

**INVESTIGATING AND PROSECUTING FINANCIAL  
FRAUD AFTER THE FRAUD ENFORCEMENT AND  
RECOVERY ACT**

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**HEARING**

BEFORE THE

**COMMITTEE ON THE JUDICIARY**

**UNITED STATES SENATE**

ONE HUNDRED ELEVENTH CONGRESS

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SEPTEMBER 22, 2010

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**INVESTIGATING AND PROSECUTING FINANCIAL FRAUD AFTER THE FRAUD ENFORCEMENT AND RECOVERY ACT**

WEDNESDAY, SEPTEMBER 22, 2010

U.S. SENATE,  
COMMITTEE ON THE JUDICIARY,  
*Washington, D.C.*

The Committee met, pursuant to notice, at 2:06 p.m., in room SD-226, Dirksen Senate Office Building, Hon. Edward E. Kaufman, presiding.

Present: Senators Kaufman, Klobuchar, Franken, and Grassley.

**OPENING STATEMENT OF HON. EDWARD E. KAUFMAN, A U.S. SENATOR FROM THE STATE OF DELAWARE**

Senator KAUFMAN. I am honored to call to order this hearing of the Senate Committee on the Judiciary. I want to thank Chairman Leahy for permitting me to chair this hearing.

Today we are going to examine the efforts of Federal law enforcement to investigate and prosecute the financial fraud that contributed to our current economic crisis in light of the Fraud Enforcement and Recovery Act, FERA, signed into law by President Obama in May 2009. This is the second post-FERA oversight hearing that we have held. The first was December 9th of last year. Today the same distinguished witnesses—and I truly mean distinguished witnesses—who testified at that hearing join us to discuss these issues: Assistant Attorney General Lanny Breuer, SEC Director of Enforcement Robert Khuzami, and FBI Assistant Director Kevin Perkins. Welcome back, gentlemen.

My objective for this hearing is several. The first comes under the heading of FERA oversight. In the time since the December 2009 hearing, what have the Department of Justice, the FBI, and the SEC done in terms of investigating and prosecuting fraud at the heart of the financial crisis? Do they have the infrastructure, personnel, and strategies in place they need to be successful?

All three entities have received significant additional resources in part as a result of FERA, and I want to explore whether those resources are being deployed effectively. I will say right now I am frustrated. I know the Justice Department, the SEC, and the FBI have all been working incredibly hard—and I mean incredibly hard—reviewing countless transactions, interviewing myriad witnesses, poring over literally millions of pages of documents.

And yet we have seen very little in the way of senior officer or board room-level prosecutions of the people on Wall Street who

brought this country to the brink of financial ruin. Why is that? Is it because none of the behavior in question was criminal? Is it because too much time passed before the investigators got serious? Has the trail gone cold? Is it because the law favors the wealthy and powerful? Or is the explanation much more complex?

Are there systemic challenges that the agencies are finding difficult to overcome? Is there a foundational, targeted strategy in uncovering those instances of actual misrepresentation of material facts which exist, which is a mountain, a veritable mountain of "everybody was doing it" mentality on Wall Street? Is the fine print exculpatory or only chilling prosecutorial efforts that still deserve to move forward?

My second objective is legislative. Are there changes in the law that would make it harder for people to construct and sell incredibly complex financial instruments without disclosing their own belief that the value of these products will soon plummet? While I will be leaving the Senate before long, I would like to help my colleagues get started on making those changes in the law, if they are required, and if there are useful changes to be made.

In the last year or so, through the work of people both in and out of Government, we have been learning more and more about the wide range of conduct that contributed to the financial collapse. I have said from the beginning that much of that behavior, though terribly misguided, inexcusable, or morally bankrupt, was not criminal. But I do remain convinced by what we have learned through a host of sources, including hearings by Senator Levin on the Permanent Subcommittee on Investigations, that appears from evidence that there was also serious criminal behavior on all of this.

Let me start a discussion about the difference between criminal behavior and behavior that was merely misguided with a hypothetical example. Assume that there is a bank in the mortgage orientation business. During the early and mid-2000s, as home prices increased nationwide, the bank is able to make huge profits both by packaging these mortgages into bonds for sale to others and by holding onto them as investments. In the race to maximize market share and raise profits, the bank decides to relax its official underwriting standards to a greater and greater degree until a large majority of even some of its riskiest loans to the least qualified borrower, or so-called liar's loans, issued without even bothering to verify that the income stated by the borrower is accurate. They literally go into a bank, "My name is Ted Kaufman." "How much are you making?" "Five hundred thousands dollars a year." And that goes on the form, and there is no further checking done on whether that is true or not true. It obviously plays a big part in what kind of a mortgage you can get.

This behavior was unwise and dangerous, creating tremendous risk on many levels—to the bank extending the credit, to the borrowers without the means to pay, to those who bought the loans from the bank. More important, it also created a grave risk to the broader economy. As we now know all too well, extending credit without regard to creditworthiness can help fuel a speculative boom that ends only with a painful market correction involving crashing prices and foreclosed-upon homeowners.

But without more, making loans that should never be made, even on a tremendous scale is not a crime, particularly if the quality of those loans were disclosed. Was there more? In the lead-up to this country's recent national housing market crash, did some banks and board room executives step over the line and commit actionable fraud? For example, what if this hypothetical banks knowingly issues widespread exceptions to its published underwriting standards while at the same time claiming to would-be purchasers of mortgage securities that the underwriting standards had been substantial complied with?

Let me repeat that. What if a hypothetical banks knowingly issues widespread exceptions to its published underwriting standards while at the same time claiming to would-be purchasers of mortgage securities that the underwriting standards had been substantial complied with? Or suppose it determines that a class of mortgages that it has held for its own investment—held for its own investment—are likely to default in the near future onto third parties. That might not be a crime. But what if the bank has claimed to purchasers that it has not selected mortgages for sale based on a belief that they are likely to default? If criminal conduct contributed to the financial meltdown, then the people responsible should be investigated, prosecuted, and sent to prison. And I know that our three witnesses agree with that. If we fail to do so, we will lose our chance to restore the public's faith in our financial markets and the rule of law.

Criminals on Wall Street must be held to account; otherwise, one of the great foundations of this country—our capital markets—will simply fade away. This is why very early in the Congress I joined with Chairman Leahy and Senator Grassley and others to help pass the Fraud Enforcement and Recovery Act. FERA was designed to ensure that additional tools and resources were provided to those charged with enforcement of our Nation's laws against financial fraud.

In the year-plus since the passage of FERA, we have seen some important progress. The FBI, the Department of Justice, and the SEC have all ramped up their efforts. Last November, President Obama created an Interagency Financial Fraud Enforcement Task Force. Its mission is not only to pursue crimes already committed, but also to deter criminal behavior that might lead to another financial crisis. But despite the new resources and the renewed emphasis, despite the presidentially created task force, we are now nearing the final quarter of 2010 without the sort of prosecutions that I had fully expected we would hope to see by this time. Without successful investigation, prosecution, and meaningful punishment, deterrence is an illusion.

So where does that leave us? That is what I want to explore in today's hearing. Where is the line between conduct that is actionable and conduct that is not? What are the disclosure obligations of individuals and entities that select, bundle, securitize, and market groups of mortgages with characteristics that at some point along the way foretold their failure? These obligations need to be strengthened in terms of either what must be included or in terms of how prominent the disclosure must be made.

Last spring, Senator Specter and I offered an amendment to the Dodd-Frank bill that would have imposed on broker-dealers and banks the same sort of duty to customers that financial advisers already have. Had that amendment become law, those broker-dealers and banks would have been obligated to disclose not only their own conflict of interest, but also their knowledge that a particular security is likely to underperform.

I want to get a sense from you, from the witnesses, in the enforcement community whether that sort of change in the law would make a difference in your world. Many on Wall Street have argued that there is no criminality in this financial crisis, merely a collective delirium brought about by soaring profits and mistaken assumptions about risks. I and others have disagreed. But so far I have waited in vain for the sort of prosecutions that we predicted would come. I hope this hearing will help us understand why that is so and also give us a better sense of what to expect in the future.

I also want to emphasize that the existence of criminality, or the lack thereof, should not be our only guiding star. Our job is to focus on what is right and wrong, fairness and unfairness, and legislate accordingly. What laws do we need to make sure that we focus on right to wrong, fairness to unfairness? Law enforcement officials represented by these witnesses today have to ask whether the conduct they are investigating violated the law? If not, they move on to the next case. As Members of Congress, we have a different obligation. We have to ask whether the laws that exist reflect sound public policy. If not, if the law permits conduct that should be prohibited, then we need to change the law.

Ours is a Government of laws rather than men, and as Justice Brandeis reminded us, "If we desire respect for the law, we must first make the law respectable." Our laws are not a static code of received wisdom from on high. They are an evolving reflection of public debate and national need. Where laws let America down, Congress must remedy those laws so that they may not do so again.

Senator Grassley, do you have something you would like to say at this point?

**STATEMENT OF HON. CHARLES E. GRASSLEY, A U.S. SENATOR  
FROM THE STATE OF IOWA**

Senator GRASSLEY. Well, first of all, I associate myself with the remarks you just made, and it is very important to have these oversight hearings, particularly within 1 year after FERA has been passed, to make sure it is working right; and, second, if it is not, as you suggested, the extent to which we need additional tools, because the goals of FERA are very important for the benefit of the taxpayers and for discouraging fraud.

I have a long statement I want to put in the record. I want to take a couple minutes to give a view of my interest in this hearing.

First of all, as a lead cosponsor for the Republicans of FERA, I am pleased that we are here today to hear testimony from the various agencies that can use it as a tool to see how the implementation of FERA is going. Our legislation is a very important key to investigating and prosecuting complex financial fraud that were a part of the root cause of the financial crisis. I am interested to hear



from the witnesses before us how FERA has helped them hunt down criminals and the extent to which it will be used as a tool to bring people to justice. While I will not be able to stay for the entire hearing, I will have a number of follow-up questions for the witnesses.

Specifically, I have a number of questions about how the Securities and Exchange Commission is implementing recommendations made by the SEC Inspector General following the failures of follow-up on investigative leads regarding the Madoff and Stanford Ponzi schemes. The Inspector General found serious deficiencies at the SEC, and I want to know whether the SEC is serious about fixing the problems.

Additionally, I would like to take a moment to alert people from the Justice Department about this letter that I sent to the Attorney General this very day, so you would not have it yet, regarding the Department's failure to respond to serious allegations raised by the retiring Inspector General of the Department of Housing and Urban Development. The Inspector General is the chair of the Mortgage Fraud Committee at the Justice Department, and he raised concerns to the Department about the systematic fraud against the Federal Housing Administration, FHA, and whether the Department obtained the best settlement possible. Given the seriousness of the allegations, I expect an answer as soon as possible from the Attorney General.

I thank you very much.

[The prepared statement of Senator Grassley appears as a submission for the record.]

Senator KAUFMAN. Thank you, Senator Grassley.

Before we turn to the opening statements of Mr. Breuer, Mr. Khuzami, and Mr. Perkins, I ask the three witnesses to stand and be sworn. Do you affirm that the testimony you are about to give before the Committee will be the truth, the whole truth, and nothing but the truth, so help you God?

Mr. BREUER. I do.

Mr. KHUZAMI. I do.

Mr. PERKINS. I do.

Senator KAUFMAN. Let us begin with Mr. Breuer.

**STATEMENT OF HON. LANNY A. BREUER, ASSISTANT ATTORNEY GENERAL, U.S. DEPARTMENT OF JUSTICE, WASHINGTON, DC**

Mr. BREUER. Good afternoon, Senator Kaufman, Senator Grassley. Thank you for inviting me to speak with you today about the Department of Justice's efforts combatting financial fraud.

Before I begin, I would like to take this opportunity just for a moment to thank this Committee, and particularly you, Senator Kaufman, for your leadership in this area of financial fraud enforcement.

As you know, and as you both have said, the Fraud Enforcement and Recovery Act, FERA, and most recently, the Dodd-Frank Wall Street Reform and Consumer Protection Act, were signed into law. Both of those laws have provided our investigators and prosecutors with more robust tools and resources in our fight against financial fraud. We thank you for your support, and we intend to continue

to aggressively use those tools and resources in the coming months and years.

I am pleased today to be able to speak with you about the Justice Department's efforts in combatting financial fraud, and I am particularly gratified to be here today with Robert Khuzami of the Securities and Exchange Commission and Kevin Perkins of the Federal Bureau of Investigation, two of our most critical partners in this fight. Together with them, and our many other partners on the Financial Fraud Enforcement Task Force, the Department of Justice is committed to investigating and prosecuting those who defraud our citizens of their hard-earned savings.

Since the passage of FERA in May of 2009, the Department has re-evaluated the manner in which it investigates financial fraud, and as a result, we have significantly heightened our enforcement efforts. We have forged even closer partnerships with the many law enforcement and regulatory agencies that are focused on fighting fraud, and we have redoubled our efforts to send a strong deterrent message to would-be fraudsters by vigorously prosecuting these criminals and sending them to jail.

Indeed, since the passage of FERA, the Department has prosecuted and incarcerated thousands of financial criminals, and we have sought stiff sentences for their crimes. Let me highlight for the Committee just a few of the areas in which we have focused our efforts.

Fraud, of course, takes many forms, but perhaps the most pervasive and pernicious of these are investment fraud schemes, which include what we commonly refer to as "Ponzi schemes." Those who commit investment fraud schemes often prey upon the vulnerable individual investors, and the resulting losses can be devastating to families around our country. For this reason, the Justice Department has dedicated significant resources to unearthing and vigorously prosecuting these crimes. Indeed, our agents and prosecutors around the country uncover and investigate investment fraud nearly every week. Let me describe for you just three examples of such prosecutions, all from last week alone.

On September 15, 2010, Nevin Shapiro, the former CEO of Capital Investments USA, Inc., pleaded guilty in Newark, New Jersey, to fraudulently soliciting funds for a non-existent grocery distribution business. Mr. Shapiro's \$880 million investment fraud resulted in losses of somewhere between \$50 million and \$100 million to investors. Mr. Shapiro will be sentenced on January 4, 2011.

On that same day that Mr. Shapiro pleaded guilty, Frank Castaldi, an accountant and businessman, was sentenced in Chicago to 23 years in prison for bilking hundreds of investors—many of them elderly Italian immigrants—out of more than \$30 million.

And just 2 days earlier, on September 13th, Michael Goldberg pleaded guilty in Bridgeport, Connecticut, to three counts of wire fraud relating to his operation of a \$100 million fraud scheme that cheated investors out of more than \$30 million over an approximately 12-year period. Mr. Goldberg will be sentenced on December 2nd.

As I mentioned, these three prosecutions, which taken together targeted fraud relating to over \$1 billion, were from last week alone. The list of investment frauds, however, goes on and on. We

stand ready to continue to prosecute the perpetrators of these frauds and to send them to jail.

Our efforts to combat financial fraud, including mortgage fraud, have also targeted high-level executives in the most sophisticated of frauds. As just one example, in June of this year, the Department obtained an indictment in the Eastern District of Virginia against Lee Bentley Farkas, the former Chairman of Taylor, Bean & Whitaker Mortgage Corporation. TBW was once one of the largest private mortgage companies in the United States. Mr. Farkas was charged with perpetrating a massive fraud scheme that resulted in losses exceeding \$1.9 billion and that contributed to the failure not just of TBW, but also of Colonial Bank, one of the 50 largest banks in the United States before its collapse in 2009. This prosecution is just one example of our sustained efforts to reach and uncover fraud at every level.

Financial fraud in its various forms has devastating effects on our citizens, and it deserves the full attention of law enforcement and regulatory communities. With the increased resources afforded to the Justice Department under FERA and other legislation, and through our close collaboration with our partners on the Financial Fraud Enforcement Task Force, we have made this fight a priority, and we will continue to do so.

Thank you for the opportunity to provide the Committee with this brief overview of the Department's efforts to address financial fraud, and, of course, I would be happy to answer any questions.

[The prepared statement of Mr. Breuer appears as a submission for the record.]

Senator KAUFMAN. Thank you.

Mr. Khuzami.

**STATEMENT OF ROBERT S. KHUZAMI, DIRECTOR, DIVISION OF ENFORCEMENT, SECURITIES AND EXCHANGE COMMISSION, WASHINGTON, DC**

Mr. KHUZAMI. Thank you, Senator Kaufman, Senator Grassley. Thank you for the opportunity to testify here today on behalf of the Securities and Exchange Commission alongside my valuable colleagues from the Department of Justice and the FBI.

When I first testified before this Committee in December of last year, we were emerging from an economic crisis that threatened our financial system and tested the public's confidence in the institutions charged with enforcing the laws that govern that system. Although there is much work to be done, during that 9 months we have achieved significant results at the SEC in our efforts to enforce the securities laws, particularly in areas relating to the financial crisis.

Our statistical accomplishments for year-to-date fiscal year 2010 are compelling, include 634 actions filed, over \$1.5 billion in disgorgement of ill-gotten gains that have been returned to investors, \$968 million in penalties imposed, and nearly \$2 billion in funds distributed to injured investors.

But statistics alone do not capture the breadth and the complexity of the high-impact cases that we have filed since I last testified, and let me just give you a couple of brief examples.

Boston-based State Street Bank and Trust Company agreed to pay over \$300 million into a Fair Fund for the benefit of injured investors to settle our charges that it misled investors about their exposure to subprime investments and selectively disclosing more complete information to certain favored investors so that they could get out of those funds sooner during the 2007 mortgage crisis.

We charged investor adviser ICP Asset Management and its founder, owner, and principal, alleging conflicts of interest and fraud related to its simultaneous management of multiple CDOs, managed accounts, and affiliated hedge funds that came under pricing and liquidity pressures in 2007. Mr. Priore and ICP collected millions of dollars in advisory fees on investments that were inflated as a result of that crisis and otherwise interposed themselves in certain trades in order to benefit themselves and to the detriment of their fiduciary clients.

As Mr. Breuer testified, we, along with the FBI, Department of Justice, SIGTARP, and many others, charged Lee Farkas, the former Chairman of Taylor, Bean & Whitaker, in the large-scale securities fraud that Mr. Breuer mentioned. I mention that because it reflects the coordination of all of our agencies, both before but only enhanced by the formation of the Federal Financial Enforcement Task Force.

In addition, Goldman Sachs agreed to pay \$550 million to settle SEC charges alleging fraud in connection with the marketing of a synthetic CDO in which Goldman represented that the portfolio of securities underlying the CDO had been selected by a neutral, objective third party, when, in fact, the hedge fund investor at whose request the CDO had been structured and whose interests were directly adverse to CDO investors had heavily influenced the selection of that portfolio.

We charged the former CEO, CFO, and comptroller of New Century Financial Corporation, once the third largest subprime lender in the United States, and they all agreed to pay disgorgement penalties and be barred from serving as an officer or director of public companies to settle charges stemming from their respective roles in the misleading New Century financial statements.

And while doing these cases, we have pursued other traditional areas of SEC focus, including accounting fraud, insider trading, municipal securities, Ponzi schemes, offering fraud, pension fund fraud, and violations of the FCPA statute.

We also brought charges against Dell, who paid a \$100 million penalty to settle charges that it failed to disclose material information to investors and used fraudulent accounting to make it falsely appear that the company consistently met Wall Street earning targets while reducing operating expenses from 2002 through 2006, and certain Dell executives, including the chairman, the CEO, the former CEO, and a former CFO, all agreed to pay penalties to settle our charges.

But we are not just focused on wrongdoing in connection with the financial crisis. We are equally focused on the future, embracing a range of initiatives designed to increase our ability to identify hidden or emerging threats to our markets.

Stopping misconduct as soon as possible and minimizing investor loss and erosion of the public's confidence in our markets is one of

our top goals. As I detail in my written testimony, to accomplish this goal we have, among other things, established national specialized units focused on key areas of activity, and we are using risk-based metrics and other proactive measures in order to identify, for example, investment advisers who misrepresent credentials or performance returns, mutual funds who charge excessively high fees, suspicious pattern and relational trading in market-moving securities, and troubling marketing practices, improperly minimizing the risk to investors of complex securities. These efforts all involve the integration of market data, event analysis, and red flags to flush out those firms, individuals, practices, and transactions that are most likely to be engaged in questionable conduct. This will help our staff to shine a bright light on the dark corners of the financial industry.

We are also engaged in other reforms, streamlining our management structure, swiftly obtaining formal orders so that our staff can focus on what they do best. And we are also integrating the new authority and responsibility granted to us under Dodd-Frank.

There is much to be done, but I am confident the Commission is up to the task. I thank you for the opportunity to appear here today, and I am happy to answer any questions.

[The prepared statement of Mr. Khuzami appears as a submission for the record.]

Senator KAUFMAN. Thank you.

Mr. Perkins.

**STATEMENT OF KEVIN L. PERKINS, ASSISTANT DIRECTOR,  
FEDERAL BUREAU OF INVESTIGATION, WASHINGTON, DC**

Mr. PERKINS. Good afternoon, Senator Kaufman and Senator Grassley. I want to thank you for the opportunity to testify before you today about the FBI's continued efforts to combat significant financial crimes.

Since my last appearance before you, the FBI has continued to uncover massive financial frauds, and there are several notable cases that I will discuss which clearly highlight our commitment to combatting financial crimes at every level.

In June, for example, and as Mr. Breuer and Mr. Khuzami have mentioned in their testimony, Lee Farkas, the former Chairman of Taylor, Bean & Whitaker, was charged and arrested in coordination with the SEC and with other—SIGTARP and the Justice Department. I mention this case specifically because of the role that leveraging resources between the various investigative agencies plays in the fight against financial frauds.

Other cases I will mention include: In June, Scott Rothstein, a Miami attorney, was sentenced to 50 years in prison and ordered to pay \$363 million in restitution for operating a \$1.2 billion Ponzi scheme, which took money from over 300 victims.

In August of this year, former chief accounting officer Michael Rand of Beezer Homes, a former Fortune 500 company, was charged and arrested for his role in an alleged accounting fraud that manipulated the company's reported earnings. Beezer Homes previously agreed to a deferred prosecution agreement and paid a \$50 million fine in relation to this fraud scheme.

Over the past 6 months, the prosecutions of the Galleon insider trading case in New York and the Petters \$3.7 billion Ponzi scheme in Minnesota continued, with guilty pleas and with significant sentences of top corporate executives.

These cases are just a few examples of the thousands of financial fraud cases investigated by the FBI and its partners and conducted in conjunction with the administration's Financial Fraud Enforcement Task Force.

Our message is clear: Together, the FBI, the Department of Justice, and our partners throughout law enforcement and regulatory communities will investigate and, where appropriate, bring charges of criminal misconduct on the part of businesses and business executives.

Mr. Chairman, the wave of mortgage fraud we have experienced shows no sign of slowing at this point. In the last 3 years alone, the FBI has seen the number of mortgage fraud cases steadily climb from 1,200 cases in 2007 to over 3,000 cases today. Seventy percent of those investigations of pending cases represent losses to victims exceeding \$1 million. In many of these cases, the losses far exceed \$1 million.

Just today, seven individuals, seven mortgage industry insiders, were indicted in San Juan, Puerto Rico, for their role in a scheme which cost victims over \$21 million.

Recently completed Operation Stolen Dreams demonstrated just how rampant mortgage fraud is in this country. This operation resulted in charges against 863 subjects who were allegedly responsible for more than \$3 billion in losses.

Since my last appearance before you, the FBI has also observed a continued rise in corporate and securities fraud schemes, such as the falsification of accounting records and the continued increase in complex investment frauds. In addition to the number of corrupt high-level executives that have been exposed during this time, we have also experienced an increase in the number of financial crime cases involving loan offenders who have defrauded unsuspecting victims of millions of dollars.

For example, earlier this month, a Federal grand jury charged an Ohio couple, Michael and Melissa Spillan, in a 47-count indictment, alleging that they defrauded over 50 victims of more than \$25 million through a series of fraudulent stock-based loan schemes.

By using the additional resources appropriated by Congress with your assistance, we have continued to implement innovative and proactive methods to detect and combat significant financial frauds. Foremost is the FBI's continued development of the Financial Intelligence Center, established 1 year ago. The Center is an amalgamation of intelligence analysts and professional staff and provides tactical analysis of financial intelligence data sets to identify ongoing financial fraud schemes. Their work includes not only traditional financial fraud schemes but also those employed within health care frauds, contracting frauds against the Government, and money laundering, among others.

Mr. Chairman, I would also be remiss if I did not emphasize the vital role that partnerships play in our efforts. Most recently, the FBI and the SEC reached an agreement to place an FBI agent on a full-time basis within the SEC's Office of Market Intelligence.

This cooperative effort on the part of both organizations will allow for a much better coordination with regard to the referral of potential criminal activity within the securities markets.

The FBI works closely with its Federal, State, and local investigative partners in efforts to combat mortgage fraud. Right now we have over 25 mortgage fraud task forces located across the country.

Mr. Chairman, I appreciate the opportunity to come before you and the Committee today and share the work the FBI is doing to combat significant financial fraud. I look forward to working with you, and I am happy to answer any questions you may have.

[The prepared statement of Mr. Perkins appears as a submission for the record.]

Senator KAUFMAN. Thank you very much. We will be doing 7-minute questions, and I will start.

Mr. Breuer, I think it is fair to say that, maybe because of popular press or whatever, we thought that on Wall Street there would be more criminal prosecutions on Wall Street, and since Bear Stearns there have not been. What is your thinking about that? Is that something that we just misjudged it, or there are problems that nobody anticipated, or we are moving ahead but it is just taking longer to get the cases started?

Mr. BREUER. Well, Senator, just to take a step back for a moment, it is always hard to know what people define and what their expectations are. But there really has been, as my colleagues have said and as I have said, a very rigorous enforcement effort. And so even if you look at FERA, you look over the last months, we have indicted, prosecuted, and sentenced numerous officials of public companies. Mr. Perkins talked about Beezer Homes, which is a publicly traded company. There we went after the chief accounting officer, and he was indicted for false revenue recognition. For the average person or investor of Beezer Homes, that is a very meaningful prosecution.

We went after the executive vice president and the former risk vice president of Integrity Bank. That is a financial institution, and those gentlemen pled guilty for both accepting bribes and for insider trading.

Aeropostale, that is another public company, Senator. There just a couple of months ago, the executive vice president was indicted for a kickback scheme.

And so we can go on and on with publicly traded companies and private companies and senior executives who, in fact, have been prosecuted vigorously.

With respect to the Wall Street institutions that you are specifically referring to, as I said last time and as I continue to and as the public press has talked about, there has been no lack of effort in pursuing fraudulent activity—and I know you know it—wherever it is. But there is a big difference between pursuing it and then concluding an investigation. If there is criminal activity, we will prosecute it. And if we cannot prove criminal activity, then we will not prosecute it. And, of course, we have the SEC, which, of course, has been extremely vigorous as our partner here.

So my view is that, in fact, it has been a very robust response by the Department of Justice and by the SEC and others. I think

we have a lot to be proud of, frankly. But these are, of course—the cases you are referring to, of course—extremely complicated cases.

Senator KAUFMAN. Right. And the point I want to make, because I am going to have a series of questions on this, but really the point that we made, that I made and that Senator Grassley made, this is an oversight hearing, and we are trying to see how the funds were spent and the rest of it. But it is also a legislative hearing. If there are some problems that you are running into in prosecuting these cases because the law—I mean, the law, as I said in my statement, it did not come from on high.

Mr. BREUER. Right.

Senator KAUFMAN. We write the laws. And so we can change the laws. I do not want a single innocent person to go to jail or be criminally indicted for any reason. But are there things going on that really give you concern, as I said in my opening statement, where there are really things going on that are clearly wrong, but just because of the way that the law is being formed or the way the law is being implemented or the way the regulations are written, we can see that people are doing bad things and not being prosecuted for them.

Mr. Khuzami, what has changed about how you identify higher-level targets and how you conduct resulting investigations? Has anything changed on that?

Mr. KHUZAMI. No, I think the fundamental tools that have always been in place are still the ones that we use—you know, thorough and vigorous investigation, partnering with our colleagues. The Galleon case was mentioned. Of course, there is no substitute for the kind of wiretap work that was done in that case, and, you know, one of the asks I would suppose I would have on my list would not necessarily be for me, but it would be more resources for the Justice Department and the FBI to be engaged in those kind of undercover activities for which there is no substitute.

We have developed a cooperation program at the SEC where we can now offer reduced sanctions in exchange for insiders who come forward and provide us with information. And the same is true with the whistleblower legislation that was part of Dodd-Frank where we will be able to award financial incentives.

Those last two efforts should do a lot to get us earlier information on the inside while a scheme is unfolding. That is the best way to get as high up in the organization as you can.

Senator KAUFMAN. Thank you.

Mr. Perkins, can you think of anything?

Mr. PERKINS. Sir, just as far as use of resources, Senator, I wanted to make note of the fact that just looking at our resource levels from 2007 to 2010, a notable increase in each of our four priorities. Right now, we utilize just over 2,000 agents to work white-collar crime matters. That is all of white-collar crime. Ninety-three percent of those 2,000 agents work our top four priorities: complex financial frauds, securities and commodities frauds, public corruption, and health care fraud.

Now, when you look back to 2001, it is known that, following 9/11, there was a shift of resources within the Bureau away from criminal activities in the early days because of the crisis the coun-



try was in. Over the ensuing 9 years and through the help of the Congress and through prioritization within the Bureau, many of those resources have come back. I am still about 200 agents below where I was on the white-collar side at 9/11. The difference between then and now, however, at that point in time—well, at this point in time, 93 percent of our resources are focused on priorities. It was much less than that at 9/11.

So what has happened is we have had to prioritize and shift our resources away from the lower-priority matters. One particular case in point, on 9/11 we had nearly 1,800 financial fraud cases where the loss suffered by the financial institution was less than \$25,000. Today we have one. And I believe that is a fugitive case that is still just pending.

So we have shifted our priorities away, and we are focusing the resources that have been given to us by the Congress where they need to be.

Senator KAUFMAN. Very good. Thank you.

Mr. Breuer.

Mr. BREUER. Well, Senator, with respect to the resources, we feel we have good resources. To make a point, Mr. Khuzami a moment ago spoke about the fact—and I could not agree more—that, for instance, one of the strategies that we are employing in these white-collar cases and insider cases is to use wiretaps. Well, at the Department of Justice, we have tripled—tripled—the number of people who review wiretaps. Now, many of those are for violent crimes, but many of those are for white-collar offenses. That is a very real direct result. We have cut down in half the time that it takes to review these. We move as nimbly as we can. And that is just one small example. Everybody knows about the prosecutors both in Main Justice and in the field. But that shows how deeply we are dealing with the situation and how nimbly we are trying to react and be as forceful as we can.

Senator KAUFMAN. Thank you very much.

Senator GRASSLEY.

Senator GRASSLEY. Thank you, Mr. Chairman.

Mr. Khuzami, the Ponzi scheme perpetrated by the Madoffs and Stanford were serious breaches of our financial regulatory system. Most shocking is how these frauds went undetected for years by SEC, despite repeated warnings and tips from various sources. So the SEC Inspector General issued some scathing reports following these frauds, finding that the SEC made a number of failures along the way that allowed these schemes to go on for so long.

Leadership there at the Commission has said that the Madoff scheme happened to be a perfect storm of fraud that allowed it to go undetected for years. I understand that the SEC has agreed with a number of recommendations that the SEC Inspector General made and that the SEC is currently implementing these recommendations. However, the Inspector General's report also recommended that the SEC take appropriate action against employees that are still employed at the agency to ensure that failures do not happen again. It has been over a year since the SEC Inspector General issued the Madoff report and 6 months since the Stanford report came out.

So the question: To date, has the SEC taken any personnel action against the SEC employees that were highlighted in the reports for failing to perform on the jobs? And if so, what sort of action was taken? And if not, why hasn't action been taken?

Mr. KHUZAMI. Senator, in both cases you mentioned, large numbers of the individuals involved are no longer with the Commission, and, of course, we cannot discipline ex-employees. But for those that remain, with respect to Madoff, the internal review is completed, and it is my understanding that those decisions will be made in the very near future.

With respect to Stanford, the same recommendations by the IG, that process is underway. We have a variety of rules and regulations we follow in these circumstances, and that is what we are doing.

Senator GRASSLEY. And that sort of punishment will be known to the public? Or will there be an attempt to keep it secret?

Mr. KHUZAMI. Senator, I actually do not know the—I will get back to you. I do not know whether or not there are restrictions on to what extent we can disseminate that information.

Senator GRASSLEY. Well, it is along the line of what the Chairman said. If heads do not roll, nobody makes any changes. I will go on with you also on another point.

The SEC Inspector General issued an audit report in March regarding the SEC's use of the whistleblower provisions that authorize the SEC to pay a bounty to individuals who provide information leading to the recovery of funds from securities fraud, particularly insider trading. That report found that, despite having the authority for more than 20 years, there has been very few payments to whistleblowers under the program. The IG noted that the number of applications for the bounty was also low and that the program was not well known either inside or outside of the agency. The Inspector General ultimately concluded that the program was not well designed and was not successful because of poor design.

During the debate on the Wall Street reform bill, enhanced whistleblower provisions were discussed as a means to bring more tips to the SEC and to make the agency more accountable. The SEC was ultimately provided a new whistleblower program under the law.

Question number one—and I have three questions. Now that you have the whistleblower authority that the SEC requested, do you believe it will fundamentally increase the productivity of the agencies in hunting down financial fraud?

Mr. KHUZAMI. Senator, I think it is potentially extremely valuable. There is no substitute for insiders, and if we incentivize them properly to come forward, that is all to the benefit. The challenge, of course, is separating the wheat from the chaff to make sure that we cast a wide enough net so we get as many people as possible, but not so wide that we inundate ourselves with complaints.

So we are working through it in a way to strike the right balance, but we are very optimistic. It was our highest priority under the Dodd-Frank legislation, and we are eagerly writing rules and moving forward.

Senator GRASSLEY. OK. Then a follow-up to that, but I think you partly answered this. Since the authority has been previously little

used based upon what the Inspector General said, and the agency did little to promote or facilitate the program as a useful tool, why should we have faith that the SEC will implement this new authority in a meaningful manner?

Mr. KHUZAMI. Senator, the plans are to distribute word of this new program far and wide—on the Internet and various other forums—to let people know that this exists and they should come forward if they have information.

Senator GRASSLEY. OK. I think you answered my last question at the same time.

Thank you, Mr. Chairman.

Senator KAUFMAN. Senator Klobuchar.

Senator KLOBUCHAR. Thank you very much, Mr. Chairman. Thank you for your work on this. We are going to miss you, I can say.

I thank all of you for being here today. I have always been a big supporter of this legislation. I was proud when the President signed it into law, and I am mostly here today just to get more updates on what has been happening. I think from what I understand, you have had nearly 3,000 defendants sentenced to prison for financial fraud between October 2009 and June 2010, and that so far the SEC has obtained orders requiring the repayment of \$1.53 billion this year.

So I guess one of my questions—maybe it is of you, Mr. Breuer—is how this compares to other years. Do you have any historical data of the number of convictions and the number of the amount of money that has been brought in?

Mr. BREUER. Senator, I do not have at my fingertips the numbers of prior years—

Senator KLOBUCHAR. Oh, come on.

Mr. BREUER. I know. It is shocking. But I will not lose the opportunity to echo what you said. I think under any objective criteria the results since October of 2009 really are quite positive. As you said, 4,300 defendants have been charged; 3,200 defendants have pled guilty; 2,800 have received prison terms; and 1,600 have received prison terms of over a year. I think by any measure those are very, very ample and high numbers. Those, of course, do not include what we are doing in the health care area, another enormous area that I know this Committee cares about. They do not deal with the FCPA, so this is just one level of criteria.

I will get you the old numbers, but this is, I think, a very robust response.

Senator KLOBUCHAR. OK. Very good. And then if you could get these numbers, that would be great.

[The information appears as a submission for the record.]

Senator KLOBUCHAR. What are some of the lessons you learned as you took over this area in terms of what works and what does not work?

Mr. BREUER. Well, clearly one of the things that works is that we need to employ aggressive techniques in the area of white-collar and financial fraud. We have to use undercovers. We have to use Title III wiretaps. We have to seek very stringent prison terms. We have to hold companies accountable and ensure that they have very

robust compliance programs. And we have to get the word out. All of that really does work.

The other thing that I think works very closely is the gentlemen at this table next to me are not just my colleagues. They have become my friends, as have their most senior people, and that works, because frankly what really matters in cases that we can pick up the phone and in a very nimble way address issues. And so that has worked, and the Financial Fraud Enforcement Task Force has, at an unprecedented level, allowed Federal prosecutors and investigators throughout the agencies to work together and, frankly, to partner with State district attorneys and State AGs. That really matters a lot, because what we need are comprehensive responses. The Federal Government cannot, and Federal prosecutors and investigators cannot, be always the answer.

Senator KLOBUCHAR. And I have found in this area, just from my past job, that those prison sentences are very important. Maybe I have mentioned before when we prosecuted eight airline pilots who were not paying their taxes in the State where they should have paid it, as in my State, it created a huge amount of money coming into our State revenue department because the prosecutions got a lot of attention. And I think in this area more than any other, going after these cases actually sets a precedent that people tend to follow. So I commend you for that.

I also wanted to mention not only the Petters case, which was, I think, the second biggest case in terms of money that was prosecuted by the Justice Department next to Madoff in the last year, but also the two others that I think were in your testimony out of our jurisdiction. I do not know if I am supposed to be proud of that, but Corey Johnston pled guilty. It was 17 lenders, \$80 million, and then you also in August of this year, a Federal judge sentenced Trevor Cook, who orchestrated a Ponzi scheme by selling \$158 million in bogus foreign currency trading investments, to 25 years in prison. So I wanted to thank you for that.

What has not worked, have you learned? Or maybe things that were going on before that you do not think were very helpful?

Mr. BREUER. Well, I think the real challenge is, candidly, the public perception and the fact that for very complicated cases there are lots of different issues. So that we will continue to do it, and we will call it the way we see it. But, obviously, we have to put enormous resources in some of the most complicated cases. They take time. They take the review of, you know, sometimes thousands, tens of thousands or more of documents. And, of course, at the end of the day, it does work in the sense that if we do not think we can prove beyond a reasonable doubt a crime, we move away. That is the system working. But I understand that that also on the public frame can cause some level of frustration.

So there is really no alternative to hard work and, frankly, as prosecutors, we could not be more delighted with what our friends at the SEC, and the other regulators, are doing because, of course, what we need as the prosecutors are people with deep, substantive knowledge who really understand these very complicated transactions, and who along with the FBI, which has done a stellar job, are able to bring the cases to us. And so that partnership has

worked. But, clearly, it will be over a period of time that we'll really be able to assess the fruits of our efforts.

Senator KLOBUCHAR. Thank you.

Mr. Khuzami—I am sorry. Every time I see your name, my staff wrote, "Pronounce it like 'tsunami.'" And so I keep wanting to say that.

Did you have those numbers on the SEC and the money brought in at all? Or maybe you are the best person to ask for that?

Mr. KHUZAMI. I do not have them specifically. We will get them for you. I can tell you that certain categories have certainly increased. The number of TROs and asset freezes we have done in the last few years has increased dramatically. That is an intentional decision because that is the best way to make sure we get as much money back to investors as possible.

Our penalty numbers are up considerably, and our Fair Fund numbers—that is the amount of money that actually gets distributed back to harmed investors—are up in the last 2 years.

So all in all, I think those statistics reflect significantly enhanced performance, but even more so, I think, is the nature of the cases. The list of credit crisis and financial crisis cases from Countrywide, to American Home Mortgage, to New Century, to Goldman, to the Colonial Bank-TBW case mentioned today, to Dell, to Ernst & Young, all of those cases, a great deal of time and effort goes into those. They are challenging cases to make. So what I am most proud of is that while we have been able to increase the statistics, at the same time or perhaps more importantly, we have taken on the challenging cases.

Senator KLOBUCHAR. OK. One last question. Mr. Perkins, maybe you are the right one for this. I just remember after Katrina there were a number of sort of disaster fraud cases. I wonder if you are seeing the same thing with the BP oil spill in the gulf.

Mr. PERKINS. We are taking some significant proactive steps to address those issues. We met, in fact, just last week with nearly all of the U.S. Attorneys from the gulf region. We went to the campus of LSU—

Senator KLOBUCHAR. You are the right person to ask.

Mr. PERKINS. Yes, ma'am.

Senator KLOBUCHAR. That is good.

Mr. PERKINS. Mr. Breuer and myself attended the conference, spoke at the conference. Mr. Feinberg was there and spoke as to his efforts with the trust fund. We have the National Disaster Fraud Center on the campus of LSU where we are operating the call centers. We are seeing some signs of fraud, but what we are trying to do is be ahead of it, and—

Senator KLOBUCHAR. Yes, to try to prevent it by the rules you have put in place?

Mr. PERKINS. It is a combination of prevention, public awareness. Our colleagues, for instance, from the Postal Inspection Service have done a great deal of media within their organization, pushing out to individuals in the gulf region that there is going to be very little tolerance to any type of fraud, that prosecution is going to take place. And so we are closely monitoring that. We will have the resources to address it.

The prosecutors and the agents met at this meeting just 2 weeks ago and spoke about what worked during Katrina, what did not work, and what we are going to try to do going forward.

Senator KLOBUCHAR. Well, that is very helpful, because as we know, this was a public trust issue to begin with, and I think now that the spill is plugged and the work is getting done to help people that were victims, we just want to make sure the money goes to the right people. So thank you very much. Thank you, all of you.

Senator KAUFMAN. Senator Franken.

Senator FRANKEN. Thank you, Mr. Chairman.

Gentlemen, I am sorry I was not here for your testimony, but I did read it last night. Mr. Khuzami, back in December I asked you a question about prosecuting credit rating agencies that had a clear conflict of interest when valuating securities. And I notice in your testimony you talked about a credit rating agency, LACE Financial, that you settled some charges against.

Mr. KHUZAMI. Correct, Senator.

Senator FRANKEN. And that was about its conflict of interest?

Mr. KHUZAMI. That arises out of—there were a number of theories there, the primary one of which is that the laws provided that you could not rate instruments for, I believe, an entity that accounted for more than 10 percent of your revenue in a given year. And there were some accounting shenanigans to make sure they did not go over that 10-percent threshold to allow—

Senator FRANKEN. Right, so for the accounting shenanigans.

Mr. KHUZAMI. Correct.

Senator FRANKEN. Right. But it was addressing this conflict of interest.

Mr. KHUZAMI. That is correct.

Senator FRANKEN. So this conflict of interest is kind of a big problem.

Mr. KHUZAMI. Senator, we are looking—we have looked at the area closely, and I agree with you. And Dodd-Frank, obviously, as I am sure you know, addressed a number of those issues.

Senator FRANKEN. Well, actually, not quite as strongly as I would have liked. In fact, I presented an amendment that passed the Senate 64–35 that would eliminate this conflict of interest by creating a third party that would assign a credit rating agency to the instrument and take the conflict of interest out. And that has been now—that became a study, after 2 years under the SEC, and that is kind of what I wanted to ask you about.

This conflict of interest is pretty serious, right?

Mr. KHUZAMI. Correct, Senator. We see conflicts not just in the credit rating agency but in a number of areas, and each time it is typically a source of concern of ours.

Senator FRANKEN. But let us talk about it specifically in the credit rating agencies. I think basically what would happen is they would get paid to rate an instrument, and they would give it a AAA rating, whether it deserved it or not often. In fact, in your testimony you have a thing about Moody's doing that, right?

Mr. KHUZAMI. Correct.

Senator FRANKEN. OK. And you say here that the Commission's report warned that, “. . .the conduct of Moody's European credit rating agency Committee was contrary to the methodologies de-

scribed in Moody's NRSRO application submitted to, and later approved by, the Commission." It sounds like they are in breach of the law.

Mr. KHUZAMI. Well, in the Moody's case, the problem was one of jurisdiction.

Senator FRANKEN. Well, I know, and that speaks to this exactly, that it is "contrary to the methodologies described in Moody's NRSRO application submitted to, and approved by, the Commission." You wrote that to say, however, it may very well be—you said, "The report cautioned Moody's and other NRSROs that deceptive conduct in connection with the issuance of credit ratings may violate the antifraud provisions of the Federal securities laws."

So my question is why—now, didn't you at one point give them a Wells notice?

Mr. KHUZAMI. We did, Senator.

Senator FRANKEN. And why did you decide not to go further with that?

Mr. KHUZAMI. Because of the jurisdictional hurdles. As I am sure you know, the transactions at issue were European—

Senator FRANKEN. Right, OK.

Mr. KHUZAMI. The ratings were done by the European entity. There was really no connection to the United States.

Senator FRANKEN. OK, even though in your own testimony here you write this caveat that it is in violation—it is possibly in violation of our laws.

Mr. KHUZAMI. Correct. If we had jurisdiction over the conduct, absolutely.

Senator FRANKEN. OK. Well, maybe I do not totally understand your testimony, then. I am sorry. I apologize if I do not.

I guess my point is that there was also testimony in Chairman Levin's Committee of a number of credit rating agencies that their e-mails basically said we better give this a good rating because we want their business, right?

Mr. KHUZAMI. Yes, I am aware of that testimony, Senator.

Senator FRANKEN. OK. And it is more evidence than testimony. It is e-mails.

I guess my point is that I want the SEC, after examining this—I would like to find some solution to this conflict of interest, and I do not see any other solution other than having some kind of third party—and it does not have to fit my prescription, but I would like to see some kind of way of eliminating this conflict of interest where the credit rating agency is chosen by the bank that is issuing the product and paid by the bank that is issuing the product.

Mr. KHUZAMI. I completely agree with you, Senator.

Senator FRANKEN. Oh, good. I am glad you do. Thank you very much.

Let us see. Mr. Breuer, thank you for being here. In a speech given to the American Bar Association, National Institute of White-Collar Crime—a terrific group, by the way—in March 2010, you discussed that the Department of Justice needed to "be more targeted, more creative, and more strategic in where and how we look for criminal conduct when investigating financial fraud."

What specifically has the Department of Justice done with FERA funds to be more creative and strategic when prosecuting crimes so that we are ahead of the curve? And maybe this was asked before, and I am sorry if it has been before I got here.

Mr. BREUER. Senator, both at Main Justice and at the U.S. Attorney's Offices, numerous U.S. Attorneys have created securities sub-groups, or even if they have not denominated them specifically as that, have either selected lawyers or recruited lawyers to work specifically on what we will call securities-related kinds of cases. That is what we are doing. We have beefed up in our Fraud Section the number of lawyers who work in this area. We have recruited lawyers with very deep experience in the specific areas. We have recruited alums of the SEC who have then decided to become prosecutors. We have recruited lawyers from other U.S. Attorney's Offices and given them supervisory positions. So that is one thing we have done.

As I said earlier, it is always hard for me to know exactly where the monies go, but we think very much that, given the kinds of cases that we need to bring, we have to be very aggressive in doing it. We have to have wiretaps, we have to have undercover. In doing that, we have allocated more positions for people who review wiretap applications, because the ones that take the longest are the ones, frankly, in the very complicated white-collar cases. And I think, Senator, you will see in the coming period of time announcements of perhaps insider trading cases or others that will have been brought about, as had the Galleon case, from things such as wiretaps. We have been taking more and more aggressive steps.

Then, frankly, we have taken these lawyers, and we have put them on some of the most complicated cases. In January, we will go to trial in the Stanford case. We, of course, brought the Farkas case dealing with TBW, one of the largest mortgage lending institutions, which led to the failure of both that and Colonial Bank.

So we are taking the funds. We are hiring lawyers. I think probably, Senator—I do not know exactly—probably nationally at this point maybe, ball park, 75, 80 new prosecutors in this area have been hired, and probably another 70 are in the process of being hired.

Senator FRANKEN. Thank you, and I want to thank all three gentlemen for your service. Thank you, Mr. Perkins. I did not get a chance to question you, but my time is up.

Thank you, Mr. Chairman.

Senator KAUFMAN. Thank you.

Mr. Breuer, during the savings and loan crisis, bank regulators played an important role in cases. Now, you used the term "deep, substantive knowledge," and I think that is the real driving force. They can deliver cases that are ready to go to prosecution.

Can you talk a little bit about how you are working with bank regulators in order to find fraud?

Mr. BREUER. Yes, it is going very well, and, Senator, it is, candidly, going particularly well after FERA, and to be very open, after speaking with members of the Committee and specifically you. We in the Criminal Division and our colleagues have been meeting regularly with the bank regulators. We have been reviewing with them, after they have selected some, the Suspicious Activ-



ity Reports, which are in this day and age the equivalent of referrals. And, frankly, those kinds of reviews are leading to very active investigations.

The task force in particular has been a terrific forum to get the regulators together. Just earlier this week in New York, for instance, the Securities and Commodities Working Group of the task force met. We met at the CFTC. Mr. Khuzami and I, and the U.S. Attorney in New York, are the co-chairs of that committee. And at that meeting, there were many of the bank regulators and others, and we spoke about these very issues.

So we will continue to work. We have more to do, but overall I think it is a good report.

Senator KAUFMAN. Great. Thank you.

Mr. Khuzami, as you justifiably said, the SEC settles its highest-profile cases, such as Bank of America, Goldman Sachs, Barclay's, and Citi. Can you kind of go through the decisions you make when settling versus taking a case to court?

Mr. KHUZAMI. Sure, Senator. Look, when we consider settlement, we consider whether or not we can achieve the objectives we started out in bringing the case through settlement. And if we can do that and avoid the litigation risk of an unfavorable outcome as well as the resource considerations—not that the resource considerations are paramount, but there are opportunity costs in everything we do. If you are working on Case A, you are not working on Case B. And so we look at all of that, and it is a complicated analysis just because you need to analyze the strength of your proof and what you think the remedies will be even if you prevail. And that is the general formula, and we do it in all of our cases.

Senator KAUFMAN. Do you ever take into account what the message will be if somehow you go into court and you lose in terms of just the impact people have about whether they can break the law?

Mr. KHUZAMI. If we lose?

Senator KAUFMAN. Yes.

Mr. KHUZAMI. We do worry about—I think about that in some context. If you are bringing a case, for example, a TRO or an asset freeze against a suspected Ponzi scheme, and you are uncertain if you have got the evidence to stop it, but you very much want to be able to because it may be an ongoing fraud, if you bring that case and lose, all of a sudden it becomes potentially -you know, the Good Housekeeping Seal of Approval that the perpetrators then say, “The SEC tried to stop us and nothing was found wrong.” And so sometimes you have to take that into account.

But as a general matter, I think that you cannot be cowed by the possibility of losing, and we do enough good things and bring enough good cases that we can take a few losses if the cause is right.

Senator KAUFMAN. Mr. Breuer, the behavior of the borrowers, lenders, banks during the housing boom, which ultimately led to the financial catastrophe, represented a continuum from innocent to the unwise to the criminal. What are the hallmarks of criminal or fraudulent behavior that you look for when deciding whether to initiate an investigation?

Mr. BREUER. Well, we look, Senator, to see if we believe that fraudulent conduct occurred and whether or not it is the kind of conduct that we believe we can prove beyond a reasonable doubt. So if someone made a material false misrepresentation and we believe that that is something that is colorable, then that is exactly what we would investigate.

And so working with my colleagues to my left, whether it is the most sophisticated or the simplest, that is the kind of benchmark that we follow.

Senator KAUFMAN. Mr. Khuzami, how about you?

Mr. KHUZAMI. In terms of what we look at?

Senator KAUFMAN. Yes, look for in terms of deciding whether to initiate an investigation. What kind of behavior kind of sends a signal that it is time to start looking and investigate this? Not prosecute, but earlier on in the investigation phase.

Mr. KHUZAMI. Well, you know, some cases come to you with pretty good evidence of wrongdoing, and that is an easy call. You look at that—

Senator KAUFMAN. And the whistleblower thing is really very helpful in that, right?

Mr. KHUZAMI. That is the—

Senator KAUFMAN. And everybody agrees to that? I mean, you know, there is nothing like having somebody come forward who can tell you actually what is going on.

Mr. KHUZAMI. That is correct. Potentially extremely valuable, both in terms of getting at the conduct earlier, getting at those who organize and supervise and lead an organization, because if you have an active scheme really of any kind, odds are there is just a handful of people who are in on it. And in order to gain access and a window into that and the evidence that you need to bring that case, you need somebody similarly trusted. And so whistleblowers and cooperators are the kind of people that can do that for you.

Senator KAUFMAN. Yes, and we have talked about it before. I mean, this is not—at one time I said it is not like drug dealers. These folks that are involved in this kind of fraud have very good lawyers and accountants, and they cover up behind themselves very, very well. Do you want to comment on that?

Mr. KHUZAMI. It is absolutely right. The simplest example is the person who is engaged in insider trading who at the same time they are receiving the information and executing the trades are searching the Internet for a few research reports on the particular company and stick it in their file, so when the cops come knocking, they point to the file and say, "This is why I bought." And in order to be able to rebut that defense, you need a pretty tight case.

Senator KAUFMAN. Mr. Perkins.

Mr. PERKINS. Senator, I can give you a couple specific examples of what we are trying to do, especially involving resources that we receive based upon FERA and through Congress over the last year. I mentioned in my opening statement in my testimony the Financial Intelligence Center. I also want to mention the usage now of forensic accountants, something we did not have in the past.

We found in the past walk-ins, people that are motivated through whistleblower and the like, yes, those can deliver a lot of cases. But the best cases are the ones you can get on the front end

where you can utilize the Title III, the undercover technique, and whatever the case, whether it is a financial fraud or any other type of criminal activity.

What we are trying to do with the Financial Intelligence Center, we have intelligence analysts there who look at SARs, which you mentioned. When I came into the Bureau in the mid-1980's, it was the RTC, Resolution Trust. I worked those cases. Today we have SARs not only from the financial institutions but from the securities industry. We are able with our analysts there to look at those, determine patterns of activity, and actually have identified investigations based out of that that no one came in the door, that we have actually referred out to our field offices, to follow up on that with the forensic accountants, again, something that 1 year ago we did not have. We have a position now—

Senator KAUFMAN. I am smiling because I can remember that little accountant in "The Untouchables."

Mr. PERKINS. Yes.

Senator KAUFMAN. The FBI accountant that found out about Al Capone.

Mr. PERKINS. Exactly.

Senator KAUFMAN. He was gone by this time.

Mr. PERKINS. Being the one accountant sitting at this table, I can appreciate that, sir. But with the forensic accountants, we have been able to hire nearly 100. We send them to a 6-week class at Quantico. Our first class graduated with 35 students just a few weeks ago.

I will give you an idea of the quality of the people we have in these classes, and these are all newly hired employees—I am sorry, 38 students. Of the 38 students, 28 of them are certified public accountants; 10 of them are certified fraud examiners. So that is just the beginning. Multiple MBAs. These people are now in the field. Over half of that original class went to our top five field offices where these cases exist.

We have another class of 40 about to start in a month, and we are going to keep that continuum going. So we are using these individuals to identify those types of cases and then to work those cases.

Senator KAUFMAN. I think that is really what we all talked about. That is what FERA was all about, to try to get the capability to move up the chain to get to the more complex cases. That is why the whistleblower provisions are in Dodd-Frank. I think this is all the ability to know you just cannot have two different sets of rules for people, and if you are powerful and you have got money and you have got good accountants and good lawyers, you can get away with something that normal people cannot.

I would like to turn back to the hypothetical I discussed in my opening statement to try to define the distinction between actionable fraud and legally permissible behavior. Mr. Breuer, I described a bank that sought to increase market share by lending a larger and larger percentage of its loans on a stated-income basis, or liar loans. Over time, almost three-quarters of the Option ARM loans and about half of the subprime loans were offered on a stated-income basis. Does that in itself give rise to actionable fraud?

Mr. BREUER. Senator, from my perspective, it really depends—I hate to say it but—on what the disclosure says.

Senator KAUFMAN. Sure.

Mr. BREUER. At the end of the day, that is the difference. If the institution materially misrepresented what it was doing, if it purported to the public one thing and was doing something very different, materially different, then, yes, that could very well be criminal. But, frankly, if within the large disclosure of the kind of activity that they were engaged in is covered in some way, then that could very well pose an enormous burden for us and could preclude us from proceeding criminally.

So until we read those dense disclosure materials or unless we have somebody from the inside telling us what was going on, those are the kinds of challenges that we will continue to face.

Senator KAUFMAN. Now, if the bank takes loans itself, it is free to sell the loans; it is free to hold them on its balance sheet, right? It can do anything with these loans it wants to do.

Mr. BREUER. There are others, such as Mr. Khuzami, who are more expert in this than I, but so far it seems as if, yes, they would be able to do that in your hypothetical.

Senator KAUFMAN. Now, if the bank at some point decides that loans on its own balance sheet are likely to default and plummet in value, may the bank sell these loans to third parties without disclosing its belief that they are a bad investment?

Mr. BREUER. Well, again, Senator, I mean, there are cases—and the SEC I think is litigating some of these right now. But I think that there would be a question of what is being disclosed and what is being withheld and whether it is just an opinion being withheld or whether the underlying facts are being withheld. And, again, those are difficult issues.

Senator KAUFMAN. Mr. Khuzami.

Mr. KHUZAMI. Well, look, under the scenario you describe of a securitization, a company in the securitization business, a couple points.

One, there are various theories: disclosure; the accounting could be bad; they could be not setting aside proper reserves given the deteriorating quality of the loan portfolio. That is a separate and independent potential violation. And there is the MDNA provisions of the disclosure laws which require them to disclose trends and uncertainties and kind of management's perspective of the business model. So you might look at all those three. In fact, in Countrywide, we brought the case based on an MDNA theory, not so much on the accounting or other aspects but the fact that they knew that the business model was deteriorating because the quality of the loan portfolio was going down, and they did not disclose that. So we try and be creative with the theories.

One of the hurdles in the securitization world is that typically these securitization vehicles, the offering materials attached to them, in addition to the disclosure, every loan in the portfolio where you get the loan identity and geographic location, the average FICO score, and all the information. So a lot of granular level is disclosed in connection with the securitization that can make it difficult to make the case.

But, on the other hand, in your hypothetical, if a company were to say, you know, our portfolio may consist of a certain percentage of liar loans and, in fact, they already do consist of that, you might even try to be aggressive and seize upon the difference between “may” and, in fact, “does” as a theory to proceed. And we consider those kind of theories as well.

Senator KAUFMAN. And this disclosure thing, because I think disclosure is really the root of a lot of these problems. Is that fair to say? You know, one of the things I was thinking about—because I have been thinking about this a lot—is, you know, we had the truth-in-lending law which took—you know, everybody in America was borrowing things, and somewhere deep down—and it was not 100 pages like some of these prospectuses are, but, you know, it would be three or four pages, little print—would be what the interest rate was. Then we took the interest rate and put it right out on the front of the page so you cannot miss the interest rate.

Is there something in disclosure—I mean, it just seems to me this is not right. This falls into the “not right” category. It may be legal that you can hide these things down in the body of the thing, you can put in there what the statements are, when all along you know what it is that you are selling is not a good thing.

What can we do in terms of changing the disclosure rules so that it makes it easier for people who are buying, even supposedly, you know, the big boys, so that people know what it is that they are getting and how really risky it is?

Mr. KHUZAMI. Well, I guess I would like to give that a little thought and perhaps get back to you.

Senator KAUFMAN. That would be fine.

Mr. KHUZAMI. A lot of the risks that are disclosed are typically disclosed up front in the offering materials, then followed on in the offering materials by more detailed and less important ones. So if you open up securitization offering material, the risks can start out, you know, the housing market, if that falls, these things are going to be badly worth; and if, you know, originators cannot make loans anymore, then this will be this, this, or this; or if there is an earthquake in Fresno, that could hurt.

And so a lot of the stuff is identified up front, but you are also right that it is a big book of information and not always fully transparent to all buyers.

Senator KAUFMAN. Mr. Breuer.

Mr. BREUER. Well, I would say the same. I mean, obviously at the Department we are less the regulators, of course. We are the prosecutors. And so whatever the regulations and the laws are, we will look to see whether people violated them.

I, too, would want to look at it. I think at its most basic level disclosure is a good thing, and making it simpler and understandable is a good thing. But, of course, in the very kinds of transactions that you are discussing and that Mr. Khuzami was referring to, many times you have very sophisticated parties on both sides of these very, very difficult and complicated transactions. And so, you know, where the right balance is I think is for others to probably figure out.

Senator KAUFMAN. But I think in the end, I think you would all admit that these ended up being sold to very unsophisticated inves-

tors. I mean, a lot of people ended up—when you go around and look at the people who—I mean, major institutions maybe, but not at all familiar with what it is that we were doing and what was going on. This was not just—so, you know, the big boy thing, just as long as everybody is a big boy. But I think if you go back and look at most of these things, they were not big boys.

OK. So they have the disclosure, and they said they had toxic securities and they sold them. But at the same time, they bet huge amounts of money against them in the credit default swap market. Mr. KHUZAMI, is that OK?

Mr. KHUZAMI. Well, I mean, if an institution is engaged in legitimate hedging activities, if it looks at its overall risk and decides I am more long in the mortgage market than I really want to be and I offset some of that risk through derivatives or other instruments, there generally is—that is not improper. And, in fact, you want companies to hedge their activities.

Senator KAUFMAN. But they can always hedge their activities by selling the securities.

Mr. KHUZAMI. They can sell them, or they can—there is a variety of hedging tools.

Senator KAUFMAN. I mean, most people, when they have something they do not like, they do not sell something, you know, as an offset, which is what the argument is. They sell the basic securities. But the basic securities are such that they know how bad they are at this point so they cannot sell them. So they can say that, you know, it is a hedging move. But if, in fact—I guess the key thing is if they know these securities are going south, they know that the housing market—at some point in there, if you know the housing market is going south, and you cannot sell the securities because you will not be able to disclose—you cannot say, “I know these are bad.” You have reached that point. Is it OK to go out at that point and then begin to sell swaps, to buy swaps to cover that?

Mr. KHUZAMI. If I understand it right, a portfolio of bad loans, a company decides they are in bad shape and I don't want them anymore, and I put them in some sort of vehicle to sell them to third parties.

Senator KAUFMAN. Right.

Mr. KHUZAMI. First off, they have to accurately describe what is in that portfolio, which means all the information that they are required to provide. If they provide any misleading information in connection with that, then that is clearly improper.

Senator KAUFMAN. But if they do not sell them, they do not want to sell them because they cannot sell them because they disclosed, and what they do is they do exactly what you said. They leverage it by going out into the swap market and bet huge sums that the securities are going to fail.

Mr. KHUZAMI. So that they basically go short.

Senator KAUFMAN. Yes.

Mr. KHUZAMI. The loans that are in their portfolio. I mean, the problem is that may be a legitimate hedging activity. They may have this risk on their books that they cannot get rid of, they cannot sell, they do not want the exposure. So they take other steps in order to protect themselves. That may not be improper if the

counterparty to the swap sort of understands what it is that the underlying reference obligations are in the swap.

Senator KAUFMAN. Got it. But to the extent that they know they have got a problem, at least it poses a conflict of interest. If they are selling some of these securities—if they are holding them all, no problem. But if they are selling some of these securities at the same time they are selling—betting against them, that is at the very least a conflict of interest, right?

Mr. KHUZAMI. It could be, yes, Senator.

Senator KAUFMAN. Is it legal for a firm to manufacture and sell securities which it knows or is virtually certain are going to default?

Mr. KHUZAMI. Well, again, if page 1 of the disclosure material said here is X security, but I am virtually certain that these are going to default, the answer would be no. Of course, no one would buy them.

Senator KAUFMAN. So the same thing, to the extent that you reach a point in a market and you have got these secured investments that you are selling, you are selling them to customers, you put the disclosure in them. But you sit down and have a meeting. In the meeting you say, you know, this business has gone south, so what I am going to do, I am going to continue to sell as much of these as I can, but I cannot sell very many, and I've got to be protected if I do not. So then I go out and I sell the swaps in order to offset any potential loss. Is that criminal behavior?

Mr. KHUZAMI. Well, is it the subject of a civil enforcement action?

Senator KAUFMAN. Excuse me. Civil action.

Mr. KHUZAMI. Well, I think the point is that at some point the securities are in such bad shape that it is virtually impossible to make adequate disclosure. And so I think if you really had a portfolio of securities that were that bad, you would—you know, odds are the disclosure, if they tried to sell them and nobody bought them, it just would not be adequate.

Senator KAUFMAN. So the key to this really is finding out—you know, if you assume—and I think we can assume based on the hypothetical—that they did not actually say the housing market is going to fail and we are all going to fail. They said what they were saying before, which is if the housing market—exactly what you said, if the housing market fails, dah, dah, dah, dah, dah, then you are going to lose.

Mr. KHUZAMI. Yes, or if—

Senator KAUFMAN. Isn't it relevant—because it is very difficult—for instance, in this hypothetical it would be very difficult if the bank never will admit that they thought the housing market has gone south. Once they admit the housing market was going to go south, they should have disclosed that, right? I mean, there is a difference between saying the housing market might go south. It is different when you know the housing market—you have decided as a group the housing market is probably going to go south. I do not think anybody disclosed in their disclosure, well, the housing market is probably going to go south, and you are going to buy this security anyway. I think what they said was—and correct me if I am wrong. That is why we are having a hearing. They said what they were saying all along, which was, you know, if you invest in the

housing market, the housing market could fail. But isn't it key at what point they think the housing market is actually going to fail? And isn't that disclosure key to whether what they are doing is criminal?

Mr. KHUZAMI. That could, although, you know, when the housing market is going to fail is a little more amorphous than more specific information about the particular security. So if they knew that, you know, the mortgages in Fresno were defaulting at a 45-percent rate and made misleading disclosures suggesting that they were performing adequately, that is more likely, were you to find the hook that you would need to bring an action.

Senator KAUFMAN. But, remember, in this hypothetical they are selling—90 percent of their prime loans are liar loans. I mean, you cannot sit there—if this housing market is going south, it is hard to figure out how instruments being sold where over 50 percent of all their loans are liar loans, that you can—you know, that this is going to work. Once you reach—that is all based—that whole philosophy of liar loans rests with if you believe it—although I must say the head of the Office of Thrift Supervision said that liar loans are anathema to the banking industry. Of course, the problem was he was overseeing a bank that was using them and did not even know it.

Mr. KHUZAMI. Right. The other hook you could use here is to show that if you had these loans on your own books, then typically you would be required to disclose that the source of these loans were your own balance sheet, because it is one thing—

Senator KAUFMAN. Yes.

Mr. KHUZAMI. You know, it is one thing if you went out into the street and collected loans from everybody and then packaged them and sold them. If you are offloading your own risk from your own balance sheet, that is typically something that needs to be disclosed because that speaks to your—

Senator KAUFMAN. But it would not—but the equivalent thing is selling these swaps, right? Wouldn't you have to disclose that, too? I mean, what is the difference between—essentially in the hedge case you gave, what is the difference between unloading stocks off your own account and going out and selling swaps?

Mr. KHUZAMI. Buying protection. No, that is certainly true, and that could be a hook. I will say that certain of many structured products, including CDOs, often disclose that the underwriter or the arranger may take a short position or may be otherwise engaged in transactions, you know, long or short of the portfolio in question. So this sort of goes to your earlier question of whether or not that kind of disclosure is sufficiently prominent that people can make a decision.

Senator KAUFMAN. But it goes back to what we are trying to say. One of the things we are talking about in the hearing, I mean, that kind of behavior should not be allowed—I mean, I know what the law is now. But isn't there something we should do about that kind of behavior, especially when you look back on what happened to so many folks after it was clear that the banks continued to sell these, continued to turn them out, continued to securitize them, mortgage brokers, appraisers knew, everybody knew what was going on, and they had this incredible conflict of interest, as you admit. I mean,



there should be some way legally we can turn that conflict of interest, if you abuse it, into a crime. Anybody?

Mr. KHUZAMI. Well, I mean, I think the answer is yes. Again, because we have a disclosure-based system, that is where the focus is on. If the question is we should just out and out prohibit that kind of activity, I think, you know, there are certainly some instances where we have seen where that would have been a better result. I would want to look at the overall impact that that might have before planting my feet.

Mr. BREUER. Senator, I just want to be clear. At its most core principle I know, of course, you are talking about the CDOs and the swaps and really the kinds of very sophisticated transactions that the SEC in particular is focusing on and doing such a great job. But if we look at the kinds of cases that we have been bringing—and there have been many, many investment fraud cases, indeed many over the last months, the one common theme is that every one of the people we have prosecuted made false statements.

Senator KAUFMAN. Right.

Mr. BREUER. They made materially false statements. They told investors one thing, whoever they were, and they did something different. And they could not point to something to show that they, in fact, had revealed whatever it was. There was falsehood and there was criminality.

And so at the end of the day—at the Department of Justice we are pretty simple—whether it is the simplest case or the most sophisticated case, that is what we are looking for, and that is what we need. That is what we need the regulators to show us. That is what we need the FBI to bring us. Those are the kinds of cases we look for, and at its core that is what we want.

So if disclosure, for instance, as you suggest, is simpler and that would be appropriate for whatever the transaction is, then we can see what the disclosure is, and we can match it up to what the conduct was. And, really, that is what we look for.

Senator KAUFMAN. Good. And, by the way, the only reason I—this probably is not going to happen again. It is going to be some new thing that is going to happen that we have not even thought about. But it is the basic premise. The basic premise is that, you know, I do not think anybody in America can sell something and at the same time sell insurance, buy insurance it is going to fail, a product. I think in a product liability case, this would be a real problem, right? If you made a car that you knew was going to crash and then sold insurance so that every time everyone crashed you made money, that would be a conflict of interest and be criminal behavior, correct?

Mr. KHUZAMI. Yes.

Senator KAUFMAN. So that is the thing we are trying to get at. In the securities industry, where in the securities industry do they have a special situation that does it?

To follow up on this, Mr. Khuzami, if the bank relies on the credit rating to market the security, which it knows to have been awarded based on faulty methodology, is that a problem?

Mr. KHUZAMI. If the bank is aware of that and they did not disclose that, that could well be a problem.

Senator KAUFMAN. If the bank relies on a credit rating that it knows to have been awarded due to a clerical error, is that a problem?

Mr. KHUZAMI. Same thing. Again, if they know that and they intentionally do not disclose it or make misrepresentations that mislead the buyer, that is, in fact, a violation of the law.

Senator KAUFMAN. And, Mr. Breuer, what if the bank relies on third-party representations such as claims by the originator regarding the quality of loans which it knows to be false?

Mr. BREUER. Well, if it knows something is false, Senator, and it acts as if it is not false, and it represents as a result to third parties that that which it knows to be false is not, then that certainly would have the potential of being a criminal case.

Senator KAUFMAN. And are there any cases like that? I mean, are you investigating cases like that? Is that a problem out there, or is it just hypothetical?

Mr. BREUER. Well, no, we are looking at a whole host of conduct, and some of the conduct we are looking at would be related to the scenarios you are discussing.

Senator KAUFMAN. Mr. Khuzami.

Mr. KHUZAMI. Same thing. I mean, typically we focus on the issuers, the underwriters, and the public companies. But it is no defense if they know that a third party is doing something improper, they know that and they do not disclose it, that is improper. Even if they tried to disclaim complete responsibility—you know, no responsibility for the conduct of the third party, I am not sure that would cure the problem.

Senator KAUFMAN. Now let us talk about some legislative changes to continue what I was just talking about because I think that is not the oversight now. What do we do going forward? And going back to this basic question, which is they are not—it is not illegal to do a number of things that I asked you about.

Where the bank manufactures assets for sale to unwitting customers while at the same time shorting those securities, Congress should pass laws to fix that, I think. How would a law imposing a fiduciary duty on broker-dealers affect your ability to do your job and to catch people that are doing bad things?

Mr. KHUZAMI. Well, Senator, as you know, that is a matter under study by the Commission now as a result of Dodd-Frank and whether or not to move to a uniform standard. For that reason, it probably would not be appropriate for me to—

Senator KAUFMAN. I am just talking about it from a legislative standpoint. I am saying, you know, it is in there as one of the things to consider. But we had offered a proposal—and I am not going to be here so I am not doing this to kind of pump my—

[Laughter.]

Senator KAUFMAN. I am really trying to figure out, genuinely trying to figure out how we help get at some of this. And I am just saying I think that—let me put it this way: What separates what went on with that hypothetical bank and what most Americans view and most—is that there is this fiduciary—there is not a fiduciary duty. In other words, the key to this thing is I can do anything I want, you know, as long as I disclose it, and I can hedge my—I can use it as a hedge, but basically the “get out of jail free”

card in this, which I think exists only in this business, is I do not have a fiduciary responsibility to tell you what is actually going on here or to warn you about what is happening. Is that fair to say?

Mr. KHUZAMI. Well, look, certainly a fiduciary standard is a heightened standard, and it would sweep into it more conduct that would be deemed improper. No doubt about that.

Senator KAUFMAN. Mr. Breuer.

Mr. BREUER. Senator, obviously, we really would at DOJ, I think, be very affected by what our friends at the SEC thought. So if they determined that broker-dealers should have an equivalent fiduciary duty, let us say as investment advisers, we would want to have long discussions with them. But, really, in the first instance, they really do have more expertise in that area than we, and so we would study it. But at the end of the day, we would probably be guided by that, and if there was a determination that that was appropriate, then to make it as simple as we can, then we would start prosecuting those cases when broker-dealers acted contrary to their duty.

Senator KAUFMAN. Great. What about a law requiring broker-dealers—Mr. Khuzami, what about a law requiring broker-dealers to disclose internal company analysis regarding securities that it offers for sale?

Mr. KHUZAMI. I am sorry. As a proposal?

Senator KAUFMAN. Yes, as a proposal. Just a thought in terms of how do we get at this problem.

Mr. KHUZAMI. Well, I suspect one result of that is there would be much less internal analysis of securities that would be issued.

Senator KAUFMAN. Yes.

Mr. KHUZAMI. So, you know, I think you would want to think about whether or not—whatever value that has—and obviously firms have research departments and they issue research across wide ranges of topics. So I guess I would want to think about that.

Senator KAUFMAN. Got it. I understand that the toxic CDOs which undermined the financial system leading up to 2008 were, by and large, accompanied by extensive disclosure. We have talked about that. The problem was that few investors bothered to read and study them. The economic crisis actually underscores one potential problem in the disclosure regime. Mr. Khuzami, is there a better way to regulate disclosure so that investors are able to more readily determine what it is they need to know about a security?

Mr. KHUZAMI. Well, I think this goes back to your point earlier about perhaps you need a Truth in Lending Act for securities disclosure. But, again, I think some of these are under consideration now, including revisions with respect to disclosure in connection with securitization and other similar products. So, again, that is something I think we would probably have to give some thought to.

Senator KAUFMAN. OK. Mr. Breuer, you testified during the December 2009 fraud hearing that one type of fraud that contributed most to the financial mortgage crisis was when banks lied about the mortgage underwriting standards they used in issuing loans. Can you tell me what progress in pursuing those cases since last December?

Mr. BREUER. Senator, I think I probably said something like we were looking at sort of a whole host of conduct from the very begin-

ning to the end without probably making a statement that, you know, I had come to a conclusion that they had, in fact, lied.

Senator KAUFMAN. Right.

Mr. BREUER. We are looking at all the codes of conduct. We continue to look at them. And obviously the cases that we have already brought suggest that. The Farkas case that we have talked about is a very good example of that where we look at an originator and we look at his misrepresentations to a financial institution and proceeded. And we continue to look, as do our colleagues throughout the country.

Senator KAUFMAN. Mr. Khuzami, when the SEC conducts an investigation and determines that the conduct was harmful though not actionable, the Commission can issue a so-called 21(a) report to publish its conclusions. Can you talk a little bit about a 21(a) report?

Mr. KHUZAMI. Sure. The 21(a) reports can be issued in a variety of circumstances, including where there is a lack of clarity in the law and, you know, the investing public is well served by hearing, you know, a description or an explanation of what kind of conduct is improper. It gives proper notice and warning to institutions involved in that business to make sure they conform their conduct to the law. So it is a good way of getting the word out even if you do not have an enforcement action to file, so you correct behavior going forward.

Senator KAUFMAN. In the case of the Moody's European credit rating committee, can you explain the facts of that case and why the SEC issued the 21(a)?

Mr. KHUZAMI. Quite simple. The structures at issue were European. The decisions—the error with respect to the rating of those instruments was European. The decisions by the individuals not to correct the error was made in Europe. There was really no connection to the United States, and, frankly, in addition, under the previous law, there was some question as to whether or not we even had the ability to bring actions against credit rating agencies with respect to either their methodologies or their ratings, which has now been cured under Dodd-Frank.

Senator KAUFMAN. Yes. You know, the 21(a)'s sound like a pretty good thing to me, I mean, in terms of what we are talking about, sending a message to the industry that, you know, this is bad behavior, we know what you are doing, we cannot bring a case. Do you ever think about issuing more 21(a)'s? Or is there a real problem with doing that?

Mr. KHUZAMI. No, I mean, we consider it on occasion. I cannot say I know the complete history of how many we have brought over the years, but it certainly is something that is always viewed as an alternative to an enforcement action.

Senator KAUFMAN. And, again, this is not for publicity or anything. This is to actually turn to behavior. One of my major concerns is—and I have spoken of this extensively. The vast majority of people on Wall Street are really good people, and I went to school with them, you know, I really think the best of them. But there is a small group up there that continues to behave in what I would call—I mean, just totally opposed to what Senator—the former hear of the Fed Greenspan said, which was, you know, peo-

ple will look out for the corporation, you know, they are not going to do anything really bad because they do not want to hurt corporation, they do not want to hurt other people. It seems to me coming out of this it continues to be a group of people who do not care about the corporation, who do not care about the taxpayer, who do not care about anything, except just maximizing—I think, again, a small percentage of people.

And I think that what worries me about the difficulty of bringing these cases because they are so complex and because of the fact that we have—they are able to gain the services of extremely competent lawyers and accountants, that it is hard to bring these cases. But I do not want people sitting around in their office on Wall Street saying, Well, you know, we have kind of been doing this, and it has kind of worked for us, so we are going to keep doing it.

So I think the deterrent piece of this is not to see someone go to jail, but a deterrent so that the next time something comes along—because it is going to be something different. It is not going to be the same thing. It is going to be something different. Could each one of you comment on that kind of thought?

Mr. BREUER. Well, Senator, I could not agree more, and there, of course, will be some group of people—small, as you suggest—that will be willing to break the law and act in a criminal manner in order to benefit themselves. And what we have to do and what we are doing and what we will continue to do is have a robust and comprehensive response.

Just last week, Senator, in New York, we completed an 8-month trial, 8 months, where we convicted a CEO and a COO of insider trading and a whole host of conduct, accounting fraud, where they took a public company and engaged in activities for their personal benefit.

We are going to continue to bring those cases, whether they are hard or not. We hope that that creates deterrence. We will continue to be as aggressive as we can be, and we will continue to seek very, very stern and long sentences for those who cannot be deterred and for those who decide that their own selfishness and need for material wealth is more important than abiding by the law. And so we will continue to do that.

Senator KAUFMAN. Mr. Khuzami.

Mr. KHUZAMI. Yes, I agree. You know, you want to take on a comprehensive effort to make sure that people do not cross the line into illegal behavior, and in any particular company or bank, there is a large number of people who work in the legal departments, the compliance departments, the risk departments, the audit departments, the control functions, the management, whose function it is to make sure the company operates properly. And you want to empower those people—they are your deputies—because they are the ones that are in the offices every day. You want to empower them in order to make sure they get the message out that improper activity will not be tolerated. So they are your allies in this fight, and to give them the tools they need, you do a whole host of things. You know, you have better quality directors and more active management and compensation reform and just a whole host of activity

that collectively sends the message to the corporation that, in short, crime does not pay.

Senator KAUFMAN. Let me ask you—Mr. Perkins, I will get to you in a minute—because that compensation thing—in the Permanent Subcommittee on Investigations, it was clear in a number of these places where bad things happened the compensation, the incentives were to behave in a very bad way. In other words, you got much more money to go out and find a subprime loan than you did, you know, a conventional loan.

Is there any—does that play any role, is there any criminal—not criminal. Is there any civil or any other thing to deal with a company that continues to offer incentives that lead to bad behavior?

Mr. KHUZAMI. Well, we have certain remedies, particularly in 304 of S-Ox, which allow us to claw back executive compensation for at least CEOs and CFOs under circumstances where there was misconduct that occurred on their watch, frankly even if they were not personally involved in it. And we have used that authority on some occasions.

There is more compensation structures—this is not really a matter of regulatory action, but more compensation structures particularly in banks that provide for claw-backs so that if a trade takes home a \$10 million payday but his book blows up 6 months after he got that bonus, some of that is going to be clawed back, so you reduce the incentives for sort of the short-term gain. And I think that is a good development.

Senator KAUFMAN. Good. And that is good for legislation.

Yes, Mr. Breuer.

Mr. BREUER. And, Senator, with respect to the Department, we, of course, were investigating, looking, for instance, at the conduct of a corporation or a large entity, there is a fair bit of discretion in how we are going to use our—how we are going to resolve the matter. Often a company is going to argue vociferously that they are a good company, that they have robust compliance programs, and that in this context they should not be prosecuted, or perhaps that they should have a deferred prosecution agreement or the like. Perverse incentives are certainly a factor and one of the issues we are going to look at, and we will look at it hard.

Similarly related to it, Mr. Khuzami said before, we want to empower and encourage lawyers, accountants, and all to do as good a job as they can, to be as robust as they can. And on the other side, when they do not do that, when they act criminally, we think we have to prosecute those gatekeepers and prosecute them aggressively. And I think that also sends a powerful message.

Senator KAUFMAN. Yes, it does.

Mr. Perkins.

Mr. PERKINS. Yes, thank you, Senator. I think you are exactly right when you described the threat tomorrow is going to be different. There is going to be something coming down the track next week that will not be anything like what we are looking at now. With my colleagues here at the table, as we have described, a great deal of effort and work is going to address the issue at hand right now, and example after example has been given.

I think the success in FERA and what it has done for the FBI in particular is that it has allowed us to begin to build our capacity

to look over that horizon. One of the issues, the mantra we push is we want to chase the threat, not the case. We want to see what is coming over the horizon. And until we have been able to establish the Intelligence Center, the Forensic Accounting Program, bringing on additional agents, we did not have that capacity to do that. We are gaining that capacity now. We are building that so that we can identify that threat, much as we are doing in a much simpler matter on the gulf coast. We are trying to be ahead of what the threat is. We are trying to be proactive and address those things before they come up.

Senator KAUFMAN. Thank you. And, listen, I want to thank the three of you for what you do, and the folks sitting in the row behind you and behind them and behind them and behind them. I mean, the people that we have, you know, fighting this fight is really quite impressive, and I think we are in a difficult war. But I am very pleased with the people we have on our side in the battle against people who are doing bad things.

The thing that bothers me, I have said repeatedly in the Congress that the two most important things we have as a country is democracy and free markets. They are just key to maintain the credibility of our free markets. If we lose that, talk about not passing on to our grandchildren being responsible. And one of the things of our free market is making sure that if people use the market in a bad way or something like that, they pay a penalty for it.

So it is really important. I mean, you are the police who make sure, you are the referees on the football field that make sure everybody is playing according to the rules. And that is really what we need. We had a period where I think we were not as concerned about that. We thought—I said a number of good people, smart people, said we do not need that anymore. But I think we have to have the confidence that our capital markets are fair, transparent. We have to make sure that capital formation—without capital formation, they will slow our growth. Widespread cheating and fraud of the sort that drove the speculative housing and derivatives securities bubbles are anathema—an anathema—to public confidence in the markets. In order to assure investors and the public that we have learned our lessons from the last disaster, we must have a full account of the criminality that has led us there.

This November, I will leave the Senate, and the task of oversight will fall to my colleagues. I encourage each of you—I do not think you really need my encouragement, but I am going to encourage you anyway—to keep up the hard work, keep digging in the offerings documents, e-mails, board minutes, to keep developing leads through whistleblowers, plea deals, and tip hotlines. I am confident you will, and I want to thank you and thank you for your service.

The record will stay open for additional information for a week. This hearing is adjourned.

[Whereupon, at 3:54 p.m., the Committee was adjourned.]

[Questions and answers and submissions follow:]

## QUESTIONS AND ANSWERS

### Questions from Senator Specter for Assistant Attorney General Lanny Breuer

1. Mr. Breuer, you note that from October 2009 through June 2010, 3,000 defendants have been sentenced to federal prison for financial fraud and that only slightly more than half of those defendants have been sentenced to jail for more than 12 months. **Since these are post-Booker sentences, can you tell us how many sentences were below the advisory sentencing guidelines and on average, how far below?**

**RESPONSE:**

The Department does not have or maintain statistics on all below-Guideline sentences. Based on sentencing data collected from the federal courts by the U.S. Sentencing Commission, of the 5,275 defendants sentenced for a "fraud" offense through the third quarter of FY 2010 (October 1, 2009, through June 30, 2010), 2,268 (about 43%) were sentenced to terms below the Guidelines' advisory range. *See U.S. Sentencing Commission Preliminary Quarterly Data Report*, U.S. Sentencing Commission, Sep. 3, 2010, at 8-9, available at [http://www.uscc.gov/sc\\_cases/USSC\\_2010\\_Quarter\\_Report\\_3rd.pdf](http://www.uscc.gov/sc_cases/USSC_2010_Quarter_Report_3rd.pdf). (The written testimony refers to those defendants sentenced for the slightly narrower category of "financial fraud," which includes offenses such as financial institution fraud, securities and commodities fraud, corporate fraud, and mortgage fraud.) Of these 2,268, 1,080 received a lower sentence as a result of reductions sought by the government, most often as a result of the defendant's substantial assistance. The remaining 1,188 received lower sentences because of departures or variances made by the sentencing judge. *See id.* at 9.

The Commission also reports that, for those fraud defendants who received below-Guidelines sentences after providing substantial assistance to the government, the average decrease from the Guidelines' minimum was 66.7%. *See id.* at 19. For those fraud defendants who received a below-Guidelines sentence pursuant to *Booker* and/or 18 U.S.C. § 3553, the median decrease from the Guidelines' minimum was 51.2%. *See id.* at 24.

2. Mr. Breuer, during the past four years, federal judges imposed prison sentences of one to four years on five defendants in the AIG fraud case that caused more than \$500 million in losses; 25 years on Ronald Treadwell for a Ponzi scheme involving a \$40 million loss; and 3 and 1/2 years on former Impath Inc.'s President Richard Adelson for a \$50 million securities fraud. The Department of Justice in a letter to the U.S. Sentencing Commission dated June 28, 2010 and signed by Jonathan Wroblewski, Director of the Criminal Division's Office of Policy and Legislation, noted these widely disparate sentences don't make sense, ignore federal sentencing guidelines, and are a sign of a potentially very big problem.
  - a. **If such disparate sentences in significant financial fraud cases go unchecked, do you agree that this will lead to disrespect for federal courts and sentencing uncertainty and that such could lead to more crimes?**



**RESPONSE:**

We are concerned about growing disparities in federal sentencing outcomes generally and in high-loss economic crimes in particular. In our consideration of federal sentencing policy, we begin from the principle that offenders who commit similar offenses and have similar criminal histories should be sentenced similarly. The growing uncertainty of sentencing outcomes may, over time, undermine the goal of deterrence.

- b. Given that the sentencing guidelines are now advisory after the Supreme Court's *Booker* decision and its progeny, what should be done to address this?**

**RESPONSE:**

The Dodd-Frank Wall Street Reform and Consumer Protection Act, which directs the Sentencing Commission to review and, if appropriate, amend the Sentencing Guidelines applicable in fraud offenses relating to financial institutions or federally-regulated mortgage loans, will provide important information as to the impact of the advisory guidelines in financial fraud cases.

Additionally, we have asked the Sentencing Commission to complete a comprehensive report on the state of federal sentencing that would include new ways of analyzing sentencing data to understand federal sentencing outcomes better, identify any unwarranted sentencing disparities, and determine whether the purposes of sentencing are being met in most cases. Since the Commission's *Final Report on the Impact of United States v. Booker on Federal Sentencing*, released in March 2006, the Commission's own data have revealed troubling sentencing trends emerging across the country. For example, certain districts are experiencing substantially higher departure and variance rates – and other districts substantially lower rates – than the national average.

More importantly, we have asked the Commission to lay out a way forward to address systemic concerns and ensure that the principles of sentencing reform – predictability, elimination of unwarranted disparity, and justice – are achieved. We look forward to the Commission's expert assessment and recommendations.

- 3. Mr. Breuer, you note in your written statement a number of investment fraud scheme prosecutions but include only sentences for two such cases. Can you tell us the sentences the others received?**

**RESPONSE:**

The written testimony cites to eight investment fraud prosecutions. Four of these defendants have been sentenced:

- Bernard Madoff received 150 years imprisonment (Case No. 09-CR-213, Southern District of New York);
- Frank Castaldi received 23 years imprisonment (Case No. 09-CR-59, Northern District of Illinois);
- Trevor Cook received 25 years imprisonment (Case No. 10-CR-75, District of Minnesota); and
- Matthew Pizzolato received 30 years imprisonment (Case No. 09-CR-378, Eastern District of Louisiana).

The defendants in three of the cases are awaiting sentencing:

- Nevin Shapiro will be sentenced on January 4, 2011 (Case No. 10-CR-471, District of New Jersey);
- Michael Goldberg will be sentenced on December 2, 2010 (Case No. 10-CR-192, District of Connecticut); and
- Corey Johnston is awaiting a sentencing hearing date (Case No. 10-CR-221, District of Minnesota).

One investment fraud case cited in the written testimony, *United States v. Allmendinger, et al.* (Case No. 10-CR-248, Eastern District of Virginia), is ongoing.

4. With regard to Operation Stolen Dreams, what sentences have been imposed? Are they within the Sentencing Guidelines or below?

**RESPONSE:**

As of June 2010, when Operation Stolen Dreams was announced, 1,517 defendants were charged with offenses related to mortgage fraud. Approximately 245 of these defendants have been sentenced as of June. We do not have the sentencing statistics for these cases.

5. Mr. Breuer, what were the sentences imposed in the Farkas prosecution? And for the two vice presidents convicted in the Integrity Bank fraud?

**RESPONSE:**

The prosecution against Lee Bentley Farkas is ongoing and, as such, no sentence has been imposed. Additionally, no sentencing date has yet been scheduled for Douglas Ballard or Joseph Foster, the two Integrity Bank vice presidents who pleaded guilty to fraud offenses in July 2010.

6. Were any individuals prosecuted in the Barclays Bank prosecution? And if not, why not?

**RESPONSE:**

In the case filed on August 16, 2010, against Barclays Bank PLC, no individuals, employees of the bank or officers of the bank were charged. *See United States v. Barclays Bank PLC*, Case No. 10-CR-218 (D.D.C.). Rather, the charges and deferred prosecution agreement filed in the case only related to Barclays itself. Decisions to charge individuals, in this and any other case, are always guided by the Principles of Federal Prosecution, detailed in the *U.S. Attorneys' Manual* § 9-27.000.

**Questions from Senator Specter for SEC Enforcement Director Robert Khuzami**

1. **Mr. Khuzami, in your written testimony you note several of the SEC's successful insider trading enforcement actions. You do so in a self-professed effort to "give [us] a more textured picture of the significant cases" the SEC has filed since you last appeared before us in December 2009. (Khuzami Stmt. at 5.) Why did you fail to mention the SEC's settled action against Pequot Capital Management and Arthur Samberg? Was that \$28 million settlement the largest SEC insider trading case ever?**

The SEC has filed many significant insider trading cases since I last testified before the Judiciary Committee in December 2009. Given that the Committee's September 22, 2010 hearing was focused on cases related to the financial crisis and subprime mortgage meltdown, my testimony included but a few actions from other areas of our enforcement program, including insider trading cases. That list was not intended to be exhaustive. Certainly, the SEC's settled action against Pequot Capital Management and Arthur Samberg is one of the many important insider trading cases that we have successfully pursued since I previously testified in December 2009.

The Commission's 1986 settlement of its insider trading action against Ivan Boesky, which included both disgorgement and a civil penalty totaling \$100 million, was the largest such settlement in SEC history. The SEC's case against Ivan Boesky successfully raised public awareness concerning insider trading in addition to the specific remedies obtained. As I indicated in my testimony, raising public awareness and enhancing the deterrent impact of securities law violations, including insider trading, remains one of the Division's programmatic priorities. We believe that our ongoing efforts in this area will enhance the integrity of our financial markets and enable us to send a consistently strong deterrent message.

2. **Mr. Khuzami, in your written testimony you note that the Enforcement Division is, "in the process of establishing a Whistleblower Office within our new Office of Market Intelligence." Recent press accounts indicate that the SEC provided Karen Kaiser and her husband a \$1 million bounty for tips that led to the successful filing and resolution of the Pequot Capital Management case. Was that the highest dollar figure the SEC ever paid as a bounty for a fruitful tip? Why do you neglect to mention it in your testimony? Will the SEC use its new Whistleblower Office to ensure that patriotic whistleblowers like Henry Markopolos, who identified the Madoff Ponzi scheme, are taken seriously?**

The \$1 million provided to Karen Kaiser in return for information that led to the successful filing and resolution of the Pequot Capital Management case was the largest bounty paid under the SEC's prior whistleblower program. The SEC's prior whistleblower program was focused on tips that led to the successful filing and resolution of insider trading cases. The new Whistleblower Program, established under the authority of the Dodd-Frank Wall Street and Reform Recovery Act, has a broader scope

that extends to all securities law violations and will, we hope, be of great value to the Division as we seek to identify and investigate securities fraud. Given that the focus of my testimony was on the new Whistleblower Office and Program, I did not describe any payments under the prior program. While the SEC's prior whistleblower program was useful, we believe that the new Whistleblower Program, in conjunction with our streamlined system for managing all tips, complaints and referrals through the Office of Market Intelligence, will further enhance our ability to protect investors.

3. **Mr. Khuzami, I was pleased to read of all the coordinated efforts between the SEC and the Department of Justice. You even have an embedded FBI Special Agent working in the Office of Market Intelligence pursuant to a Memorandum of Understanding with the Bureau. Can you tell us whether that nascent relationship has borne fruit in the form of solid investigative leads or securities prosecutions?**

Since the FBI Special Agent has been embedded in our Office of Market Intelligence ("OMI"), the relationship has improved information-sharing between the Commission and the FBI. OMI reviews hundreds of tips, complaints, and referrals from the general public each week. The embedded Special Agent has enhanced our ability to review and evaluate those tips, complaints, and referrals, and to ensure that those with a criminal component are forwarded to the appropriate law enforcement agency in a timely manner. The resulting improved coordination between the SEC and the FBI has enabled both agencies to respond more quickly to referrals and to better direct resources to time-sensitive referrals. In addition, OMI and the embedded Special Agent have been able to link several ongoing FBI and SEC investigations. By collectively analyzing data received by the SEC from the general public, the SEC and the FBI have been able to more effectively target emerging securities fraud trends, particularly in the area of microcap fraud.

4. **Mr. Khuzami, a district court in Oregon dismissed the indictment in *United States v. Stringer*, 408 F.Supp.2d 1083 (D.Or. 2006), holding that the United States had violated the defendant's due process rights by coordinating its criminal prosecution with an SEC investigation. I thought the decision was wrong at the time and it was ultimately overturned on appeal. See *United States v. Stringer*, 535 F.3d 929 (9<sup>th</sup> Cir. 2008). Is there any foment against parallel or coordinated proceedings between the Department of Justice and the Securities and Exchange Commission ongoing in the federal courts? Did the Dodd-Frank bill include text to alleviate concerns that parallel proceedings would be challenged in district courts?**

The initial Stringer decision, which as you note was reversed on appeal, addressed perceived abuses of the constitutional rights of criminal defendants, including the right against self-incrimination, under circumstances where the criminal investigation was conducted "in the shadows" of the SEC's civil enforcement investigation, where such rights do not exist. SEC and DOJ personnel are well-trained to avoid undermining the constitutional rights of criminal targets. In addition, the small number of cases where

courts have found abuses of this nature in parallel proceedings, when compared to the large number of parallel criminal-civil proceedings, is strong proof that this is not a systemic problem and that the SEC, as well as criminal authorities, understand how to conduct investigations within the bounds of the law.

The SEC has a long history of successful coordination with the Department of Justice in parallel civil and criminal investigations. One of the ways we ensure success is by having strong information-sharing mechanisms in place. The Financial Fraud Enforcement Task Force ("FFETF") has further enhanced information-sharing in parallel investigations and has strengthened channels of communication between the SEC and the Department of Justice, as well as other federal law enforcement agencies. Although we benefit from enhanced coordination, our staff is mindful of observing appropriate limitations on information-sharing.

Section 929K of the Dodd-Frank Wall Street Reform and Recovery Act further enhances the Commission's ability to share information that may be deemed privileged with other law enforcement authorities without compromising the confidential and privileged nature of the information. We believe that this provision will be a particularly valuable tool for Enforcement. While we remain subject to limitations on sharing grand jury information, we are hopeful that Dodd-Frank section 929K may encourage the Department of Justice to provide us with internal memoranda and other privileged information that does not consist of grand jury material. Indeed, information-sharing is critical to our ability to leverage our resources and avoid duplication of efforts as we pursue parallel investigations. Sharing work product, financial intelligence information, case leads, and information from informants and whistleblowers among regulatory and law enforcement agencies will, we believe, greatly advance parallel investigations.



SUBMISSIONS FOR THE RECORD  
**Department of Justice**

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STATEMENT OF

LANNY BREUER  
ASSISTANT ATTORNEY GENERAL  
CRIMINAL DIVISION

BEFORE THE

COMMITTEE ON JUDICIARY  
UNITED STATES SENATE

ENTITLED

"INVESTIGATING AND PROSECUTING FINANCIAL FRAUD AFTER THE FRAUD  
ENFORCEMENT AND RECOVERY ACT"

PRESENTED

SEPTEMBER 22, 2010

**Statement of Lanny A. Breuer  
Assistant Attorney General  
Criminal Division  
United States Department of Justice**

**Before the United States Senate  
Committee on the Judiciary**

**Hearing Entitled  
“Investigating and Prosecuting Financial Fraud  
After the Fraud Enforcement and Recovery Act”**

**September 22, 2010**

**I. INTRODUCTION**

Good afternoon, Mr. Chairman, Senator Sessions, and distinguished Members of the Committee. Thank you for inviting me to speak with you today about the Department of Justice’s efforts in financial fraud enforcement.

I am honored to appear before you on behalf of the Department, where I am privileged to lead the Criminal Division’s more than 500 dedicated lawyers. Together with our partners in the Federal Bureau of Investigation, the Securities and Exchange Commission, the Commodity Futures Trading Commission, and other agencies, the Department of Justice is absolutely committed to the investigation and prosecution of financial fraud, and we have been investigating and prosecuting financial fraud aggressively since the passage of FERA sixteen months ago. I am proud to work day-in and day-out with our many law enforcement partners, including with Robert Khuzami from the Securities and Exchange Commission and Kevin Perkins from the Federal Bureau of Investigation, who are both here with me today.

The Department of Justice is busy investigating and prosecuting financial fraud in all its forms, including investment fraud schemes, mortgage-related fraud, securities fraud, insider



trading, money laundering, and other crimes. Since the passage of FERA, in May 2009, we have re-evaluated the manner in which we investigate financial fraud, the types of investigative techniques we employ, and the nature of our relationships with our law enforcement and regulatory partners. The Department's participation in the Financial Fraud Enforcement Task Force has greatly facilitated this review, and has allowed for improved inter-agency cooperation with the SEC, the FBI, the U.S. Commodity Futures Trading Commission (CFTC), and other agencies. The Task Force has also improved our ability to ferret out financial crimes using aggressive investigative techniques. Since I became Assistant Attorney General, in April 2009, we have prosecuted and incarcerated thousands of financial criminals, and we have sought stiff sentences for their crimes. For example, between October 2009 and June 2010, nearly 3,000 defendants were sentenced to prison for financial fraud, and over 1,600 of these defendants have received sentences of more than 12 months. We are committed to continuing this fight in the years to come.

## **II. FINANCIAL FRAUD ENFORCEMENT TASK FORCE**

The Financial Fraud Enforcement Task Force, which was created in November 2009 to root out and prosecute financial fraud, has been integral to the Department's renewed effort against financial fraud. The Task Force has brought together prosecutors, investigators, and others from across the law enforcement and regulatory spectrum, including the Departments of Justice, Treasury, Housing and Urban Development, and Homeland Security, as well as the SEC, the CFTC, and many other federal, state, and local agencies. We have conducted parallel investigations and charged defendants in criminal and other proceedings.

The benefits of this inter-agency cooperation have been real, both in terms of prosecution

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results and the development of important relationships across law enforcement:

- Task Force members meet on a regular basis – both informally and during regional summits – to discuss investigations, emerging fraud schemes in particular communities, and best practices to attack ongoing criminality;

- Task Force members regularly discuss new innovations, new training, and new techniques to ensure the continued development of tactics to most effectively investigate frauds, whether they be related to whistleblower provisions, parallel proceedings, or data sharing; and

- Task Force members have also trained government officials to detect and prevent fraud before it happens. For example, to date, Task Force members have trained more than 50,000 officials and nearly 4,000 agents and auditors on issues relating to the application for and distribution of Recovery Act funds – all in an effort to ensure that these taxpayer funds are used for the intended purpose.

### **III. CRIMINAL PROSECUTIONS**

The primary work of the Department – and of the U.S. Attorneys' Offices and the Fraud Section of the Criminal Division in particular – is to ensure that we vigorously prosecute fraud and that those who commit financial crimes go to prison. Our investigations have been aimed at a wide range of fraudulent activity, including fraudulent investment schemes, securities fraud, bank fraud, mortgage fraud, procurement fraud, insider trading, and also disaster fraud.

#### **A. Investment Fraud Schemes**

Perhaps the most pervasive and pernicious frauds consistently committed around the country are investment fraud schemes, which take many forms, including what are classically referred to as Ponzi schemes. These schemes often prey upon vulnerable, individual investors,

and can be devastating to the families that invest in them. We are all aware of the massive scheme perpetrated by Bernard Madoff involving billions of dollars in losses, but Mr. Madoff's scheme was just one of many investment fraud schemes that have snared unsuspecting investors across the country, in places as diverse as Minnesota, New Jersey, Connecticut, Texas, Illinois, California, and elsewhere. We have investigated and uncovered countless numbers of these schemes and have succeeded in bringing many of their perpetrators to justice.

For example, on September 15, 2010, Nevin Shapiro, the former CEO of Capital Investments USA, Inc., pleaded guilty in Newark, New Jersey to fraudulently soliciting funds for a non-existent grocery distribution business. Mr. Shapiro's \$880 million investment fraud scheme resulted in between \$50 million and \$100 million in losses to investors. On the same day, Frank Castaldi, an accountant and businessman, was sentenced in Chicago to 23 years in prison for bilking hundreds of investors – many of them elderly Italian immigrants – out of more than \$30 million.

On September 13, 2010, a defendant named Michael Goldberg pleaded guilty in Bridgeport, Connecticut to three counts of wire fraud relating to his operation of a \$100 million investment fraud scheme that cheated investors out of more than \$30 million over an approximately 12-year period. Mr. Goldberg solicited more than 350 individuals to invest money in "diamond contracts" and to purchase distressed assets from JP Morgan Chase Bank.

On September 9, 2010, three principals in a group of businesses that acquired and marketed life settlements to investors were arrested and charged in an 18-count indictment for their alleged roles in a \$100 million fraud scheme with more than 800 victims across the United States and Canada.

On September 2, 2010, a defendant named Corey Johnston pleaded guilty in Minneapolis, Minnesota to operating an investment fraud scheme involving overselling loan participation in large commercial and personal loans, resulting in a fraud on at least 17 lenders of approximately \$80 million.

On August 24, 2010, a federal judge in Minnesota sentenced Trevor Cook, who orchestrated a Ponzi scheme by selling \$158 million in bogus foreign currency trading investments, to a term of 25 years in prison.

On July 22, 2010, in Louisiana, Matthew Pizzolato received a 30-year prison term for a \$15 million scheme that targeted retiree investors with the promise of no risk and high rates of return.

These are just a handful of examples of the many financial fraud prosecutions that we have recently brought. Our renewed partnerships and enhanced enforcement efforts have strengthened our ability to bring these cases, and we continue to pursue them aggressively.

#### **B. Operation Stolen Dreams**

The Financial Fraud Enforcement Task Force has also been active with respect to education, public outreach, and the investigation and prosecution of those involved in mortgage fraud – a crime that FERA specifically sought to target. These efforts culminated this past June with the successful completion of the largest mortgage-fraud sweep in the Department's history, referred to as Operation Stolen Dreams. Operation Stolen Dreams resulted in the prosecution of a broad range of schemes, including mortgage origination fraud, builder bailouts, and foreclosure rescue scams that victimized countless homeowners. The operation resulted in more than 525 arrests and involved 1,517 defendants in criminal mortgage fraud schemes, with estimated losses

of over \$3 billion. Of those arrested, 391 have already been convicted and nearly 250 have been sentenced. On the civil side, Operation “Stolen Dreams” has resulted in 191 enforcement actions involving another 395 defendants, and the recovery of almost \$200 million.

Through Operation Stolen Dreams, we saw that mortgage fraud manifests itself in all shapes and sizes – from schemes that ensnare the elderly to fraudsters who target immigrant communities. We saw mortgage fraud schemes that resulted in dozens of foreclosures and millions of dollars in losses, as well as fraudsters who have bankrupted entire companies and national lenders who were not playing by the rules. For example:

- In Miami, we arrested two defendants who allegedly targeted the Haitian-American community, often claiming they would assist their victims with immigration and housing issues, but instead using the victims’ personal information to produce false documents to obtain mortgage loans.
- In Chico, California, a prominent home builder, caught with a significant amount of unsold new homes as the housing market cooled, allegedly used straw buyers to sell his houses at inflated prices with undisclosed sales rebates. This scheme inflated prices on other homes in the area, creating artificially high comparable sales and affecting the overall new-home market. To date, 38 of the homes have fallen into foreclosure, and ten more have been the subject of short sales.
- In Detroit, we charged several individuals who were part of a “ghost loans” scheme involving more than 70 people and over \$100 million. The conspirators posed as mortgage brokers, appraisers, real estate agents, and title agents, and used straw buyers to obtain approximately 500 mortgages on 180 properties.

**C. Farkas/Colonial**

Our efforts against criminals involved in mortgage fraud have also targeted executives. In June of this year, for example, the Department obtained an indictment in the Eastern District of Virginia against Lee Bentley Farkas, the former chairman of Taylor, Bean & Whitaker Mortgage Corporation. TBW, as it is called, was once one of the largest private mortgage companies in the United States. Mr. Farkas was charged with perpetrating a massive fraud scheme that resulted in losses exceeding \$1.9 billion and that contributed to the failure not just of TBW, but also of Colonial Bank, one of the 50 largest banks in the United States before its collapse in 2009.

The allegations against Mr. Farkas demonstrate that fraud in the pursuit of profit can destroy the financial institutions upon which Americans rely. The Farkas prosecution resulted from the partnership among various Task Force members, including the Federal Deposit Insurance Corporation's Office of Inspector General, the Special Inspector General for the Troubled Asset Relief Program, the FBI, the Department of Housing and Urban Development's Office of Inspector General, the Internal Revenue Service, and Treasury's Financial Crimes Enforcement Network.

**D. Integrity Bank**

The Task Force has been aggressive with respect to other bank frauds as well. In Atlanta this past July, for example, two vice presidents of Integrity Bank, a \$1 billion financial institution that failed in 2008, pleaded guilty to fraud. Our prosecution resulted in Douglas Ballard, Integrity's former executive vice president in charge of lending, admitting to conspiring with a major bank customer – another co-defendant, Guy Mitchell – to provide bogus loans in

exchange for cash bribes. Ballard's abuse of his position caused Integrity Bank to distribute almost \$20 million in loan proceeds for Mitchell's personal use, including the purchase of a private island in the Bahamas. At the same time, the bank's former vice president in charge of risk management, Joseph Foster, pleaded guilty to insider trading of Integrity stock based on non-public information that Integrity Bank was facing a growing risk that Mitchell would default on his \$80 million in outstanding loans.

\* \* \* \* \*

The Colonial and Integrity Bank investigations are just two examples of the Task Force's and the Criminal Division's aggressive efforts to hold bank executives to account. We will continue to prosecute individuals and believe that sending white-collar criminals to prison sends a strong message to would-be fraudsters that if they commit fraud, we will find them, we will prosecute them, and we will incarcerate them.

**E. Financial Institutions**

An equally important focus of the Department's enforcement strategy is on corporations that permit, or participate in, fraudulent conduct. Just as prosecutions of high-ranking officers put executives everywhere on notice that they are no more above the law than their investors, corporate prosecutions serve to put companies' boards of directors and controlling officers on notice that corporations will be held accountable for their executives' and employees' misdeeds.

In addition, prosecutions of corporations is one effective way to reform a corporate culture so that the entity as a whole complies with legal requirements. Among other things, these prosecutions and settlements send a message to similarly-situated businesses that they, too, must design and implement compliance programs in order to prevent and detect corporate

wrongdoing before it happens.

We have prosecuted several large financial institutions over the last year. For example, just last month, Barclays Bank agreed to forfeit \$298 million in connection with violations of the International Emergency Economic Powers Act and the Trading with the Enemy Act. From the mid-1990s until September 2006, Barclays moved hundreds of millions of dollars through U.S. financial institutions on behalf of banks from sanctioned countries. As part of the agreement, Barclays admitted its acts and agreed to implement stringent compliance measures. The forfeited amount is approximately 29 times the amount of profit that Barclays earned on the illegal transactions. In similar cases against Credit Suisse and Lloyds TSB Bank, the Department has secured approximately \$886 million in forfeited funds.

**F. Disaster Fraud**

The Department's efforts with respect to disaster-related fraud have also been significant. We have learned through experience that fraud schemes follow the money in good times and bad. Since Hurricane Katrina hit five years ago, the Department has been hard at work to protect the monies that were distributed to those affected and those who have sought to rebuild after the storm.

To date, the National Center for Disaster Fraud, which was established in the wake of Katrina in Baton Rouge, Louisiana, has received and screened more than 39,000 complaints of disaster fraud and referred more than 25,000 of those to law enforcement for investigation. Our efforts have helped victims of fraud related to Hurricanes Katrina, Rita, Wilma, Ike and Gustav, as well as to floods in Iowa, North Dakota, and Minnesota, and wildfires in California. The Department of Justice has brought charges against more than 1,300 defendants in 47 judicial



districts charging various fraud schemes relating to Katrina, Rita, and Wilma alone, and many of these criminals have been sent to prison.

Today we face a different challenge in the same region. Last month, the Gulf Coast Claims Facility, which is run by Kenneth Feinberg and administers the BP compensation fund, opened for business. This private fund is dedicated to addressing the Deepwater Horizon oil spill disaster. Using the model employed with respect to other disaster-related frauds, the Department of Justice and its agency partners will protect against any diversion of these funds from their intended recipients. We stand ready to investigate and prosecute vigorously fraudulent activity related to the Gulf Coast disaster. We will not tolerate fraud that exploits the disaster to the detriment of the residents and businesses along the Gulf Coast, and we are placing a high priority on the prompt investigation and prosecution of all types of oil-spill related fraud schemes.

#### **IV. CONCLUSION**

Financial fraud in its various forms has devastating effects on our citizens, and it deserves the full attention of the law enforcement and regulatory communities. The financial crisis and the passage of FERA required the Department to rethink its approach to financial fraud, by adding resources and refocusing our investigations and our investigative techniques. Through the increased resources afforded to the Department and our partnerships on the Financial Fraud Enforcement Task Force, we have made this fight a priority, and we will continue to do so. I can assure you that we will examine all allegations of fraud closely, follow the facts wherever they lead, and seek appropriate and tough punishments for individuals and corporations alike.

Thank you for the opportunity to provide the Committee with this brief overview of the Department's efforts to address financial fraud, and I look forward to working with the Committee further. I would be happy to answer any questions.

Testimony Concerning Investigating and Prosecuting Fraud after the Fraud Enforcement  
and Recovery Act

by

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Before the United States Senate  
Committee on the Judiciary

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**I. Introduction**

Chairman Leahy, Ranking Member Sessions, Senator Kaufman, and Members of the Committee, thank you for the opportunity to testify today on behalf of the Securities and Exchange Commission (SEC). I am pleased to be here to testify before you alongside my colleagues from the U.S. Department of Justice (DOJ) and the Federal Bureau of Investigation (FBI).

When I first testified before the Committee in December of last year, we were emerging from an economic crisis that threatened our financial system and tested the public's confidence in the institutions charged with enforcing the laws governing the financial system. That December 2009 hearing was titled "Mortgage Fraud, Securities Fraud and the Financial Meltdown: Prosecuting Those Responsible." Although there is much more work to be done, during the nine months since I last testified, we have achieved significant results in our efforts to enforce the securities laws, particularly in areas relating to the recent financial crisis.

In the last nine months, we brought enforcement actions against companies and individuals that:

- Concealed from investors the risks and exposures from subprime mortgage-based securities;
- Concealed business strategies that heightened the risks relating to mortgage-based securities;
- Failed to disclose to investors the involvement of adverse parties in structuring complex mortgage-based securities;
- Concealed that investment funds contained high-risk mortgage-based securities; and
- Marketed high-risk mortgage-based securities while secretly divesting themselves of their own holdings.

We obtained hundreds of millions of dollars in penalties; the disgorgement of additional hundreds of millions of dollars in unlawful profits; barred wrongdoers from engaging in improper business practices in the future; required companies to institute internal controls to prevent future harm from such practices; and required other remedies that send a strong deterrent message. We accomplished these results while implementing the most significant reorganization of the Division of Enforcement in decades.

We also are embracing a range of initiatives designed to increase our ability to identify hidden or emerging threats to the markets, and to stop that misconduct early in order to minimize harm to investors and to the public's confidence in our markets.

Across our Division, whether in the Regional Offices or in Washington, we are launching risk-based investigative initiatives, tapping into the expertise of our colleagues in the Office of Compliance, Inspections and Examinations (“OCIE”) and other SEC offices and divisions, hiring talent with particularized market expertise, and reaching out to academia, law enforcement, and the regulated community to collect data on where misconduct is occurring and ideas on how to prevent it. In short, we are being smarter and more strategic, and as a result more successful.

One example of this approach is our new national specialized units, which were staffed and fully launched in May 2010. These units have focused on the key areas of Structured and New Products, Market Abuse, Municipal Securities and Public Pensions, Asset Management, and violations of the Foreign Corrupt Practices Act. The Units are hiring industry experts to work directly with our teams of experienced attorneys and accountants to ensure that we stay on the cutting edge of industry trends. And, we have been using these units as a platform to enhance training for our investigative staff. By refining our expertise in financial market structural issues, suspicious trading techniques, novel and complex structured products, indicators of suspicious hedge fund performance, and other investigative initiatives, we are enhancing our already strong knowledge base for the benefit of investors.

In addition to the work of the specialized units, our completion of other organizational reforms – such as streamlining our management structure and obtaining delegated authority from the Commission to allow us to swiftly obtain formal orders and related subpoena power – has enabled our staff of attorneys and accountants to focus on what they do best: investigating and stopping securities fraud. Our staff has responded

to these challenging times by concentrating on making smart investigative decisions, obtaining key evidence, tracing investor funds and aggressively pursuing wrongdoers.

To augment our staff's efforts, we continue to build on our already strong working relationships with our law enforcement partners, particularly the Department of Justice and the FBI, as well as the banking regulators, other federal and state agencies, and our other partners around the world. In particular, our work as co-chairs of the Securities and Commodities Fraud Working Group of the Financial Fraud Enforcement Task Force facilitates effective communication with our law enforcement partners nationwide engaged in parallel investigations alongside of our own.

In addition, we are rapidly integrating the new authority and responsibility granted to us under the Dodd-Frank Wall Street Recovery and Reform Act of 2010 ("Dodd-Frank Act"). When I last testified in front of you in December, I discussed what were then our "legislative initiatives": to obtain congressional authority to institute a whistleblower program, to obtain nationwide service of process, to obtain the ability to seek civil penalties in cease-and-desist proceedings, to obtain the ability to seek penalties against aiders and abettors under the Investment Advisers Act of 1940, and the ability to charge aiding and abetting violations under the Securities Act of 1933 and the Investment Company Act of 1940, among other initiatives. The Dodd-Frank Act included many of those legislative initiatives, for which we are very grateful, and we must now demonstrate our ability to deliver on those requests.

As I will describe in more detail, as provided by the Dodd-Frank Act, we are in the process of establishing a Whistleblower Office within our new Office of Market Intelligence. In the last nine months, the Office of Market Intelligence has successfully

launched a system dedicated to triaging and assigning all tips, complaints, and referrals (“TCRs”) received by the Division so that the right staff with the right skills and experience opens the right investigation in a timely and effective way. Information received through our new Whistleblower Program will enhance the ability of that Office to provide staff with a broader set of relevant evidence at the initial stages of an investigation.

I would like to use today’s testimony to give you a more textured picture of the significant cases that we have filed since I last testified before you; the extent of our coordination with law enforcement partners; the impact of our internal management streamlining and investigative process reforms; the new fraud-detection and risk-based initiatives instituted by our staff throughout the Division, including within the national specialized units; and our efforts to incorporate the new authority and responsibilities given to us under the Dodd-Frank Act.

## **II. Recent Significant Cases**

At the same time that we that we undertook the largest reorganization of the Division in recent history, we maintained a high level of enforcement activity. Although our efforts are ongoing, so far in fiscal year 2010, the Enforcement Division has:

- Filed 634 enforcement actions;
- Obtained orders requiring disgorgement of \$1.53 billion in ill-gotten gains;
- Obtained orders requiring payment of penalties of \$968 million;

- Obtained 45 emergency temporary restraining orders to halt ongoing misconduct and prevent imminent investor harm;
- Obtained 56 asset freezes to preserve funds for the benefit of investors; and
- Distributed to injured investors nearly \$2.0 billion from 42 separate Fair Funds.

Statistics alone, however, cannot capture the breadth and complexity of the high-impact cases that we have filed in connection with the financial crisis. We have filed cases alleging accounting and disclosure violations by subprime lenders; fraud by companies and individuals involved in the bundling and marketing of mortgage-based securities; conflicts of interest by a collateral manager who managed multiple collateralized debt obligations (“CDOs”); misrepresentation of complex mortgage-based securities as appropriate for retail investors seeking safe financial products; fraud in connection with synthetic CDO marketing materials; and misleading disclosures to fund investors concerning fund exposure to subprime investments. In particular, since I last testified in December, we have filed the following actions involving mortgage-related securities and mortgage-related products linked to the financial crisis:

- On April 15, we filed charges against Goldman Sachs & Co. and one of its employees, Fabrice Tourre, alleging fraud in connection with the marketing of a synthetic CDO, in which Goldman represented that the portfolio of securities underlying the CDO had been selected by a neutral, objective third party when, in reality, a hedge fund investor at whose request the CDO had been structured and

whose interests were directly adverse to CDO investors, heavily influenced the portfolio selection. The Goldman marketing materials failed to disclose the hedge fund's role in the transaction, its adverse economic interests, or its role in the portfolio selection. On July 20, 2010, the court entered a consent judgment in which Goldman agreed to pay \$550 million to settle the Commission's charges. Of the \$550 million paid by Goldman in the settlement, \$250 million was returned to harmed investors through a Fair Fund distribution and \$300 million was paid to the U.S. Treasury. As part of the settlement, Goldman expressly acknowledged that its marketing materials for the subprime product contained incomplete information, and agreed to tighten internal controls and assess the roles and responsibilities of Goldman personnel to ensure that disclosures in future offerings of mortgage-based securities are full and accurate. The SEC's litigation continues against Goldman employee Fabrice Tourre.

- On June 21, 2010, we charged investment adviser ICP Asset Management LLC and its founder, owner and, president, Thomas Priore, alleging conflicts of interest and fraud related to its simultaneous management of multiple CDOs, managed accounts, and an affiliated hedge fund as they came under pricing and liquidity pressures in 2007. Our case also alleges that ICP and Priore caused the CDOs to make numerous prohibited investments without obtaining necessary approvals, which were later misrepresented to the trustee of the CDOs and to investors. We allege that the prices of many of these investments were intentionally inflated to allow ICP to collect millions of dollars in advisory fees from the CDOs, and that



ICP and Priore executed undisclosed cash transfers from a hedge fund they managed in order to allow another ICP client to meet the margin calls of one of its creditors. Our litigation against ICP and Priore is ongoing.

- On June 16, 2010, we charged Lee B. Farkas, the former chairman of what was once the nation's largest non-depository mortgage lender Taylor, Bean & Whitaker ("TBW"), alleging that he orchestrated a large-scale securities fraud scheme and then attempting to defraud the U.S. Treasury's Troubled Asset Relief Program ("TARP") to cover up the scheme. Our Complaint alleges that Farkas, through TBW, sold more than \$1.5 billion worth of fabricated or impaired mortgage loans and securities to Colonial Bank. Those loans and securities were falsely reported to the investing public as high-quality, liquid assets. We allege that Farkas also was responsible for a bogus equity investment that caused Colonial Bank to misrepresent that it had satisfied a prerequisite to qualify for TARP funds. Fortunately, the Treasury Department never awarded Colonial Bank any TARP funds. This case was the product of extensive cooperation with DOJ, FBI, SIGTARP, and other law enforcement partners within the Financial Fraud Enforcement Task Force. Our case is proceeding, and DOJ is pursuing a parallel criminal action against Farkas.
- On July 29, 2010, we filed an action alleging that Citigroup made misleading statements in earnings calls and public filings between July and November 2007 about the extent of its holdings of assets backed by subprime mortgages. We

alleged that throughout this period, Citigroup represented that the subprime exposure of its investment banking unit was \$13 billion or less, when in fact, at all times during that period, the bank's subprime exposure was over \$50 billion. To settle the action, Citigroup agreed to pay a \$75 million penalty, which the proposed settlement would distribute to harmed investors. The SEC also instituted administrative proceedings against two former Citigroup executives, including the company's former Chief Financial Officer, for their roles in causing Citigroup to make certain of the misleading statements. To settle the administrative proceedings, the executives each were required to make monetary payments to the U.S. Treasury. The proposed settlement with Citigroup remains subject to final court approval.

- On September 2, 2010, we filed settled charges against a credit rating agency, LACE Financial Corp., for alleged misstatements in connection with its application to become registered with the Commission as a Nationally Recognized Statistical Rating Organizations ("NRSRO"). We alleged that LACE materially misstated the amount of revenue it received from its largest customer during 2007. This alleged misstatement was significant because LACE had applied for an exemption to a conflict of interest provision that otherwise would have been triggered by the amount of revenue it received from that customer. In addition, SEC charged LACE's founder and majority owner for his alleged role in LACE's conduct, as well as for his alleged participation in determining a credit rating for an entity whose stock he owned, and for failing to disclose in LACE's

registration application that it performed an extra layer of review on the credit ratings of issuers whose securities made up the pools for asset-backed securities managed by LACE's largest customer.

- On April 7, 2010, we announced administrative proceedings against Morgan Keegan & Co, Morgan Asset Management, and two employees, including a portfolio manager, accused of fraudulently overstating the value of securities backed by subprime mortgages. Our action alleges that Morgan Keegan failed to employ reasonable procedures to internally price the portfolio securities in five funds managed by Morgan Asset, and consequently did not calculate accurate "net asset values" ("NAVs") for the funds. We allege that Morgan Keegan recklessly published these inaccurate daily NAVs, and sold shares to investors based on the inflated prices.
- On February 4, 2010, we filed a settled action charging Boston-based State Street Bank and Trust Company with misleading investors about their exposure to subprime investments while selectively disclosing more complete information only to certain favored investors during the 2007 subprime mortgage crisis. To settle our action, State Street agreed to pay over \$300 million into a Fair Fund for the benefit of injured investors.
- On August 31, 2010, we cautioned Moody's Investor Services and other NRSROs (more commonly known as credit rating agencies), through a Report of

Investigation under Section 21(a) of the Securities Exchange Act of 1934. This Report arose from the investigation of Moody's Investor Service's European credit rating committee's conduct in connection with an error in their ratings of certain constant proportion debt obligation ("CPDO") notes during the financial meltdown. As a result of significant uncertainty regarding a jurisdictional nexus to the United States in this matter, the Commission declined to pursue a fraud enforcement action against Moody's. The Commission's Report, however, warned that the conduct of Moody's European credit rating committee was contrary to the methodologies described in Moody's NRSRO application submitted to, and later approved by, the Commission. The Report cautioned Moody's and other NRSROs that deceptive conduct in connection with the issuance of credit ratings may violate the antifraud provisions of the federal securities laws and that under the new provisions of the Dodd-Frank Act they are required to establish, maintain, and enforce effective internal controls over their procedures and methodologies for determining credit ratings.

In addition to these significant cases arising out of the financial crisis, we have continued to bring cases in many other important areas including:

- ***Insider Trading.*** On August 20, 2010, we obtained an emergency court order freezing the assets in the U.S. brokerage accounts of two Spanish nationals charged with insider trading in call options of Potash Corp. just prior to an August 17, 2010 public announcement by Potash that it had received and

rejected an unsolicited proposal from BHP Billiton Plc to acquire Potash's stock for \$130 per share. As a result of the rapid response of our staff, we were able to file our emergency action successfully within 48 hours after the suspicious trading.

- On September 1, 2010, we filed charges against James W. Self, Jr., an Executive Director of Business Development at a pharmaceutical company located in New Jersey, and Stephen R. Goldfield, a former hedge fund manager, for engaging in unlawful insider trading in advance of the April 23, 2007 announcement that AstraZeneca would acquire MedImmune, Inc. (MEDI). The Commission's complaint alleged that Self tipped Goldfield, a friend and former business school classmate, with material nonpublic information regarding the MEDI acquisition and that Goldfield unlawfully purchased 17,000 MEDI call options and 255,000 shares of MEDI stock while in possession of the material nonpublic information provided to him by Self. Goldfield realized actual profits of approximately \$14 million from his alleged unlawful trading. Self and Goldfield agreed to settle the case by paying penalties and disgorgement, respectively.
- On March 25, 2010, we charged Igor Poteroba, an investment banker at a global financial institution, Aleksey Koval, a securities industry professional, and Alexander Vorobiev, a third person with whom they were acquainted, in connection with an alleged scheme to misappropriate confidential information

about at least eleven impending acquisitions, tender offers or other business transactions. We allege that in advance of each transaction, Poteroba tipped his co-schemers with material nonpublic information about the transactions using coded email messages that, among other things, referred to the securities as “frequent flier miles” or “potatoes.”

- In addition, in the Galleon and Cutillo insider trading cases, we charged more than a dozen hedge fund managers, lawyers, and investment professionals in two overlapping serial insider trading rings that collectively constituted one of the largest insider trading cases in Commission history. In the parallel criminal prosecutions, eleven individuals have already pled guilty and nine additional individuals have been indicted.
- **Offering Fraud.** On September 2, 2010, we charged Sandra Venetis, a New Jersey-based investment adviser, and three of her firms with operating a multi-million dollar offering fraud involving the sale of phony promissory notes to investors, many of whom were retired or unsophisticated in investments. We alleged that Sandra Venetis falsely told investors that the promissory notes were guaranteed by the Federal Deposit Insurance Corporation and would earn interest of approximately 6 to 11 percent per year that would be tax-free due to a loophole in the tax code. She also told investors that she would use their money to fund loans to doctors that would be backed by Medicare reimbursement payments to those doctors. Instead of making investments, we

alleged that Venetis looted investor funds to pay business debts and personal expenses. To settle the charges, Venetis and the entities agreed to consent to a court order freezing their assets and requiring monetary payments, including financial penalties. Venetis also agreed to an SEC administrative action barring her from future association with any investment adviser or broker-dealer. The U.S. Attorney's Office for the District of New Jersey has filed a parallel criminal action in this matter.

- In June 2010, we obtained an emergency asset freeze against two Canadian nationals we charged with fraudulently touting penny stocks through, among other venues, social media websites such as Facebook and Twitter. The method of communication – using social media websites and text messages – was a twist on traditional fraudulent conduct and is an illustration of our responsiveness to developing trends.
- ***Municipal Securities Fraud.*** On August 18, 2010, we charged the State of New Jersey with violations of the securities laws in connection with its offer and sale of over \$26 billion in municipal bonds from August 2001 through April 2007. We alleged that, in 79 municipal bond offerings, the State misrepresented and failed to disclose material information regarding its underfunding of the State's two largest pension plans, the Teachers' Pension and Annuity Fund ("TPAF") and the Public Employees' Retirement System ("PERS"). More specifically, we alleged that the State did not adequately

disclose that it was under funding TPAF and PERS, the reason it was under-funding TPAF and PERS, or the potential effects of the under-funding.

- ***Pension Fund Fraud.*** On April 15, 2010, in a pension fund pay-to-play case, we filed an action against a private investment firm, Quadrangle Group LLC, and one of its affiliated entities, charging them with participating in a widespread kickback scheme to obtain investments from New York's largest pension fund. To settle the charges, Quadrangle agreed to pay a \$5 million penalty and consented to a permanent injunction barring it against future violations of the Securities Act of 1933. This investigation was coordinated with the Office of the New York State Attorney General.
- ***Accounting and Financial Fraud.*** In the area of accounting and financial fraud, auditor Ernst & Young LLP consented to make a payment of \$8.5 million -- one of the largest payments ever by an accounting firm -- to settle charges that it facilitated a fraudulent scheme carried out by its audit client, Bally Total Fitness Holding Corporation. In addition, six current and former partners were held accountable for their conduct in the audit of Bally, including abdicating their responsibility to function as gatekeepers while their audit client engaged in fraudulent accounting.
- ***FCPA Violations.*** On April 1, 2010, we filed charges against Daimler AG alleging that Daimler paid at least \$56 million in bribes in order to obtain and



retain business in numerous foreign countries over a period of more than 10 years. The payments involved more than 200 transactions in at least 22 countries. Daimler earned \$1.9 billion in revenue and at least \$90 million in illegal profits through these tainted sales transactions, which involved at least 6,300 commercial vehicles and 500 passenger cars. We alleged that Daimler also paid kickbacks to Iraqi ministries in connection with direct and indirect sales of motor vehicles and spare parts under the United Nations Oil for Food Program. To settle the SEC's charges, Daimler AG agreed to pay \$91.4 million in disgorgement and retain an independent consultant for a three year period to review its FCPA compliance. To settle a separate criminal proceeding brought by DOJ, Daimler AG agreed to pay a separate \$93.6 million fine.

- On March 18, 2010, we charged Innospec, Inc. with paying millions of dollars in bribes to Iraqi and Indonesian officials in exchange for contracts under the UN Oil for Food program. On August 5, we followed up with charges against the two Innospec executives, alleging that they were responsible for the payment of the company's bribes. To settle the SEC's charges, Innospec agreed to pay \$11.2 million in disgorgement and retain an independent consultant for a three year period to review its FCPA compliance. To settle a separate criminal proceeding brought by DOJ, Innospec agreed to pay \$14.1 million in fines. In addition, as part of a global settlement, Innospec agreed to pay \$12.7 million to settle charges brought by the U.K.'s Serious Fraud

Office. This case was the first global settlement between the SEC, the DOJ, and the U.K. Serious Fraud Office in an FCPA matter.

### **III. Cooperation and Coordination with Other Authorities**

While we have actively pursued our own enforcement actions this past year, the Division also has continued to build on its historically close and cooperative working relationship with criminal and other regulatory authorities, including the DOJ, the FBI, self-regulatory organizations, foreign regulators, state securities regulators, the Commodity Futures Trading Commission (CFTC), IRS, the U.S. Postal Inspection Service, SIGTARP, and banking regulators. The nature and extent of the cooperation and coordination varies as appropriate from case to case and can include referrals, information sharing, simultaneous actions, SEC staff details, or other assistance on criminal cases. Just last week we entered into an agreement with the Federal Trade Commission, which will provide us access to certain data that will be extremely helpful source of investigatory information.

As noted in the case discussion above, we have brought several recent significant actions in conjunction with parallel criminal proceedings. We are continuing to work with DOJ on a number of active investigations. We also recently entered into an MOU with the FBI under which an FBI agent will be embedded within our Office of Market Intelligence. This initiative is another example of effective coordination to combat financial fraud. We are confident that our ongoing cooperative efforts will continue to heighten our shared law enforcement mission.

#### **IV. Internal Process Reform and Management Streamlining**

Turning to our internal efforts, as part of the now completed reorganization of the Enforcement Division, we have established five new national specialized units, the Office of Market Intelligence dedicated to the handling of tips, complaints and referrals, and the Office of the Managing Executive dedicated to reforming administrative processes and eliminating unnecessary administrative hurdles faced by our investigative staff. We also completed our management restructuring and investigative process streamlining, introduced new cooperation tools, and launched new training initiatives.

##### *A. Office of Market Intelligence*

Each year, the SEC receives an enormous number of tips, complaints and referrals (“TCRs”) from a countless array of sources. The challenge is to identify from this unstructured mass of information, which includes anonymous submissions that may contain little specificity, those items that involve actual fraud and wrongdoing. To more effectively handle this critical task, we established the Office of Market Intelligence and staffed it with market surveillance specialists, accountants, attorneys and other support personnel. As noted above, we also recently added to the Office an embedded FBI Special Agent under a Memorandum of Understanding with the FBI.

As part of an agency-wide effort, the Office has updated policies and procedures to handle TCRs and, in April 2010, implemented an interim repository to serve as a central system for collecting all TCRs while new systems are being developed. The Office is also a key partner in developing a centralized information technology system for tracking, analyzing, and reporting on the handling of TCRs, which we expect to deploy in the coming months. The mission of the Office is to ensure that we collect all TCRs in

one place, combine that data with other public and confidential information on the persons or entities identified in the TCRs, and then dedicate investigative resources to those TCRs presenting the greatest threat of investor harm. Significantly, the Office of Market Intelligence also will serve a strategic function, harvesting the TCR databases to identify newly-emerging techniques and trends in securities fraud. This strategic function is critical to the Enforcement Division's top priority of being more nimble and proactive, thus permitting us to identify misconduct as early as possible in the life-cycle of a fraudulent scheme.

***B. Office of the Managing Executive***

Essential to the Division's success is a strong "back office" function with the expertise to handle important support areas such as IT, workflow, management processes, data collection and analysis, HR and other administrative responsibilities. For that reason, last year we launched an Office of the Managing Executive. This Office is leading the Division's efforts to create and collect data, including a "dashboard" of quantitative and qualitative metrics, and to incorporate this data into our regular review process with each member of the Enforcement Division, including its most senior officers.

The Office also is focused on initiatives to improve our electronic document management capacity, in order to provide greater capacity and functionality in loading, storing and searching the massive amounts of data we receive in the course of our enforcement investigations. Other initiatives including improved case tracking capabilities, enhanced closing processes for terminated or completed investigations (FY 2010 case closings are projected to increase 32 percent over FY 2009), and facilitating

ongoing hiring, including critically-needed paraprofessional hiring. In addition, the Office manages the Division's Digital Forensics Program. The Digital Forensics team is creating a new Digital Forensics Lab with added staff and improved technical capabilities to allow for more efficient forensic examination of software and hardware evidence, with advanced cell phone, smart phone and email processing capabilities.

***C. Management Restructuring***

Since I last testified in December, we have completed our restructuring process and now have achieved a flatter, more streamlined organizational structure that eliminated an entire layer of management. We reallocated a number of staff who were first level managers – some of our most experienced and dedicated attorneys – to the mission-critical work of conducting front-line investigations. Across the Division, we now have achieved staff-to-manager ratios that reduce unnecessary process and bureaucracy, while at the same time preserving the substantive consultation and collaboration that ensures timely case-building, quality control, effective investigative execution, and staff growth and development.

***D. Investigative Process Streamlining***

In addition, we have streamlined a number of our investigative processes and procedures. This streamlining includes permitting senior officers to approve the issuance of subpoenas for documents and testimony on a case-by-case basis without obtaining advance formal authorization from the Commission. The Commission's delegation of formal order authority to senior officers has increased our ability to act more swiftly in initiating investigations and uncovering evidence of wrongdoing. For example, in 2010

to date, we have opened 487 formal investigations through our delegated formal order authority, allowing us to investigate wrongdoing on a more timely basis and use subpoena authority where necessary to defeat dilatory tactics or address recalcitrant witnesses. In addition, we eliminated unnecessary internal approval processes for routine settlement negotiations, Wells notifications, and informal investigation openings, and we have shortened and simplified the administrative steps required before an Action Memo recommending an enforcement action is provided to the Commission.

***E. Cooperation Tools***

We also have developed formal 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 our “cooperation agreement,” require that cooperators provide truthful evidence and testimony concerning the organizers, leaders, and managers of wrongful activity in exchange for a potential reduction in sanctions. Cooperation agreements have the capacity to secure the availability of witnesses and information for the Division earlier in investigations so that our cases can be developed in a more timely and effective manner. This program has been operational for much of the last year and we are confident that it will allow us to build stronger cases than otherwise would be possible.

***F. Training Initiatives***

We are implementing a number of other initiatives designed to improve our processes and overall effectiveness. We have enhanced our training programs, and have

created a formal training unit to ensure that our staff is armed with the knowledge and expertise necessary to confront today's complex market and products.

**V. New Initiatives to Identify Securities Fraud**

While the Enforcement staff is dedicated to bringing programmatically significant cases, we are particularly focused on developing new initiatives to quickly spot emerging trends and risks. For example, in late 2009 and early 2010, Office of Compliance Inspections and Examinations ("OCIE") staff conducted a series of examinations of registered investment advisers to identify possible conflicts of interest at certain types of collateral pool managers working with various classes of structured products. The examinations focused on trading practices, disclosures, transactions between clients, and valuation practices. In advance of and during these exams, OCIE staff and Enforcement staff received specialized training in structured products from industry experts. Working closely with the Examination staff, the Enforcement staff is analyzing information and data learned through this initiative and will evaluate whether any investigations should result.

A key initiative of the Market Abuse Unit is the development and enhancement of the Commission's electronic Bluesheet System and the full integration of its capabilities into our investigative process. "Bluesheets" are the mechanism by which clearing firms report to the SEC and self-regulatory organizations individual trades in securities that they clear. Historically, the Division has not had the capacity to systematically search its bluesheet database on an aggregate basis to identify relationships between suspicious trading.

Using pattern and relational trading analysis across large volumes of bluesheet trading data involving multiple securities, the Market Abuse Unit is using offensive strategies for identifying possible relationships among traders who may be acting in a coordinated fashion – such as trading networks or rings of individuals who may be serially trading in concert or coordinating manipulative activity across various securities. This trader-oriented approach looks at traders across a wide range of equity and options securities and, through automated analysis, identifies securities common to those traders. By identifying traders who are common to multiple securities involved in market-moving events, we can isolate relationships indicative of the misuse of material non-public information.

In addition, the Market Abuse Unit is in the process of establishing the Division's Analysis and Detection Center that will be staffed by attorneys and specialists trained in conducting Automated Bluesheet Analysis. The purpose of the Analysis and Detection Center is to assist staff attorneys conducting investigations into complex trading schemes by analyzing trading strategies across all types of securities, identifying potentially abusive trading practices.

Our Asset Management Unit, focused on mutual funds, private funds, and investment advisers, has developed several initiatives targeting disclosure, performance and valuation by funds and their advisers. For example, the Unit has launched a Bond Fund Initiative that focuses on disclosure and valuation issues in mutual fund bond portfolios. Based on practices identified in an examination of a significant bond fund complex, the Unit has collaborated with other Divisions and Offices within the SEC to develop risk analytics that identify red flags for further investigation, such as



misrepresentations of leverage, outlier performance, and problematic valuations. In conjunction with the SEC's examination staff, the Unit also has developed a Problem Adviser Initiative – a risk-based approach to detecting problem investment advisers through on-going due diligence reviews of advisers' representations to investors related to their education, experience, and past performance. The Asset Management Unit also has established a Mutual Fund Fee Initiative to develop analytics, along with other SEC Divisions, for inquiries into the extent to which mutual fund advisers charge retail investors excessive fees. These analytics are expected to result in examinations and investigations of investment advisers and their boards of directors concerning duties under the Investment Company Act.

Our Municipal Securities and Public Pensions Unit conducts investigations across a highly diverse market of approximately 50,000 state and local municipal securities issuers, as well as the \$2 trillion public pension arena. Despite the size and complexity of this market, it is thinly regulated. Municipal securities are exempt from the registration requirements of the federal securities laws; they are, however, subject to the antifraud provisions of the federal securities laws. Under the Dodd-Frank Act's new provisions, municipal advisers are now subject to registration with the Commission. The Unit is actively involved in the Commission's efforts to develop new rules governing municipal advisers under authority granted by the Act. In addition, under a recent Memorandum of Understanding with the IRS, Unit staff participate in quarterly meetings with the IRS's tax-exempt bond group to facilitate cooperation and discussion of emerging trends.

Our Structured and New Products Unit is actively engaged in a number of initiatives to immerse Unit staff in various complex securities products. In addition to

mortgage and other asset-backed securities and related structured products, the Unit initiatives include a review of products such as reverse convertible notes, auto-callable notes, principal protected notes, and total return swaps. With respect to each securities product, Unit staff is engaged in a detailed assessment of the history of the product, various iterations of the product, institutions that market and/or sell the product, the nature of the investors in the product, and the product's potential risks to those investors. In addition, to build relationships with other regulators, the Unit formed a Coordination Working Group, which has helped to establish contacts with numerous Federal, state, and foreign regulators. The Unit also formed an Outreach Working Group, which is helping to establish contacts with market participants, including investors, industry groups, broker-dealers, rating agencies and audit firms.

Finally, our FCPA Unit is working closely with our law enforcement partners to pursue programmatically significant cases involving bribery and corruption by U.S. companies and corporate executives in their international operations. In addition, given that our FCPA investigations often are conducted in parallel with criminal investigations, the Unit is engaged in various outreach efforts with the criminal authorities. For example, the FCPA Unit recently conducted a multi-day FCPA training "boot camp" for our law enforcement colleagues, including DOJ and the FBI, to assimilate knowledge and identify best practices for investigations that often span the globe.

We believe that these Unit-based initiatives, among others, will expand our knowledge base and technical capacity to pursue cutting-edge investigations in the coming year and beyond.

**VI. New Tools under the Dodd-Frank Wall Street Reform and Consumer Protection Act**

The Dodd-Frank Act has increased our arsenal in several significant ways. We anticipate that a number of investor protection provisions in the Investor Protection and Securities Reform Act of 2010, contained within Title IX of the Act, will improve our ability to protect investors and deter wrongdoing by enhancing the Division's powers and effectiveness.

**A. Whistleblower Program**

Our Office of the Market Intelligence is taking a leading role in the development and implementation of our new Whistleblower Program. The whistleblower provisions of the Dodd-Frank Act enable us to provide substantial rewards to persons providing original information leading to certain successful securities enforcement actions. We expect our Whistleblower Program to generate significant tips from individuals with direct knowledge of serious securities law violations.

The Division currently is in the process of drafting the proposed rules applicable to the Whistleblower Program, including rules setting forth the procedures for whistleblowers to submit original information to the Commission and for the Commission to make awards to whistleblowers. We also have begun the process of staffing the Commission's Whistleblower Office. As we create the Program and the Office, we will be mindful of competing interests, including: (i) a desire to encourage whistleblowers to provide the Commission with high-quality tips regarding potential violations of the federal securities laws, and (ii) a need to avoid creating undue burdens

on the Commission and the constituencies that we protect and regulate that could result from groundless whistleblower submissions.

***B. New Investor Protection Measures***

Other investor protection measures established by the Dodd-Frank Act that we are in the process of utilizing include the following:

- ***Establishing nationwide service of process.*** The Act makes nationwide service of process available in SEC civil actions filed in federal court and provides a number of significant benefits, including requiring live witnesses to appear at trial. Nationwide service of process also will result in a significant savings in travel costs and staff time through the elimination of duplicative depositions.
- ***Secondary actors.*** The Act expanded and clarified the Commission's authority to enforce securities law violations by secondary actors, including providing the Commission with the ability to charge aiding and abetting violations under the Securities Act of 1933 and the Investment Company Act of 1940.
- ***Remedies.*** The Dodd-Frank Act also expanded and clarified the Commission's remedies, including the ability to seek civil penalties in cease-and-desist proceedings, the ability to seek penalties against aiders and abettors under the Investment Advisers Act of 1940, and the ability to impose collateral bars. For example, when we obtain a bar against a broker-dealer who misappropriates customer funds, the Commission now has to power to bar that individual simultaneously from engaging in similar conduct in another part of the securities industry, such as acting as an investment adviser.

- **Coordination with Other Authorities.** The new legislation includes a provision to enhance the ability of the SEC to share certain privileged information with other regulatory authorities by providing that sharing such information does not waive applicable privileges.

Also we are hopeful that the Act's provisions regarding the regulation of over the counter derivatives and the registration of hedge fund advisers, among others, will improve the Division of Enforcement's access to information about trades through uniform audit trails, greater transparency, and recordkeeping and reporting requirements.

## **VII. Conclusion**

The Division of Enforcement's mission to protect investors and enhance the integrity of the financial markets through vigorous enforcement of the federal securities laws is critical. Although I have described for you some of our recent achievements and reforms, we are continuously assessing our progress and the way that we use our resources to best protect investors and the integrity of our financial markets. While the Dodd-Frank Act certainly will help address some of the practical challenges that we face in policing the securities markets, we recognize that there is more work to be done. One thing that has not changed since I last testified is my firm belief that the Division's extremely talented staff is the key to our ongoing success. With the dedicated professionals that I work with every day in the Division, and alongside my colleagues at the DOJ, the FBI, and other law enforcement authorities, I know that we will successfully fulfill our shared mission of protecting the public against financial fraud and enhancing the integrity of our financial markets.

I thank you for the opportunity to appear before you today. I would be pleased to answer your questions.

*United States Senator Chuck Grassley*

*Iowa*

<http://grassley.senate.gov>



Prepared Statement of Senator Chuck Grassley of Iowa  
U.S. Senate Committee on the Judiciary  
Hearing on "Investigating and Prosecuting Financial Fraud after the  
Fraud Enforcement and Recovery Act  
Wednesday, September 22, 2010

Mr. Chairman, thank you for holding today's follow-up hearing on the Fraud Enforcement Recovery Act (FERA). As the lead Republican sponsor of FERA, I am glad to be here today to discuss the efforts of our law enforcement and regulatory agencies to combat complex financial frauds that were part of the root cause of the financial crisis. Given the massive government interventions into the private markets and the corresponding vulnerabilities to taxpayer investments, it is important to ask some tough questions of the agencies that are the front line defense against fraud and abuse.

President Obama signed FERA into law in May of last year. Since that time we've continued to face a difficult climb out of the recession. Unemployment remains unacceptably high and millions of Americans that want to work simply can't find jobs. The immediate urgency of the financial and housing crises have largely subsided, but we must continue our efforts to ensure the stability of our financial markets. For the markets to truly stabilize we must do all we can to bring integrity back. We can achieve this by increasing transparency in the markets, but we also must ensure that those who committed frauds and continue to take advantage of individuals during tough times are prosecuted to the fullest extent of the law.

Regulators, law enforcement, and prosecutors must coordinate their efforts to combat these unscrupulous fraudsters and bring them to justice. This was the fundamental goal of the FERA legislation. To provide law enforcement, prosecutors, and regulators the tools they needed to launch a coordinated attack on those that committed complex financial frauds, such as mortgage and securities fraud. This approach received overwhelming bi-partisan support and became law. However, over a year later it is right to look back and make sure that the agencies enforcing the law implemented and utilized the resources and tools provide FERA in an effective manner.

This hearing also provides us an opportunity to find out whether the agencies implementing FERA are seeing any new or evolving trends in fraud that need to be addressed. At the first hearing in February 2009, we were still formulating the FERA legislation when we heard testimony about the dramatic increase in Suspicious Activity Reports (SARs) reported by banks to the Financial Crimes Enforcement Network

(FinCEN) at the Department of the Treasury. At that time, the data showed an exponential increase in mortgage related SARs. Since that hearing, mortgage fraud prosecutions by the Secret Service and the Federal Bureau of Investigation (FBI) have increased dramatically based in large measure on this information. To date, many of these mortgage fraud investigations and prosecutions are still ongoing and the changes to our federal criminal laws made in FERA continue to help law enforcement and prosecutors take these fraudsters off the streets.

Despite the original focus of FERA on mortgage frauds, the legislation was not simply limited to addressing mortgage fraud. Instead, we also included necessary amendments to combat money laundering, securities fraud, and civil recoveries of taxpayer dollars under the False Claims Act. At a follow-up hearing last December, this Committee heard testimony about ongoing investigations and prosecutions of high profile securities frauds. Since that time, there have been a number of high profile cases at the Securities and Exchange Commission (SEC) that have come to light. Unfortunately, many of those high profile cases have highlighted the failures of the SEC to learn about these complex frauds and ponzi schemes until it was too late and investor money was lost and gone forever.

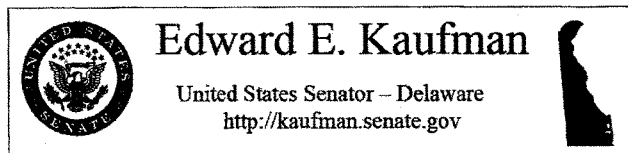
The ponzi schemes conducted by Bernard Madoff and Robert Stanford were serious breaches of our financial regulatory system that went undetected by the SEC for years. Despite opportunities for the SEC to uncover these massive frauds, regulators at the SEC turned a blind eye to leads and information they should have utilized to track down these schemes. Subsequent reports issued by SEC Inspector General David Kotz have criticized the SEC's failure to detect these schemes. Despite original assurances by the SEC that the ponzi scheme conducted by Bernard Madoff was a perfect storm that was not likely to repeat itself, other missed opportunities continue to haunt the SEC. For example, a report issued by the SEC Inspector General dated February 26, 2010, titled, "Failure to Timely Investigate Allegations of Financial Fraud" outlined yet another instance the SEC failed to catch a significant financial fraud. The SEC Inspector General ultimately "identified significant flaws in the processes Enforcement used to handle complaints and to close cases. The OIG investigation concluded that from February 2005 through September 2007, multiple...complaints were mishandled and mismanaged and, consequently, these complaints were simply not reviewed, analyzed or investigated." These are serious problems that were outlined by the Inspector General.

Time permitting, I'd also like to discuss the SEC's whistleblower program that was created under the recently enacted Wall Street Reform. As a longtime supporter of whistleblowers, I worked closely with the Agriculture and Banking Committees to harmonize the two provisions in that legislation that created new whistleblower incentives at both the SEC and the Commodities Future Trading Commission (CFTC). I want to hear from SEC Director of Enforcement Khuzami how implementation of this important program is coming along and about what efforts he is undertaking to fix the many problems that the SEC Inspector General has outlined and when solutions will be implemented.

The FERA legislation was an important step in combating the complex mortgage and financial frauds that fueled the financial crisis. The legislation was designed to be broad enough to encompass future frauds. However, FERA, like any important legislation, is only effective when implemented properly and administered with the intent of Congress. I look forward to hearing the testimony of the witnesses to see how the Administration has implemented this important law. Our law enforcement and regulatory agencies need to improve their ability to tackle these complex issues in the future, before the problems reach a point where the damage they can cause can impact the entire economy like the financial and housing crises did. We owe it to the American taxpayers to ensure that the agencies are spending taxpayer dollars wisely and implementing the law properly. Thank you.

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**FOR RELEASE:** September 22, 2010  
**CONTACT:** Amy Dudley 202-224-5042

**Senate Judiciary Committee Hearing on Investigating and Prosecuting Financial  
 Fraud after the Fraud Enforcement and Recovery Act  
 Opening Statement of Senator Ted Kaufman (D-DE)  
 September 22, 2010**

I am honored to call to order this hearing of the Senate Committee on the Judiciary. I thank Chairman Leahy for permitting me to chair this hearing.

Today we're going to examine the efforts of federal law enforcement to investigate and prosecute the financial fraud that contributed to our current economic crisis, in light of the Fraud Enforcement and Recovery Act (FERA), signed into law by President Obama in May 2009.

This is the second post-FERA oversight hearing that we've held. The first was on December 9 of last year.

Today, the same three distinguished witnesses who testified at that hearing join us again to discuss these issues: Assistant Attorney General Lanny Breuer, SEC Director of Enforcement Robert, and FBI Assistant Director Kevin Perkins.

My objectives for this hearing are several. The first comes under the heading of FERA oversight. In the time since that December 2009 hearing, what have the Department of Justice, the FBI, and the SEC done in terms of investigating and prosecuting fraud at the heart of the financial crisis? Do they have the infrastructure, personnel, and strategies in place that they need to be successful?

All three entities have received significant additional resources, in part as a result of FERA, and I want to explore whether those resources are being deployed effectively.

I will say right now that I'm frustrated. I know that the Justice Department, the FBI, and the SEC have all been working incredibly hard, reviewing countless transactions, interviewing myriad witnesses, poring over literally millions of pages of documents. And yet we have seen very little in the way of senior officer or boardroom-level prosecutions of the people on Wall Street who brought this country to the brink of financial ruin. Why is that?

Is it because none of the behavior in question was criminal? Is it because too much time passed before investigators got serious, so the trail has gone cold? Is it because the law favors the wealthy and powerful? Or is the explanation more complex?

Are there systemic challenges that the agencies are finding difficult to overcome? Is there a foundational, targeted strategy at uncovering those instances of actual misrepresentation of material facts, which exist within a mountain of the "everyone was doing it" mentality on Wall Street? Is the fine print exculpatory, or only chilling prosecutorial efforts that still deserve to move forward?

My second objective is legislative. Are there changes in the law that would make it harder for people to construct and sell incredibly complex financial products without disclosing their own belief that the value of those products will soon plummet? While I will be leaving the Senate before long, I'd like help my colleagues get started on making those changes to the law, if there are useful changes to be made.

In the last year or so, through the work of people both in and out of government, we've been learning more about the wide range of conduct that contributed to the collapse.

I've said from the beginning that much of that behavior, though terribly misguided, inexcusable, or morally bankrupt, was not criminal.

But I remained convinced, by what we've learned through a host of sources, including hearings held by Senator Levin in the Permanent Subcommittee on Investigations, that it appears from the evidence that serious criminal behavior occurred as well.

Let me start a discussion about the difference between criminal behavior and behavior that is merely misguided with a hypothetical example. Assume that there is a bank in the mortgage-origination business. During the early- and mid-2000s, as home prices increase nationwide, the bank is able to make huge profits both by packaging these mortgages into bonds for sale to others and by holding onto them as investments.

In the race to maximize market share and raise profits, the bank decides to relax its official underwriting standards to a greater and greater degree, until a large majority of even some of its riskiest loans to the least qualified borrowers were so-called "liars' loans," issued without even bothering to verify that the income stated by the borrower was accurate.

This behavior was unwise and dangerous, creating tremendous risk on many levels – to the bank extending the credit, to borrowers without the means to pay, to those who bought the loans from the bank.

More important, it also created a grave risk to the broader economy. As we now know all too well, extending credit without regard to creditworthiness can help fuel a speculative boom that ends only with a painful market correction involving crashing prices and foreclosed-upon homeowners.

But without more, making loans that should never be made, even on a tremendous scale, is not a crime. Particularly if the quality of those loans were disclosed.

Was there more? In the lead-up to this country's recent national housing market crash, did some banks and boardroom executives step over the line and commit actionable fraud?

For example, what if this hypothetical bank knowingly issues widespread exceptions to its published underwriting standards, while at the same time claiming to would-be purchasers of mortgage securities that the underwriting standards had been substantially complied with?

Or suppose it determines that a class of mortgages that it has held for its own investment are likely to default in the near future and seeks to offload these mortgages onto third parties. That might not be a crime, but what if the bank has claimed to purchasers that it has not selected mortgages for sale based on a belief that they are likely to default?

If criminal conduct contributed to the financial meltdown, then the people responsible should be investigated, prosecuted, and sent to prison.

If we fail to do so, I we'll lose our chance to restore the public's faith in our financial markets and the rule of law. Criminals on Wall Street must be held to account. Otherwise, one of the great foundations of this country – our capital markets – may simply fade away.

This is why, very early in this Congress, I joined with Chairman Leahy, Senator Grassley, and others to help pass the Fraud Enforcement and Recovery Act.

FERA was designed to ensure that additional tools and resources were provided to those charged with enforcement of our nation's laws against financial fraud.

In the year plus since the passage of FERA, we've seen some important progress. The FBI, the Department of Justice, and the SEC have all ramped up their efforts.

Last November, President Obama created an interagency financial fraud enforcement task force. Its mission is not only to pursue crimes already committed, but also to deter criminal behavior that might lead to another financial crisis.

But despite the new resources and renewed emphasis, despite the presidentially created task force, we're now nearing the final quarter of 2010 without the sort of prosecutions that I had fully expected we would see by this time.

Without successful investigation and prosecution, and meaningful punishment, deterrence is an illusion.

So where does that leave us? That's what I want to explore today in this hearing.

Where is the line between conduct that is actionable and conduct that is not? What are the disclosure obligations of the individuals and entities that select, bundle, securitize, and market groups of mortgages with characteristics that, at some point along the way, foretold their failure? Do those obligations need to be strengthened, in terms of either what must be included or in terms of how prominent the disclosure must be?

Last Spring, Senator Specter and I offered an amendment to the Dodd-Frank bill that would have imposed on broker-dealers and banks the same sort of duty to their customers that financial advisors already have. Had that amendment become law, these broker-dealers and banks would have been obligated to disclose not only their own conflicts of interest, but also their knowledge that a particular security is likely to underperform.

I want to get a sense from the enforcement community whether that sort of change in the law would make a difference in their world.

Many on Wall Street have argued that there was no criminality in this financial crisis, merely a collective delirium brought about by soaring profits and mistaken assumptions about risks.

I and others have disagreed, but so far have waited in vain for the sorts of prosecutions that we predicted would come. I hope this hearing will help us understand why that is so, and also give us a better sense of what to expect in the future.

I also want to emphasize that the existence of criminality, or the lack thereof, should not be our only guiding star. Our job is to focus on right and wrong, fairness and unfairness, and legislate accordingly.

Law enforcement officials, represented by these witnesses today, have to ask whether the conduct they are investigating violated the law. If not, they move on to the next case.

As members of Congress, we have a different obligation. We have to ask whether the law as it exists reflects sound public policy. If not, if the law permits conduct that should be prohibited, then we need to change the law.

Ours is a government of laws, rather than men. And, as Justice Brandeis reminded us, "If we desire respect for the law, we must first make the law respectable." Our laws are not a static code of received wisdom from on high. They are an evolving reflection of public debate and national need. Where laws let America down, Congress must remedy those laws so that they may not do so again.

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**Statement Of Senator Patrick Leahy (D-Vt.)  
Chairman, Senate Judiciary Committee,  
Hearing On "Investigating And Prosecuting Financial Fraud  
After The Fraud Enforcement And Recovery Act"  
September 22, 2010**

I am glad that Senator Kaufman is chairing this hearing, and I thank him for his continued commitment to eliminating mortgage and financial fraud. Early last year, Senator Kaufman, Senator Grassley and I introduced the bipartisan Fraud Enforcement and Recovery Act (FERA). Through strong, bipartisan efforts, the bill passed both the House and Senate with strong support and was signed into law by the President last May.

Senator Kaufman held a similar hearing about this issue last December, and I applaud him for continuing to conduct oversight of the enforcement of this important law. It is important to examine how these new enforcement tools are working, and to review the current state of our financial fraud efforts in order to better understand what steps we can take to strengthen anti-fraud laws in the future.

The Fraud Enforcement and Recovery Act has provided new, important enforcement tools that strengthen the Federal Government's capacity to investigate and prosecute the types of financial fraud that helped to undermine our economy and leave so many Americans without work, without savings and without homes. The law was the most significant anti-fraud passed in the past decade and will help to hold those who have done such damage to our economy accountable and to deter the efforts others who might otherwise try to defraud hard-working Americans.

Mortgage fraud had reached epidemic levels in the country. Reports of mortgage fraud are up over 680 percent over the past six years, and more than 2800 percent in the past decade. Coupled with massive corporate frauds like the \$65 billion Ponzi scheme run by Bernard Madoff, these preventable and enforceable crimes contribute to a lack of consumer and investor confidence that makes real economic recovery very difficult. Because of FERA, we can now take action to better protect the victims of these frauds. These victims include homeowners who have been fleeced by unscrupulous mortgage brokers who promise to help them, only to leave them unable to keep their homes and in even more debt than before. They include retirees who have lost their life savings in stock scams and Ponzi schemes, which have come to light as the markets have fallen and corporations have collapsed. They also include American taxpayers who have invested billions of dollars to restore our economy, and who expect us to protect that investment and make sure those funds are not exploited by fraud.

In the past few years, the Department of Justice and the administration have taken important steps to address these problems. Between 2006 and 2009, the number of criminal mortgage fraud investigations opened by the Federal Bureau of Investigation doubled, and we understand that number is continuing to rise quickly. Last November, President Obama established the Financial Fraud Enforcement Task Force, a group designed to strengthen cooperative efforts between Federal, State and local law enforcement to investigate and prosecute these crimes. I hope that the passage of FERA last year and subsequent appropriations have allowed the FBI and other enforcement agencies to commit more resources to combating fraud.

Fraud enforcement is an excellent investment for the American taxpayer. Studies have shown that the Government recovers up to \$15 for every dollar spent on criminal fraud litigation. We need to ensure going forward that FERA is fully funded and that enforcement agencies allocate sufficient resources to combating fraud.

The Fraud Enforcement and Recovery Act also made a number of straightforward, important improvements to fraud and money laundering statutes to strengthen prosecutors' ability to combat this growing wave of fraud, and it strengthened one of the most potent civil tools we have for rooting out fraud in Government – the False Claims Act. The Federal Government has recovered more than \$22 billion using the False Claims Act since it was modernized through the work of Senator Grassley and Congressman Berman in 1986, and FERA made the statute still more effective, as did further improvements made in this year's health care and Wall Street reform laws. I look forward to hearing how these new tools have helped enforcement efforts.

In nearly a year and a half since FERA was passed, I have been proud to continue to work with Senator Kaufman and others on other important and common sense fraud bills. One such bill, which was eventually adopted into the major health care reform bill and passed into law, takes aim at the estimated \$60 billion dollars a year lost to health care fraud each year. The amendment increased sentencing guidelines for health care fraud offenses and strengthened a number of statutes on health care fraud enforcement. Another bill that was eventually passed as an amendment to the Wall Street reform package increased sentences for those who commit securities and bank fraud. It also gave prosecutors more time to investigate difficult cases and further strengthened protections for whistleblowers.

This Congress has seen some major legislative strides in anti-fraud efforts. These steps are important to helping those victimized by fraud and to continuing our economy down the path to recovery. However, we must continue to be vigilant and ensure that the new tools that have been provided to law enforcement to fight fraud are being effectively and aggressively utilized. Too many Americans been preyed upon by selfish and dishonest individuals who think nothing of the suffering they cause.

I look forward to hearing from today's witnesses about what progress has been made in cracking down on fraud and what more we can do to protect the financial well being of Americans.

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# Department of Justice

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STATEMENT OF

KEVIN PERKINS  
ASSISTANT DIRECTOR  
FEDERAL BUREAU OF INVESTIGATION

BEFORE THE

COMMITTEE ON JUDICIARY  
UNITED STATES SENATE

ENTITLED

“INVESTIGATING AND PROSECUTING FINANCIAL FRAUD AFTER THE FRAUD  
ENFORCEMENT AND RECOVERY ACT”

PRESENTED

SEPTEMBER 22, 2010

**STATEMENT OF  
KEVIN L. PERKINS  
ASSISTANT DIRECTOR, CRIMINAL INVESTIGATIVE DIVISION  
FEDERAL BUREAU OF INVESTIGATION  
BEFORE THE  
JUDICIARY COMMITTEE  
UNITED STATES SENATE  
SEPTEMBER 22, 2010**

Good afternoon Senator Kaufman and distinguished Members of the Committee. I want to thank you for the opportunity to testify before you today about the FBI's ongoing efforts to combat significant financial crimes.

Since my last appearance before you, the FBI has continued to uncover massive frauds, including newly identified Ponzi schemes. In June, Lee Farkas, former chairman of Taylor, Bean, and Whitaker, a large mortgage origination company was charged with a \$1.9 billion fraud that contributed to the failure of Colonial Bank, one of the largest banks in the United States and the sixth largest bank failure in the country.

On September 15, 2010, Nevin Shapiro, owner and former chief executive officer of Capitol Investments, pled guilty to an \$880 million Ponzi scheme involving his firm in New Jersey. In July, Paul Greenwood, a managing partner at both WG Trading and Westridge Capital Management, pled guilty for his role in a \$700 million scheme that defrauded charitable and university foundations as well as pension and retirement plans.

Over the past six months, the prosecutions of the Galleon insider trading case in New York and the Petters \$3.9 billion Ponzi scheme in Minnesota continued with guilty pleas and significant sentences of top-level corporate executives. These cases are just a few examples of the thousands of financial fraud investigations ongoing at the FBI and conducted in conjunction with the Administration's Financial Fraud Enforcement Task Force.

Mortgage Fraud

In the last three years alone, the FBI has seen the number of mortgage fraud cases steadily climb from 1,200 in 2007 to over 3,000 in 2010. Nearly 70 percent of these pending cases represent losses to financial institutions and other victims exceeding \$1 million. In many of these cases the loss far exceeds \$1 million.

Operation Stolen Dreams - a three and a half month takedown of mortgage fraud schemes throughout the country - demonstrates just how rampant mortgage fraud is in this country. The sweep was organized by President Obama's interagency Financial Fraud Enforcement Task Force, which was established to lead an aggressive, coordinated and proactive effort to investigate and prosecute financial crimes. Operation Stolen Dreams involved 1,517 criminal defendants nationwide, including 863 Informations/Indictments filed and 525 arrests of those who are allegedly responsible for more than \$3.05 billion in losses. Additionally, the operation has resulted in 191 civil enforcement actions, which have resulted in the recovery of more than \$196 million.

Mortgage Fraud, however, is just one component of the recent financial crisis. At this time, I



would like to highlight some of the other types of financial schemes the FBI is currently investigating.

#### Corporate Fraud

The FBI's efforts to address complex securities and corporate frauds have also greatly expanded in recent years. New corporate fraud cases, for example, are up by 111% while High Yield Securities Frauds have grown by over 200%.

Corporate Fraud has been associated with the failures of prominent financial institutions, the falsification of accounting records, the manipulation of earnings reports, embezzlement by corporate insiders, and misrepresentations regarding the risks and valuations of complex financial instruments (e.g., credit default swaps and mortgage backed securities).

Through the manipulation of financial data, the share price of a corporation's stock remains artificially inflated based on fictitious performance indicators provided to the investing public. In addition to significant financial losses to investors, Corporate Fraud has the potential to cause immeasurable damage to the U.S. economy and investor confidence.

As the lead law enforcement agency investigating Corporate Fraud, the FBI has focused its efforts on cases which involve accounting schemes, self-dealing by corporate executives, and obstruction of justice.

The majority of Corporate Fraud cases pursued by the FBI involve accounting schemes designed to deceive investors, auditors, and analysts about the true financial condition of a corporation. In FY 2010, our efforts have translated into over 600 Corporate Fraud investigations throughout the United States, several of which involved losses to public investors that individually exceed \$1 billion.

#### Securities Fraud

Over the last five years, losses associated with open securities and commodities fraud schemes have increased into the billions of dollars. Some specific schemes associated with this type of fraud include:

##### *High Yield Investment Fraud/Ponzi Schemes*

High Yield Investment Fraud schemes have many variations, all of which are characterized by offers of low risk investments, guaranteeing an unusually high rate of return. Victims are enticed by the prospect of easy money, and a fast turnaround.

These schemes use money collected from new victims, rather than profits from an underlying business venture, to pay the high rates of return promised to earlier investors. This arrangement gives investors the impression there is a legitimate, money-making enterprise behind the fraudster's story; but in reality, unwitting investors are the only source of funding.

In Prime Bank Investment Fraud, for example, victims are told that certain financial instruments such as notes, letters of credit, debentures, or guarantees have been issued by well-known institutions such as the World Bank, and offer a risk-free opportunity with high rates of return. Perpetrators often claim unusually high rates of return and low risk are the result of a worldwide secret exchange open only to the world's largest financial institutions. Victims are often drawn into Prime Bank Investment Frauds because the criminals use sophisticated terms, legal looking documents, and claim that the investments are insured against loss.

In FY 2010, the FBI has opened 291 new High Yield Investment Fraud cases. Many of the Ponzi scheme investigations have an international nexus, and have affected thousands of victims. The most significant of these, the \$64 billion Ponzi scheme perpetrated by Bernard L. Madoff, resulted in the longest prison sentence in the history of financial crime – 150 years. More recently, Scott Rothstein, a prominent Florida attorney, was sentenced to 50 years in prison for orchestrating a Ponzi scheme that took in \$1.6 billion. The FBI continues to target this criminal threat, and currently has more than 780 pending High Yield Investment Fraud cases.

#### *Market Manipulation*

Market Manipulation, or "Pump and Dump," schemes are based on the manipulation of lower-volume stocks purchased on small over-the-counter markets. The basic goal of market manipulation fraud is to artificially inflate ("pump") the price of penny stocks so the conspirators can sell ("dump") their shares at a large profit. The "pump" involves recruiting unwitting investors through false or deceptive sales practices, public information, or corporate filings. Many of these schemes use "boiler room" methods where brokers, who are bribed by the conspirators, use high pressure sales tactics to increase the number of investors and, therefore, raise the price of the stock. Once the price of the targeted shares reaches a certain point, the perpetrators "dump" their shares at a huge profit and leave innocent investors with significant losses. These schemes generate an estimated \$6 billion in losses each year, and have the ability to significantly impact investor confidence.

The trend seen in Market Manipulation cases involving computer intrusion also continues. Computer intrusion for the purpose of Market Manipulation often includes a criminal hacking into victims' personal online brokerage accounts and using the accounts to purchase shares of a penny stock to inflate its price. As in normal Pump and Dump schemes, once the price of the stock reaches a certain point, the perpetrators dump their own shares and walk away with large profits. To date in FY 2010, FBI investigations have translated into charges being brought against 31 individuals allegedly involved in Market Manipulation schemes.

#### *Insider Trading*

Lack of regulatory oversight and transparency in Hedge Fund markets continues to make this industry susceptible to various types of Securities Fraud and Insider Trading, and creates significant challenges for law enforcement. In addition, since these funds are typically heavily leveraged, there is always the potential for significant losses.

The FBI proactively investigates Insider Trading schemes, using all available tools to remove the most egregious offenders from the financial markets. To address the threat, the FBI also continues to coordinate with the U.S. Securities and Exchange Commission (SEC) in a parallel law enforcement and regulatory effort to ensure financial markets are fairly operated. To date in FY 2010, the FBI has more than 65 pending Insider Trading cases.

As this Committee is aware, the FBI successfully infiltrated the Insider Trading ring associated with the Galleon Group, a prominent Hedge Fund in New York City. Indeed, since my last appearance before you, several high level executives/participants have pled guilty or been sentenced for their role in this ring.

#### Partnerships

In response to the wave of financial crimes, the FBI established Mortgage Fraud Task Forces across the country. With representatives of federal, state, and local law enforcement, these task

forces are strategically placed in areas identified as high threat areas for Mortgage Fraud. Partners are varied, but typically include representatives of HUD-OIG, the U.S. Postal Inspection Service, the Internal Revenue Service – Criminal Investigative Division, FinCEN, the Federal Deposit Insurance Corporation (FDIC), the Department of Homeland Security Immigration and Customs Enforcement - Homeland Security Investigations, and the U.S. Secret Service, as well as state and local law enforcement offices.

This multi-agency task force model serves as a force-multiplier, providing an array of resources to adequately identify the sources of the fraud; allowing agencies to share investigative expertise; and increases jurisdictional avenues, allowing task force members to find the most effective way to prosecute each case, particularly in active markets where fraud is widespread.

In addition, the FBI participates on both the national Mortgage Fraud Working Group (MFWG), and the national Bank Fraud Working Group (BFWG). The MFWG and BFWG, chaired by the DOJ Criminal Fraud Section, represent a collaborative effort of multiple federal agencies; and facilitate the information sharing process across agencies, as well as to private organizations. Working in partnerships, the FBI is building on existing FBI intelligence databases to identify industry insiders and egregious criminal enterprises conducting systemic Mortgage Fraud.

In order to most effectively combat the threats of Corporate and Securities Fraud, the FBI has partnered with numerous external agencies to form numerous working groups that address Corporate Fraud and/or Securities Fraud across the country. These working groups, such as the DC Metro Corporate Fraud Working Group, enhance cooperation and information sharing, and provide a venue where the FBI can meet with our partners to discuss current trends, threats, and the progress of selected ongoing investigations. In addition, the FBI works closely with the Special Inspector General for the TARP (SIG-TARP) to guard against fraud in the \$700 billion TARP. The FBI is currently conducting several joint investigations with the SIG-TARP. Further, the FBI participates on the Term Asset-Backed Securities Loan Facility (TALF) Task Force. The TALF is a Federal Reserve program through which the Federal Reserve Bank of New York makes loans, which are secured by collateral in the form of asset-backed securities. These loans are typically made to Hedge Funds and other investment groups, and are vulnerable to fraud.

As you know, the FBI is a member of the Administration's Financial Fraud Enforcement Task Force (FFETF). The task force is chaired by the Attorney General and is currently comprised of more than 20 agencies, including the SEC, the Commodities Futures Trading Commission (CFTC), the Department of Treasury, the FDIC, and HUD. Such coordination allows us to maximize intelligence sharing and to ensure that significant financial crimes are appropriately addressed.

The FBI also participates in the Securities and Commodities Fraud Working Group, a national interagency coordinating body established by the DOJ Criminal Fraud Section to provide a forum for exchanging information, discussing violation trends, legal developments, law enforcement issues, and investigative techniques. In addition, FBI Corporate Fraud and Securities Fraud program managers frequently meet with their counterparts at the SEC's Home Office in Washington, D.C. to discuss threats, emerging trends, pending investigations, and to share intelligence.

#### Industry Liaison

In addition to its partners in law enforcement and regulatory areas, the FBI continues to foster relationships with representatives of the mortgage industry to promote Mortgage Fraud awareness. The FBI has spoken at and participated in various mortgage industry conferences and seminars, including those sponsored by the Mortgage Bankers Association (MBA), the American Bankers Association, and the BITS Financial Services Roundtable (a consortium of financial institutions).

To raise awareness of this issue and provide easy accessibility to investigative personnel, the FBI has provided contact information of the FBI's Mortgage Fraud Supervisors to relevant groups, to include the MBA, Mortgage Asset Research Institute (MARI), Fannie Mac, Freddie Mac, and others.

Also, the FBI frequently participates in industry-sponsored fraud deterrence seminars, conferences, and meetings, which include topics, such as, quality control and industry best practices to detect, deter, and prevent Mortgage Fraud. These meetings play a significant role in training and educating industry professionals. Companies share current and common fraud trends, loan underwriting weaknesses, and best practices for fraud avoidance. These meetings also increase the interaction between industry and FBI personnel.

Additionally, the FBI continues to train its personnel and conduct joint training with HUD-OIG and our partners in industry on Mortgage Fraud. For example, industry experts have assisted in the training of FBI personnel on mortgage industry practices, documentation, and industry views of laws and regulations. Industry partners have also offered to assist the FBI in developing advanced Mortgage Fraud investigative training material and fraud detection tools.

Likewise, the FBI makes considerable investment in industry liaison for our Corporate Fraud and Securities Fraud programs. We not only bring in industry experts to train FBI personnel, but FBI personnel also frequently attend meetings and conferences set up by industry as part of our effort to foster relationships and proactively gather information.

#### Proactive Approach to Financial Fraud

In addition to more than tripling the number of FBI Special Agents who investigate mortgage fraud cases in the field, the FBI has implemented a number of innovative and proactive methods to detect and combat Mortgage Fraud, and other significant financial frauds.

Our Financial Institution Fraud Unit (FIFU) has responsibility for management of the FBI's Mortgage Fraud program and serves as a veritable fusion center. Through program guidance, oversight, training, and information sharing, the FIFU provides the tools necessary to identify the most egregious Mortgage Fraud perpetrators, prioritize pending investigations, and ensure that Mortgage Fraud efforts are both threat-based and intelligence driven.

Furthering its efforts to expand and mature intelligence collection and analysis capabilities, the FBI's Financial Intelligence Center (FIC) provides tactical analysis of intelligence data, data sets, and databases. Through the use of evolving technology and data exploitation techniques, the FIC creates targeting packages to identify the most egregious criminal offenders and to enhance current criminal investigations. The FIC also coordinates with FBI field offices in an effort to both complement field resources and to identify emerging economic threats.

The FBI continues to utilize its analytical computer application to identify property-flipping transactions. As potential targets are analyzed and flagged, the information is provided to the respective FBI field office for further assessment. Illegal Property flipping is described as purchasing properties and artificially inflating their value through false appraisals. The artificially valued properties are then sold to an associate of the "flipper" at a substantially inflated price. Quite often the property is "flipped" within 30 days, but sometimes the "flip" occurs on the same day as the original purchase. Typically, illegally flipped properties go into foreclosure, and are ultimately repurchased for a fraction of their original value.

Other methods employed by the FBI include sophisticated investigative techniques, such as, undercover operations. These investigative measures not only result in the collection of valuable evidence, but also provide an opportunity to apprehend criminals in the commission of their crimes, thus reducing losses to individuals and financial institutions.

#### Conclusion

Mr. Chairman, the FBI remains committed to its responsibility to aggressively investigate significant financial crimes. To maximize our current resources, we have used our expanded and maturing intelligence collection and analysis capabilities to better identify and understand the growing threat posed by financial frauds. We also continue to rely heavily on the strong relationships we have with our law enforcement, regulatory and industry partners.

The FBI looks forward to working with you, and other members of this committee, in solving this serious threat to our nation's economy. Thank you for allowing me the opportunity to testify before you today.

