vigorously to reform the way we operate. We have read letters from harmed investors that were filed with the court in connection with Madoff's sentencing. It is a sobering and humbling experience.

The IG Report traces the SEC's failure with Madoff to shortcomings in a number of areas, including insufficient expertise, training, experience and supervision by management; inadequate internal communication and coordination among and within various SEC divisions; deficiencies in investigative planning and prioritization; lack of follow-through on leads; and insufficient resources.

We deeply regret our failure to detect the Madoff fraud and pledge to continue to fix the problems that contributed to this failure. Today we commit to you, investors across the country and the public generally, that we will carefully study the content and findings of the IG Report and any forthcoming audit reports and continue to implement the changes necessary to strengthen our enforcement and examination programs. We also each personally pledge our unwavering commitment to establish heightened levels of expertise and tenacity within both the Office of Compliance Inspections and Examinations ("OCIE") and the Division of Enforcement ("Enforcement") in an effort to restore the trust of the investors we are charged to protect.

In this testimony, we would like to describe in detail some current initiatives and future programmatic commitments of Enforcement, OCIE and the Commission overall to address the issues raised in the IG Report.

Even before the report was issued, the agency already had begun instituting extensive reforms, including vastly expanding our training programs, hiring staff with new skill sets, streamlining management, putting seasoned investigators on the front lines, revising our enforcement and examination procedures, restructuring processes to ensure better sharing of information, leveraging the knowledge of third parties, revamping the way we handle the hundreds of thousands of tips we receive annually, and improving our risk-assessment techniques so that examiners are knocking on the right doors and delving into the right issues.

Despite the many changes we recently have initiated, we nevertheless recognize that much more needs to be done. This will require commitment and creativity. In addition, while we sincerely appreciate the support that Congress has provided the Commission, it is clear that addressing key problems identified by the IG's Report will also ultimately require additional resources. The acquisition of specialized skill sets and needed technology will require the agency and Congress to work together to make these priorities a reality.

In the coming weeks, we will continue to review the full report closely in order to learn every lesson we can, and to help buildupon the many reforms that we have already begun to put into place.

II. Current Initiatives

While the Commission has awaited the results of the IG investigation and audits, we have not waited to implement changes needed in our structure and process. Prior to the release of the IG Report, Enforcement, OCIE and the Commission as a whole have taken decisive and comprehensive steps to address self-identified deficiencies, in addition to filling gaps in our rules, which we will address later.

The Enforcement Division:

With respect to Enforcement, since Mr. Khuzami joined the Commission as Director of Enforcement in March of this year, he has been undertaking what has been referred to as "the unit's biggest reorganization in at least three decades."[1] Upon his arrival, his first mission was to establish nine working groups comprised of Enforcement Division staff and charge them with a top-to-bottom self-assessment of Enforcement's operations. Phase One of this self-assessment is now complete, and the resulting recommendations are now in the implementation phase. The recommendations, which will begin to address many of the issues identified in the IG Report, include:

- creating five national specialized investigative groups comprised both of in-house experts and newly hired staff with practical trading, market, and other specialized skills;
- adopting a flatter organizational structure by reducing current management by 40 percent and deploying those personnel to the mission-critical work of conducting front-line investigations;
- establishing structures and procedures to enhance training and supervision;
- eliminating needless bureaucratic approvals and process;
- hiring the Division's first-ever chief operating officer and beginning the task of transferring administrative and infrastructure tasks from investigative personnel to centralized operations personnel;
- establishing an improved structure to gather, analyze, assign and monitor the hundreds of thousands of complaints, tips and referrals received by the SEC annually; and
- seeking more resources to help achieve these goals.

Office of Compliance Inspections and Examinations:

With respect to OCIE, Mr. Walsh became Acting Director last month and will continue to serve in that capacity while we are conducting a search for permanent leadership. The first task for any new leader will be to conduct the same kind of top-to-bottom review of OCIE that was conducted by Enforcement in order to fundamentally rethink how it conducts business. Since his appointment, Mr. Walsh's most important goal has been to push forward several significant reforms that are reshaping the examination program. These include: placing an emphasis on fraud detection in addition to the program's overall goal of identifying potential violations of specific securities laws and rules; strengthening procedures and internal controls to better ensure we are maximizing limited resources, staffing examinations with the right skill sets, and improving oversight and communication throughout OCIE; recruiting examiners with specialized skills; increasing expertise through enhanced training and widespread participation in certified training programs such as the Certified Fraud Examiner credential; and ensuring that examiners know that they have management's full support as they follow the facts wherever they lead.

A. Expertise, Experience and Supervision

Across the SEC, there is significant focus on hiring staff with specialized expertise, greater experience and new skill sets within the confines of our current budget. These efforts should address some of the issues identified in the IG Report.

The Enforcement Division:

The Division of Enforcement is undergoing a fundamental restructuring. We are creating five national specialized units that will be dedicated to high-priority areas of securities enforcement, with a particular emphasis on complex products, markets, transactions or practices. In order to help the agency keep pace with the complexity of the markets and market practices, staff assigned to these specialized units will

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[1] David Scheer, *SEC Never Did 'Competent' Madoff Probe, Report Finds (Update 2), Bloomberg.com,* Sep. 2, 2009, *http://www.bloomberg.com/apps/news?pid=20603037&sid=aBHQkUqCQppk.*

receive advanced training, including training customized to reflect market developments and particular investigative challenges in those subject areas.

With the help of Congress, Enforcement is assigning to these units and seeking to hire specialists with practical market experience and expert skills. Approximately 7 positions of the 23 allocated from reprogrammed 2009 funds are being used for specialists to be assigned to the specialized units. Of course, current market conditions make this an opportune time to recruit staff with this expertise, and additional funding would allow us to hire more quickly specialists with significant market experience.

Unit members will acquire the expertise and investigative insights that can only be developed by conducting investigations in the same subject area, combined with ready access to others with specialized skills. With increased focus, training, and access to specialized expertise, investigative staff will make better investigative decisions and be less likely to be misled by those using complexity to conceal their misconduct.

Below is a description of the five specialized units. Future units may be added as experience and priorities dictate.

- ***The Asset Management Unit*** will focus on investment advisers, investment companies, hedge funds and private equity funds. Asset managers are responsible for an ever-growing percentage of invested assets, and the lines between different entities involved in these markets are blurring and overlapping. We anticipate that this unit will work closely with colleagues in OCIE and in the Division of Investment Management who also have substantial expertise in investment adviser and investment company issues.
- ***The Market Abuse Unit*** will focus on large-scale market abuses and complex manipulation schemes by institutional traders, market professionals, and others. We expect to build some of our own technological tools and screening programs to ferret out suspicious trading activity as well as working with others within the Commission who have expertise with the firms and products we investigate. Using these tools, our staff will analyze trading and other activity across markets, including equities, debt securities, and derivatives, and across different corporate announcements and other market events. This should allow us to detect patterns, connections and relationships that might otherwise remain hidden if we simply analyzed a single security or announcement.
- ***The Structured and New Products Unit*** will focus on complex derivatives and financial products, including credit default swaps, collateralized debt obligations and securitized products. These are huge, opaque markets. Staying current with these markets, and whatever new products are next devised, requires specialized knowledge and commitment. This unit will benefit from the hiring of staff with new skill sets as well as working closely with our colleagues in the Division of Trading and Markets who have significant expertise in these areas.
- ***The Foreign Corrupt Practices Act Unit*** will focus on new and proactive approaches to identifying violations of the Foreign Corrupt Practices Act, which prohibits U.S. companies from bribing foreign officials for government contracts and other business. Although the SEC has been quite active in this area, more needs to be done, including working more closely with foreign counterparts, and taking a more global and proactive approach to investigating violations.
- ***The Municipal Securities and Public Pensions Unit*** will focus on problems in the municipal securities market including offering and disclosure issues, tax and arbitrage-driven activity, unfunded or underfunded liabilities, and "pay-to-play" schemes in which money managers pay kickbacks and provide other favors in return for being selected to advise funds.

Of course, there are investigations that will cut across a number of these specialized areas such as insider trading, financial fraud, and Ponzi schemes. Each specialized unit and its personnel will be available as a source of expertise to the extent the unit is not handling the investigation. Specialization will therefore better enable the entire Enforcement staff to develop and benefit from particular subject-matter expertise within the agency.

In addition, the Enforcement Division is creating a searchable data base listing staff members with particular securities industry background, professional experience, academic degrees, certifications, specialized investigative expertise, and other relevant credentials. Staff will be able to use this resource—in addition to the specialized units—to identify those with the relevant skills and experience to answer questions and provide advice. This information sharing occurs now, but on a more informal and less comprehensive basis. This data base also will be used to identify

potential gaps in expertise and to develop both an enhanced initial core training program for new hires, as well as an expanded range of advanced training for more senior staff members.

In addition, Enforcement is planning to implement a new and more rigorous performance evaluation process for staff and supervisors alike. In contrast to the current system, this new approach will incorporate a five-level measure of performance, with objective performance goals established at the front end of the performance cycle. These goals will be oriented to results and not simply the accomplishment of tasks, and will identify the knowledge, skills and behaviors that need to be demonstrated to achieve those results. Individual professional development plans will also be incorporated into the new system. Further, supervisors in the Enforcement division will be required to review regularly caseload reports generated by the Division's newly enhanced case management data base (discussed below in more detail under the heading "Examination and Investigative Planning and Follow-Through").

Additionally, Enforcement is focused on improving training. While there already is formal training consisting of a program for new hires supplemented by sessions for experienced staff on substantive topics offered by SEC or outside experts, a systematic approach to training has not been a sufficiently high priority. This is changing. Enforcement is creating a formal training unit and will prioritize training by including in the evaluation of staff and supervisors the extent of their participation in formal training programs.

Our new hire training, which will be expanded, already includes sessions on, among other things, the use of forensic technology; investigating financial fraud, market manipulation, Ponzi schemes and offering frauds; and coordination among SEC offices. Since April, our sessions for experienced staff have included, among other things, forensic and investigative accounting; investigating offering frauds and market manipulation; Ponzi scheme investigative techniques; understanding and investigating certain insurance products; and hedge fund investigation issues. In the last 3 months, an increasing number of Enforcement staff has signed up to participate in Certified Fraud Examiner Training. In addition, substantial training resources are available to staff on shared internal websites. Training comes from a variety of sources, including seminars led by senior SEC staff, other government agencies (*e.g.,* Federal Law Enforcement Training Center) and private industry experts, interactive offerings, and courses directed to regulatory (Series 7) and other certifications (Certified Fraud Examiner).

Enforcement's forward focus will be to establish and implement a comprehensive training strategy to ensure that staff members receive regular training, have access to thorough and timely training materials and effectively apply training resources to their enforcement responsibilities. Upcoming training will emphasize current financial services topics as well as investigative techniques. Specialized training for managers also will include a focus on leadership and managing investigations.

The Office of Compliance Inspections and Examinations:

OCIE, which leads the Commission's examination program, will support Enforcement's specialization initiative, primarily through risk-targeted or "sweep" examinations. In an examination sweep, multi-disciplinary teams of examiners draw on their specialized experience to take a focused look at a single compliance issue. Recently, for example, examiners have been vigorously reviewing custody practices and the safety of client assets generally at a number of firms, including both advisers and broker-dealers.

Generally, in a sweep, the examiners review several firms according to a single examination plan, which has been developed with the cooperation of other offices and divisions within the SEC. Now, working with Enforcement's specialized units, OCIE is forming multi-disciplinary sweep teams to provide focused examination expertise that would support the Enforcement units.

OCIE also has begun to increase the expertise and skills of its examination staff. Chairman Schapiro has authorized a new type of position—a Senior Specialized Examiner—to attract experienced industry professionals with specialized experience in trading, portfolio management, valuation, complex products, sales, compliance, and forensic accounting. As vacancies arise, OCIE also is recruiting other staff with similar skills. Current market conditions make this an opportune time to recruit staff with this expertise. We received to date over 380 applications for only six Senior Specialized Examiner positions advertised. Thus, additional resources would allow us to bring on more specialists without waiting for attrition. These new skills should enhance OCIE's ability to detect sophisticated and well-hidden frauds.

Further, OCIE is strengthening the expertise of its staff through enhanced training, including:

- providing training by internal and external industry experts on complex issues such as hedge funds, options trading, and credit default swaps;
- enrolling its examiners in other certification programs such as the Certified Fraud Examiner (in which one-third of examiners are participating), Chartered Financial Analyst, and Chartered Alternative Investment Analyst certification programs;
- conducting joint training programs with other regulators, such as a recent specialized program designed to permit examiners to better identify red flags and uncover potential fraud; and
- establishing an internal training program focusing on establishing third-party verification of customer assets.

In addition, supervisors in the examination program will be required to review regularly the status of examinations (discussed in more detail under the heading "Examination and Investigative Planning and Follow-Through").

Agency-wide:

On an agency-wide basis, the SEC is also working to enhance its risk assessment capabilities. As part of that effort, the agency has recently created the *Industry and Market Fellows Program,* through which it is hiring highly seasoned financial experts to help it keep pace with the practices of Wall Street and protect investors. These experts should provide staffers with the information and perspectives necessary to identify emerging issues and understand ways the industry is changing.

B. Communication and Coordination

The IG Report described weaknesses in coordination among Enforcement, OCIE, and other SEC offices and divisions, as well as among and within divisions or regional offices, and with third parties. In the Madoff matter, this lack of effective coordination resulted in missed opportunities, miscommunications, and a failure to share knowledge and evidence. Over the past year, we have been addressing this weakness.

Office of Compliance Inspections and Examinations:

Traditionally, the OCIE examination program has been divided along the lines of registrants, with some examiners focusing on broker-dealers and others focusing on investment advisers and investment companies. This organization is a legacy of the program's origins in two different operating divisions. While this structure allowed examiners to develop particular expertise, the IG Report illustrates how there has not been enough interaction between the two operational groups, especially since many entities that are examined operate as both a broker-dealer and an investment adviser.

We are moving to address this issue. For example, the New York Regional Office already has adopted a protocol under which a single team of examiners, drawn from the broker-dealer and investment management units, will jointly examine selected firms to ensure that the examination team includes those most expert in the subject of the examination. The examination program in other regional offices has been consolidated under the leadership of a single senior manager to ensure consistent supervision on their coordination, collaboration and communication. In addition, regional offices are evaluating additional initiatives—like the initiative underway in New York—to better integrate the broker-dealer and investment adviser examiners as necessary.

OCIE also is emphasizing enhanced planning of examinations that involve firms jointly registered as broker-dealers and advisers to ensure they have staff with the right skill sets and adequate information to understand the firms' businesses. OCIE has prepared new guidance to assist examiners in their review of broker-dealers with advisory affiliates or operations. The guidance includes detailed procedures for examiners to follow when reviewing such firms, including lines of inquiry regarding supervision, referral arrangements, advertising and trading. This new guidance already has been used in selected examinations to field-test its effectiveness and will soon be deployed to the entire examination program. Also, OCIE recently held a variety of training programs to cross-train examiners and examination managers in each others' specializations.

The Enforcement Division:

Similarly, the Enforcement initiatives described above will improve coordination and communication. National specialized units will discourage the existence of separate regional "silos" that could develop based solely on a regional organization. National specialized units, as opposed to exclusively geographically defined units, will foster a more comprehensive and coherent national program that encourages com-

munication and collaboration. Effective communications with other SEC offices or divisions is essential to ensure that Enforcement is benefiting from our collective agency resources.

In addition, Enforcement senior management has re-emphasized to Enforcement staff the importance of consulting with other SEC offices and divisions early and often to identify and resolve issues. Enforcement also has a formal process by which it seeks review and comment from other offices and divisions before it submits an enforcement recommendation to the Commission, and it will continue to use this important resource.

Further, Enforcement is creating an Office of Market Intelligence to improve the Division's handling of tips and complaints. This new office dovetails with the agency-wide effort to revamp the way in which it handles the hundreds of thousands of tips and complaints the SEC receives each year. (This is described below in further detail under the heading "Additional Initiatives to Protect Investors.") The Office of Market Intelligence will be responsible for the collection, analysis, risk-weighing, triage, referral and monitoring of the hundreds of thousands of tips, complaints, and referrals the SEC receives each year. The office also will draw on the expertise of the agency's various offices to help analyze the tips and identify wrongdoing while greatly increasing our communication with other divisions and offices about how to respond to tips and complaints. Through this effort, we hope to have a unified, coherent, coordinated agency-wide response to the huge volume of information we receive every day.

C. Examination and Investigative Planning and Follow-Through

The IG Report also found that the Madoff investigation suffered from poor examination and investigative planning and follow-through. The Commission has been working on these very issues over the past year. Where they can be addressed by new procedures, we are adopting them. Beyond procedures, however, the leadership of enforcement and examination programs at all levels are enhancing planning and follow-through as a management priority.

For example, the Commission is deeply concerned about the IG's findings that Madoff attempted to intimidate investigators and examiners. We are addressing this unacceptable tactic by sending a consistent internal and external message. When junior investigators or examiners believe they are being subjected to intimidation tactics, they should immediately notify their supervisors. OCIE, for example, has created a new internal Hotline for examiners to immediately reach a senior attorney in headquarters when a firm is being uncooperative, unreasonable, or otherwise resisting appropriate oversight. Supervisors at all levels *will* back up more junior personnel. We will not be successful if we tolerate intimidation tactics directed against our staff. Indeed, we will train our staff to view these tactics as a red flag, and instruct to dig deeper, and look harder, at the firms that try to use them.

Office of Compliance Inspections and Examinations:

OCIE is reviewing its written procedures and internal guidance to make sure it provides clear and consistent practices across the examination program. The guidance concerns pre-examination planning, document requests, responses to red flags, tracking managing findings, organizing and retaining work papers, preparing closing reports, and making enforcement referrals. OCIE is paying particular attention to procedures governing the scope of for-cause examinations, including procedures for more careful (and documented) examination planning and supervisory involvement. Specifically, the procedures help ensure that complaints and tips are appropriately examined.

OCIE also has implemented new procedures for obtaining third-party verification of information obtained in examinations. As the IG Report notes, third-party verification is a critical examination technique. OCIE now requires examiners to utilize third-party verification techniques routinely to ensure that asset and account information is accurate. As appropriate, examiners contact counter-parties, custodians and customers.

As noted earlier, we are also implementing mandatory Quarterly Reviews in which supervisors will formally review progress on examinations with assigned staff. The Quarterly Reviews will enable supervisors to assess each new matter and its examination scope and plan, to identify and address roadblocks to achieving the scope and plan, as well as new issues that could require a modification to the scope and plan, and with respect to an aged examination, to assess the examination work to date and develop a plan for resolving the open issues and bringing the examination to an appropriate conclusion. The Quarterly Reviews will provide direct supervision at regular intervals of all examinations open in an office or supervisory unit. Supervisors will be instructed, in all such reviews, to consider whether an examina-

tion could benefit from the deployment of new or different expertise or assistance from other offices, divisions, or functional units within the SEC.

The Enforcement Division:

The Enforcement Division's efforts toward specialization and reducing process and administrative burdens will improve investigative planning and execution. Enforcement's initiative to streamline its structure through a 40 percent reduction in management will result in a redeployment of highly experienced staff to front-line investigations, the heart-and-soul function of the division. It should be emphasized, however, that this streamlining will not come at the cost of appropriate levels of investigative supervision. At the same time Enforcement is redeploying its branch chiefs to the front lines, it is expanding the number of Assistant Directors in order to maintain staff to manager ratios that allow for close substantive consultation and collaboration.

As noted earlier, we also are implementing mandatory Quarterly Reviews in which senior supervisors will formally review progress on investigations with assigned staff. The Quarterly Reviews will enable supervisors to assess all new matters and their investigation plans; to devise strategies to overcome investigative roadblocks and challenges; and, with respect to aged investigations, to assess our findings and develop plans to obtain the proper and sufficient evidence to either proceed to an enforcement recommendation or close the matter. The Quarterly Reviews will provide senior direct supervision at regular intervals throughout an investigation to ensure comprehensive oversight and the swiftest possible completion. In conducting these reviews, supervisors will benefit from the use of our newly updated case management data base that shows at a glance key progress milestones in the matters under review.

D. Resources

The IG Report identifies a number of shortcomings that will require additional resources. Nevertheless, we are aggressively reallocating existing resources into areas that maximize our ability to achieve our mission.

The Enforcement Division:

A number of initiatives underway in the Division of Enforcement seek to address, directly or indirectly, serious resource-constraint issues. Specialization and a flatter management structure will increase Enforcement's investigative capacity and permit a greater focus on programmatic priorities. Eliminating or streamlining internal processes will give staff more time to dedicate to core investigative work, as will improved training and information technology capability. Creating incentives for witnesses to cooperate in investigations, or for whistleblowers to provide information on ongoing frauds, should also increase efficiency by permitting Enforcement to obtain high-quality evidence from insiders. Each of these is a current initiative within the Division of Enforcement.

In addition, Enforcement is seeking to deploy newly available resources as thoughtfully as possible. Enforcement allocated recent headcount increases among market specialists, trial attorneys, paralegals and paraprofessional support, and training personnel.

Enforcement also is committed to reducing administrative burdens on our attorneys so they can spend more time on the front lines. In fact, just last week, Enforcement hired the division's first-ever chief operating officer, who will oversee improved coordination and centralization of various infrastructure and administrative tasks. Many of these tasks currently are handled by lawyers in Enforcement. Similarly, future resources have been committed to more than tripling the number of full-time paralegals and support personnel in Enforcement and to dedicating significantly greater resources to ongoing technology initiatives. Leveraging resources is critical given the breadth of the agency's responsibility to enforce the securities laws as to more than 35,000 registrants and monitor for fraud involving all categories of investors.

Office of Compliance Inspections and Examinations:

Over recent years, recognizing the need to best use its limited inspection resources in contrast to the vast number of regulated entities, OCIE has developed risk-based processes for selecting firms and activities for examination in order to ensure that it is deploying its resources most effectively. One process currently relies on registration information that firms must file with the SEC or self-regulatory organizations (SROs), information from past examinations, and information OCIE can obtain from public sources. OCIE has also developed a second process that identifies key risks observed by staff and assesses each risk's probability of occurrence and potential impact. We focus on risks such as fraud, abuse, misappropriation, manipu-

lation and unregistered firms and offerings. OCIE is exploring a variety of ways to enhance these processes, and we look forward to working with this Committee on any necessary legislative foundations.

Risk-based processes are critical because the number of entities subject to SEC examination has grown much faster than the number of staff available to examine them. The SEC's examination program has approximately 790 staff dedicated to examining approximately 11,300 investment advisers, approximately 8,000 mutual funds, approximately 5,000 broker-dealers (with more than 170,000 branch offices), as well as hundreds of other entities such as SROs, transfer agents, credit rating agencies, and clearing agencies.

E. Additional Initiatives To Protect Investors

In the wake of the Madoff fraud, the SEC also has embarked on a number of initiatives in addition to those discussed above aimed to enhance its capacity to detect and prevent similar frauds. For example:

- The SEC has contracted with Mitre, a federally funded research and development center, to help the agency revamp its processes to improve the handling of hundreds of thousands of complaints, tips, and referrals it receives each year. After reviewing and analyzing its intake procedures, the SEC is now beginning to improve upon its processes for collecting, recording, investigating, referring and tracking this information. Among other things, the agency is creating a centralized system for handling this information. Once the information and processes are centralized, the agency will apply risk analytics to better enable it to reveal links, trends, statistical deviations and patterns that might not be observable when each complaint is examined one at a time and provide a platform for greater communication about tips and complaints throughout the agency.
- The SEC has advocated for expanded authority from Congress to reward whistleblowers who bring forward substantial evidence to the agency about significant Federal securities violations. Under proposed legislation, money collected from wrongdoers that is not otherwise distributed to investors would be used to establish a fund to reward whistleblowers whose contributions lead to successful enforcement actions. We welcome the opportunity to work with Congress as it considers this important legislation.
- In May the Commission proposed two rules that are designed to better protect clients of investment advisers from theft and abuse. The rules are designed to provide assurance to these clients that their accounts contain the funds as represented by their investment adviser and account statements. Among other things, these rules are designed to encourage investment advisers to place their clients' assets in the custody of an independent firm, or obtain an independent custody controls review, commonly referred to as a SAS–70 review, by a PCAOB-registered and examined independent accounting firm. In addition, the rules would require investment advisers with custody of their clients' assets to undergo an unannounced exam by an independent accounting firm in order to verify clients' assets. These asset-verification exams would occur on an annual basis at the time of the accountant's choosing. As with all our rule proposals, the Commission looks forward to reviewing and evaluating the comments on these rule proposals. The proposed rules provide for:
  - *Surprise Exams:* One proposal would require all investment advisers who control or have custody of their clients' assets to hire an independent public accountant to conduct an annual "surprise exam" to verify those assets actually exist. This surprise examination would provide another set of eyes on the clients' assets, thereby offering additional protection against the theft or misuse of funds.
  - *Third Party Reviews:* A second proposal would apply to investment advisers who do not use independent firms to maintain their clients' assets. Such advisers would be required to obtain a third party written report assessing the safeguards that protect the clients' assets. The report—prepared by an accountant registered and inspected by the Public Company Accounting Oversight Board—would, among other things, describe the controls that are in place to protect the assets, the tests performed on the controls, and the results of those tests. Existing rules make no distinction between an investment adviser whose affiliate holds its clients' funds and an investment adviser that uses a truly independent custodian.
- Finally, working with senior SEC staff, FINRA has committed to establish a new system to enhance the oversight and professional requirements of personnel performing back-office functions at broker-dealer firms. "Back-office" per-

sonnel typically perform critical custody, accounting, transfer agency, and account maintenance functions. Under the new regime, certain back-office personnel would be subject to licensing and education requirements as well as enhanced oversight. The new regime will further promote the qualifications and professionalism of those performing back office functions so that client accounts are better protected.

III. Recent Enforcement Efforts

As Chairman Schapiro previously observed before this Committee, the SEC is the only agency focused primarily on the protection of investors. As the agency's most public face, a strong Division of Enforcement is critical to the investing public's confidence in the integrity of our markets. Over the past year, while the criticism surrounding the Madoff fraud has been sharp and steady, our organizational response in light of these acknowledged errors is exactly what taxpayers and the public have every right to expect. We have taken the lessons to heart and implemented a far-reaching program of change and improvement. Our investigators have not been complacent or hesitant to take on the most difficult and challenging investigations aggressively and intelligently.

Although numbers do not tell the whole story, the metrics demonstrate the hard work of our staff. Comparing the period from late January to the present to the same period in 2008, Enforcement has:

- opened more investigations (1,377 compared to 1,290);
- issued more than twice as many formal orders of investigation (335 compared to 143);
- filed more than twice as many emergency temporary restraining orders (57 compared to 25); and
- filed more actions overall (458 compared to 359).

The justified criticism of the SEC arising from the Madoff fraud should not obscure the 75-year tradition of vigorous enforcement resulting from the dedicated efforts of public servants who work tirelessly and with impressive results to protect the investing public. Here is a small sample of Enforcement's recent actions:

- ***Credit Crisis-Related Cases:*** The SEC charged the former CEO of Countrywide Financial and two other former executives with fraud for allegedly deliberately misleading investors about the significant risks it was undertaking.[2] The SEC's charges allege that Countrywide portrayed itself as underwriting mainly prime quality mortgages, while privately describing as "toxic" certain of the loans it was extending. The SEC's complaint also charged the former CEO with insider trading.

In other mortgage-related cases, the SEC brought actions against former mortgage-lending company executives for accounting fraud and allegedly making false and misleading disclosures relating to the risk of the mortgages originated and held by the company as the credit crisis began to unfold.[3] The SEC sued registered representatives of a broker-dealer firm for allegedly making false statements in marketing investments in mortgage backed securities as safe and suitable for retirees and others with conservative investment goals.[4] The SEC also charged a registered investment adviser and its affiliate with allegedly overstating the value of a mutual fund that invested primarily in mortgage-backed securities and for selectively disclosing problems with the fund to favored investors, allowing them to bail out early to avoid losses.[5]

And in the Reserve Fund matter, the SEC charged the managers of a $62 billion money market fund whose net asset value fell below $1.00, or "broke the buck" based in part on investments in Lehman-backed paper, for their alleged failure to properly disclose to the fund board all material facts relating to the value of the Lehman-backed paper.[6]

- ***Ponzi Schemes:*** The SEC investigates and prosecutes many Ponzi schemes cases each year, the majority of which are brought as emergency actions—seeking a temporary restraining order and an asset freeze—both to prevent new vic-

[2] *SEC v. Angelo Mozilo, David Sambol, and Eric Sieracki,* Lit. Rel. No. 21068A (June 4, 2009).
[3] *SEC v. Michael Strauss, Stephen Hozie and Robert Bernstein,* Lit. Rel. No. 21014 (April 28, 2009).
[4] *SEC v. William Betta, Jr., et al.,* Lit. Rel. No. 21061 (May 28, 2009).
[5] *In the Matter of Evergreen Investment Management Company, LLC and Evergreen Investment Services, Inc.,* AP File No. 3–13507 (June 8, 2009).
[6] *SEC v. Reserve Management Company, Inc., Resrv Partners, Inc., Bruce Bent Sr. and Bruce Bent II,* Lit. Rel. No. 21025 (May 5, 2009).

tims from being harmed and to maximize the recovery of assets to investors. Since January, the SEC already has filed 45 enforcement actions involving Ponzi schemes or Ponzi-like payments, a significant increase over the same period last year.

- ***Public Trust:*** Working with the New York State Attorney General, the SEC pursued placement agents and others for allegedly extracting kickbacks from investment management firms seeking to manage the assets of New York's largest pension fund, the New York State Common Retirement Fund.[7]
- ***Derivatives and Structured Products:*** We have been looking aggressively at fraudulent schemes involving structured products. In May, the SEC charged a former portfolio manager at hedge fund investment adviser Millennium Partners and a salesman at Deutsche Bank for alleged insider trading in credit default swaps on international holding company VNU. In this case, bank employees allegedly tipped the portfolio manager about an anticipated change in VNU's underlying bond structure that substantially increased the price of the credit default swap, which allowed the defendants allegedly to profit from their purchase of credit default swaps when the restructuring was announced[8] In addition, the SEC filed a civil injunctive action late last year against four individuals for allegedly engaging in a fraudulent scheme to overvalue the commodity derivatives trading portfolio at Bank of Montreal (BOM) and thereby inflate BOM's publicly reported financial results.[9]
- ***Accounting Fraud:*** The SEC charged General Electric with using improper derivative accounting methods to increase its reported earnings and revenues and avoid reporting negative financial results.[10] The SEC also charged Terex Corporation with accounting fraud for allegedly making material misstatements in its financial reports to investors, as well as allegedly aiding and abetting a fraudulent accounting scheme at United Rentals, another public company.[11]
- ***Abusive Short Selling:*** In two separate actions, the SEC charged two broker-dealers and two options traders for alleged "naked" short sale rule violations.[12] In these actions, the SEC alleged that the respondents improperly claimed that they were entitled to an exception to the Regulation SHO requirements that broker-dealers must locate a source of borrowable shares prior to selling short and circumvented the requirement to deliver securities sold short by a specified closeout date.
- ***Foreign Corrupt Practices Act:***Late last year, the SEC filed a civil injunctive action charging Siemens Aktiengesellschaft (Siemens), a Munich, Germany-based manufacturer of industrial and consumer products, with violations of the anti-bribery, books and records, and internal controls provisions of the Foreign Corrupt Practices Act. In this settled action, Siemens offered to pay a total of $1.6 billion in disgorgement and fines, which is the largest amount a company has ever paid to resolve corruption-related charges.[13]

Enforcement is continuing to investigate rigorously cases in all of these areas and more: misconduct relating to the credit crisis, accounting and financial fraud, structured product fraud, suspected Ponzi schemes, hedge fund and investment adviser fraud, insider trading, market abuse, and market manipulation based on complex use of technology and advanced trading systems.

IV. Conclusion

Our mission is critical. We are thus committed to using all of our energies, efforts, experience, expertise, and a sincere dedication to investor protection to continue to revitalize and improve our programs. These are challenging times, but we believe they are also times of great opportunity for improvement. We are aggressively pur-

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[7] *SEC v. Henry Morris, et al.,* Lit. Rel. No. 20963 (March 19, 2009), Lit. Rel. No. 21001 (April 15, 2009), Lit. Rel. No. 21018 (April 30, 2009).

[8] *SEC v. Jon-Paul Rorech, et al.,* Lit. Rel. No. 21023 (May 5, 2009).

[9] *SEC v. David Lee, et al.,* Lit. Rel. No. 20811 (Nov. 18, 2008).

[10] *SEC v. General Electric Company,* Lit. Rel. No. 21166 (August 4, 2009).

[11] *SEC v. Terex Corporation,* Lit. Rel. No. 21177 (August 12, 2009).

[12] *In the Matter of TJM Proprietary Trading, LLC, Michael R. Benson and John T. Burke,* AP File No. 3–13569 (August 5, 2009) and *In the Matter of Hazan Capital Management, LLC and Steven M. Hazan,* AP File No. 3–13570 (August 5, 2009).

[13] Siemens agreed to pay $350 million in disgorgement to the SEC. In related actions, Siemens agreed to pay a $450 million criminal fine to the U.S. Department of Justice and a fine of €395 million (approximately $569 million) to the Office of the Prosecutor General in Munich, Germany. Siemens previously paid a fine of €201 million (approximately $285 million) to the Munich Prosecutor in October 2007. *SEC v. Siemens Aktiengesellschaft,* Lit. Rel. No. 20829 (Dec. 15, 2008).

suing long-term changes in our structure and processes, while at the same time working hard to continue our vigorous enforcement and examination efforts. We can say without reservation that we are proud to be part of this institution, and we are confident of our future success.

We appreciate the opportunity to appear before you today. We would be happy to answer your questions.

RESPONSE TO WRITTEN QUESTION OF CHAIRMAN DODD FROM H. DAVID KOTZ

Effect of Madoff's Stature in the Investment Community

Q.1. How many of the current or former SEC staff who you interviewed for your study were aware that Madoff was influential in the securities community at the time of the investigation or examination with which they were involved? What was their reaction to this knowledge and how did it influence their judgment?

A.1. The OIG investigation found that most of the current and former SEC staff who worked on Bernard Madoff-related examinations and investigations were aware, or became aware, of Madoff's prominence in the industry, and that Madoff used his stature and perceived connections to try to influence examinations and investigations. We also found Madoff participated in SEC panels and events and communicated with SEC Chairmen, and that SEC Officials participated in conferences arranged by Bernard Madoff's niece, Shana. We further found that there were several instances in which the SEC staff visited Bernard Madoffs offices in New York City as part of official SEC events.

However, we did not find evidence that SEC examiners or investigators failed to aggressively follow-up on their suspicions of fraudulent activity because of concerns that they were targeting such an influential figure in the securities industry. We did find that the SEC examiners' and investigators' awareness of Madoff's stature played an ancillary role in the conduct of their examination and investigatory work in that they had difficulty believing that Madoff, who had an established and well-known reputation in the industry, would be operating a Ponzi scheme.

The following provides the specific level of knowledge on the part of current or former SEC staff and its impact for each major investigation and examination of Madoff. In connection with the 1992 SEC investigation of Avellino & Bienes, an SEC examiner acknowledged that Madoff's stature and reputation in the industry may have influenced their decision not to further examine Madoff's operations while investigating Avellino & Bienes for a possible Ponzi scheme. Former SEC Branch Chief John Gentile (Gentile) stated that he was aware that Madoff's firm "was very prominent in developing third market particular automated trading." Similarly, former SEC examiner Demetrios Vasilakis (Vasilakis) stated that during the 1992 examination, he was "made aware" by Bernard Madoff himself that Madoff served in various industry committees, was a well respected individual and noted that the SEC examiners used an NASD manual with Bernard Madoff's name on it. In fact, when asked for his recollections of Bernard Madoff at the time of the examination, Vasilakis stated as follows:

> My personal conclusions [from the examination] were that [Bernard Madoff] was a pioneer in the industry, to use the term that's been thrown around now, but that he really used, you know, technology to bring trading to the next level. It was strictly—when I walked out of there it was more along the lines of wow, this guy is a third market guy that does X percent of the volume on the exchange. This is where I actually learned about third market. I didn't even know the so-called term that that's what it was called [prior to the examination.]

Gentile stated that it was fair to say that because of Bernard Madoff's reputation at that time as a large broker-dealer, there may not have been any thought to look into Madoff's operation any further because of their disbelief that Madoff would be operating a Ponzi scheme.

With respect to the 2003 SEC examination of Madoff, former SEC Associate Director John McCarthy (McCarthy) stated he became aware of Madoff when he conducted an examination in the mid-90s. McCarthy said he subsequently learned that Madoff's firm was one of the largest third market maker firms and that they had a very good reputation in terms of their execution quality of retail customer orders. Former SEC Assistant Director Eric Swanson (Swanson) also stated that in the later 1990s he became aware of Madoff Securities as a large market maker in over-the-counter space. SEC Branch Chief Mark Donohue (Donohue) stated that he was also aware of Madoff's firm as a market maker prior to the 2003 examination.

Although McCarthy, Swanson, and Donohue were aware of Madoff's stature, there is no evidence that Madoff's prominence impacted their examination, and they denied that their examination was influenced by Madoff's reputation. However, there is evidence that when McCarthy, Swanson, and Donohue discussed their examination with other SEC examiners, they made a point to inform the SEC examiners of Madoff's stature in the industry.

According to SEC examiner William Ostrow (Ostrow), during a conference call on May 31, 2005 with Swanson, McCarthy, and Donohue, he and fellow SEC examiner Peter Lamore (Lamore) were informed that Madoff was a powerful and well-connected individual, stating:

> I don't know who said it, someone from [the SEC's Office of Compliance Inspections and Examinations (OClE)] basically, '[Madoff's] a very powerful person, Bernie, and you know, just remember that.' . . . But basically just, 'He is a very well-connected, powerful person.'

Ostrow interpreted the statement to raise a concern for them about pushing Madoff too hard without having substantial evidence. Lamore had a similar recollection, stating "I'm not sure if those were the exact words, but it struck me as odd at the time." Assistant Director on the SEC examination John Nee (Nee) also recalled the statement, although he did not interpret it to mean they should "tread lightly." He thought the comment indicated "they might get a phone call from someone but we never did."

The OIG investigation uncovered further evidence that Ostrow and Lamore were well aware of Madoff's stature in the industry, that Madoff attempted to intimidate and impress them with his perceived connections, and that the junior examiners were overmatched in their interactions with Madoff making them unable to aggressively conduct the 2005 SEC examination.

Prior to beginning the examination, Ostrow stated he knew the name Bernie Madoff because Madoff was "a large market maker." We also found that around the time of the examination, Ostrow and Lamore exchanged articles describing Madoff's significant achievements, including "serv[ing] as chairman of the board of directors of the Nasdaq Stock Market as well as a member of the board of Governors of the NASD . . . [and] of the Securities Indus-

try Association . . . [and] a founding member of the board of directors of the International Securities Clearing Corporation in London." Another article exchanged by the examiners was entitled, "The Madoff Dynasty" and described Madoff's family members.

Lamore also testified that the name Madoff was familiar to him when he began the examination, stating he was aware that Madoff was "a pretty prominent maker." Lamore acknowledged that after researching Madoff prior to the examination, he concluded that Madoff was an impressive and influential figure in the industry. Nee and SEC Associate Director Robert Sollazzo (Sollazzo) also recalled being aware of Madoff as a big market-maker when they began the cause examination. Lamore said Madoff made efforts to emphasize his role in the securities industry during the examination. Lamore said he found it "interesting" but also "distracting" because they were there "to conduct business."

Ostrow indicated that there were efforts made by Madoff to impress and even intimidate the examiners. Ostrow stated that "[all throughout the examination, Bernard Madoff would drop the names of high-up people in the SEC." Ostrow reported that Madoff told him and Peter Lamore that former SEC Chairman Christopher Cox (Cox) was going to be the next Chairman of the SEC a few weeks prior to Cox being officially named. Ostrow stated they "were pretty amazed" that Madoff knew this information and he felt that Madoff's intention was to both impress and intimidate them. Ostrow said Madoff made clear that "he knew everybody in OCIE," and referenced his relationship with Lori Richards, then-Director of OCIE.

Ostrow also reported that Madoff told them that Madoff himself "was on the short list" to be the next Chairman of the SEC. Ostrow said they believed it was a possibility since he was very well known in the industry. However, Ostrow also stated that Madoff's name-dropping "didn't really impress us." Lamore also recalled that Madoff would drop the names of senior SEC officials, including referencing a meeting or rulemaking relating to then-Commissioner Annette Nazareth. Lamore stated that Madoff was trying to impress him with all his connections, and noted that dropping the name of a Commissioner of the SEC, "was a pretty big name to mention." Lamore also recalled Madoff saying that he was on the short list to be the next Chairman of the SEC. In fact after the examiners received an email from the Director of the SEC's New York office announcing that Chairman William Donaldson would be resigning, Lamore sent an email to Nee stating, "Bernie told us he was on the short list when Chairman Donaldson was selected. Maybe this time." Nee responded to Lamore's email, stating, "Maybe you and William can be his aides." Nee stated that in his response on the email about Lamore and Ostrow being Madoff's aides, he "was trying to be facetious."

While Nee stated he did not believe that Ostrow was "star struck" when meeting Madoff, he did note that he later found out that Ostrow had his wife take pictures of Madoff when he was being arraigned. Nee acknowledged that Madoff's intent was to impress and intimidate the examiners, but he thought these efforts were unsuccessful and the examiners found Madoff to be a "bit of a blowhard." Sollazzo also acknowledged that given the frequent

interaction between Madoff and the examiners, there was a possibility that Madoff's "reputation and supposed world of knowledge" that he could "overcome" or "stonewall examiners." He stated that they may have been "overwhelmed" by Madoff and "outmatched a bit." Elaine Solomon, who worked as Peter Madoff's secretary from March 1997 until December 2008, stated that the SEC examiners who met with Madoff looked like they were "in awe" of him.

In connection with the 2005–2006 SEC Enforcement investigation, the OIG found that the Enforcement investigators were not aware of Madoff's stature before they began the investigation. Former SEC Assistant Director Doria Bachenheimer stated that when she first learned of Markopolos' complaint, she had not heard the name Bernie Madoff or Madoff Securities. Former SEC Branch Chief Meaghan Cheung (Cheung) stated that she had "embarrassingly" not heard of Madoff or his firm before the Madoff case. SEC Staff attorney Simona Suh (Suh) similarly stated that prior to being assigned the case, she had never heard of Madoff or his firm.

In addition, while the Enforcement investigators acknowledged becoming aware of Madoff's stature during the investigation, they denied that his prominence impacted the investigation, except to the extent that they were less likely to believe that Bernie Madoff had engaged in a Ponzi scheme. Cheung acknowledged that during the investigation, she learned that Madoff was an influential figure in the securities industry, and had a high-level position with the NASDAQ. Moreover, when asked if once she learned of Madoff's reputation, she thought that the staff treated him differently, Cheung stated as follows:

> I don't think there was ever a conscious desire to make something go away or to ignore an allegation about Bernie Madoff. Do I think that there's an inherent bias toward the sort of people who are seen as reputable members of society, there may be an inherent bias in that way. I think that we did not forego investigative steps because of who he was, and I don't think we were easier on him. I have personally interviewed, requested documents, gotten tolling agreements, pushed from people who I view as—as sort of more powerful than Bernie Madoff without, I think, pulling a punch.

Suh stated in testimony, "Madoff [did] sort of try to play up his prominence to some degree. He talked about, you know, being on panels of, I believe, NASD or something like that." However, Suh stated, "[i]t did not really matter much to me." Suh, did, however, acknowledge, "[i]t's certainly true that he didn't fit the profile of a Ponzi schemer, at least as we—in the world that we knew then," however, "I never had a concern in terms of, you know, stepping on the wrong toe or anything like that, and I had no impression that anybody else did."

Cheung, however, denied that in her mind, it was "just inconceivable" that someone like Bernie Madoff would have run a Ponzi scheme, stating that the investigators significantly looked at and considered the issue of a potential Ponzi scheme even though he was Bernie Madoff.

For further information about this topic, please see the OIG's August 31, 2009 Report of Investigation entitled "Investigation of the SEC's Failure to Uncover Bernard Madoff's Ponzi Scheme" at Section VI(E)(2).

Thank you for your continued interest in our work.

RESPONSES TO WRITTEN QUESTIONS OF CHAIRMAN DODD FROM JOHN WALSH

Resources and Examinations

Q.1. Please describe the typical experience levels of staff who conduct exams of an investment advisor and of a broker-dealer. On average, how many new examiners are hired by your Office each year and what is their typical experience level?

A.1. Our examination staff is primarily comprised of accountants, lawyers, and former industry professionals. At the beginning of 2009, approximately 63 percent of our examination staff were accountants, 18 percent were CPAs, approximately 13 percent were attorneys, approximately 7 percent were examination support staff, including information technology staff, and approximately 1 percent were financial analysts. We have continued to recruit experienced industry professionals, and more than 70 percent of the examination staff hired during the past few years had securities experience prior to joining the SEC.

Oversight of FINRA Examinations

Q.2. Please describe the scope of the Commission's authority over the examinations conducted by FINRA of broker-dealers and the extent and frequency of the Commission's supervision of FINRA's examinations. Include in this discussion examinations conducted pursuant to Section 13(c) of the Securities Investor Protection Act, which provides that, subject to limited exceptions, the SRO of which a member of SIPC is a member shall inspect or examine such member for compliance with all applicable financial responsibility rules. Also, please describe the scope and frequency of the SEC's review of FINRA's exams and exam process during the past 25 years.

A.2. Section 19(g)(1) of the Exchange Act requires each SRO to comply with, and enforce compliance with, the provisions of the Exchange Act, the rules and regulations thereunder, and the SRO's own rules. The SEC oversees FINRA's compliance with these obligations through its inspections of FINRA and through its oversight examinations of broker-dealers. OCIE conducts inspections of FINRA to assess the adequacy of FINRA's regulatory programs, generally focusing on select regulatory programs in each inspection. Such inspections periodically include a review of FINRA 's regulatory programs for examining its member firms, including its financial responsibility examinations program.

OCIE also conducts oversight examinations of broker-dealers pursuant to its examination authority under Section 17 of the Exchange Act. During such examinations, SEC examination staff analyze and sample a broker-dealer's records from the same time period and focus areas that FINRA reviewed during its examination. These examinations serve the dual purposes of evaluating the quality and effectiveness of FINRA's examinations of its member firms, as well as detecting violations or compliance risks at broker-dealers. Such examinations generally include a review of the firm's financial responsibility and net capital assessments if FINRA had focused on these issues. In fiscal year 2008, the examination program conducted 720 broker-dealers examinations, representing approxi-

mately 13 percent of registered broker-dealers. When taking into account both SEC and SRO examinations, approximately 57 percent of registered broker-dealers were examined in fiscal year 2008.

The Problem of "Silos"

Q.3. A recent column in *The New York Times* stated, "Bureaucratic rivalries are nothing new, and the S.E.C. is certainly not one big happy family. But when an agency's goal is to protect investors, it needs to ensure that everyone is working toward that end. Opening up the lines of communication both within and between divisions, and encouraging them to work with one another and share all information rather than view others as potential rivals, is a much better way to operate."

Over the years, I have heard many complaints from industry about stovepipes, or "silos," within the SEC—Divisions or Offices that do not communicate or cooperate with each other. The Report identifies several instances where this contributed to the failure of the SEC to find the Madoff fraud.

Are you concerned about the problem caused by silos? What are you doing to promote cooperation among the units in your Office and between them and other SEC offices?

A.3. The Inspector General's report described how a lack of effective coordination both among staff within OCIE as well as with other offices and divisions resulted in missed opportunities, miscommunications, and a failure to share information. I agree that opening the lines of communication within the examination program and with staff in other SEC offices and divisions is crucial to the agency's ability to successfully detect fraud going forward.

Over the past year, the SEC has taken many steps to address this weakness. Chairman Schapiro has repeatedly stressed the fact that we are one agency that can only succeed if we fully cooperate with each other, share information and rely on the expertise throughout the agency. She specifically brought together her senior managers to convey this message. She also began a program in which she and her senior managers are visiting every regional office to discuss the importance of learning lessons from the Madoff fraud, the importance of having a "culture of cooperation," and to begin an ongoing dialog throughout the agency about how different divisions and offices can better help each other as we work to protect investors.

With respect to the examination program, OCIE has traditionally been divided along the lines of registrants, with different groups focusing on different types of entities such as investment advisers, broker-dealers, and SROs. We have focused our efforts on breaking down these silos in many different ways over the past several months. For example, we have provided cross-training to examiners and have strongly emphasized the necessity for joint planning of examinations that involve firms jointly registered as broker-dealers and advisers. Further, we have formed a task force to assess how we can best improve collaboration among the various groups within the examination program. The task force has assessed, among other things, how the cross-training and coordinated planning has impacted examinations involving the need for joint onsite reviews. Ultimately, the task force will recommend solutions to enhance our

internal communication, promote cross-staffing from the various examination groups on certain examinations where specific expertise is necessary, and to encourage staff to reach out to other staff across the examination program that might have specialized knowledge.

In addition, we have initiated a quarterly review program to foster communications among examination program managers and enhance our internal controls. As previously mentioned, this review involves quarterly meetings at which a team of managers review and discuss all open examinations and assess whether additional expertise is necessary to resolve issues and finalize those examinations. This review process will help ensure that examinations do not "fall through the cracks," and that important issues get timely resolved, and will provide an opportunity for managers to obtain fresh perspectives on the issues under review. The review process will include managers that are not the line supervisors of the examinations under review.

Finally, OCIE has worked to improve communication and collaboration with other SEC offices and divisions. For example, OCIE holds regularly scheduled meetings and training programs in which examiners have the opportunity to interact with staff from other offices and divisions within the SEC. In particular, these sessions enable examiners to discuss current trends and issues they have recently identified during examinations with staff in other offices and divisions that may have specialized knowledge of such issues. Further, OCIE consistently seeks input from other offices and divisions when planning our goals for each fiscal year, and when planning and conducting sweep examinations. Within the examination program, we will continue to proactively identify ways in which we can encourage examiners to reach out to staff in other offices and divisions for ideas and expertise.

Custodial Funds

Q.4. At this Committee's hearing on January 27, 2009, we heard testimony about the need for independent verification of custody of client funds and securities. I am glad that the SEC's Division of Investment Management has proposed a rule that would strengthen the regulation of the custodial practices of registered investment advisers. What is the timetable for further action on this proposal?

A.4. I fully agree with the need to conduct independent, third-party verification of information obtained during examinations. I am not able to specify the timetable in which the SEC intends to further act on the rule proposal. I am pleased to report, however, that OCIE has implemented a program for verifying custody of client funds and securities. We have incorporated verification techniques into the examination program and require examiners to verify certain information with third-parties as a routine part of examinations. Further, we have required all examiners to attend training sessions on third-party asset verification techniques and procedures. Using these third-party verification techniques will enable examiners to (1) verify the existence and integrity of client/customer assets managed by the firm; and (2) confirm that the information provided to examiners by the firm represents a full, true,

and accurate record of the firm's investment, brokerage, and other business activities.

SEC Examination of Newly Registered Investment Advisors

Q.5. At this Committee's January hearing on Madoff, the SEC staff testified that "the Commission's staff did not examine [Madoff's] advisory operations, which first became registered with the Commission in late 2006."

Post-Madoff, what is the policy for the SEC staff examining newly registered investment advisors?

A.5. In light of the number of examiners in comparison to the number of registered investment advisers and mutual fund companies subject to SEC examination, OCIE continues to use a risk-based scoring process to select investment advisers for priority, cyclical examination. To assess the relative risks and thereby prioritize advisory firms for examination, all investment advisers' filings with the SEC on Form ADV, Part I, as well as results of any past examinations, are analyzed each year. Advisers that are designated "higher risk" are placed on a 3-year examination cycle. Approximately 10 percent of advisers are in this "higher risk" category. Finally, OCIE selects a sample of advisers for examination each year using random selection techniques. Among other things, the randomly selected examinations allow the staff to monitor and assess the effectiveness of the risk-based scoring process.

In addition, as resources allow, examination staff conducts limited-scope reviews of recently registered advisers not classified as "high risk" in order to assess their risk-rating. In these reviews, the examination staff seeks to obtain an initial assessment of the recently registered adviser's compliance culture, conflicts of interest, the compliance policies and procedures used to mitigate or manage those risks, and the capabilities of the firm's compliance and other personnel. These limited-scope visits assist offices in determining whether a recently registered adviser's risk rating is appropriate, and if not, to facilitate the assignment of a more accurate risk rating. In addition, these reviews allow field offices to become more familiar with the business activities of recently registered investment advisers, which may identify emerging trends or unique issues. In many instances, such information is useful to the examination program as a whole. Finally, these visits may correct clearly problematic compliance practices early on in the registrants' existence.

Markopolos Recommendations

Q.6. Mr. Markopolos has recommended ideas to improve the SEC's capability to detect financial frauds. These include recommendations for the Commission to: administer competency exams for applicants for professional staff positions before hire; change performance metrics from the number of exams undertaken; conduct a skills inventory of the professional staff; and develop an SEC knowledge base. Will you consider these ideas from Mr. Markopolos?

A.6. In the examination program, we reviewed Mr. Markopolos' recommendations and noted many good ideas. We have already taken action to implement certain recommendations. In particular, we

have sponsored training with other regulators designed to enhance examiner skills in identifying potential fraud, including financial fraud, and following up on red flags. We have assessed the skills of current examination staff and have increased and diversified training opportunities for examiners to increase their skills and expertise. For example, we have offered training programs by industry professionals on complex products, buy-side trading strategies, and options trading, among others. In addition, we have offered training in certain FINRA professional series, such as Series 7 training. Further, we have actively encouraged and obtained broad examiner participation in certain certification programs such as the Certified Fraud Examiner program and have made other programs available, such as the Chartered Financial Analyst program. We will certainly consider other of Mr. Markopolos' recommendations as we continue to improve our examination program.

Supervisors Who Lack A Particular Expertise

Q.7. The Report states that an SEC staff accountant and Mr. Markopolos both testified that when Mr. Markopolos presented his analysis to SEC staff "it was clear that the BDO's Assistant District Administrator did not understanding the information presented. Our investigation found that this was likely the reason that the reason that the BDO decided not to pursue Markopolos' complaint or even refer it to the SEC's Northeast Regional Office (NERO)." The Report refers to other similar situations.

Does this concern you? What is OCIE's policy about what ADAs or other supervisors in similar situations should have done?

A.7. I believe that we made mistakes with respect to handling Mr. Markopolos' tips and we all share responsibility for failing to detect the Madoff fraud. I believe it is extremely important that we are receptive to information regarding potential misconduct and possible investor harm. Every tip, complaint and referral should be thoroughly analyzed and each should be presumed to have merit until there is a reasonable basis for concluding otherwise. Examination supervisors should seek expertise and assistance from other SEC offices or divisions as necessary to accurately and thoroughly analyze a tip, referral or complaint as to its merits and the appropriate actions to be taken, if any. In addition, we are determined to give individual staff the training, tools, and resources they need to thoroughly perform their duties. Finally, in this regard, we look forward to full deployment of the new tips, complaints, and referrals system that is being developed under Chairman Schapiro's leadership.

Human Resources Actions

Q.8–A. The Report identifies some SEC employees who demonstrated good professional judgment, such as the two employees of the Boston Office who "had substantial experience and knowledge of investment funds" and recommended that Mr. Markopolos' allegations be investigated.

Do you feel that the SEC should recognize or reward employees who the Report documents to have demonstrated good judgment and recognized the gravity of Madoff's conduct? Will they be put

into appropriate positions of responsibility, so that the SEC and investors can benefit from their good judgment?

Q.8–B. The Report describes supervisory staff that appears to have lacked the expertise or judgment to successfully discharge their duties. Has the SEC reviewed their performance and considered moving them to positions more suited to their abilities and where they will not cause harm to investors? Are you reviewing and revising your criteria for promotion to avoid future types of problems?

A.8. We all take very seriously our failure to detect the Madoff fraud. As recommended by the Inspector General, we are carefully considering what, if any, action is necessary with respect to employees mentioned in the report. As an initial measure, we placed certain individuals named in the report under heightened supervision pending a thorough review and evaluation of the matters set forth in the Inspector General's report. We have now received the underlying documentation relied on by the Inspector General during his investigation. We will assess this information to evaluate what steps should be taken to increase specific individual's expertise or impose disciplinary action as necessary.

As a Federal agency, the Commission must follow an established process in all personnel decisions. We are committed to rewarding good performance and addressing any poor performance identified during this review process. We will act as quickly as reasonably possible in a manner consistent with the law.

Enforcing the Laws Against "Well-connected, Powerful" People

Q.9. The Report states that on a conference call about two Madoff exams, "a senior-level Washington D.C. examiner remind[ed] the junior NERO [New York Regional Office] examiners that Madoff 'was a very well-connected, powerful person,' which one of the NERO examiners interpreted to raise a concern for them about pushing Madoff too hard."

What is the OCIE policy about investigating compliance with the laws by "well-connected, powerful" people? How does OCIE protect its staff from people under investigation who might seek to intimidate or threaten to blackball staff from a future job in the industry?

A.9. OCIE's policy has always been to fairly and consistently pursue examination goals, regardless of the size of the firm or the perceived stature of the firm's personnel. Examiners are bright, dedicated, and professional individuals who consistently look for ways to protect investors. In my experience, examiners are not easily intimidated by tactics a registrant may use to avoid examination.

I was deeply concerned about the Inspector General's findings that Madoff attempted to intimidate investigators and examiners. To address this unacceptable tactic, OCIE has created a new internal Hotline by which examiners can immediately contact senior managers and attorneys in headquarters when a firm is being uncooperative, unreasonable, or otherwise resisting appropriate oversight by the examination team. Supervisors at all levels *will* back up more junior personnel. We will train our staff to view these tactics as a red flag, and instruct to dig deeper, and look harder, at

the firms that try to use them. We all recognize that, in order to ensure the examination program is successful we must not tolerate such intimidation tactics directed against our staff.

Measuring the Effectiveness of Reforms

Q.10. The SEC is undertaking various reforms, but it will take time to see whether these will improve the situation. Former SEC Chief Accountant Lynn Turner has said, "Will it fix the problem? I don't think we'll know the answer . . . until we see what comes out of the agency for the next couple of years." ["Madoff's Lies Weren't Scrutinized," *The Los Angeles Times,* Sept. 3, 2009]

What steps are you taking to measure whether the changes that you are making will solve the apparent problems?

A.10. OCIE now measures the success of its program through various metrics that focus on the results we achieve. In examinations, for example, we now track "significant findings."[1] Such findings include those that could cause significant investor harm, those that give rise to a referral to another regulator or to the Division of Enforcement and those that involve willful conduct, among others. For fiscal year 2008, OCIE published in the SEC's annual Performance and Accountability Report the percentage of examinations that resulted in significant findings. In addition, as another example, we now also track the number of registrants that take corrective action in response to our findings.

SEC Culture

Q.11. A column in The New York Times stated "The issues at the commission are not so much ones of personnel or training, but instead the S.E.C.'s culture." ["Lessons for the S.E.C. From the Madoff Debacle," September 8, 2009]

What change to the culture are you making so that OCIE will be more efficient, professional and effective?

A.11. OCIE is working to improve communication and collaboration both within OCIE and with other SEC offices and divisions. For example, the SEC has formed working groups, such as a hedge fund working group and a life settlement working group, comprised of individuals from various offices and divisions in order to promote collaboration and enhance opportunities for sharing ideas. OCIE has formed similar groups within the examination program in order to bring together staff from various groups within the examination program. As mentioned above, one specific task force formed by OCIE is focused on breaking down silos within OCIE, enhancing internal communication, promoting cross-staffing from the various examination groups on examinations where diverse expertise is necessary, and encouraging staff to reach out to other staff across the examination program that might have specialized knowledge.

In addition, OCIE holds regularly scheduled meetings and training programs in which examiners have the opportunity to interact with staff from other offices and divisions within the SEC. In par-

[1] OCIE has issued guidance to all examiners on the different findings that would constitute a "significant finding" for purposes of our measurement process. Such findings include those that could cause significant investor harm, those that give rise to a referral to another regulator or to the Division of Enforcement, deficiencies that involve willful conduct, among others.

ticular, these sessions enable examiners to discuss current trends and issues they recently identified during examinations with staff in other offices and divisions that may have specialized knowledge of such issues.

As the Chairman has stated, we should never stop questioning and should not worry about appearing foolish by our questions.[2] As an agency, we should encourage questions and be open to ideas from all of our colleagues. I believe that encouraging examination staff to regularly reach out to others both within the examination program and in other offices and divisions will foster an environment in which examiners are not hesitant to ask questions and learn from others.

RESPONSES TO WRITTEN QUESTIONS OF SENATOR BROWN FROM JOHN WALSH

Q.1. To what specific set of reasons do you attribute the previous failure of the SEC to thoroughly investigate Bernie Madoff and bring him to justice? How does the SEC plan to operate differently in the future?

A.1. The Inspector General's report noted shortcomings in areas including insufficient expertise; inadequate internal communication and coordination within the Office of Compliance Inspections and Examinations ("OCIE") and with other SEC offices and divisions; deficiencies in planning examinations and investigations; and lack of follow-through on tips and complaints. Even before the report was issued, the SEC had begun to institute extensive reforms. With respect to the examination program, these reforms include enhancing and strengthening our internal controls, initiating a quarterly review program for all open examinations, and developing the expertise and skills of the examination staff.

OCIE has focused on enhancing and strengthening our internal procedures. In particular, we have fully incorporated third-party asset verification as a routine component of the examination program. We have implemented procedures for examiners to follow when verifying information with third parties, and generally require third-party verification of information in all examinations. We have also emphasized fraud detection through examinations, and sponsored a conference with other regulators to train examiners in methods of identifying potential fraud and following up on red flags during examinations. I believe that this increased emphasis on fraud detection and third-party verification of information has already strengthened the examination program.

Further, we have initiated a quarterly review program to enhance our internal controls. As part of the quarterly review program, a team of managers will meet to review and discuss all open examinations and assess whether additional expertise is necessary to resolve issues and finalize those examinations. This review process helps ensure that examinations do not "fall through the cracks" and important issues get timely resolved. This quarterly review also provides an opportunity for fresh perspectives on project

[2] Speech by SEC Chairman: Applying the Lessons, Chairman Mary L. Schapiro, Harvard University John F. Kennedy School of Government, Institute of Politics (Nov. 5, 2009).

issues, as the review process includes managers that are not involved in the examinations. Most recently, we have begun recruiting a compliance specialist to perform annual testing of our policies and procedures and to recommend changes to these procedures as necessary and appropriate given the results of the testing. This specialist will also be responsible for testing compliance across the examination program with internal procedures and guidelines. Overall, we believe that this will further enhance our internal controls and quality assurance.

Finally, OCIE has focused on developing the expertise and skills of the examination staff. We recognize that training is key to the success of the examination program and have implemented new trainings to improve examiner skills and expertise on complex issues. This has included widespread participation in certified training programs such as the Certified Fraud Examiner credential; and ensuring that examiners know that they have management's full support as they follow the facts wherever they lead. In addition, we conducted a mandatory training for all examiners on third-party verification techniques, which included a refresher course on the trade settlement process. We also now hold cross-training sessions for examiners from the broker-dealer and investment adviser programs to enhance examiners' ability to identify complex broker-dealer and adviser issues during examinations and enable examination managers and staff to timely seek expertise from other parts of the examination program. Further, we have continued to actively recruit examination staff with practical, "hands on" expertise, most recently through our new Senior Specialized Examiner positions. These new positions have enabled us to attract industry professionals with expertise in areas such as portfolio management, derivatives and other complex products, and options and equities trading strategies. Enhancing staff expertise provides more flexibility to examination managers in selecting the appropriate expertise or skill set necessary for staffing examinations.

Q.2. What is the current regulatory capacity of the SEC, *i.e.,* how many agents, examiners, investigators, *etc.,* does the SEC have for all the individuals and businesses that must be overseen? Does the SEC need more resources to do its job effectively? Are there any additional enforcement powers that the SEC needs Congress to enact?

A.2. As of the end of 2008, the SEC-registered examination population consisted of approximately 11,300 investment advisers; 950 fund complexes (representing over 4,600 registered funds); 5,500 broker-dealers (including 174,000 branch offices and 676,000 registered representatives); and 600 transfer agents. It also included eleven exchanges, five clearing agencies, ten NRSROs, FINRA, the Municipal Securities Rulemaking Board and the PCAOB.[1] Currently, the SEC has approximately 425 examination staff for oversight of all registered investment advisers (including registered hedge fund managers) and the entire mutual fund industry, and approximately 300 examination Staff for examinations of broker-

[1] The SEC has oversight and enforcement authority over the PCAOB, which is treated like a registered securities association for SEC examination and recordkeeping purposes.

dealers, transfer agents, SROs, trading markets, clearing agencies, credit rating agencies, and other types of firms.

While we sincerely appreciate the support that Congress has provided, it is clear that addressing key problems identified by the Inspector General's Report will ultimately require additional resources. As Chairman Schapiro has noted, the SEC's staff size and investments in new technology are below where they were in 2005.[2] At the same time, there has been significant growth in the market and the registered population that the agency oversees. New technology could significantly enhance the SEC's ability to carry out its mission of protecting investors.

In addition, we continue to invest in our current resources through training and other initiatives. As we continue our work to strengthen the examination program, we must ensure that we give individual staff members the training, tools, and other resources that they may need to thoroughly perform their jobs.

There are several legislative measures currently under consideration that would enhance investor protection and improve the examination program by:

- enhancing the SEC's authority to review the books and records of registered investment companies in order to align this authority with the SEC's books and records authority with respect to registered investment advisers, self-regulatory organizations, transfer agents, and other SEC-registered entities;
- authorizing the SEC to obtain information for surveillance and risk assessment purposes and to protect the confidentiality of that information, which will enable the examination program to more effectively target examinations and allocate resources; and
- authorizing the SEC to review certain books and records of custodians, which will enable examiners to more readily confirm that investor assets are not being misappropriated.

Q.3. Compare the current culture of the SEC to that of the previous administration. What are the differences in attitude, approach to regulation, and management?

A.3. Under the current administration, the Commission has reinvigorated the agency's mission of investor protection. Recognizing the importance of tips, complaints and other information to the Commission's efforts, the agency hired an outside consultant to recommend an effective system for tracking and reviewing all such information submitted to the agency, and to enable staff to research a central source of information during the course of planning and carrying out their investigations and examinations.

The Commission has fully supported the examination program's mission to protect investors, detect wrongdoing and foster compliance. Specifically, the Commission has supported OCIE's efforts to increase expertise within the examination program through trainings and certification programs, such as the Certified Fraud Examiners and Chartered Financial Analyst certification programs. In addition, the Chairman supported OCIE's creation of a new posi-

[2] Speech by SEC Chairman: Applying the Lessons, Chairman Mary L. Schapiro, Harvard University John F. Kennedy School of Government, Institute of Politics (Nov. 5, 2009).

tion entitled *Senior Specialized Examiner* to attract industry professionals with expertise in areas such as portfolio management, valuation, complex products, and trading. The examination program has further been supported through the creation of a new branch of examiners dedicated to the oversight of nationally recognized statistical rating organizations.

Q.4. What in your view should be the non-negotiable issues in financial regulatory reform? In other words, if Congress does nothing else, what should they include in any reform proposal?

A.4. Chairman Schapiro has emphasized that we must close gaps in regulation, improve transparency, strengthen enforcement and establish a workable, macroprudential regulatory framework. She also has indicated that any legislation should improve consumer and investor protection, as well as address systemic risk—both the risk of sudden failures of the financial system and the longer-term risk that large, "too big to fail" institutions will be unintentionally favored at the cost of smaller, more nimble innovators. I agree with the importance of these measures.

In addition, there are several legislative measures currently under consideration that would enhance investor protection and improve the examination program by:

- enhancing the SEC's authority to review the books and records of registered investment companies in order to align this authority with the SEC's books and records authority with respect to registered investment advisers, self-regulatory organizations, transfer agents, and other SEC-registered entities;
- authorizing the SEC to obtain information for surveillance and risk assessment purposes and to protect the confidentiality of that information, which will enable the examination program to more effectively target examinations and allocate resources;
- authorizing the SEC to review certain books and records of custodians, which will enable examiners to more readily confirm that investor assets are not being misappropriated; and
- expanding the SEC's authority to oversee credit rating agencies.

RESPONSES TO WRITTEN QUESTIONS OF CHAIRMAN DODD FROM ROBERT KHUZAMI

Tone at the Top

Q.1. Mr. Khuzami, in your testimony, you referred to "tone at the top" as being important for promoting change at the SEC.

Later, you testified that the failure of the SEC to find the Madoff fraud after receiving what the Inspector General said was "ample information in detailed and substantive complaints" from 1992 to 2008 through three exams and two investigations, which the SEC Inspector General characterized as "not being thorough or competent," was "the perfect storm." You described this "perfect storm," as a "confluence of events, including a lack of experience by the individuals, a lack of going to sources of competence to get advice, perhaps some personality conflicts, a lack of rigorous supervision, and a number of other factors meant that—and perhaps Mr.

Madoff himself, who, while there was a finding that there was not undue influence, you know, it takes a little while for your mind to get around the fact, I suspect, if you are not careful, that someone like Mr. Madoff may be running a $50 billion Ponzi scheme. There are lots of indicia of legitimacy that he had, from the nature of his institutional investors to his stature to other factors. So I think, unfortunately—and this was the terrible result—all these factors came together to lead to the conclusion that we missed this."

What tone at the top do you believe is set by attributing the Commission's response to a "perfect storm"?

A.1. I believe that as Director of Enforcement, I have set exactly the right "tone at the top" in the Division of Enforcement. I believe that there may be some misunderstanding as to the meaning of my reference to the Madoff investigation representing a "perfect storm."

First, I have acknowledged unambiguously in multiple speeches, on national television, and in testimony before Congress, that the Madoff investigation was a tragic failure with tragic consequences. As I said in my testimony, "no one can defend, excuse or deflect responsibility for the SEC's handling of the Madoff matter. Simply stated, in this case we failed in our fundamental mission to protect investors . . . [w]e have read letters from harmed investors that were filed with the court in connection with Madoff's sentencing. It is a sobering and humbling experience." I have also held a number of Town Hall meetings with Enforcement Division personnel, and have visited eight of the 11 regional offices since my appointment as Division Director. In those occasions, I have emphasized the twin themes of the grave consequences of our failure to uncover the Madoff scheme, and the critical need to implement the aggressive program of change that we have embraced.

The unvarnished acknowledgement that we failed in the Madoff investigation is at the core of my "tone at the top" message to Division personnel. I have been clear and definitive—because investor protection is our mission, all of our operations, processes, and structures must be reevaluated in light of that mission, and there are no "sacred cows" that are immune from this scrutiny. As I have said publicly, "[t]here's no denying the fact that the Madoff tragedy was a terrible event, a situation where we should have performed better . . . We did not, and the best way to put meaning into our failure is to study the case and the outcome and determine how we can do better."[1]

This "tone at the top"—an acknowledgement of our previous shortcomings combined with an unwavering commitment to strengthen the Division and its ability to protect investors—has translated into action. We initiated a rigorous top-to-bottom self-assessment of our entire operations. Phase one of that self-assessment is now complete, and we have implemented or are in the process of implementing a number of significant and far-reaching reforms. These changes have been described as the "the unit's big-

[1] Jenna Greene, *New Enforcement Chief Aims to Restore Confidence in SEC,* Nat'l L.J. (Oct. 20, 2009).

gest reorganization in at least three decades."[2] Highlights of the current changes include the following:

- We are creating five new national specialized investigative groups that will be dedicated to high-priority areas of enforcement, with a particular emphasis on complex products, markets, transactions, or practices. Members of the specialized units will acquire the expertise and investigative insights that can only be developed by conducting investigations in the same subject area, combined with ready access to others with specialized skills. With increased focus, training, and access to specialized expertise, investigative staff will make better investigative decisions and be less likely to be misled by those using complexity to conceal their misconduct. With a national focus, these specialized groups will also help to break down silos that inevitably develop when an organization, such as the Enforcement Division, is organized along regional lines, and will help to cultivate a sense of common mission and mutual support among Division personnel in different offices. We are currently conducting final interviews for National Unit Chief positions to lead these specialized units.
- We are adopting a flatter, more streamlined organizational structure under which we will eliminate the Branch Chief position, which constituted an entire layer of management. Our self-assessment revealed that we had a management structure that was too top-heavy, and which resulted in too much process and rework, slow decisionmaking, and a stifling of creativity, autonomy, and accountability. This is not to say that the Branch Chiefs are not highly valued employees—indeed, they were some of our strongest performers. But their talents are better employed by reallocating them back to the mission-critical work of conducting front-line investigations. As a corollary, those who are currently serving at the next level of management (Assistant Directors) will become first line managers, in turn bringing their experience and expertise to the forefront. As part of this effort, the number of Assistant Directors will be expanded in order to maintain staff to manager ratios that allow for close substantive consultation and collaboration—the goal is to have a management structure that facilitates cases, ensures quality control, and provide for the growth and development of the staff—ultimately enhancing the Division's ability to fulfill its investor protection mission. We are currently in the process of filling the additional Assistant Director positions.
- We are implementing a number of structures and procedures further to enhance training and supervision. With respect to training, we are creating a formal training unit and including in the evaluation of staff and supervisors the extent of their participation in formal training programs. We are also creating a searchable data base listing staff members with particular background and experience. In addition, we will be making

[2] David Scheer, *SEC Never Did 'Competent' Madoff Probe, Report Finds (Update 2), Bloomberg.com,* Sep. 2, 2009, *http://www.bloomberg.com/apps/news?pid=20603037&sid=aBHQkUqCQppk.*

available model templates and checklists to guide various types of investigations. With respect to supervision, we are implementing a new and more rigorous performance evaluation process for staff and supervisors alike and requiring the regular review by supervisors of caseload reports generated by the Division's newly enhanced case management data base. These initiatives will ensure that the staff will be better trained, and will know where to go to get answers to investigative questions, as well as be subject to closer and more informed supervision. Together, these efforts will hopefully decrease the chances of missed opportunities such as occurred in the Madoff investigation.

- We are streamlining a number of internal processes and procedures. This streamlining includes the recent delegation of formal order authority (which enables the staff to issue subpoenas for testimony and documents) by the Commission to me, and which I in turn have sub-delegated to senior Enforcement staff. In addition, Chairman Schapiro has abolished the prior Commission's "penalty pilot program" (which required Enforcement staff to obtain full Commission approval before beginning settlement negotiations regarding civil penalty amounts with public issuer defendants).
- We are developing, for use by the SEC, agreements, similar to those used by criminal law enforcement authorities, to secure the cooperation of persons who are on the "inside" or otherwise aware of organizations or associations engaged in fraudulent activity. These agreements, the most important of which is a so-called "cooperation agreement," provide that such persons must agree to provide truthful evidence and testify against the organizers, leaders and managers of such wrongful activity, in exchange for a possible reduction in sanctions imposed on them. Such cooperation agreements have the capacity to secure the availability of witnesses and information for the Enforcement Division early on in investigations, and thus minimize the number of harmed investors and enhance access to persons with strong first-hand evidence of wrongdoing. This will allow us to build stronger cases and to file them sooner than would otherwise be possible, thus preventing more investor harm.
- We have hired the Division's first-ever "Managing Executive," who is focused on the Division's operations. Previously, many administrative, operational and infrastructure tasks were handled by investigative personnel, who did not necessarily have the training or expertise to handle such matters, and for whom these tasks amounted to distractions from their investigation-related functions. By hiring someone with workflow, information technology and process skills, these tasks can be centralized and more efficiently handled, which will better support the investigative functions.
- We are establishing an Office of Market Intelligence, which will (1) oversee, coordinate, and implement a system for the handling of complaints, tips, and referrals that come to the attention of the Division; (2) coordinate the Division's risk assessment activities and act as a liaison for risk management

issues with other SEC divisions and offices, as well as with Federal, state, and foreign regulators; and (3) support the Division's strategic planning activities by providing analysis and information and making recommendations to my office. We are in the process of hiring a Senior Officer to head this new office.

In addition to these changes, we have hired experienced former Federal prosecutors to serve as Deputy Director of Enforcement and Director of the New York Regional Office, two of the most significant positions in the Division.

Consequently, I believe there is no ambiguity in the Division that the Madoff case reflected a failure of our investor protection mission, and we are doing all that we can to address the root causes of that failure. There is no "business as usual" in the Division.

Second, my testimony describing the Madoff matter as a "perfect storm" simply reflects the multiple failures that occurred and how aspects of our operations that normally would have caught or compensated for such failures failed themselves. To take a step back, organizations and processes have built-in redundancies that permit effective operations to continue despite the fact that one or more aspects of the operation may fail. The Enforcement Division is no different. Thus, there is a natural preference, when possible, to assign cases to persons with expertise in the particular area under investigation. Where that is not possible, we look to team investigators up with others who possess such expertise. In addition, supervisors often have experience in many types of investigations and can provide the necessary advice and guidance, or know where to get it. Other guidance and advice can be obtained through other members of the Enforcement Division who have relevant experience, or by reaching out to members of other SEC offices or divisions or third parties, including whistleblowers and other complainants. Training can be helpful, as can investigative "how to" checklists and other materials. In the Madoff case, however, none of these "redundancies" operated to prevent our failure to detect Madoff's fraud (even though many were utilized). Aggravating the situation in my view was poor communication with our Office of Compliance Inspections and Examinations and Madoff's stature, which I speculated may have presented a psychological barrier to concluding that he was operating a massive Ponzi scheme. That is what I meant by the reference to a "perfect storm"—that the various means utilized by Enforcement to ensure that we conduct informed investigations did not function as intended in this case. That is not an excuse and it is not to suggest that we don't need to fix these problems, or that the situation was a "one-off" or beyond anyone's control, and thus there is no risk of repetition that needs to be addressed. To the contrary, we are taking a series of ambitious steps, as outlined above, to address the deficiencies revealed by the episode and as set forth in the OIG Report.

Handling Tips

Q.2. Former SEC Chairman William Donaldson in a speech to the Securities Industry Association on November 3, 2003, in the wake of the Commission staff's failure to act appropriately on tips it had received alleging that mutual funds had engaged in late trading and market timing, stated, "I have ordered a reassessment of our

policies and procedures on how tips are handled. Tips from whistleblowers are critical to our mission of pursuing violations of the Federal securities laws. I want to be sure that there is appropriate follow through on this type of information and that they are given expedited treatment."

Please describe each of the policies since 2003 that the Commission has observed governing how the Commission reviews unsolicited allegations of violations of the Federal securities laws or "tips" that it receives.

A.2. The SEC has strived to improve its handling of complaints, tips and referrals while leveraging available resources. By way of background, for example, prior to 2003 Enforcement established the Enforcement Complaint Center (ECC). The ECC implemented procedures to ensure review of complaints, tips and referrals by the members of the professional staff. Although the ECC was an important step forward in modernizing Enforcement's capacity for processing information received about potential wrong-doing in the industry, it was not designed to handle information received outside the channels of the ECC. The allegations surrounding market timing and late trading were reported directly to regional staff and not to the ECC. To close this gap in handling information about possible wrongdoing, Enforcement instituted a new Complaints, Tips and Referrals (CTR) policy in 2003. The CTR policy applied specifically to information that was received directly by Enforcement staff without first passing through the ECC. This policy required that complainants receive a prompt response, and that staff submit the information received for entry into a CTR electronic data base. The CTR data base served as an additional "backstop" system to prevent key leads from being lost or overlooked. Information required to be transmitted by the staff under the CTR policy included the actual disposition of the tip. At this time, the CTR data base includes information on nearly 12,000 investigative tips.

Enforcement continued to review and refine its complaint handling capabilities beyond the CTR policy of 2003 to the extent that resources permitted. In 2008, the SEC developed a more comprehensive electronic data base, CTR–2009. CTR–2009 built upon the information gathered in the prior data base by importing all of the complaints previously entered and enhanced the search capacity, reporting capability, and "user friendliness" of the prior data base. CTR–2009 served to further consolidate multiple complaint tracking data bases and systems utilized throughout the SEC and reduce administrative duplication. Under CTR–2009, all complaints, tips, and referrals received by Enforcement through the ECC, directly to staff or by other offices and divisions within the SEC, were required to be entered into CTR–2009 for tracking. CTR–2009 was intended to be a crucial interim resource for Enforcement while the SEC-wide complaint center was in development.

Of course, the most wide-ranging reinvention of the complaints, tips, and referral handling process involves our recent work with the MITRE Corporation and the Division's establishment of the Office of Market Intelligence (OMI) within Enforcement. OMI will be responsible for the collection, analysis, triage, prioritization, referral, and monitoring of the huge numbers of complaints, tips and,

referrals that the Division of Enforcement receives. This new office, headed by a senior officer, who will report to Enforcement's new and first-ever "Managing Executive" and the Deputy Director, dovetails with agency-wide efforts to upgrade and modernize its capacity for handling information it receives. Our goal is to have a unified, coherent, coordinated agency-wide process for understanding and managing every complaint, tip, or referral.

Markopolos Recommendations

Q.3. Mr. Markopolos has recommended ideas to improve the SEC's capability to detect financial frauds. These include recommendations for the Commission to: administer competency exams about the capital markets to applicants for professional staff positions before hiring; change evaluation criteria from the number of exams undertaken; conduct a skills inventory of the SEC staff; and hire qualified industry professionals. Do you plan to examine these ideas from Mr. Markopolos?

A.3. The SEC has not only examined Mr. Markopolos's recommendations but has already implemented many of them to the extent practicable and legally permissible. In other instances, the SEC has taken steps that are consistent with the purpose and spirit of Mr. Markopolos's recommendations.

As described above, the Enforcement Division has undertaken a comprehensive self-evaluation and devised a broad range of new initiatives designed to improve the Division's operations, efficiency, and ability to detect fraud. These initiatives include the creation of five specialized units to be staffed in part by experienced market professionals; the elimination of a layer of management to free up some of the Division's most talented and experienced staff for front line investigative work; the creation of an Office of Market Intelligence to address all complaints, tips and referrals received by the Division, as well as risk management and proactive strategic planning; and substantial expansion of the Division's training programs and personnel.

With respect to the specific recommendations mentioned above, the Division is actively seeking to hire applicants with extensive industry experience, including those with industry certifications. As part of its self-assessment, the Division recently completed a skills inventory of staff and the results are presently being compiled. While competency examinations are presently not within the scope of the hiring criteria for Federal employment at the SEC, the SEC already has numerous staff members who have industry certifications and indisputable expertise in many complex subject matter areas. The Commission's efforts to attract and hire additional industry professionals with extensive practical experience in various market areas will further ensure the competency of the SEC staff.

Supervisors Who Lack A Particular Expertise

Q.4. The Report states that an SEC staff accountant and Mr. Markopolos both testified that when Mr. Markopolos presented his analysis to SEC staff "it was clear that the BDO's Assistant District Administrator did not understand the information presented. Our investigation found that this was likely the reason that the reason that the BDO decided not to pursue Markopolos' complaint

or even refer it to the SEC's Northeast Regional Office (NERO)." The Report refers to other similar situations.

Does this concern you? What is Enforcement's policy about what ADAs or other supervisors should have done in similar situations? In what ways has the SEC made this policy known to supervisors?

A.4. We take the findings of the OIG Report very seriously. To ensure the proper handling of tips, complaints, and referrals, as previously described, the Division is creating an Office of Market Intelligence that will coordinate and consolidate the intake, triage and resolution of the huge number of tips, complaints, and referrals that we receive each year. In addition, the SEC hired the MITRE Group, a non-profit, federally funded research firm, to conduct a comprehensive review of the agency's systems and procedures for evaluating and tracking complaints, tips, and referrals. Finally, the Division formed a Risk Focus/Advisory Group in December 2008 to look for ways to improve the Division's tip-handling process.

In addition, our own top-to-bottom self-assessment earlier this year also found that training and expertise had not been appropriately prioritized. We have begun to address the issue through several initiatives. This past year, the Division formed the Training and Resources Working Group. The Group assessed the training needs of the staff and is now determining which types of training should be mandatory for all staff. To further strengthen our training program, we are committed to creating a formal training unit to operate a comprehensive training program, including an expanded new hire training program. To provide incentives to supervisors to encourage the staff to complete training, we plan to make staff training one of the factors considered under the new performance evaluation for managers.

As noted above, we have also begun the process of restructuring the Division to take advantage of staff expertise. We will be rolling out five new units that will focus on highly specialized and complex issues (asset management, market abuses, structured and new products, Foreign Corrupt Practices Act, and municipal securities and public pensions). Staff in these units will receive specialized training. Further, we are compiling a skills inventory of all Enforcement staff. Once completed, investigators in the Enforcement Division will have a searchable data base listing staff members with particular expertise, such as securities industry experience, academic degrees, certifications, specialized investigative experience, and other relevant credentials. Staff will be able to use this resource—in addition to the specialized units—to identify those with the relevant skills and experience to answer questions and provide advice.

Human Resources Actions

Q.5–A. The Report identifies some SEC employees who demonstrated good professional judgment, such as the two employees of the Boston Office who the SEC Inspector General found "had substantial experience and knowledge of investment funds" and recommended that Mr. Markopolos' allegations be investigated.

What has been done or what will the SEC do to recognize or reward employees who the Report documents have demonstrated

good professional judgment and issue recognition? Will they be put into appropriate positions of responsibility so that the SEC and investors can benefit from their good judgment?

Q.5–B. The Report describes some supervisory staff who appear to have lacked the expertise or judgment to successfully discharge their responsibilities in critical situations. Have you reviewed the performance of such employees under your supervision and considered moving them to positions more suited to their abilities and where they will not cause harm to investors? Are you reviewing and considering revisions to the criteria for promotion to avoid future types of problems?

A.5. As recommended in the OIG Report, we are closely considering the issue of whether any action—positive or negative—is appropriate with respect to current employees in light of the massive failures to detect Madoff's fraud. Our evaluation will include what, if any, retraining, mentoring, or disciplinary action should be taken. There is an established process in place that we are required to follow for personnel actions, as we would in any employment issue involving Federal Government workers. We will act as quickly as reasonably possible in a manner consistent with the law.

Our first step has been to ensure that the employees who remain at the SEC are appropriately supervised, including heightened supervision if necessary, while we determine whether and what personnel actions should be taken. Our second step has been to review the record and evidence. We had deferred to the OIG during its investigation into this matter. We have now received the OIG's collected evidence, including source documents and testimony transcripts, and we are in the process of reviewing the evidence and determining whether and what actions are appropriate.

Under the law, a proposing official will review the record and determine whether and what action to propose. The official notifies the employee of the proposed action and the employee then has the right to add a reply to the record. After considering the employee's reply, a deciding official determines the final action. The employee may appeal that action.

To the extent that there is public information that we can provide about any actions taken, we will provide that information at an appropriate time. We will remain mindful that we are legally obligated to respect SEC employees' rights to privacy and procedural due process.

The Problem of "Silos"

Q.6. A recent column in *The New York Times* stated:

> Bureaucratic rivalries are nothing new, and the S.E.C. is certainly not one big happy family. But when an agency's goal is to protect investors, it needs to ensure that everyone is working toward that end. Opening up the lines of communication both within and between divisions, and encouraging them to work with one another and share all information rather than view others as potential rivals, is a much better way to operate.

Over the years, I have heard many complaints from industry about stovepipes, or "silos," within the SEC—Divisions or Offices

that do not communicate or cooperate with each other. The Report identifies several instances where this contributed to the failure of the SEC to find the Madoff fraud.

Are you concerned about the problem caused by stovepipes or silos? What are you doing to promote cooperation among the units in your Division and between them and other SEC offices?

A.6. I am deeply concerned about the problems caused by stovepipes or silos. The Enforcement Division's self-assessment and the OIG Report noted important gaps in communication, and I consider the need to close these gaps one of our top priorities.

In the wake of the Madoff IG Report, Chairman Schapiro repeatedly has stressed the fact that we are one agency that can only succeed if we fully cooperate with each other, share information and rely on the expertise that exists throughout the agency. She specifically brought together her senior managers to convey this message. She also began a program in which she and her senior managers are visiting every regional office to discuss the importance of learning lessons from the Madoff fraud, the importance of having a "culture of cooperation," and to begin an ongoing dialog throughout the agency about how different divisions and offices can better help each other as we work to protect investors.

Within the Division, we are taking a number of steps toward creating a solid framework for increasing lines of open and efficient communication, including the establishment of a unified, coherent, and coordinated response to the massive amount of complaints, tips, and referrals that we receive on a daily basis.

The steps we have taken to improve communication and coordination include:

- Specialization and restructuring. National specialized units will discourage the existence of separate regional "silos" that could develop based solely on a regional organization. Units defined by specialization, as opposed solely to geography, will create a natural structure for better communication and collaboration across geographic lines, and ultimately a more comprehensive and coherent national program. We may also assign staff from other SEC offices and divisions with relevant expertise to serve as liaisons to these newly formed Specialized Units within the Enforcement Division, such that there exists a point-of-contact that Enforcement staff can consult with questions related to the activity of other SEC offices and divisions. Moreover, the flattening of the management structure will streamline and improve communications between staff and management.
- Emphasis of current policies regarding consultation with other SEC divisions and offices. Enforcement senior management has emphasized to the staff the importance of consulting with other SEC divisions and offices early and often. In addition to informal consultation, there is a formal process by which Enforcement staff seeks review and comment from other divisions and offices before it submits an enforcement recommendation to the Commission. We view other SEC offices and divisions as

an important resource and will continue to strive to keep the lines of communications open and effective.[3]

- The SEC's MITRE Initiative. The SEC has contracted with MITRE, a federally funded research and development center, to help the agency revamp and improve its processes for handling the high volume of complaints, tips, and referrals (CTRs) it receives each year. This project focuses on the central role that tips and complaints may play in uncovering fraud and protecting investors.
- Creation of an Office of Market Intelligence. Dovetailing with the MITRE initiative, we are establishing a new Office of Market Intelligence. This Office will be responsible for the collection, analysis, risk-weighing, triage, referral, and monitoring of CTRs. This Office will have open lines of communication with the agency's various divisions and offices and draw on their expertise to analyze and respond to CTRs. Through this effort, we hope to have a unified, coherent, coordinated agency-wide response to the huge volume of information we receive every day.

We take very seriously the criticisms of silos and stovepiping. Continual communication on issues concerning an investigation is of the utmost importance. We are determined to put into practice the lessons learned from the Madoff failures and from our Division's self-assessment about the central importance that communication and collaboration play in shaping an investigation and bringing wrongdoers to justice.

Enforcing the Laws Against "Well-connected, Powerful" People

Q.7. The Report states that on a conference call about two Madoff exams, "a senior-level Washington D.C. examiner remind[ed] the junior NERO [New York Regional Office] examiners that Madoff 'was a very well-connected, powerful person,' which one of the NERO examiners interpreted to raise a concern for them about pushing Madoff too hard." What is the Division of Enforcement policy about investigating compliance with the laws by "well-connected, powerful" people? How does the SEC protect its staff from people under investigation who might seek to intimidate or threaten to blackball staff from a future job in the industry?

A.7. The Division's Mission Statement states that integrity and fairness are integral to the Division's mission of protecting inves-

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[3] Enforcement also highlights the importance of consultation with other SEC divisions and offices, and communication generally, in the Enforcement Manual. Section 1.4.3. of the Enforcement Manual, entitled "Consultation," states:

"Although this Manual is intended to be a reference for the staff in the Division who are responsible for investigations, no set of procedures or policies can replace the need for active and ongoing consultation with colleagues, other Divisions and Offices at the SEC, and internal experts. Investigations often require careful legal and technical analysis of complicated issues, culminating in difficult judgment calls that may affect market participants, individuals, and issuers. Therefore, any time an issue arises for which colleagues or other Divisions or Offices may hold particular expertise, the staff should consider consultation. In addition, staff should keep other Divisions and Offices informed regarding issues of interest that arise during investigations, and consult with interested Divisions and Offices before making recommendations for action to the Commission at the conclusion of an investigation."

See SEC Division of Enforcement, Enforcement Manual, Oct. 6, 2008, *http://www.sec.gov/divisions/enforce/enforcementmanual.pdf* (Enforcement Manual).

tors, and fairness compels treatment "without regard to wealth, social standing, publicity, politics, or personal characteristics."[4] Thus, well-connected persons are given no special treatment. The same is true with respect to the opposite concern—that staff will pursue the well-connected more vigorously than others simply because of who they are. In short, staff is expected to act honestly, forthrightly, and impartially in every aspect of work.[5]

The integrity of the staff is of central importance to the success of our mission to protect investors. Thus, supervisors are sensitive to situations where the well-connected or influential may seek to bully or intimidate staff, or utilize other more subtle ways to deflect an investigation. I also believe that the "tone at the top" is crucial in empowering employees to conduct investigations in a way that is fair and impartial, without regard to a person's status or wealth. Fostering a culture of integrity and professionalism is one of the Division's priorities. To that end, staff is encouraged to communicate openly to management if they encounter roadblocks in investigations. If staff does not feel comfortable speaking directly to a manager, there is an anonymous email box available to Enforcement staff. Contents of the box are regularly reviewed and considered by senior members of the Division's staff.

In addition, as the enforcement arm of the agency, communications between my staff and persons involved in investigations are generally through legal counsel. Face-to-face interactions usually occur only in formal settings. For example, if a person has been subpoenaed to testify in an investigation, that testimony is sworn and on-the-record. These settings lend inherent protections for Enforcement staff against intimidation and threats.

Measuring the Effectiveness of Reforms

Q.8. The SEC is undertaking various reforms, but it will take time to see whether these will improve the situation. Former SEC Chief Accountant Lynn Turner has said, "Will it fix the problem? I don't think we'll know the answer . . . until we see what comes out of the agency for the next couple of years." ["Madoff's Lies Weren't Scrutinized," *The Los Angeles Times,* Sept. 3, 2009]

What steps are you taking to measure whether the changes that you are making will solve the apparent problems?

A.8. With respect to Enforcement, the Division has already begun a process of developing additional metrics to gauge how it is accomplishing its mission. These new metrics are designed to reflect better the relative significance of our investigations and enforcement actions and our concomitant use of resources. Over time, the new measures should help us evaluate whether reforms now being implemented are achieving the desired results.

In the past, the metric most commonly used as a shorthand measure of the Division's success has been the number of enforcement actions filed or instituted during a fiscal year. There is a valid concern that such an approach could have the unintended effect of discouraging the staff from investigating more complex matters that may take longer to complete or have a lower likelihood

[4] *See* Enforcement Manual at Section 1.4.1.
[5] *See id.*

of actually resulting in filed cases. Certainly, an internal and external focus on the number of enforcement actions alone as a standard for success creates too great of a risk that other important information will be ignored or put on the back burner. We need to consider and evaluate other important information about each of our matters which can help give us a complete picture of what we are doing right and where we can improve.

Accordingly, we are moving to a system of both qualitative and quantitative metrics that will align incentives with programmatic goals. Among other things, Enforcement is looking to measure the programmatic importance of enforcement actions, the timeliness of filed or instituted actions, monetary sanctions imposed (disgorgement and penalties), the productivity of our staff's work on each action (including productivity by office or other relevant unit), and the use of litigation resources. As another means of gauging whether we are maximizing our efficacy and resources, we also intend to measure regularly the number of priority investigations and actions as compared to our total caseload. We are also seeking to develop a metric that captures important investigative efforts where the evidence does not warrant enforcement actions.

We are developing reporting tools for these and other measures that will provide updated information on a rolling basis. Many of these metrics are being compiled into a readily useable Enforcement "dashboard" report. Examples of the types of measurements that we are considering for inclusion in the monthly dashboard are:

- New investigations opened by Regional Office, Home Office group, or Specialized Unit in particular priority areas of emphasis (*e.g.,* Ponzi schemes);
- Length of investigation from opening of investigation to first action taken, broken down by subject matter, for each Regional Office, Home Office group, or Specialized Unit; and
- Emergency court actions sought to preserve investor assets or halt ongoing frauds.

We have already implemented some of these initiatives designed to improve the management and effectiveness of the Enforcement program. For instance, a report detailing the highest priority investigations being conducted nationwide is now prepared bi-monthly and circulated to senior officers within the Division. The report breaks down the investigations by subject matter and stage of investigation. Thus, among other information, senior managers can see what percent of priority investigations involve, for example, subprime mortgage fraud, what the key facts of each investigation are, and what progress the staff has made toward completing the investigation since the prior report.

Among the changes that I have already initiated are: the streamlining of internal processes for review of proposed enforcement actions, the subdelegation of authority to senior officers in Enforcement to approve formal orders of investigation, and the streamlining of other internal processes for the issuance of Wells notices and the review of settlement parameters. We are conducting final interviews for the hiring of chiefs of the Specialized Units. We anticipate that the implementation of streamlined procedures and the establishment of meaningful "dashboard" metrics as described

above will help us monitor the effectiveness of the changes to Enforcement's operation and program.

SEC Culture

Q.9. A column in *The New York Times* stated "The issues at the Commission are not so much ones of personnel or training, but instead the S.E.C.'s culture." ["Lessons for the S.E.C. From the Madoff Debacle," September 8, 2009]

What changes to the culture are you making in order to enhance the effectiveness of the Division of Enforcement?

A.9. The ambitious self-assessment and restructuring that we have undertaken can only be successful if there is an accompanying change in culture. It is my view that human capital—the brains and experience of people—is the most critical asset of most organizations. The SEC is no exception. Not only must we as an organization capture, nurture, and optimally utilize our skill sets, we need to ensure that our assumptions, values, and norms—that is, our culture—are conducive to our success.

Maintaining and fostering a culture of integrity and professionalism is one of the Division's top priorities. It is my belief that the current changes we are making in structure and organization will engender a shift in culture: one in which the staff feels more empowered because it has better training, better access to expertise, and overall better tools to tackle an investigation; one in which the staff has the time—because resources are better leveraged—to push, probe, and follow through when it needs to find verified answers to its questions; one in which management—in part because of a tighter staff to supervisor ratio—invites open communications and responds with encouragement when staff come forward with questions, suspicions, or ideas for investigations; one in which the staff feels more personally and professionally responsible because the Commission has supported and shown deference where appropriate to staff assessments; and ultimately, one in which the staff is held to the highest standards. Finally, to further guard against the possibility that an issue is missed because a staffer does not feel comfortable approaching a supervisor, there is now an anonymous email suggestion box available to Enforcement staff. Contents of the box are regularly reviewed and considered by senior members of the Division's staff.

My first day on the job as the Director of the Division of Enforcement, I asked the staff to approach the critically important work of enforcement by embracing four key principles:

- First, I asked the staff to be as *strategic* as possible. We must use our resources as efficiently as possible and in a manner that achieves the greatest impact. This means a focus on cases involving the greatest and most immediate harm and on cases that send an outsized message of deterrence.
- Second, I asked the staff to be as *swift* as possible. A sense of urgency is critical. If cases are unreasonably delayed, if there is a wide gap between conduct and accountability, then the message is diluted. Timeliness is paramount. Corporate institutions are dynamic and ever-changing. When a case is brought years after the conduct, the sanctions still hurt but the

opportunity to achieve a permanent change in behavior and culture is greatly reduced.

- Third, I asked the staff to be as *smart* as possible. Our resources are finite and critically limited. We must better determine on an informed basis whether to continue an investigation, who to continue it against, how to shape it, and how to charge it. This means a constant focus on investigative plans and regular decision point during the life-cycle of a case.
- And last, I asked the staff to be as *successful* as possible. We need to win. This means building strong cases so that defendants settle quickly on the Commission's terms or face a trial unit armed with compelling evidence.

With these principles as a backdrop and the reorganization and other changes currently being implemented, I am hopeful that our organization will rise to the challenge. The mission of investor protection is too important for us to do anything less.

Restacking Project

Q.10. In March, the Inspector General reported on the SEC's "restacking" project, in which many staff offices were relocated to segregate an office or division in a separate floor area at a cost of almost $4 million. The original space assignments were designed to improve communication and consultation among divisions and reduce the "silo mentality."

Is the SEC now evaluating the effects of restacking on issues of communication between divisions and the "silo" effect?

A.10. The Division's ongoing reorganization effort is aimed at, among other concerns, the "silo" mentality or effect. National specialized units, as opposed to geographically defined units, will foster a more comprehensive and coherent national program, both within the Division and with respect to staff in other SEC divisions and offices. We anticipate that the staff of the specialized units will foster and develop ongoing relationships with their counterparts in the other SEC divisions and offices with the relevant expertise. Ideally, such ongoing relationships will further encourage the free flow of information and dialog that can only serve to enhance the Division's investigative abilities.

In addition, our Division senior management continues to emphasize to Enforcement staff the importance of consulting with other SEC divisions and offices early and often to identify and resolve issues. There is also a formal process in place by which Enforcement staff seeks review and comment from other SEC divisions and offices before it submits an Enforcement recommendation to the Commission.

With respect to the specific effects of restacking, it is my belief that the current configuration—where divisions and offices are located together—discourages siloization. When staff in the same division or office sit in close proximity, the group is more cohesive and unified. There is naturally more communication and consultation. It is also my belief that morale is raised when no subgroups are left to feel isolated or disconnected from the main body of the Division.

As described in the SEC Office of Inspector General's report, Review of the Commission's Restacking Project, Report No. 461 (March 31, 2009), senior managers at the Commission believed that the original configuration impeded effective communication and collaboration among staff within divisions and offices.[6] More specifically, the Management Comments to the report noted that the original configuration made no attempt to keep offices and divisions together. Instead, operating units were intentionally broken up and spread across multiple floors and both buildings, scattering offices and working groups for no discernible benefit. Divisional and office leadership across large and small operating units agreed that this configuration created significant management difficulties and operational inefficiencies, discouraged effective communication and collaboration, and adversely affected staff morale. Accordingly, over the course of 2007, agency management engaged in extensive deliberations and consultation with staff on whether to undertake a reconfiguration—or stacking—of the then-existing layout.[7]

The benefits of Division cohesiveness and improved morale, in my mind, outweigh any potential detriment that may occur when different divisions or offices are not physically commingled. Moreover, different divisions and offices are not segregated from one another—we still sit in the same buildings[8] and often sit on the same floors. We often attend the same meetings or participate in joint training. In addition to the formal and informal processes described above for inter-divisional communication and consultation, staff can still get up and walk down the hall or up the stairs to discuss relevant matters or to form professional relationships.

I am deeply concerned with any potential siloization, and I know Chairman Schapiro shares that concern. Chairman Schapiro has repeatedly stressed the fact that we are one agency that can only succeed if we fully cooperate with each other, share information and rely on the expertise throughout the agency. She specifically brought together her senior managers to convey this message. She also began a program in which she and her senior managers are visiting every regional office to discuss the importance of learning lessons from the Madoff fraud, the importance of having a "culture of cooperation," and to begin an ongoing dialog throughout the agency about how different divisions and offices can better help each other as we work to protect investors.

I will continue to monitor and evaluate the effects of restacking on communication and collaboration. Similarly, the restacking project is still under evaluation by the agency. One of the OIG's recommendations was that the Office of Administrative Services conduct another survey of staff after the restacking process has been completed to understand the effects and impacts of the project better and determine what, if any, changes should be implemented. The Commission's response was to concur with the recommendation, stating that it intended "to conduct a full review of the restacking project, including a survey of affected staff, after its com-

[6] *See* SEC Office of Inspector General, Review of the Commission's Restacking Project, Report No. 461 (March 31, 2009), Executive Summary, pp. i–iv.

[7] *See id.* at Appendix V, Management Comments, pp. 32–41.

[8] Headquarters consists of two interconnected buildings.

pletion in order to better understand the impact of the project and apply lessons learned to future comparable projects."[9]

Dealing with Staff Biases

Q.11. The Report states that the New York Regional Office Enforcement staff, unlike the Boston District Office, "failed to appreciate the significance of the evidence in the 2005 Markopolos complaint and almost immediately expressed skepticism and disbelief about the information." It states that the branch chief "took an instant dislike to Markopolos" and did not even pick up a folder of materials that Mr. Markopolos offered.

Is this a concern to you? What does the SEC do to assist staff to separate their personal biases from their professional job analysis and performance?

A.11. Several initiatives will help prevent staff bias from affecting the treatment of a tip or follow-through during an investigation.

First, we are centralizing the processing of the high volume of complaints, tips and referrals that the Division receives each year. As previously noted, the new Office of Market Intelligence will ensure that tips are triaged by a team of experts who can then refer them to the appropriate investigative team. The treatment of tips will be tracked to ensure appropriate follow-up. In addition, as this new Office specializes in handling complaints, they will have a broad range of experiences, and will have seen tips and complaints from a whole host of sources. Presumably, they will be less inclined to dismiss one because of a personal bias.

Second, restructuring the Division to include five specialized units that organize staff around areas of specialization will enable the Division to harness the expertise of staff more efficiently and effectively. Tips and complaints will be routed to staff who have the experience and skills to understand and act on the information.

Third, we are prioritizing training for both new and seasoned staff. As part of our self-assessment, we are determining which types of training should be mandatory for all staff and we are committed to creating a formal training unit to operate a comprehensive training program. Supervisors will be evaluated on staff training as part of our new performance evaluation for managers.

Finally, new hires are required to attend new hire training at which the importance of integrity and professionalism are highlighted as central to the SEC's mission. Professionalism and fairness mean that staff are expected to treat persons without regard to wealth, social standing, publicity, politics, or personal characteristics.

Bank of America Case

Q.12. On September 14, 2009, in *SEC v. Bank of America Corporation,* a District Court judge issued an opinion rejecting the SEC's proposed settlement with Bank of America for $33 million to settle charges that "defendant Bank of America Corporation materially lied to its shareholders in the proxy statement of November 3, 2008 that solicited the shareholders' approval of the $50 billion acquisition of Merrill Lynch & Co." The Court stated that the "essence of

[9] *Id.* at p. 40.

the lie . . . was that Bank of America 'represented [to shareholders] that Merrill had agreed not to pay year-end performance bonuses or other discretionary incentive compensation to its executives prior to the closing of the merger without Bank of America's consent [when] [i]n fact, contrary to the representation . . . Bank of America had agreed that Merrill could pay up to $5.8 billion . . . in discretionary year-end bonuses to Merrill executives for 2008."

The Court characterized the SEC's proposed settlement as "a contrivance designed to provide the S.E.C. with the facade of enforcement and the management of the Bank with a quick resolution of an embarrassing inquiry—all at the expense of the sole alleged victims, the shareholders. Even under the most deferential review, this proposed Consent Judgment cannot remotely be called fair." The Court concluded that the proposed settlement was "neither fair, nor reasonable, nor adequate."

Please describe the process by which the Enforcement Division and the Commission determined the terms of the proposed settlement in this case. Was this process substantially similar to the process used for arriving at proposed settlements in similar types of securities cases? To what does the Commission attribute the Court's rejection of its proposed settlement? In light of the Court's opinion, will the Commission change any aspect of its processes for arriving at settlements to proposed to courts?

A.12. In the *SEC v. Bank of America* matter, the Division of Enforcement presented a settlement offer from Bank of America to the Commission. The Commission determined whether to accept the offer by reviewing a memorandum from the Division of Enforcement and consulting with the Office of the General Counsel as well as other interested SEC divisions and offices. The procedures through which the Commission considered Bank of America's settlement offer were the same as the procedures used to consider settlement offers generally.

Contrary to the suggestion of the Court, the Commission made no allegation that the Bank "lied"—*i.e.,* that it engaged in intentional misrepresentation. Rather, the Commission alleged that the Bank failed to meet its obligation to ensure the accuracy and completeness of all statements made in a proxy and to disclose in the proxy all material terms of the merger agreement with Merrill. The terms of the proposed settlement with Bank of America reflected the principle that when a corporate issuer has not met its statutory obligations, the need for corporate deterrence is paramount. The $33 million penalty would have sent a clear message to corporations and those who advise them that proxy statements must include the substance of a separate nonpublic document that materially qualifies or contradicts representations contained in the underlying proxy statement. It also would have established an incentive for corporations to maintain internal controls for preventing and detecting misstatements contained in proxy statements.

Although we believe that the proposed settlement was reasonable, appropriate, and in the public interest, we take Judge Rakoff's decision very seriously. Judge Rakoff's opinion in which he rejected the settlement outlined his reasoning, and, as with any court ruling, we will factor his decision into our regular ongoing assessment of our activities and determinations.

RESPONSES TO WRITTEN QUESTIONS OF SENATOR BROWN FROM ROBERT KHUZAMI

Q.1. To what specific set of reasons do you attribute the previous failure of the SEC to thoroughly investigate Bernie Madoff and bring him to justice? How does the SEC plan to operate differently in the future?

A.1. There were a number of deficiencies in the Madoff investigation. These included: (1) the staff attorney and immediate supervisor lacked expertise in the alleged trading strategies employed by Madoff and in Ponzi scheme investigations in general, resulting in the failure to take investigative steps that might well have revealed the fraud; (2) lack of perseverance and follow-up in obtaining answers to questions in the investigation even when that information was requested; (3) poor investigative planning and supervision; (4) a lack of proper communication with other offices and divisions within the SEC, including the Office of Compliance Inspections and Examinations; and (5) failure to accumulate and utilize the information contained in various tips and complaints received over the years that reflected concern about Madoff's operations. In addition, there were a number of general deficiencies that were revealed, including the lack of training and the lack of resources.[1]

To address these problems, the SEC had begun to initiate extensive reforms even before the issuance of the OIG Report.[2] With respect to the Division of Enforcement, since I became the Director in March of this year, we have been undertaking a top-to-bottom self-assessment of our Division's operations. We have asked not only the specific question of what went wrong and what steps can we take to prevent the same terrible failures from reoccurring, but the broader question of how can we improve overall: how can we work smarter, swifter, be more strategic and more successful? In short, what can we do as an organization and as individual public servants to best fulfill our critical mission of investor protection?

Phase One of our Division self-assessment is now complete, and we have implemented or are in the process of implementing a number of key reforms. These changes have been described as the "the unit's biggest reorganization in at least three decades."[3] Together, these changes are intended to maximize our resources, to gather and utilize expertise across the Division and the agency, to bring cases more swiftly and more efficiently, and to increase strategic analysis and proactive investigations. Highlights of the current changes include the following:

- We are creating five new national specialized investigative groups that will be dedicated to high-priority areas of enforcement, with a particular emphasis on complex products, markets, transactions, or practices. Members of the specialized units will acquire the expertise and investigative insights that can only be developed by conducting investigations in the same

[1] *See generally* SEC Office of Inspector General, Report of Investigation of Failure of the SEC to Uncover Bernard Madoff's Ponzi Scheme, Report No. 509 (2009).

[2] *See* The Securities and Exchange Commission Post-Madoff Reforms, *http://www.sec.gov/spotlight/secpostmadoffreforms.htm.*

[3] David Scheer, *SEC Never Did 'Competent' Madoff Probe, Report Finds (Update 2), Bloomberg.com,* Sep. 2, 2009, *http://www.bloomberg.com/apps/news?pid=20603037&sid=aBHQkUqCQppk.*

subject area, combined with ready access to others with specialized skills. With increased focus, training, and access to specialized expertise, investigative staff will make better investigative decisions and be less likely to be misled by those using complexity to conceal their misconduct. With a national focus, these specialized groups will also help to break down silos that inevitably develop when an organization, such as the Enforcement Division, is organized along regional lines, and will help to cultivate a sense of common mission and mutual support among Division personnel in different offices. We are currently in the process of filling National Unit Chief positions to lead these specialized units.

- We are adopting a flatter, more streamlined organizational structure under which we will eliminate the Branch Chief position, which constituted an entire layer of management. Our self-assessment revealed that we had a management structure that was too top-heavy, and which resulted in too much process and rework, slow decisionmaking, and a stifling of creativity, autonomy, and accountability. This is not to say that the Branch Chiefs are not highly valued employees—indeed, they were some of our strongest performers. But their talents are better employed by reallocating them back to the mission-critical work of conducting front-line investigations. As a corollary, those who are currently serving at the next level of management (Assistant Directors) will become first line managers, in turn bringing their experience and expertise to the forefront. As part of this effort, the number of Assistant Directors will be expanded in order to maintain staff to manager ratios that allow for close substantive consultation and collaboration—the goal is to have a management structure that facilitates cases, ensures quality control, and provides for the growth and development of the staff—ultimately enhancing the Division's ability to fulfill its investor protection mission. We are currently in the process of filling the additional Assistant Director positions.
- We are implementing a number of structures and procedures further to enhance training and supervision. With respect to training, we are creating a formal training unit and including in the evaluation of staff and supervisors the extent of their participation in formal training programs. We are also creating a searchable data base listing staff members with particular background and experience. In addition, we will be making available model templates and checklists to guide various types of investigations. With respect to supervision, we are implementing a new and more rigorous performance evaluation process for staff and supervisors alike and requiring the regular review by supervisors of caseload reports generated by the Division's newly enhanced case management data base. These initiatives will ensure that the staff will be better trained and will know where to go to get answers to investigative questions, as well as be subject to closer and more informed supervision. Together, these efforts will hopefully decrease the chances of missed opportunities such as occurred in the Madoff investigation.

- We are streamlining a number of internal processes and procedures. This streamlining includes the recent delegation of formal order authority (which enables the staff to issue subpoenas for testimony and documents) by the Commission to me, and which I, in turn, have sub-delegated to senior Enforcement staff. In addition, Chairman Schapiro has abolished the prior Commission's "penalty pilot program" (which required Enforcement staff to obtain full Commission approval before beginning settlement negotiations regarding civil penalty amounts with public issuer defendants).
- We are developing, for use by the SEC, agreements, similar to those used by criminal law enforcement authorities, to secure the cooperation of persons who are on the "inside" or otherwise aware of organizations or associations engaged in fraudulent activity. These agreements, the most important of which is a so-called "cooperation agreement," provide that such persons must agree to provide truthful evidence and testify against the organizers, leaders, and managers of such wrongful activity, in exchange for a possible reduction in sanctions imposed on them. Such cooperation agreements have the capacity to secure the availability of witnesses and information for the Enforcement Division early on in investigations, and thus minimize the number of harmed investors and enhance access to persons with strong first-hand evidence of wrongdoing. This will allow us to build stronger cases and to file them sooner than would otherwise be possible, thus preventing more investor harm.
- We have hired the Division's first-ever "Managing Executive," who is focused on the Division's operations. Previously, many administrative, operational, and infrastructure tasks were handled by investigative personnel, who did not necessarily have the training or expertise to handle such matters, and for whom these tasks amounted to distractions from their investigation-related functions. By hiring someone with workflow, information technology, and process skills, these tasks can be centralized and more efficiently handled, which will better support the investigative functions.
- We are establishing an Office of Market Intelligence, which will (1) oversee, coordinate, and implement a system for the handling of complaints, tips, and referrals that come to the attention of the Division; (2) coordinate the Division's risk assessment activities and act as a liaison for risk management issues with other SEC divisions and offices, as well as with Federal, state, and foreign regulators; and (3) support the Division's strategic planning activities by providing analysis and information and making recommendations to my office. We are in the process of hiring a Senior Officer to head this new office.

I am confident that these significant changes—and others we will make along the way as we continue to self-assess and evaluate our progress—will reinvigorate our Division, restore investor confidence, and enable us to fulfill our mission of investor protection.

Q.2. What is the current regulatory capacity of the SEC, *i.e.,* how many agents, examiners, investigators, *etc.,* does the SEC have for all the individuals and businesses that must be overseen? Does the

SEC need more resources to do its job effectively? Are there any additional enforcement powers that the SEC needs Congress to enact?

A.2. The scope and complexity of the financial industry has grown significantly over the last decade. Currently, the SEC oversees over 30,000 registrants, including 12,000 public companies, 11,000 investment advisers, 4,600 mutual fund families, 5,500 broker dealers, and 600 transfer agents. The SEC oversees the securities industry with a total staff of about 3,600 people. Enforcement staff makes up less than one third of that total. The entire Enforcement staff nationwide, including lawyers, accountants, information technology staff and support staff, is just above 1,100. The entire Examination staff in the Office of Compliance Inspections and Examinations is just over 725.

Given the size, complexity, cross-border scope of the securities industry, and the huge volume of information that the agency receives, the SEC needs more resources to improve its ability to protect investors. For example, we receive hundreds of thousands of emails, letters and phone calls, of which tens of thousands are complaints and tips that require staff review for possible investigation. To be sure, we recognize our obligation to use the resources we have as efficiently as possible, which is why we have, for example, flattened our management structure to redeploy our Branch Chiefs back to being front-line investigators. But even with these and other steps to increase our efficiency, our resources are inadequate for the task we confront. Thus, we must, among other improvements, increase the number of qualified staff in the Enforcement program and invest in critical information technology initiatives. Because of several years of flat or declining SEC budgets, the SEC has faced significant declines in resources in recent years. In fact, despite the much appreciated budget increase received in 2009, Enforcement will still have significantly fewer staff than in it did 4 years ago, and its budget for improvements in technology remains lower than it was in 2005.

The SEC has proposed several legislative measures to improve its ability to protect investors and deter wrongdoing. With respect to enforcement powers, the SEC has requested authorization to:

- establish a "whistleblower" program, which would permit the SEC to set up a fund to pay significant financial awards for information that leads to enforcement actions.
- establish nationwide service of process in Federal civil actions to streamline costs, avoid the need to obtain duplicative depositions, and improve the effectiveness of litigation by securing the participation of live witnesses.
- impose collateral bars against regulated persons across all segments of the securities industry, not just one segment.
- seek penalties in cease-and-desist proceedings.
- seek penalties against aiders and abettors under the Investment Advisers Act of 1940.
- add aiding and abetting authority to the Securities Act of 1933 and the Investment Company Act of 1940.
- obtain improved access to grand jury materials.

- clarify the application of Section 106 of the Sarbanes-Oxley Act of 2002 to allow the SEC and the PCAOB to review workpapers and other documents of foreign auditors.

Q.3. Compare the current culture of the SEC to that of the previous administration. What are the differences in attitude, approach to regulation, and management?

A.3. The current administration is fully supportive of—and in fact demands from our Division—the vigorous enforcement of the Federal securities laws. As noted above, Chairman Schapiro paved the way for the Commission to abolish the "penalty pilot program" and delegated formal order authority to me, which I in turn have subdelegated to senior Enforcement staff. Both of these actions have demonstrated to Enforcement staff not only that swiftness and timeliness are paramount but that the Commission has confidence in the staff's judgment and professionalism. In addition, the Commission has removed certain other procedural impediments relating to Commission approval of enforcement recommendations; shown greater deference, where appropriate, to the staff on charging, settlement, and other case-related issues; and repeatedly emphasized, both publicly and in internal forums, the critical nature of the agency's mission and the staff's responsibility to fulfill that mission. Finally, the Commission also has been fully supportive of the Division's current restructuring efforts, including the dramatic changes in management and organization that are intended, in part, to promote personal and professional responsibility on the part of each and every staff member.

With regard to approach to regulation, the Commission has been providing input and support for a variety of regulatory reforms, including those included in the Restoring American Financial Stability Act of 2009, and similar legislation prepared by the House Financial Services Committee. The Commission has also been active in rulemaking, including just in the last 2 months, rulemaking actions or proposals to increase the transparency of dark pools,[4] prohibit the practice of flashing marketable orders,[5] and bolster the oversight of credit ratings agencies by enhancing disclosure and improving the quality of credit ratings.[6]

The agency's renewed vigor as a whole is reflected in the work of the Division. Just in the last 2 weeks, the Commission has authorized the Division of Enforcement to charge a former CFO of a New York-based hedge fund with securities fraud and seek an order to freeze the CFO's assets,[7] file charges against two complex insider trading rings involving hedge funds and corporate insiders, among others,[8] initiate administrative and cease-and-desist proceedings against a New York-based investment adviser and others

[4] Dark pools are essentially private trading systems in which participants can transact their trades without displaying quotations to the public. *See* SEC Issues Proposals to Shed Greater Light on Dark Pools, SEC Press Release 2009–223 (Oct. 21, 2009).

[5] A flash order enables a person who has not publicly displayed a quote to see orders less than a second before the public is given an opportunity to trade with those orders. *See* SEC Proposes Flash Order Ban, SEC Press Release 2009–201 (Sept. 17, 2009).

[6] SEC Votes on Measures to Further Strengthen Oversight of Credit Rating Agencies,SEC Press Release 2009–200 (Sept. 17, 2009).

[7] *SEC v. Levy,* Lit. Rel. No. 21289 (Nov. 10, 2009).

[8] *SEC v. Cutillo, et al.,* Lit. Rel. No. 21283 (Nov. 5, 2009) and *SEC v. Galleon Management, LP, et al.,* Lit. Rel. No. 21284 (Nov. 5, 2009).

in a $24 million fraudulent scheme,[9] file charges against former executives of a medical software provider with accounting fraud,[10] and initiate administrative and civil actions against a New York-based broker-dealer and two of its former managing directors for their roles in an unlawful municipal securities pay-to-play scheme involving Jefferson County, Alabama.[11]

Q.4. What in your view should be the non-negotiable issues in financial regulatory reform? In other words, if Congress does nothing else, what should they include in any reform proposal?

A.4. I share Chairman Schapiro's strong emphasis that we must close gaps in regulation, improve transparency, strengthen enforcement and establish a workable, macroprudential regulatory framework. The legislation also should improve consumer and investor protection, as well as address systemic risk—both the risk of sudden failures of the financial system and the longer-term risk that large, "too big to fail" institutions will be unintentionally favored at the cost of smaller, more nimble innovators.

Regulatory gaps are exploited by market participants, thus heightening systemic risk. For example, major institutions use over-the-counter derivatives to engage in enormous, virtually unregulated trading in synthetic versions of other financial products. I would prioritize legislation to close these gaps by ensuring that similar products are regulated similarly.

Market transparency should be another priority in legislation to reduce systemic risk. Increased transparency reduces risk by giving regulators and investors better information. When investors have better information about assets, liabilities, and risks, they can allocate capital away from risk or demand higher returns, thus providing a first line of defense against systemic risk. Transparency is particularly important in the area of "dark pools" in which securities are traded without oversight or information flow. Also, enormous risk resides in off-balance sheet vehicles hidden from investors and other market participants. Investors and others may allocate capital more efficiently if risks are fully disclosed.

Strengthening enforcement is another important prong that addresses systemic risk by anchoring market players to the principles that protect consumers, investors, and taxpayers. Enforcement actions serve to deter and counterbalance the development of questionable business practices that help create systemic risk. As noted above, the SEC has identified several important tools that would make the SEC a more effective and efficient enforcer:

- establish a "whistleblower" program, which would permit the SEC to set up a fund to pay significant financial awards for information that leads to enforcement actions.
- establish nationwide service of process in Federal civil actions to streamline costs, avoid the need to obtain duplicative depositions, and improve the effectiveness of litigation by securing the participation of live witnesses.

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[9] *In the Matter of Value Line, Inc., et al.,* AP File No. 3–0913675 (Nov. 4, 2009).

[10] *SEC v. Merge Healthcare Incorporated, et al.,* Lit. Rel. No. 21282 (Nov. 4, 2009).

[11] *SEC v. LeCroy and MacFaddin,* Lit. Rel. No. 21280 (Nov. 4, 2009) and *In the Matter of J.P. Morgan Securities Inc.,* AP File No. 3–13673 (Nov. 4, 2009).

- impose collateral bars against regulated persons across all segments of the securities industry, not just one segment.
- seek penalties in cease-and-desist proceedings.
- seek penalties against aiders and abettors under the Investment Advisers Act of 1940.
- add aiding and abetting authority to the Securities Act of 1933 and the Investment Company Act of 1940.
- obtain increased access to grand jury materials.
- clarify the application of Section 106 of the Sarbanes-Oxley Act of 2002 to allow the SEC and PCAOB to review workpapers and other documents of foreign auditors.

Although the roles of regulation, transparency, and enforcement are critical in addressing systemic risk, each has potential shortcomings. Therefore, any financial regulatory reform should include a Financial Stability Oversight Council that can identify risks across the system, write rules to strengthen existing standards, minimize systemic risk, and help ensure that future regulatory gaps—and arbitrage opportunities—are minimized or avoided.