FINANCIAL MANAGEMENT, WORK FORCE, AND OPERATIONS AT THE SEC: WHO'S WATCHING WALL STREET'S WATCHDOG

JOINT HEARING

BEFORE THE

SUBCOMMITTEE ON TARP, FINANCIAL SERVICES AND BAILOUTS OF PUBLIC AND PRIVATE PROGRAMS

AND THE

SUBCOMMITTEE ON GOVERNMENT ORGANIZATION, EFFICIENCY AND FINANCIAL MANAGEMENT

OF THE

COMMITTEE ON OVERSIGHT AND GOVERNMENT REFORM

HOUSE OF REPRESENTATIVES

ONE HUNDRED TWELFTH CONGRESS

FIRST SESSION

MARCH 10, 2011

Serial No. 112–11

Printed for the use of the Committee on Oversight and Government Reform

Available via the World Wide Web: http://www.fdsys.gov
http://www.house.gov/reform

U.S. GOVERNMENT PRINTING OFFICE

67–368 PDF WASHINGTON : 2011

For sale by the Superintendent of Documents, U.S. Government Printing Office
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FINANCIAL MANAGEMENT, WORK FORCE, AND OPERATIONS AT THE SEC: WHO'S WATCHING WALL STREET'S WATCHDOG

THURSDAY, MARCH 10, 2011

HOUSE OF REPRESENTATIVES, SUBCOMMITTEE ON TARP, FINANCIAL SERVICES AND BAILOUTS OF PUBLIC AND PRIVATE PROGRAMS, JOINT WITH THE SUBCOMMITTEE ON GOVERNMENT ORGANIZATION, EFFICIENCY AND FINANCIAL MANAGEMENT, COMMITTEE ON OVERSIGHT AND GOVERNMENT REFORM,

Washington, DC.

The subcommittees met, pursuant to notice, at 1:30 p.m. in room 2157, Rayburn House Office Building, Hon. Patrick T. McHenry (chairman of the Subcommittee on TARP, Financial Services and Bailouts of Public and Private Programs) presiding.

Present from the Subcommittee on TARP, Financial Services and Bailouts of Public and Private Programs: Representatives McHenry, Guinta, Buerkle, Amash, Meehan, Walsh, Gowdy, Ross, Quigley, Maloney, Welch, Yarmuth, and Speier.

Present from the Subcommittee on Government Organization, Efficiency and Financial Management: Representatives Platts, Mack, Lankford, Amash, Gosar, Guinta, Farenthold, Towns, Cooper, Connolly, and Norton.

Also present: Representatives Issa and Cummings.

Staff present: Molly Boyl, parliamentarian; Larry Brady, staff director; Sharon Casey, senior assistant clerk; Katelyn E. Christ, research assistant; Benjamin Cole, policy advisor and investigative analyst; Drew Colliatie, staff assistant; Tyler Grimm, Ryan M. Hambleton, and Tabetha C. Mueller, professional staff members; Peter G. Haller, senior counsel; Frederick Hill, director of communications and senior policy advisor; Christopher Hixon, deputy chief counsel, oversight; Hudson Hollister, counsel; Justin LoFranco, press assistant; Mark Marin, senior professional staff member; Tegan Noelle Millspaw, research analyst; Laura L. Rush, deputy chief clerk; Ronald Allen, minority staff assistant; Carla Hultberg, minority chief clerk; Scott Lindsay, minority counsel; Jason Powell and Steven Rangel, minority senior counsels; and Dave Rapallo, minority staff director.

Mr. MCHENRY. The committee will now come to order.

I will start today's hearing by reading the Oversight and Government Reform Committee's Mission Statement.

We exist to secure two fundamental principles. First, Americans have the right to know that the money Washington takes from them is well spent. Second, Americans deserve an efficient, effective government that works for them.

Our duty on the Oversight and Government Reform Committee is to protect these rights. Our solemn responsibility is to hold government accountable to taxpayers because taxpayers have a right to know what they get from their government.

We will work tirelessly in partnership with citizen watchdogs to deliver the facts to the American people and bring them genuine reform to the Federal bureaucracy. This is the mission of the Oversight and Government Reform Committee.

Today, we are here for a joint hearing between the Oversight and Government Reform Subcommittee on TARP, Financial Services and Bailouts of Public and Private Programs and the Subcommittee on Government Organization, Efficiency and Financial Management on "SEC: Who's Watching Wall Street's Watchdog."

When we called this hearing originally, we were concerned about capital formation and accountability at the SEC. A number of management practices had come to light at that point that we thought it would be important to discuss, but a lot has changed just in the last 2 weeks in terms of disclosures of what is happening at the SEC and larger issues of concern with management that strike the agency's credibility. So there will be a lot of questions to that regard in today's hearing.

I welcome the panel. I thank you for being here and with that, I yield to the chairman of the full committee, my customary 5 minutes as subcommittee Chair, for his opening statement.

Chairman ISSA. I thank the chairman and I thank him for his generosity with the opening statement.

I, too, thought this hearing would be about slightly different matters, but in recent days, the committee has become aware of what could be the greatest challenge to the SEC's credibility since Bernie Madoff managed to dup so many Americans, steal so much money with his ponzi scheme, and escape the proper scrutiny of the SEC for so long.

As we have learned, in 2009, the former general counsel, Mr. Becker, came to the SEC and informed the chairman that he had a potential conflict of interest. We hope to learn exactly how that was expressed, but in fact, he had received, along with his siblings, $2 million that came from the liquidation of a Bernie Madoff fund in 2005. That would be serious enough that anyone would normally consider that he should be recused from any activity related to the Madoff after action.

Notwithstanding that, Mr. Becker, feeling that this was, as we have understood it, a de minimis amount relative to his estate, in fact, not only continued to be involved, but was instrumental in having the SEC inserted into the process of trying to change how the determination of how much money would be considered to be eligible to be retained by those who got their money out before the collapse versus how much would be clawed back for the greater good of all those involved and victimized by the ponzi scheme.

Had Mr. Becker's suggestions been taken, in fact, Mr. Becker's mother's estate of $2 million would have benefited well all those who were there to the end and lost so much would have been victimized.

The problem we are going to be probing in this hearing, in addition to others, is can we trust an SEC where the process allows an individual to inform the chairwoman, to inform the ethics individual who actually reports to the general counsel, and get effectively a clean bill of health not to disclose and not to recuse and even to be involved in an action that had it been accepted, as our understanding is, by the trustees, would have led to a distortion of process in favor of Mr. Becker's family.

We take Mr. Becker at his word that, in fact, he intended no wrong. We are willing to take factually in 25 minutes, the ethics individual at SEC made a determination there was no problem and stuck by it. We are willing to hear the Chairwoman here today.

What we are not willing to do, as the committee that deals in waste, fraud and abuse, and as a committee of Congress, all of us being concerned a great deal about the confidence in what the SEC represents in its oversight, its fairness and its competence, we are not willing to accept that this can ever happen again.

Mr. Chairman, I am not going to presume any facts not yet in evidence. So far, we only have a limited amount of reports, a clawback procedure against Mr. Becker and Mr. Becker's own interview here with some of our investigators. Today, we have an opportunity to listen to the Chairwoman, to realize that she inherited an organization that had no flaws, but her independent agency has, in fact, been the subject of the President's attention, her attention.

We have not yet high confidence but high hope that the SEC will live up to its mandate, not just of having a complex web of rules that tell public companies that if their own child works for a company, they cannot be outside or independent officers or directors of the company, or, for example, what a conflict is to the people who oversee, who can be on the compensation committee, who cannot. It is a complex business but it relies on a belief that the rules are necessary, they are implemented in a sensible way, uniformly and that they are for a purpose.

I believe as we look further into the Becker matter, we are going to find the SEC failed to have the highest level of fear so that public confidence could be maintained. I can find no way out of this. I hope today we at least understand how this mistake came to happen.

Mr. Chairman, once again, thank you for holding this important hearing and I yield back.

Mr. MCHENRY. Thank you, Mr. Chairman. Thank you for your statement. With that, I recognize the distinguished Member from Illinois, the chairman of the Subcommittee on TARP, Financial Services and Bailouts of Public and Private Programs, Mr. Quigley, for 5 minutes.

I am sorry, I just promoted you to chairman—ranking member, Mr. Quigley.

Mr. QUIGLEY. Thank you so much, Mr. Chairman. I soon will be joined by Chairman Platts, as well.

I thank our witnesses for their time today and their contributions.

As we all know, in December 2008, Bernard Madoff was arrested for running the largest ponzi scheme in American history. Losses from Madoff's fraud have been estimated at $18 billion, devastating the savings of many Americans.

We all know the SEC missed Madoff despite being tipped off on several occasions. Although no regulatory agency should be expected to be perfect, a failure of this magnitude is clearly unacceptable.

How did this happen? Many have blamed the SEC's outdated technology, which is woefully behind what the financial firms are using; many have blamed the SEC's silo problem which prevents coordination among the SEC's many offices. Another culprit that has been cited is the SEC's work force which some argue includes too many lawyers and not enough industry veterans. We have all heard about the SEC employees viewing pornography instead of doing their jobs. These are reasonable concerns and all merit oversight from these two subcommittees.

We have also heard about a potential conflict of interest from David Becker, formerly senior counsel at the SEC. It is my understanding that SEC IG David Katz is investigating this matter. I look forward to his report.

Just a few years removed from Madoff and the worst financial crisis since the Great Depression, we need the SEC to do its job and do it well. The SEC is Wall Street's policeman. It was estimated by the 1934 Security Exchange Act to prevent fraud and abuse in the securities market. Creating the SEC was essential to restoring investor trust in our country's economic system. If our economic system is going to work, says Nobel laureate, Joseph Stiglitz, then we have to make sure that what people gain when they cheat is offset by a system of penalties.

Each year, the SEC brings hundreds of enforcement cases against firms that have sold fraudulent financial products. In 2010, for example, the SEC brought 681 enforcement cases against 1,800 defendants.

Just as all of us feel more comfortable in our neighborhoods when they are well policed, investors feel more comfortable buying financial products when the SEC is doing its job and prosecuting white collar crime. The SEC is more important today than ever before. Trust in our financial system is at its lowest ebb and this lack of trust is impeding our economic recovery.

The financial regulatory reform law passed here was a step in the right direction, but it alone is insufficient. Laws have to be enforced and the SEC needs to be a strong enforcer.

Unfortunately, the House-passed budget would reduce SEC funding from its current $1.1 billion. For comparison's sake, City Bank spent $1.6 billion on marketing alone in 2010. How is the SEC expected to police Wall Street when its entire budget is less than the marketing budget of one Wall Street Bank?

In a May 2010 report, the minority staff of the Oversight Committee found that the Commission security disclosure procedures are technologically backward. Yet, under the House-passed cuts, the SEC won't be able to continue any improvement of its IT systems. If the SEC's budget is reduced to 2008 levels, as some have proposed, the SEC would have to layoff 600 workers.

My point is this. Just a few years after the Madoff incident and the worst financial crisis in recent history, should we really be talking about taking 600 cops off Wall Street? Let us strengthen the SEC, not weaken it. Let us also ensure that the SEC undertakes common sense report to avoid past mistakes.

Put another way, after 9/11, despite our intelligence failures, we did not cut the intelligence budget, we doubled it. It is my understanding that the SEC has already reorganized, brought in a COO and designed a new tips referral system. These are all commendable steps.

In the end, our country will be safer from another financial crisis if the SEC is well organized and well funded.

I look forward to hearing from our witnesses who I hope will provide some constructive ideas on how to improve the SEC's oversight of financial markets.

Thank you. I yield back.

[The prepared statement of Hon. Mike Quigley follows:]

Opening Statement, March 10, 2011, Subcommittee on TARP and Financial Services
Rep. Mike Quigley, Ranking Member

Chairman McHenry and Chairman Platts, I'd like to begin by thanking you for convening today's hearing.

I'd also like to thank our witnesses for generously contributing their time and expertise to this discussion.

In December 2008, as we all know, Bernard Madoff was arrested for running the largest Ponzi scheme in history.

Losses from Madoff's fraud have been estimated at $18 billion dollars, devastating the savings of many Americans.

We all know that the SEC missed Madoff, despite being tipped off on several occasions.

Although no regulatory agency should be expected to be perfect, a failure of this magnitude is clearly unacceptable.

How did this happen?

Many have blamed the SEC's outdated technology, which is woefully behind what the financial industry is using.

Many have also blamed the SEC's "silo problem", which prevents coordination among the SEC's many offices.

Another culprit that has been cited is the SEC's workforce, which includes too many lawyers and not industry veterans.

And we have all heard about the SEC employees viewing pornography instead of doing their jobs.

These are all reasonable concerns, and all merit oversight from these two subcommittees.

We have also heard about a potential conflict of interest from David Becker, formerly senior counsel at the SEC.

It is my understanding that SEC IG David Kotz is investigating this matter—I look forward to his report.

Just a few years removed from Madoff and the worst financial crisis since the Great Depression, we need the SEC to do its job *and to do it well.*

The SEC is Wall Street's policeman—it was established by the 1934 Securities Exchange Act to prevent fraud and abuse in the securities market.

Creating the SEC was essential to restoring investor trust in our country's economic system.

"If our economic system is going to work", says Nobel laureate Joseph Stiglitz, "then we have to make sure that what [people] gain when they cheat is offset by a system of penalties."

Each year, the SEC brings hundreds of enforcement cases against firms that have sold fraudulent financial products.

In 2010, for example, the SEC brought 681 enforcement cases against 1,817 defendants.

Just as all of us feel more comfortable in our neighborhoods when they're well policed—

—investors feel more comfortable buying financial products when the SEC is doing its job and prosecuting white collar crime.

And the SEC is more important today than ever before.

Trust in our financial system is at its lowest ebb, and this lack of trust is impeding our economic recovery.

The financial regulatory reform law passed last year was a step in the right direction, but it alone is insufficient.

Laws have to enforced, and the SEC needs to be a strong enforcer.

Unfortunately, the House-passed budget would reduce SEC funding from its current $1.1 billion dollars.

For comparison's sake, Citibank spent $1.6 billion dollars on marketing alone in 2010.

How is the SEC expected to police Wall Street when its *entire budget* is less than the *marketing* budget of one Wall Street bank?

In a May 2010 report, the Minority staff of the Oversight Committee found that "The Commission's securities disclosure processes are technologically backward."

Yet under the House-passed cuts, the SEC won't be able to continue any improvement of its IT systems.

And if the SEC's budget is reduced to 2008 levels, as some have proposed, the SEC would have to lay off 600 workers.

My point is this: just a few years after Madoff and the worst financial crisis in recent history, should we really be taking 600 cops off Wall Street?

Let's strengthen the SEC, not weaken it, and let's also ensure that the SEC undertakes commonsense reform to avoid past mistakes.

It's my understanding that the SEC has already reorganized, brought in a COO, and designed a new tips referral system—these are all commendable steps.

In the end, our country will be safer from another financial crisis if the SEC is well-organized *and* well-funded.

I look forward to hearing from our witnesses, who I hope will provide some constructive ideas on how to improve the SEC's oversight of financial markets.

Mr. MCHENRY. I thank the ranking member.

With prior agreement on our side, Dr. Gosar from Arizona will have 5 minutes for an opening statement.

Mr. GOSAR. Thank you, Mr. Chairman.

Let me preface my comments with the following. I am not a financial analyst, I am not an accountant and I am not a lawyer, but I do have skin in the game, as do most Americans. Most Americans are compelled to invest in the markets through their employer-sponsored retirement plans whether they are 401(k) plans or public or union pension plans. The money largely goes to Wall Street.

The public needs assurances that those who handle our money and our retirement futures are playing by the rules and are being fair and are honoring their fiduciary responsibilities and obligations.

The public assurances come from the Securities Exchange Commission. The SEC is supposed to be guarding the hen house. This hearing raises troubling questions. Who is watching the hen house—the fox or the guard?

Mr. Chairman, recent news reports have focused on David Becker's conflict of interest, but this hearing is not about a single incident. This problem is actually far deeper and goes to the very heart of management practices at the SEC.

Every organization needs a set of mechanisms to prevent or detect fraud, waste or mismanagement. These are commonly known as internal controls. It would appear that internal controls at the SEC are not functioning properly.

One, the Government Accounting Office tells us that the SEC is unable to reliably track its finances because it cannot control its own financial reporting. Two, the SEC's inspector general tells us that 30 employees, including an assistant regional director, viewed sexually explicit materials at work and only one was actually fired. Was anyone else ever disciplined? Three, now the news media tells us that the SEC's general counsel was allowed to advise the Commissioners on the Madoff case when he had a personal, financial interest.

All these matters represent a breakdown in oversight and management, a failure of internal controls. The sad irony is that the SEC is the Federal agency in charge of making sure publicly traded companies have effective internal controls and public governance structures. In fact, Mr. Chairman, if these events happened at a publicly traded company, the SEC would be investigating itself and what would be the penalties?

Federal agencies are subject to the Federal Managers Financial Integrity Act which dictates that they provide annual assurances to Congress that their internal controls are adequate. This law has been in effect since 1982 and governs not just financial management, but program management as well.

The Federal Managers Financial Integrity Act is within this committee's jurisdiction. Therefore, this hearing has an important legislative and oversight purpose in the Commission's compliance with the law and others. Mr. Chairman, the anecdotal example of internal breakdowns are symptoms of a much larger systemic breakdown. Since there is no SEC to investigate the SEC, today I challenge my colleagues.

Thank you, Mr. Chairman. I yield the balance of my time.

Mr. McHENRY. I thank the gentleman.

I now recognize the ranking member of the Subcommittee on Government Organization, Efficiency and Financial Management, Mr. Towns, former chairman of the full committee, for 5 minutes.

Mr. TOWNS. Thank you very much, Mr. Chairman, and thank you for holding this hearing today.

The SEC is at an important crossroad. It is successfully emerging from a troublesome period leading up to collapse of the country's financial system. It is paused to take the lead in reforming Wall Street and preventing another financial meltdown through its enforcement of the Dodd-Frank Act.

This hearing will examine financial management, the work force and internal operations at the SEC. It is encouraging to see all the new initiatives Chairman Schapiro has put in place in the last 2 years. The SEC hired its first chief operating officer to oversee the accounting functions, financial reporting and internal controls, and we salute you for that, Madam Chair.

The SEC has also hired a new chief information officer to oversee its information technology functions. The Chairperson has restructured the entire Enforcement Division, recruited experts and has put a new governing structure in place. This is commendable as well.

As with any organization, lapses can, do and will occur. I understand the SEC has taken disciplinary action against those who have been accused of misconduct at the Commission and that greater accountability has been integrated into the disciplinary process.

The SEC is responsible for safeguarding the confidence of American investors in the financial markets and I hope our hearing today will help our financial watchdog fulfill its mission.

I now yield the balance of my time to the ranking member of the full committee.

Mr. CUMMINGS. I thank the gentleman for yielding.

This committee is responsible for ensuring that our government operates effectively and efficiently. That means holding public officials to the highest standards, demanding excellence at every turn and eliminating even the appearance of impropriety.

Today, the committee intends to examine against David Becker, the former general counsel of the SEC. I do not know Mr. Becker, I have never met him, never talked to him, and the minority was excluded from Mr. Becker's interview when Chairman Issa's staff interviewed him, but I do want to make sure that everyone who comes before this committee is treated fairly, including Mr. Becker, Chairwoman Schapiro and others.

If I understand the facts correctly, Mr. Becker's parents invested about $500,000 with Bernie Madoff in 2000. Mr. Becker's mother died in 2004 and when her funds were divided among Mr. Becker and his two brothers in 2006, they had increased to about $2 million.

Mr. Becker joined the SEC in 2009, he notified the SEC officials about his inheritance and when issues arose relating to his inheritance, he sought advice from SEC ethics officials and received clearance to proceed. Some have suggested that Mr. Becker may have benefited financially from the SEC's later decisions, but it appears that the opposite may be true.

The basic question the SEC faced was whether to support an asset valuation method used by the trustee representing the Madoff victims, called the cash-in-cash-out method, or a different valuation method proposed by several law firms called the last statement method.

Under the first, Mr. Becker's inheritance would be subject to litigation to recover or clawback assets on behalf of the Madoff victims. Under the second, it appears that it would not. Based on the court filings, the SEC chose to support the first method. This meant that the trustee could sue Mr. Becker and his brothers to recover some of his mother's inheritance which is exactly what happened.

Mr. Chairman, in your briefing memo for today's hearing, you acknowledged that the SEC's decision was "actually detrimental to Mr. Becker's interest." Nevertheless, I have serious questions about the conclusions of the SEC's Ethics Office, Chairman Schapiro, that these issues had no effect on Mr. Becker's financial interest. Someone else of questionable character might have tried to take advantage of this situation. I also have questions about whether Mr. Becker's interests should have been disclosed more widely within the SEC and I hope we can learn more about this process today.

I also invite my Republican colleagues to join us in making sure that the SEC has all the resources it needs. There is a proposed cutting of $148 million from their budget and we do need a robust SEC.

Chairwoman Schapiro, I read what you have done and what you have accomplished. You inherited a mess. You inherited an agency that Senator McCain said the former Chair should resign, so we understand that.

Again, I am looking for a fair hearing and one where we can get to the bottom of all of this.

I yield back.

Mr. MCHENRY. I thank the ranking member.

All Members may have 7 days to submit opening statements for the record.

I will now recognize the panel. We have the Honorable Mary Schapiro, Chairman, Securities and Exchange Commission; Mr. Jeffrey Risinger, Director, SEC Office of Human Resources; Mr. Jonathan Jack Katz, the former Secretary of the Securities and Exchange Commission for 20 years; Mr. Stephen Crimmins, a securities attorney with K&L Gates—he served as deputy chief litigation counsel of the SEC's Enforcement Division from 1993–2001; and Ms. Helen Chaitman, the attorney representing approximately 350 investors in Mr. Bernard L. Madoff's investment securities firm.

It is the policy of the committee that all witnesses be sworn before they testify. Please rise and raise your right hands.

[Witnesses sworn.]

Mr. MCHENRY. The record will reflect that all the witnesses answered in the affirmative. With that, I thank you.

We will begin at this time with Chairman Schapiro. I think you heard the Members' opening statements and we would love to hear your comments, especially about this conflict that has been discussed. Ms. Schapiro.

STATEMENTS OF MARY SCHAPIRO, CHAIRMAN, U.S. SECURITIES AND EXCHANGE COMMISSION, ACCOMPANIED BY JEFFREY RISINGER, DIRECTOR, OFFICE OF HUMAN RESOURCES, U.S. SECURITIES AND EXCHANGE COMMISSION; JONATHAN KATZ; STEPHEN J. CRIMMINS, K&L GATES, LLP; AND HELEN CHAITMAN, ESQ., BECKER & POLIAKOFF, LLP

STATEMENT OF MARY SCHAPIRO

Ms. SCHAPIRO. Thank you very much, Chairman McHenry, Ranking Members Quigley and Towns, members of the subcommittee.

Thank you for inviting me to testify today regarding the financial management, work force management and internal operations of the Securities and Exchange Commission. As you know, I am joined by Jeff Risinger, Director of our Office of Human Resources.

When I arrived at the SEC 2 years ago, the agency was reeling from a variety of economic events and mission failures and in need of across the board reform. We needed more experts, better training, improved communication among our divisions and offices and an effective strategy for handling tips and complaints. These challenges were exacerbated by inadequate infrastructure, material weaknesses in financial management and a culture that had failed to keep up with an increasingly complex financial marketplace. We immediately and comprehensively set out to change the way the Commission worked. My written testimony details the reforms of the last 2 years, but I would like to highlight a few.

We brought new leadership and senior management to virtually ever office and hired the Commission's first chief operating officer. We revitalized and restructured our enforcement and examination operations and revamped our handling of tips and complaints. We broke down internal silos and created a culture of collaboration. We recruited more staff with specialized expertise and real world experience and expanded our training. We enhanced safeguards for investors' assets through new rules and the leveraging of public accounting firms.

Although we have made significant progress, we continue to seek ways to improve our operations. After all, our core responsibility is pursuing fraud, reviewing corporate disclosures, overseeing the largest capital markets in the world and inspecting the activities of thousands of financial intermediaries are essential to restoring investor confidence in the wake of the financial crisis.

Our funding has presented challenges. From 2005 to 2007, the SEC experienced 3 years of frozen or reduced budgets, forcing a 10 percent reduction in the agency staff. Similarly, the agency's investment in new or advanced systems declined approximately 50 percent between 2005 and 2009.

While SEC staffing levels are just now returning to 2005 levels, the securities markets have undergone tremendous growth since then. Indeed, during the past decade, trading volume has more than doubled, the number of investment advisors grew by 50 percent and the funds they manage increased to $38 trillion. Operating under the continuing resolution only exacerbates the imbalance between our resources and the magnitude of our mission.

At the same time, the Dodd-Frank is significantly expanding the SEC's responsibilities for the derivates market, hedge fund advisors and union support advisors. In addition, we are also charged with enhanced supervision of rating agencies, heightened regulation of asset-backed securities and the creation of a new whistleblower program.

For these reasons, I am concerned that without additional resources, we will not be able to fulfill these responsibilities in the manner in which Congress intends and the American people deserve.

Finally, I would like to address the issue of former Counsel David Becker's role in light of his mother's ownership of an account at Madoff that was closed years before the fraud was revealed.

Mr. Becker informed me, I believe shortly after he arrived in 2009, that his mother had an account with Madoff before she died and that it had been closed a number of years before he returned to the agency. It did not strike me that his mother's account closed years ago would present a financial conflict of interest.

Mr. Becker was, and is, an experienced attorney who had served as general counsel under three chairmen. I relied on him to present any ethics related issues to the ethics counsel and follow the ethics counsel's advice. I understand that is what he did.

When I returned to the agency in 2009 having served there in the late 1980's and early 1990's, appointed by President Reagan and President Bush, I read many letters from Madoff's victims, people who have lost everything. My entire focus was on how to fix the SEC to ensure that another tragedy like Madoff could never happen again, and how to make sure within the contours of the Securities Investors Protection Act that we could get the most money to people who were literally losing their homes.

I am proud of how much we have accomplished in the past 2 years working tirelessly with an extraordinary staff to improve the operation of the Commission and enhance the public's perception of the integrity of our work and the fairness of our decisions.

While Mr. Becker did solicit and follow advice from the ethic's counsel, I realize in light of this incident that as chairman, I have to ensure that we go beyond what may be required in any particular situation. On matters like these, I have to be looking around the next corner, looking beyond the horizon and thinking above and beyond what may be appropriate advice from the ethics counsel to make sure nothing occurs that could raise questions about the Commission's mission or processes.

To ensure that this matter is fully reviewed, I requested that the SEC inspector general conduct an independent review and analysis of all of the relevant facts. In addition, under the leadership of our new ethics counsel, we have been performing a top to bottom review of our ethics program.

In the meantime, I look forward to answering questions about this matter to the best of my recollection, but I can say to this committee with assuredness, we will learn from this experience and we will take all actions necessary to earn the trust the public places in us.

Thank you.

[The prepared statement of Ms. Schapiro follows:]

Testimony on the Financial Management, Work Force Management and Internal Operations of the U.S. Securities and Exchange Commission

by Chairman Mary L. Schapiro
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Before the Subcommittee on TARP, Financial Services and Bailouts of Public and Private Programs and the Subcommittee on Government Organization, Efficiency and Financial Management of the U.S. House of Representatives Committee on Oversight and Government Reform

Thursday, March 10, 2011

Chairmen McHenry and Platts, Ranking Members Quigley and Towns, and members of the Subcommittees:

Thank you for inviting me to testify today regarding the financial management, work force management and internal operations of the Securities and Exchange Commission.[1]

When I arrived at the SEC two years ago, the agency was reeling from a variety of economic events and mission failures that had severely harmed the ability of the agency to achieve its mission of protecting investors, maintaining fair and orderly markets, and facilitating capital formation. The failures of Bear Stearns and Lehman Brothers and other events of the economic crisis had shaken investors' faith in the ability of the agency to supervise some of the nation's largest financial entities. In addition, the failures to discover and act on the devastating financial schemes by Bernard Madoff and Allen Stanford struck directly at the core competencies of the SEC. We needed more experts, our training was deficient, our divisions and offices did not effectively communicate, and the manner in which we processed tips and complaints was critically lacking. These problems were exacerbated by inadequate infrastructure and material weaknesses in financial management and a siloed culture that had failed to keep pace in skills or technology with a rapidly changing and increasingly complex financial marketplace.

Reform was needed across the agency, and we immediately initiated decisive and comprehensive steps to reform the way the Commission operates. We brought in new leadership and senior management in virtually every office, including the Commission's first Chief Operating Officer, revitalized and restructured our enforcement and examination operations, revamped our handling of tips and complaints, took steps to break down internal silos and create a culture of collaboration, improved our risk assessment capabilities, recruited more staff with specialized expertise and real world experience, expanded our training, and, through rulemaking and leveraging of public accounting firms' efforts, enhanced safeguards for investors' assets, among

[1] The views expressed in this testimony are those of the Chairman of the Securities and Exchange Commission and do not necessarily represent the views of the Commission. Testifying with me today will be Jeffrey Risinger, the Director of the Commission's Office of Human Resources. I have attached biographical information for Mr. Risinger as an appendix to this testimony.

other things. Our goal throughout these many changes has been to create a more vigilant, agile and responsive organization to perform the critical mission of the agency.

It is clear our efforts are paying dividends. Last fiscal year, the SEC returned $2.2 billion to harmed investors, twice the agency's budget for that year. Similarly, last fiscal year there was $2.8 billion in disgorgement and penalties ordered in SEC enforcement actions, a 176 percent increase over the amounts ordered in fiscal year (FY) 2008. Our enforcement actions have ranged from complex cases against parties that played significant roles in the recent economic crisis to lesser known cases involving real harm to individual investors. Our examiners and enforcement investigators now collaborate frequently and effectively, resulting in a number of recent enforcement actions generated from examination referrals.

Although we have made progress in reforming the Commission, we continue to seek ways to improve our operations. Section 967 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) directed the agency to engage the services of an independent consultant to study a number of specific areas of SEC operations. During the past four months, our staff has been fully engaged with the Boston Consulting Group (BCG), participating in interviews, providing documentation, and responding to questions. BCG's report will be released to Congress soon, and I expect that it will include recommendations that will identify additional efficiencies for the agency's operations. I look forward to implementing those and any others that will improve the way operate and enhance our ability to fulfil our mission.

New Leadership, Organizational Structures, and Expertise

In the last two years, we have brought in new leadership to run the agency's five largest operating units: the Division of Enforcement, the Office of Compliance Inspections and Examinations, the Division of Corporation Finance, the Division of Trading and Markets, and the Division of Investment Management. We also selected a new General Counsel, Chief Accountant, head of the Office of Investor Education and Advocacy, Chief Freedom of Information Act and Privacy Act Officer, Ethics Counsel, and directors for the New York, Miami, and Atlanta regional offices.

In addition, in May 2010, as mentioned, the Commission hired the agency's first Chief Operating Officer to oversee the operations of the finance and accounting functions of the SEC's Office of Financial Management, including financial reporting internal controls, the Office of Information Technology, and the Office of FOIA, Privacy & Records Management. In addition, we hired the agency's first Chief Compliance Officer in April 2010, and also named a new Chief Information Officer to oversee the Commission's information technology functions in October 2010.

This new and talented leadership team is committed to a culture of collaboration – sharing information and sharing ideas – and is playing a vital role in our efforts to transform the agency.

The scope and breadth of this agency's responsibilities is extraordinary. We are responsible for examining more than 11,000 investment advisers, over 5,000 broker-dealers with in excess of

160,000 branch offices, and 7,500 mutual funds. We are tasked with enforcing the securities laws governing the largest markets in the world and in which millions of Americans participate. We also are responsible for the review of nearly 10,000 public companies, including tens of thousands of disclosure documents each year, plus initial public offerings and other public capital markets transactions of corporate issuers, public asset-backed securities offerings, and proxy statements, public mergers, acquisitions and tender offers. The SEC also oversees approximately 500 transfer agents, 15 national securities exchanges, 10 nationally recognized statistical ratings organizations (NRSROs), as well as the Public Company Accounting Oversight Board (PCAOB), Financial Industry Regulatory Authority (FINRA), Municipal Securities Rulemaking Board (MSRB), and other self-regulatory organizations (SROs). We also are responsible for examining 9 clearing agencies.

Creation of RiskFin to Provide Sophisticated and Interdisciplinary Analysis

In September 2009, we created and staffed a new division – the Division of Risk, Strategy, and Financial Innovation (RiskFin) – to bore through the silos that for too long have compartmentalized and limited the impact of our institutional expertise. Because today's financial markets and their participants are dynamic, fast-moving, and innovative, the regulators who oversee them must continue to improve their knowledge and skills in order to regulate effectively. RiskFin provides the Commission with sophisticated analysis that integrates economic, financial, and legal disciplines, and is re-focusing the agency's attention on and response to new products, trading practices, and risks. RiskFin has attracted renowned experts in the financial, economic, and legal implications of the financial innovations being crafted on Wall Street.

Enforcement Division Reforms

The SEC's Enforcement Division (Enforcement) has implemented a series of fundamental structural reforms designed to improve its performance and responsiveness. Highlights of the initiatives currently being implemented include:

Specialization. Enforcement created five new national specialized investigative groups dedicated to high-priority areas of enforcement: Asset Management (hedge funds and investment advisers), Market Abuse (large-scale insider trading and market manipulation), Structured and New Products (various derivative products), Foreign Corrupt Practices Act violations, and Municipal Securities and Public Pensions. These groups conduct "deep dives" into their respective subject areas, thus increasing their knowledge of products, markets, transactions and practices where fraud and misconduct are most likely to occur. With this knowledge, they are better able to detect patterns and trends that lead to wrongdoing and investor harm, and make it less likely that wrongdoers can conceal their misconduct in complex structures or practices. To accomplish this goal, the groups, as well as various specialization initiatives in the SEC's regional offices, are utilizing enhanced training, specialized industry experience and skills, and targeted investigative approaches to better detect links and patterns suggesting wrongdoing, ultimately leading to more efficient and effective investigations. In addition to investigative work, the specialized units are engaged in a number of initiatives with colleagues in our examination unit and other Divisions to develop risk analytics that proactively identify red flags for further examination and investigation.

Management Restructuring. Enforcement adopted a flatter, more streamlined organizational structure under which it has reallocated a number of staff who were first line managers to the mission-critical work of conducting front-line investigations. Although a layer of management has been eliminated, Enforcement is maintaining staff-to-manager ratios that will allow for close substantive consultation and collaboration, resulting in a management structure that facilitates timeliness, quality, and staff development.

Office of the Managing Executive. Also essential to Enforcement's success is a strong "back office" function with the expertise to handle important support areas such as information technology, workflow, management processes, data collection and analysis, human resources and other administrative responsibilities. For that reason, Enforcement launched an Office of the Managing Executive, which 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. Enforcement also hired its first Managing Executive, who is focused on the Division's administrative, operational, and infrastructure functions, thus freeing up valuable investigative resources for mission-critical work.

Office of Market Intelligence. Enforcement established an Office of Market Intelligence to serve as a central office for the handling of tips, complaints and referrals (TCRs) received by Enforcement; coordinate Enforcement's risk assessment activities; and support Enforcement's strategic planning activities. This office will allow the division to have a unified, coherent, coordinated response to the huge volume of TCRs we receive every year, thereby enhancing our ability to open the right investigations, bring solid cases, and effectively protect investors.[2] In addition, Enforcement will use this TCR information to identify emerging threats to investors and markets, which will in turn inform how we employ our limited enforcement resources in order to maximize investor protection and deterrence.

Moreover, over the past two years, we have completely revamped the way the entire agency handles TCRs, including new policies, procedures and systems, as well as a centralized database so that staff across the agency has this information available to them. In fact, next week we plan to begin rolling out our new TCR system that improves our ability to obtain information from the public while providing the staff with workflow tools to better correlate, prioritize, assign and track progress of TCRs through to resolution.[3]

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[2] Each year, the SEC receives an enormous number of 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.

[3] In April 2010, the SEC implemented an interim repository to serve as a central system for collecting all TCRs while the new system was being developed.

Elimination of Unnecessary Process. We improved our law enforcement capabilities and sent a clear signal to our staff that we value toughness and speed by removing procedural roadblocks impeding investigations. For example, we delegated to senior staff the authority to issue subpoenas, so investigations can be launched without the time-consuming process of obtaining the approval of the Commission. Enforcement also has eliminated duplicative and unnecessary approvals for certain routine settlement discussions, Wells notices, and the opening of initial matters under investigation. In addition, we have abolished the requirement that staff obtain Commission approval before entering into settlement talks involving civil monetary penalties against public issuers. Proper levels of supervision remain across all of these areas – we simply eliminated unnecessary and inefficient processes and approvals that slowed down investigations.

Whistleblower Office. The Dodd-Frank Act substantially expands the agency's authority to compensate individuals who provide the SEC with information about violations of the federal securities laws. Last November, the Commission proposed rules mapping out the procedure for would-be whistleblowers to provide critical information to the agency.[4] The proposed rules convey how eligible whistleblowers can qualify for an award through a transparent process that provides them an opportunity to assert their claim to an award. Recently, we announced the selection of a Whistleblower Coordinator to oversee the whistleblower program. We also have fully funded the SEC Investor Protection Fund, which will be used to pay awards to qualifying whistleblowers. Pending the adoption of final rules, Enforcement staff has been reviewing and tracking whistleblower complaints submitted to the Commission.

Cooperation Program. We have added a host of measures to encourage corporate insiders and others to come forward with evidence of wrongdoing. These new cooperation initiatives establish incentives for individuals and companies to cooperate and assist with SEC investigations and enforcement actions. This program will encourage "insiders" with knowledge of wrongdoing to come forward early, thus allowing us to shut down fraudulent schemes earlier than would otherwise be possible.

These reforms are already generating improvements. Court-ordered disgorgements in FY 2010 were over $1 billion more than those ordered in FY 2008 ($1.82 billion compared to $774 million), and court-ordered penalties in FY 2010 exceeded the penalties imposed in FY 2008 by over $770 million ($1.03 billion compared to $256 million). We also returned to harmed investors in FY 2010 $2.2 billion, or $1.2 billion more than we returned in FY 2008, and filed more than twice as many Ponzi scheme cases in FY 2010 as we filed in FY 2008.

Of course, numbers alone do not fully capture the complexity, range, or importance of our enforcement accomplishments. During the past year, the Commission brought significant

[4] *See* Release No. 34-63237, *Proposed Rules for Implementing the Whistleblower Provisions of Section 21F of the Securities Exchange Act of* 1934 (November 3, 2010), http://www.sec.gov/rules/proposed/2010/34-63237.pdf. In addition, last October, the Commission provided its first annual report to Congress on the Whistleblower Program as provided by the Dodd-Frank Act.

actions involving issues arising from the financial crisis, including actions against the former CEO and other executives of Countrywide Financial, Citigroup and its former CFO and Head of Investor Relations, Morgan Keegan, Goldman Sachs, State Street Bank, former executives of New Century Financial, Brookstreet Securities, former executives of IndyMac Bancorp, and ICP Asset Management and its President. We have obtained multi-million dollar settlements with Tyson Foods, Alcatel-Lucent, Technip, and General Electric for violations of the Foreign Corrupt Practices Act (FCPA). We filed our first case against a state involving municipal securities. We brought accounting fraud cases against Dell, Diebold, and DHB Industries. We brought a significant case involving inappropriate use of confidential customer information by a proprietary trading desk at Merrill Lynch and an action against AXA Rosenberg in the challenging and rapidly evolving area of computer-based quantitative investment management. More recently, we brought charges involving illegal trading on confidential information obtained from technology company employees moonlighting as expert network consultants, and involving a $1.5 billion mortgage securities fraud scheme concerning an attempt to scam the U.S. Treasury's Troubled Asset Relief Program.

Examination Program Reforms

Similarly, our Office of Compliance, Inspections and Examinations (OCIE) recently instituted significant reforms to sharpen its focus on a risk-based examination process in the wake of an intensive nation-wide self assessment program it launched last March. These reforms and improvements to the office's risk-based approach were driven in part by the fact that our current examination resources can cover only a small portion of the registrants that we are responsible for examining. For example, there are approximately 460 exam staff responsible for more than 11,000 advisers that manage,[5] among others, 7,500 mutual funds and thousands of additional private funds. These advisers manage nearly $40 trillion in assets under management, including more than $11 trillion in mutual fund portfolios.

Improved Risk Assessment Procedures. OCIE is improving its risk assessment procedures and techniques to better identify areas of risk to investors and more effectively allocate limited resources to their highest and best use. Last fall, OCIE formed a central Risk and Surveillance Unit to analyze emerging risks among the SEC's registrant population. OCIE also is enhancing the information that financial firms submit and is improving techniques to better identify those particular firms that represent the highest risk profiles and therefore warrant a closer look. Once we select firms for examination using a risk-focused methodology, OCIE examination staff are more rigorously reviewing information about these individual firms before sending examiners out to the field, so that we can use our limited resources more effectively and target key risk areas at those firms with the greatest overall risk profiles.

Improved Fraud Detection. We also have instituted measures to improve the ability of examiners to detect fraud involving theft of assets and other types of violations. Examination

[5] While the number of registered advisers is anticipated to shrink by 28 percent, the total assets managed by advisers registered with the Commission are expected to rise.

staff across the country now routinely reach out to third parties such as custodians, counter-parties and customers during examinations to verify the existence and integrity of all or part of the client assets managed by the firm. The measures also include expanded use of exams of an entire entity when firms have joint or dual registrants such as affiliated broker-dealers and investment advisers.

Greater Collaboration with Enforcement. As a result of various Enforcement/OCIE initiatives, there now exists a significantly increased level of collaboration between Enforcement and OCIE staff. OCIE and Enforcement staff and leadership have been directed to evaluate potential enforcement referrals from the OCIE exam staff regularly and determine the disposition of referrals. If there is disagreement on a case at the regional level, exam staff has been instructed to escalate the matter to the attention of senior leadership in Washington. These processes ensure that concerns can be escalated in a timely manner to senior leadership of both the exam and enforcement programs for appropriate review and resolution.

Enforcement and OCIE also hold regular meetings to discuss issues raised in ongoing examinations. Moreover, OCIE policy now requires that exam staff hold quarterly Exam Reviews in which the progress and status of every exam in a Regional Office is discussed and evaluated for several factors, including significant issues with the firm being examined, determining whether more staff resources are needed, and deciding if a potential referral to Enforcement is appropriate. These reviews are an opportunity to preview findings that appear likely to trigger possible Enforcement referrals, as well as to flag any potential differences in the assessment of urgency, potential harm to investors, or other issues that can then be raised at the joint regional meetings or to OCIE senior management.

Recruiting and Hiring Experts. In FY 2010, OCIE hired new staff with diverse skill sets to expand its knowledge base and improve its ability to assess risk, conduct examinations, detect and investigate wrongdoing, and focus our priorities. We have hired new Senior Specialized Examiners – and hope to bring on board more – who have specialized experience in areas such as risk management, trading, operations, portfolio management, options, compliance, valuation, new instruments and portfolio strategies, and forensic accounting. Many of these Senior Specialized Examiners now co-chair OCIE's five new Specialization Working Groups where managers and examiners across the country can hone their expertise in critical areas. We also hired additional staff with expertise in financial products and techniques – such as derivatives, structured products and hedge fund activities. This will permit other staffers to tap into that expertise to help them identify emerging issues and understand the ways the industry is changing. Such expertise can also be helpful in efforts to improve the techniques used in examinations and the collection and analysis of data.

Integration of Our Exam Programs. In addition, OCIE has instituted several measures to integrate the activities of the broker-dealer and investment adviser examination programs. The New York Regional Office, for example, has adopted a protocol that integrates examination teams to make sure people with the right skill sets are assigned to examinations. Under the protocol, a single team of examiners, drawn from the broker-dealer and investment management units, jointly examines selected dually-registered firms to ensure that the examination team includes those personnel relevant to the subject of the exam. In addition, the examination program has expanded opportunities for examiners to cross-train and increase coordination between broker-dealer and investment management staff on their examination plans. Finally, the examination program has begun to include experts from other SEC divisions and offices in exams to ensure we are leveraging SEC expertise and knowledge across the exam process.

New Governance Structure. OCIE a recently implemented a new governance structure, which is transforming our lines of communication and accountability. Specifically, the OCIE National Leadership Team now includes Directors of the Regional Offices, who manage both the Enforcement and Examinations programs in each Regional Office. This strengthens the OCIE/Enforcement partnership and speeds alerts, information hand offs, and transitions from OCIE Exam staff to the Enforcement Division when warranted.

Improved Exam Staffing. In addition, OCIE has outlined a new "open architecture" structure for staffing exams that will enable management to reach across disciplines and specialties to better match the skills of examination teams to the business models and risk areas of registrants. OCIE is also redesigning our exam team structure to redeploy the expertise and experience of managers from office administration to on-site exams in the field. These changes will help ensure that managers spend additional time and attention on supervision and oversight in the field on exams of registrants.

Improvements to our FOIA Program

The Commission's Freedom of Information Act (FOIA) workload has escalated rapidly in the last 10 years. In 2001, we received approximately 2,500 requests. In the most recent fiscal year, we received over 10,000 requests, the most in Commission history and an almost 33 percent increase over FY 2009. By way of contrast, the total number of FOIA requests received by the FDIC, CFTC, and the Federal Reserve Board in FY10 totaled less than 2,900. Almost 75 percent of the FOIA requests we received were from commercial entities performing due diligence research on companies, investment advisers, and broker-dealers.

I share the commitment to accountability and transparency that FOIA encourages, and as Chairman I am committed to improving our FOIA program so that we respond to requests in a timely manner, treat all requesters equally, and provide as much information as possible without adversely affecting our mission.

Since hiring a new Chief FOIA Officer in October 2009, we have, among other things:

- issued new procedures that provide clear and concise processing guidance to all FOIA liaisons and Commission staff involved in FOIA responses;

- restructured the FOIA Office to improve management oversight of the quality and consistency of responses as well as adherence to policies and procedures;

- upgraded existing technology resources;
- made additional equipment available to deal with the escalating number of FOIA requests; and
- made more training available to all staff responsible for processing FOIA requests by using recognized experts in the field, such as a former Co-Director of the Justice Department's Office of Information Policy, which is responsible for providing guidance to all Government agencies on FOIA matters.

Last fiscal year, the Commission realized an 11 percent increase in the number of FOIA requests where records were released in full, and a 6 percent increase where records were released in part. Discretionary withholding also has decreased. Despite the tremendous increase in workload, the Commission ended the year with only 399 pending requests, the lowest number in eight years.

Significantly, action has been taken on all recommendations made by the SEC's Inspector General in his September 25, 2009 report on SEC FOIA operations, and the Inspector General has since closed out the report.

Prompt Responses to Recommendations

I have made it a top management priority to strengthen the SEC's program for ensuring appropriate and timely follow-up on audit recommendations, including by the agency's Office of Inspector General (OIG) and the Government Accountability Office (GAO).

In 2009, with the assistance of the SEC's Inspector General, we drafted and approved a new internal rule (SEC-R 30-2) to strengthen controls and accountability over audit follow-up activities. Among other things, it requires that offices prepare and share with the OIG a formal corrective action plan for all unresolved audit recommendations, as a way of ensuring consultation with the OIG through the audit follow-up process. I also appointed an Audit Follow-up Official and empowered her to ensure that agency managers are held accountable for timely and appropriate follow-up on audit recommendations.

With these efforts, the agency has made significant progress to address recommendations made in OIG reports. In the two years since I became Chairman, the SEC has successfully addressed and closed approximately 360 OIG recommendations, nearly double the number closed in the comparable preceding period.

The SEC also made it a particular priority to ensure that the agency undertakes all necessary actions in response to lessons learned from the agency's handling of the Madoff fraud, which had recently been discovered when I took office. I am pleased to report that, within one year, we were able to address and close all 69 recommendations arising from the OIG's Madoff reports. In addition, our website details all post-Madoff reforms undertaken by the agency.

I also am pleased that the SEC Inspector General's most recent semiannual report to Congress includes a number of further positive indicators with respect to SEC management's reinvigorated commitment to OIG cooperation and follow-up. He reports that, for the most recent period, there were no significant management decisions with which he disagreed, and no instance where agency management refused to produce requested information.

Implementation of Data Standardization

It is imperative that the SEC be able to make timely and efficient use of the information it gathers from filers. Standardizing data is important because it enables us to ensure that we are comparing "like with like," which in turn promotes sound analysis at the entity, industry, and systemic levels. Standardizing data can make it easier for both the SEC and investors to understand the implications of financial statements and other reports, while enabling comparisons between filers and among industries.

In the last two years, the Commission has incorporated data tagging requirements into several of its most significant rulemaking initiatives to increase the ability of parties to analyze the data that filers are required to provide. Among these are the Commission's rules on interactive data to improve financial reporting[6] and the rules on interactive data for mutual fund risk/return summary.[7] The Commission also included data tagging requirements in amendments to its Nationally Recognized Statistical Rating Organizations rules,[8] its rule on money market fund reform[9], as well as in its proposed rules on asset-backed securities,[10] disclosure of payments for resource extraction issuers,[11] and security-based swap data repository registration.[12]

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[6] *See* Release No. 33-9002, *Interactive Data to Improve Financial Reporting* (Jan. 30, 2009), http://www.sec.gov/rules/final/2009/33-9002.pdf.

[7] *See* Release No. 33-9006, *Interactive Data for Mutual Fund Risk/Return Summary* (Feb. 11, 2009), http://www.sec.gov/rules/final/2009/33-9006.pdf.

[8] *See* Release No. 34-59342, *Amendments to Rules for Nationally Recognized Statistical Rating Organizations* (Feb. 2, 2009) http://www.sec.gov/rules/final/2009/34-59342.pdf; Release No. 34-61050, *Amendments to Rules for Nationally Recognized Statistical Rating Organizations* (Nov. 23, 2009), http://www.sec.gov/rules/final/2009/34-61050.pdf.

[9] *See* Release No. IC-29132, *Money Market Fund Reform* (Feb. 23, 2010), http://www.sec.gov/rules/final/2010/ic-29132.pdf.

[10] *See* Release No. 33-9117, *Asset-Backed Securities* (April 7, 2010), http://www.sec.gov/rules/proposed/2010/33-9117.pdf.

[11] *See* Release No. 34-63549, *Disclosure of Payments for Resource Extraction Issuers* (Dec. 15, 2010), http://www.sec.gov/rules/proposed/2010/34-63549.pdf.

[12] *See* Release No. 34-63347, *Security-Based Swap Data Repository Registration, Duties and Core Principles* (Nov. 19, 2010), http://www.sec.gov/rules/proposed/2010/34-63347.pdf. The Commission also discussed the importance of standardizing data in its concept release on the U.S. proxy system, inquiring into the feasibility of requiring data-

It is critical that the SEC be able to benefit from our data-tagging initiatives, both in terms of enhanced analytics and increased efficiencies. To enable prompt and effective analysis of such tagged data, I directed staff early in my tenure to identify, acquire, and begin to train our reviewing staff on how to use new analytic tools that may be available. Unfortunately, the SEC's current budget situation has reduced our ability to staff fully the desired interactive data platform.

The Commission will continue to promote transparency through data standardization techniques such as data tagging with the goal of improving the intelligibility and analyzability of filings. However, this effort, like our other IT initiatives, will be dependent in part on future resources. Moreover, I expect that, as the utility of tagged data in promoting our analytic objectives becomes more widely known, the market will offer additional analytic tools and develop new taxonomies, while continuing to refine existing ones.

Addressing Material Weaknesses in Internal Controls

In November 2010, the SEC completed its Performance and Accountability Report, the equivalent of a company's annual report. A GAO audit found that the financial statements and notes included in the report were presented fairly and in conformity with U.S. GAAP, but also identified two material weaknesses in internal controls over financial reporting: one in information systems, and a second in financial reporting and accounting processes.

I find these material weaknesses to be unacceptable. The root causes of these weaknesses are gaps in the security and functionality of the agency's financial system, resulting from years of under investing in financial system technologies. Rather than incur the development risks of creating new technology and systems, we made the decision to outsource this function by migrating to one of the Office of Management and Budget's designated Federal Shared Service Providers (FSSP), under the Financial Management Line of Business model.

After detailed analysis and careful consideration, the Commission selected as its FSSP the Department of Transportation's (DOT) Enterprise Service Center (ESC). Through the implementation of the new financial system, the Commission will reap the benefits of expanded functional capability; business process reengineering, where appropriate; and better integration of program, financial, and budgetary information to support more efficient and effective operations.

In November 2010, the SEC began the planning phase of the financial management improvement project, which focused on the development of a detailed project plan for the full implementation of the ESC solution and the identification of unique Commission requirements. The SEC and the ESC just completed this planning phase, and on February 25 signed an interagency agreement to

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tagging for proxy-related materials. *See* Release No. 34-62495, *Concept Release on the U.S. Proxy System* (July14, 2010), http://www.sec.gov/rules/concept/2010/34-62495.pdf.

commence the implementation phase. We will work together over the next 13 months to migrate the SEC's financial system and data, with a planned cutover in April 2012.

Employee Discipline

Like most other federal agencies, the Commission is required to follow the termination procedures set forth in Chapters 43 and 75 of Title 5 of the United States Code. These statutes create various procedural requirements, including providing the employee a specification of the charge, providing the employee an opportunity to respond to the charge orally and in writing, and a written decision by the deciding official. If the discipline imposed is greater than a 14 day suspension, the employee has a right to appeal to the Merit Systems Protection Board (MSPB), including the right to an evidentiary hearing before the MSPB. Obviously, before terminating an employee, the Commission must of course meet the requisite burden of evidentiary proof.

In March 2010, I issued a memorandum requiring the Office of Human Resources (OHR) to concur on all disciplinary matters. Prior to this change, OHR did not have the authority necessary to insure consistent and appropriate discipline across the agency. In addition, I have required OHR staff to meet with my office on a monthly basis to discuss the status of all pending disciplinary cases. These changes have built a greater level of accountability into the process.

In April 2010, I sent an email to all SEC employees conveying my anger and frustration at those few individuals who had used SEC time and resources to view sexually explicit materials on the Internet. In that email, I emphasized that any person that violated our clear rules against this inappropriate behavior faced termination of employment, and that we could not – and would not – tolerate such misconduct. I believe our efforts since that time have been effective in addressing that inappropriate use of agency resources.

While these cases have caused the SEC embarrassment, the fact that they have come to light is a sign of our aggressive approach. We employ sophisticated surveillance and internet filters to detect potential abuse, and forward suspected misconduct to the OIG for investigation.

The President's FY 2012 Budget Request

Our longstanding core responsibilities – pursuing securities fraud, reviewing public company disclosures and financial statements, inspecting the activities of investment advisers and broker-dealers, and ensuring fair and efficient markets, to name a few – are essential ingredients to restoring investor confidence and trust in financial institutions and markets following the recent financial crisis.

Until recent years, the SEC has faced significant challenges in maintaining a staffing level and budget sufficient to carry out its core mission. The SEC experienced three years of frozen or reduced budgets from FY 2005 to 2007 that forced a reduction of 10 percent of the agency's staff. Similarly, the agency's investments in new or enhanced IT systems underwent a decline of about 50 percent from FY 2005 to 2009.

SEC staffing levels are just now returning to the level of FY 2005, despite the fact that the size and complexity of the securities markets have undergone tremendous growth since then. During the past decade, trading volume has more than doubled, the number of investment advisers grew by 50 percent, and the funds they manage have increased to $38 trillion. A number of financial firms spend many times more each year on their technology budgets alone than the SEC spends on all of its operations.

In July 2010, the President signed into law the Dodd-Frank Act. The Dodd-Frank Act significantly expanded the SEC's responsibilities and will require significant additional resources for full implementation. In addition to our traditional market oversight and investor protection responsibilities, the new responsibilities under Dodd-Frank include a parallel set of responsibilities to oversee the over-the-counter derivatives market, including direct regulation of participants such as security-based swaps dealers, venues such as swap execution facilities, warehouses such as swap data repositories, and clearing agencies set up as long-term central counterparties. In a similar fashion, whereas the agency has long overseen traditional asset managers, under the Dodd-Frank Act the SEC has been mandated with similar responsibilities for hedge fund advisers, including those that trade with highly complex instruments and strategies. Additionally, the Commission has new responsibility for registration of municipal advisors, enhanced supervision of NRSROs, heightened regulation of asset-backed securities, and creation of a new whistleblower program.

In the short term, the Dodd-Frank Act requires the SEC to promulgate more than 100 new rules, create five new offices, and conduct more than 20 studies and reports. To date, the SEC has proceeded with the first stages of implementation of the Dodd-Frank Act without additional funding.[13] These tasks have taken staff time from other responsibilities, and have been done almost entirely with existing staff.

The SEC's FY 2012 request of $1.407 billion – an increase of $264 million over the agency's current FY 2011 spending authority – is designed to provide the SEC with the resources required to achieve multiple, high-priority goals: adequately staff the agency to fulfill its core mission; continue to implement the Dodd-Frank Act; and expand the agency's information technology systems and management infrastructure to serve the needs of a more modern and complex organization. Moreover, the request will permit additional improvements to the agency's internal operations, including to strengthen the Office of the Chief Operating Officer, build a more robust operational risk management program, and improve program and management controls, including in response to OIG and GAO audits.

It is important to note that the SEC's FY 2012 funding request will be fully offset by matching collections of fees on securities transactions. Currently, the transaction fees collected by the SEC are approximately two cents per $1,000 of transactions. Under the Dodd-Frank Act, beginning with FY 2012, the SEC is required to adjust fee rates so that the amount collected will

[13] To date, in connection with the Dodd-Frank Act, the Commission has issued 25 proposed rule releases, seven final rule releases, and two interim final rule releases. We have received thousands of public comments, completed five studies, and hosted five roundtables.

match the total amount appropriated for the agency by Congress. Under this mechanism, SEC funding will be deficit-neutral, as any increase or decrease in the SEC's budget would result in a corresponding rise or fall in offsetting fee collections.

Of the new positions requested for FY 2012, 312 positions (40 percent) will be used to strengthen and support core SEC functions and to continue reforming its operations and fostering stronger protections for investors. The other 468 positions (60 percent) of the new positions requested for FY 2012 are necessary initially to implement the Dodd-Frank Act. The agency also will invest in technology to facilitate the registration of additional entities and capture and analyze data on the new markets. The costs of these new positions and technology investments to implement the Dodd-Frank Act will be approximately $123 million. Many of these new positions will be for experts in derivatives, hedge funds, data analytics, credit ratings, and other new or expanded responsibility areas.

Investing in Improved Information Technology

Data management and analysis is critical in identifying and assessing potential risk to the U.S. financial markets. The recent growth in the size and technological complexity of the U.S. markets requires that the SEC leverage its own technology to identify and address the most significant threats to investors, as well as to continuously improve agency productivity.
The SEC's budget request for FY 2012 will support information technology investments of $78 million, an increase of $23 million over FY 2011. This will help to address the technology gap that resulted between FY 2005 and 2009, when SEC investments in new IT systems dropped by more than half. This level of funding is needed to support critical new technology initiatives, including data management and integration, document management, EDGAR modernization, market data, internal accounting and financial reporting, infrastructure functions, and improved project management. This funding also will permit the agency to develop risk analysis tools to assist with triage and analysis of the thousands of tips, complaints, and referrals received annually, and to complete a digital forensics lab that enforcement staff can use to recreate data from computer hard drives and cell phones to catch sophisticated fraudsters. This request also includes funding for technology needed to facilitate the registration of additional entities required by the Dodd-Frank Act and to capture and analyze data on these new markets.

Conclusion

While the SEC has made substantial progress in reforming its operations and increasing its efficiency, our efforts are ongoing. Our budget request reflects this need to further improve our internal operations, and also provides the resources needed to accomplish our core mission, implement the responsibilities given to us under the Dodd-Frank Act, and undertake badly needed new technology initiatives. I look forward to continuing to work closely with Congress as this legislative session continues, I thank you for inviting me here today, and I look forward to answering your questions.

Mr. MCHENRY. Thank you, Chairman.

I would counsel the committee that the lights before you, at 1 minute to go, it will turn yellow and red means stop. With that, if you could keep your comments to 5 minutes we would certainly appreciate it.

Mr. Risinger.

STATEMENT OF JEFFREY RISINGER

Mr. RISINGER. Mr. Chairman, I am happy to be before the committee today. I look forward to taking your questions. I don't have any further statements.

Mr. MCHENRY. Five seconds. That might be a record. Thank you and congratulations.

Mr. Katz.

STATEMENT OF JONATHAN KATZ

Mr. KATZ. Good afternoon, Chairman McHenry, Chairman Platz, Ranking Member Quigley, Ranking Member Towns, members of the two subcommittees. It really is an honor to be invited to testify on the operations of the Securities and Exchange Commission today.

It is a matter of great interest and importance to me personally because for most of my career, I was an employee of the SEC. For 20 of those years, I served as the Commission's Secretary, which was one of those unusual positions that afforded me a rare opportunity to participate firsthand in virtually every aspect of the Commission's responsibilities.

I retired from the Commission in January 2006. In the five intervening years, I have really been fortunate. I have served as a technical advisor to a variety of securities commissions in governments in emerging market countries and have also had the opportunity to speak and write about financial regulation in the United States.

In 2008, the Center for Capital Market Competitiveness at the U.S. Chamber of Commerce invited me to conduct a study and to write a report on how to improve the efficiency and effectiveness of the SEC. I wrote this study based upon interviews with more than 50 current and former SEC staff persons and Commissioners who agreed to be interviewed and gave me their ideas, insights and criticisms, the best of which I shamelessly stole.

In addition to this report, in 2009, I wrote a second article for the Pittsburgh Law Review. This article focused primarily on the Enforcement Division of the SEC, a subject that I did not discuss in the Chamber report. Unlike the Chamber report which reflected the collective views of a wide range of people, this article was really my own personal views. In both documents, I attempted to constructively identify what could be done to make the agency a more effective capital market regulator.

Today, I am aware that one of the focal points is, of course, the SEC's budget and question of resources. I have to answer that I, like most people, agree that the SEC does need more staff to carry out its responsibilities, but why more money and more staff is necessary, I don't think it is sufficient. To do the job well, the agency has to reexamine how it does that job and I think it has to make changes. I think it is time to critically self examine the core functions and recognize that most of them just haven't been very effective.

My concern is that just having more people do more of the same thing in the same way is not the best solution. I think we need fundamental changes in organization and management and mission definition. Chairman Schapiro has identified a number of the initiatives she has undertaken and I commend her on them.

I worked for seven chairmen and four acting chairmen and I will tell you that with the possible exception of John Schad, the first chairman I worked with, Chairman Schapiro has probably focused more of her attention on management and organization than any of the other intervening Chairmen, but again, these are first steps and I think more needs to be done.

I want to highlight five points that are contained in my witness statement. I don't have time to go through all of them but if people have questions, I would be happy to do it.

I think the agency needs a partial reorganization. I advocate what is referred to internationally as the Twin Peaks approach, one division that deals with all aspects of retail financial services regulation and another division that handles all credential functions, the so-called safety soundness and stability functions.

I think the agency needs a chief operating officer. I applaud Chairman Schapiro for appointing one, but I think you have to go further. You need a chief operating officer who really is that and has more than the title. The way I distinguish it is when you try and build a house, the architect and owner design the house, but you need a general contractor to actually get it done, to build it well, to keep you on budget and on time.

I see my time is almost up, so I will quickly identify two other things. I think there needs to be substantial changes in enforcement. When you look at Madoff, you understand, in my opinion, this was not a question of culpability, a few bad people doing bad things.

Madoff is similar to other failures of the Commission in the past. These are structural issues that go with how the Division of Enforcement frames its responsibilities and conducts those responsibilities. It has to be proactive, not reactive, and its results have to be aimed at remediation, not penalties. Penalties are the function of the Justice Department. In that respect, I would advocate very strongly for beefing up a Criminal Securities Office in the Department of Justice so that the agency doesn't have to rely upon the Southern District of New York which has limited jurisdiction.

Just in closing, I want to mention what I think is the most important recommendation of all, the need for a special study of the securities markets. In 1961, the SEC was similarly troubled, the markets were in similar upheaval.

Congress appropriated funds to create a special study of the securities market. A group of technocrats, experienced people in government and from industry spent 18 months studying the markets and studying how the SEC functioned. They issued a five volume report that literally for 25 years was the touchstone for everything the SEC did. I think we need another one.

Thank you very much for the time. I am happy to answer questions.

[The prepared statement of Mr. Katz follows:]

Statement of Jonathan G. Katz Before The Subcommittee on TARP, Financial Services and Bailouts of Public and Private Programs, and The Subcommittee on Government Organization, Efficiency and Financial Management, United States House of Representatives

March 10, 2011

Good afternoon, Chairman McHenry, Chairman Platts, Ranking Member Quigley, Ranking Member towns, and members of the Subcommittees. It is an honor to be invited to testify today on the operations of the Securities and Exchange Commission. This is a subject that is of great importance to me personally. For 23 years I was an employee of the SEC. For 20 of those years I served as the Commission's Secretary. This was a position that afforded me a rare opportunity to participate first hand in virtually every aspect of the Commission's responsibilities. I considered it an honor and a privilege.

I retired from the SEC in January 2006. In the five years since my retirement I have been equally fortunate. I have had the opportunity to use the knowledge I gained at the SEC to advise government regulators in a wide array of countries. This experience has taught me a great deal about financial regulation, what it means and what it can accomplish. During these trips I have learned that while markets may be similar, and the regulatory problems may be similar, the appropriate responses may be very different. As I explain to foreign regulators, no matter how thoroughly and how well you study a problem, you should not expect to identify the perfect solution. A regulator must instead focus on identifying several viable actions and rationally choose from among the reasonable, if imperfect, alternatives. If a financial market is truly a free market, it changes quickly. Any regulatory action taken must be regularly reconsidered. When the market inevitably changes, a regulator must accept that the action chosen may have to change as well.

In addition to my international work, I have also had the opportunity to speak and write about financial regulation in the U.S. In 2008, the Center for Capital Market Competitiveness at the U.S. Chamber of Commerce invited me to conduct a study and write a report on how to improve the efficiency and effectiveness of the SEC. That study focused on three core responsibilities of the Commission: The no-action letter process, primarily in the Division of Corporation Finance; the process for reviewing self-regulatory organization rule filings in the Division of Trading and Markets; and the process in the Division of Investment Management through which registered investment companies apply for and obtain exemptions from specific requirements under the Investment Company Act of 1940. In addition to these activities I also wrote a separate chapter on how the management structure of the SEC could be improved.

While I wrote the report for the Chamber, I cannot take sole credit for its recommendations. The 23 recommendations in the report represent the collective ideas of more than fifty current and former SEC staff and Commissioners who agreed to be interviewed and who freely offered their ideas, insights and criticisms. It is gratifying that, in the two years since the report was published, the SEC has implemented or begun to implement several of the recommendations.

This statement and my testimony today also are based on an article I wrote in 2009, published in the University of Pittsburgh Law Review. The article focuses primarily on the Enforcement program at the SEC, a subject that I did not discuss in the Chamber Report. While the Chamber Report is based upon a series of interviews, the enforcement article is based solely on my personal views and research. I have previously provided the Committee's staff with electronic copies of both articles. Both documents are freely available on the websites of the Chamber of Commerce and the University of Pittsburgh Law Review.[1]

Rather than repeat everything that is contained in these documents, today I will focus on five recommendations that I believe to be most germane to this hearing. They are:

1. Improving SEC management and organization
2. Improving the efficiency and effectiveness of core SEC functions
3. Improving the quality of the SEC policy development process
4. Improving SEC enforcement
5. The need for a second Special Study of the Securities Market

Improving SEC management and organization

The size, structure and complexity of the U.S. capital markets and financial companies have grown substantially in the past thirty years. While the size of the SEC has increased significantly over that time, its organizational and management structure has not changed to reflect these developments. Reorganization of key divisions and a better system for managing operations are needed. The ability of the five-member Commission to interpret policy and oversee staff implementation of policy must also be strengthened.

A partial reorganization proposal

Throughout its history, the SEC has followed an organizational model that roughly paralleled the functions, organization and structure of the financial services industry it regulated. Unfortunately, it is based upon the functions, organization and

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[1] The Chamber of Commerce report is available at:
http://www.centerforcapitalmarkets.com/wp-content/uploads/2010/04/ExaminingtheSECrdcfinal.pdf.
The Law review article is available at:
http://lawreview.law.pitt.edu/issues/71/71.3/71_3_Katz_Reviwing_the_sec.pdf

structure of the financial services industry as it existed in the 1970's, when the last major reorganization occurred. While the structure of the financial services industry has changed dramatically in the past forty years, the organization of the SEC has not changed substantially. Today the financial services industry in the United States is highly integrated. A single entity, typically organized as a holding company with separately incorporated and registered subsidiaries, provides a complete suite of investment products and services. The public increasingly works through a single point of contact. A broad reorganization of the SEC is long overdue. The SEC organizational structure should be changed to parallel these changes in the industry, with one division responsible for regulation of retail services to the public and one division with comprehensive responsibility for oversight of securities markets and prudential regulation of the finances and operations of all entities and subsidiaries regulated by the SEC. This is not an original idea. It is analogous to the "twin peaks" model of regulation that originated in Australia and is being adopted in many other countries.[2]

One division would have responsibility for regulation of all retail investment products and services and all professionals. When a retail investor meets with a "financial adviser or consultant", they may believe that the same laws and professional standards apply regardless of the designation or company letterhead. This is not correct. In the past few years a great deal of attention has focused on the different fiduciary standards that apply under the Exchange Act and the Investment Advisers Act. With a clear mandate under Dodd-Frank the SEC is undertaking to address this problem. But it is not the only important difference between the two regulatory regimes. Here are a few other examples. One regulatory regime imposes restrictions on the sale of securities by related parties and the other does not. One system imposes minimum operating capital requirements and the other does not. One system requires individuals to pass qualification exams and the other does not. I am not suggesting as a solution that the SEC adopt a one size fits all approach. I am suggesting that a single division with comprehensive authority would be better able to adopt regulatory policies that are rational and apply in the same way to the same type of service or relationship.

While many of these differences are explicitly embedded in the different laws and can only be harmonized through Congressional action, the current organization of the Commission exacerbates the problem. Efforts to rationalize, reduce or eliminate these differences have traditionally been hampered by "turf wars" between divisions and offices. Under the proposed structure one office would be responsible both for Exchange Act regulation of "registered representatives" and Investment Adviser Act regulation of investment advisers.

The disparity in the regulation of persons under the two acts is mirrored in the regulation of investment products. Consider, for example, the regulation of exchange-traded funds as an alternative investment to mutual funds. The clear distinction of the

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[2] For a detailed discussion and analysis of the Twin Peaks model see GROUP OF THIRTY, THE STRUCTURE OF FINANCIAL SUPERVISION: APPROACHES AND CHALLENGES IN A GLOBAL MARKETPLACE (2008), https://www.deloitte.com/assets/Dcom-UnitedStates/Local%20Assets/Documents/us_fsi_banking_G30%20Final%20Report%2010-3-08.pdf.

past between discrete investments in the secondary market and investments in mutual funds has become blurred. Coherent and consistent SEC regulation should be structured so that a single division is responsible for all retail investment products and services offered.

A separate division should have sole responsibility for prudential regulation, the so-called safety, soundness and stability component of financial regulation. This would include oversight of secondary markets, as well as the responsibility for licensing, oversight of the back-office and capital adequacy of regulated entities. Within this division, there should be a greatly expanded capacity to oversee the debt markets. The SEC has historically focused its resources on the equity markets, reflecting its view that large institutions dominate the debt markets and these "professional" markets can be largely self-policing. Events of the last several years have demonstrated the limitations of the "self-policing" model. Furthermore, as the "baby boom" generation ages and shifts its collective investment portfolio from equity into fixed-income securities, greater regulatory oversight of this market will become more important.

A critical component of this recommendation is the reconsolidation of the examination functions of the Office of Compliance, inspection and Examination ("OCIE") into the new divisions. When OCIE was created, it was envisioned that a separate unit devoted to examinations would provide greater visibility. It was also thought that a merger of the two primary exam programs (investment company/investment adviser and broker-dealer/SRO) would create synergies and improve efficiency. While the first goal, greater visibility has been achieved, the hoped-for synergies is a matter on which there is disagreement.

Unfortunately, the creation of OCIE had several deleterious unintended consequences. The separation of the on-site examinations staff from the regulatory policy divisions has deprived the regulatory policy divisions of critical real-time information. As one former division director commented, "The division has lost its eyes and ears. I used to be able to read an article in the Wall Street Journal in the morning and have an examination team from the New York office on-site in the afternoon. That's no longer possible". Today, it is more likely that information from an examination will be the basis for a formal order of investigation. While this may be appropriate in many instances, it is another reflection of the shift at the SEC from a "regulatory compliance" paradigm to a "regulation by enforcement" paradigm.

A Chief Operating Officer with broad responsibility to monitor and assess core operations is needed at the SEC

The responsibilities of the SEC are substantial and the issues that require its attention are often dictated by the conditions of the capital markets. These are matters of national policy and require careful attention. The Chairman and the Commissioners must focus their time on regulatory policy. There is insufficient time to effectively oversee the core daily functions of the SEC. At the SEC, the primary operating divisions of the Commission, and the comparably sized OCIE, operate semi-autonomously. Each has virtually complete control over its operations (with the exception of Enforcement, which has only limited delegated authority) and may adopt policies and procedures that differ from the other operating units. While the Chairman will be informed of significant activities and have the opportunity to control any decision, this is often a reactive not a proactive process. The division largely controls what is presented to the Chairman or the Commission. For this reason, the daily operations of the SEC are rarely given much attention. The Commissioners' problem of insufficient time also applies to the division directors. While many division directors are selected from the Commission's staff, frequently they are hired from outside the SEC. While some division directors serve for a decade or more, most serve for the term of the Chairman who appointed them. They arrive with an agenda of policy matters that they hope to address and delegate responsibility for daily operations to others. While efficiency is always a goal, it is seldom a priority.

In providing this critical assessment of the problem, one must acknowledge that it is a generalization based upon the practices of a variety of division directors over the past twenty-five years. While there have been several occasions when a particular Chairman or division director has made operating efficiency a priority, these have been the exception and short-lived. When the catalyst for the attention fades away or the individual who championed the initiative leaves, the commitment disappears. A COO would institutionalize this current commitment to agency efficiency and reduce the pressure on each division director to be the driving force. If a Chairman appointed a COO whose mandate is to improve agency operations it would relieve the division directors of this responsibility and provide them with greater freedom to focus on agency policy. A single COO could also address the inconsistencies in process that exist.

This is not a new concept. Over the years, some SEC Chairmen have assigned COO duties to either the Chairman's Chief of Staff (also referred to as Executive Assistant to the Chairman or Managing Director) or the Executive Director. In fact, when the position of Executive Director was established at the SEC, this was to be a core responsibility.[3] Historically this has not occurred, largely because an executive director must focus on the annual Congressional appropriation cycle, budgeting process and administrative duties. Because of the critical importance of these responsibilities executive directors have been selected who posses expertise in these areas, rather than knowledge of agency operations. The Chief of Staff has similar higher priority duties, including managing the office of the Chairman, working with the division directors on policy issues, and acting as the Chairman's surrogate or representative.

A COO, on the other hand, must understand the federal securities laws and the complex and varied functions that the staff performs. To be effective, a COO would have

[3] The description of responsibilities for the Executive Director includes the following "The Executive Director is responsible for developing and executing the overall management policies of the Commission for all its operating divisions and staff offices." 17 C.F.R. §200.13.

to have the authority to assign responsibilities, impose deadlines, allocate staff resources and have a role in personnel selection, evaluation and bonuses.

The creation of a COO may appear to represent a diminution in the authority of the division directors, the General Counsel and the Chairman's Chief of Staff. In fact it likely would have the opposite effect. Senior officials have substantial responsibilities and limited time. Furthermore, directors appointed from outside the agency may not have sufficient expertise in internal operating procedures to feel comfortable taking personal responsibility. Inevitably every Director of Corporation Finance has a substantial number of regulatory projects that will always take priority over issues such as which regulatory filings to review and how can staff better identify problems in these filings that may reveal enormous financial misconduct at the next Enron or Worldcom. Under this structure, the Division Director would still retain final authority for policy decisions that must be made and implemented by the operating staff.

Prior to making this recommendation, serious consideration was given to a less dramatic alternative, creation of a COO position in each operating division, a strategy adopted by Director Khuzami for the Division of Enforcement. Admittedly this alternative would be less controversial and less unsettling. It would not alter the primacy of the division director. The downside to this approach is that the ability of the COO to improve efficiency or effect change would be completely dependent upon the support provided by each division director. As noted previously, the current system is flawed because short-term division directors typically have limited time horizons and higher priority policy agendas. If a division director is not personally committed to improving efficiency, a subordinate COO will be unlikely to achieve success.

For these reasons, I believe that a broad reorganization of the SEC should include the creation of a Chief Operating Officer (COO) for the SEC, who reports directly to the Chairman and oversees its daily operations.[4] Under this model, the COO would not be a policy official; rather he or she would be the person responsible for implementing the policy decisions made. By empowering this person to oversee operations across divisions, it is hoped that he or she would be able to deal with the silo problem at the SEC and the recurring dilemma faced by registrants who must shuttle back and forth between multiple offices and divisions when questions require action by more than one office or division.[5]

An immediate priority of a COO should be to identify an appropriate set of metrics to monitor agency efficiency and effectiveness and to evaluate the performance of its individual staff. Throughout the SEC, there is a pattern and history of relying upon the simplest and most basic measures of performance. Too often these measures reward the wrong things and contribute to agency inefficiency. For example, when the

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[4] In 2010 Chairman Schapiro created a COO position. However in creating the position, the SEC chose to split in half the existing responsibilities of the SEC Executive Director. With the announcement that the Executive Director is resigning, a decision may be made to reconsolidate the split functions under the COO. This, of course, would only reestablish the prior status quo, albeit with a new title for its head.

[5] For a more detailed discussion of this function see the Chamber of Commerce Report, pages 18-22.

Enforcement Division measures success by the total number of cases brought, it motivates the staff to investigate the easy cases rather than the complex and time-consuming cases. Similarly, when the Division of Corporation Finance measures its staff by the number of filings reviewed or the number of questions included in a comment letter, it too motivates its staff to focus on the routine. By developing meaningful measures of performance, a COO could immediately contribute to improving agency effectiveness and efficiency.

Strengthening the role of the Commissioners in interpreting regulatory policy

For much of its early history, the Commission met almost daily and acted on virtually every decision that had to be made. Several changes in the laws over time caused a significant diminution in the responsibilities of the five Presidential-appointed Commissioners. The Reorganization Plan 10 of 1950 ("Reorg. Plan 10")[6] shifted executive functions, such as administration, budget, personnel and staffing from the Commission to the Chairman, who would serve as a Chief Executive Officer for the agency. In 1962, Congress amended the Exchange Act to permit the Commission to delegate discrete responsibilities, other than rulemaking, to its staff.[7] Over the years the Commission has delegated to the staff the vast majority of daily decisions, with the notable exception of decisions to authorize and resolve enforcement actions.

An often-overlooked but highly significant legal change was the Government in the Sunshine Act ("Sunshine Act"), enacted in 1975[8]. The Sunshine Act is a procedural law that ostensibly does not change the legal responsibilities of the Commission. It merely requires Commission deliberations to be conducted in public meetings, unless the subject of the deliberations is included in one of the ten categories excepted from the public meeting requirement.

Virtually every Commissioner who has served since the Act's passage in 1975 has commented or expressed frustration over the Commission's inability to meet confidentially with the staff to discuss division operations, activities and decisions. The inevitable consequence of this limited role for the Commission has been the transfer of a significant amount of responsibility for setting policy from the Commissioners, acting as a collegial bi-partisan body, to the division directors, who personally report directly to the Chairman. As one Commissioner suggested sarcastically at one Commission meeting, "the securities bar doesn't want to know what I think, they want to know what the Chief Counsel thinks".

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[6] 64 Stat. 1265 (1950).

[7] Reorg Plan 10 and the 1962 authority to delegate responsibility to the staff implemented recommendations to Presidents Truman and Kennedy, respectively, made by the same individual, James Landis, the second Chairman of the SEC and one of the co-authors of the Federal securities laws.

[8] 5 U.S.C. §552b.

Over the years, the SEC has attempted to address this problem to the extent possible without violating the Sunshine Act. These efforts have included the use of advice and information memos to the Commission[9], periodic briefing memos or "term sheets" and occasional non-public Commission briefing meetings, in which the staff make a presentation, but the Commissioners are required to refrain from engaging in a discussion, "joint deliberations" or expressing opinions. None of these "fixes" has been effective.

In making this recommendation, it is critical to emphasize that the goal is not to require the Commission to micromanage the daily responsibilities of the staff or to discourage the staff from doing its job. This would be a disastrous outcome. The staff must retain the ability to act quickly and decisively in its daily activities. Much of this work is highly technical and it is unrealistic to expect that the five Commissioners collectively would have the expertise and the time to act on questions concerning, for example, the Commission's net capital rule or executive compensation disclosure rules. However, the Commission is the final authority on questions of regulatory policy, both in the interpretation of rules and in periodically overseeing and engaging in discussions of the priorities of each division. In order to exercise this authority it must have the freedom to work with the staff informally and confidentially.

The SEC, likely with the support of other Federal regulatory agencies, should request that Congress amend the Sunshine Act for the limited purpose of providing each agency with sufficient flexibility to meet regularly with its own staff in non-public meetings to discuss the interpretation of agency regulations and the application of these regulations to decisions that have been delegated to the staff.

Improving the efficiency and effectiveness of Core SEC Functions

The question of whether the SEC has sufficient resources to do its job is the highest and most immediate priority to be examined. While everyone is focusing on the new responsibilities and burdens included in Dodd-Frank, insufficient consideration is being given to whether existing resources are used optimally. As I discussed initially, in the Chamber Study I focused on three core SEC functions that I believe could be performed more effectively and efficiently. I believe that if these recommendations are implemented it would reduce the level of resources devoted to routine tasks, permit staff to be deployed on these new responsibilities. I believe that available staff must focus on the important emerging issues. They must simplify and improve the methods by which they provide advice to members of the industry to promote industry compliance and best

[9] An advice memo is submitted by the staff to the Commission to solicit the Commission's views on a decision that the staff intends to take by delegated authority, prior to taking action. Typically an advice memo contains a time deadline, "Unless the Commission instructs otherwise in XX days, the staff intend to do the following". An information memo is sued to inform the Commission of a significant action or event after it has occurred.

practices. They must examine regulatory strategies that are not narrowly defined to fit within the current silos.

Rather than repeat what is included in the Chamber Report, I will briefly focus on one core function, exemptive orders under the Investment Company Act. Because of the structure of the Investment Company Act, an important activity of the Division of Investment Management of the SEC is reviewing and granting companies exemptions from specific requirements of the act when the division, acting pursuant to delegated authority, concludes that it is appropriate and in the public interest. This authority to grant exemptions from specific statutory requirements is provided in thirty-three sections of the Investment Company Act.

The exemptive application process is vital to an effective regulatory program. It provides the financial services industry with a vehicle to experiment and innovate in ways unforeseen when the Investment Company Act was passed in 1940. It enables the SEC, as the regulator, to permit such experimentation in a limited and controlled way. It can create and impose unique conditions on the innovator to protect investors and limit adverse consequences to the market. These conditions can be developed through negotiation with the applicant to ensure that the conditions are not so burdensome that the relief is no longer attractive. The statutory notice and comment requirement provides transparency to this negotiated process and enables third parties, including investors and potential investors, to participate in the decision. This is pragmatic and collaborative regulation that has stood the tests of time.

The ability of the Commission's staff to review and responsibly act on the hundreds of applications that it receives each year is critical to the effectiveness and vitality of its regulatory system. The time and resources it takes to review and act on these requests is also an important measurement of regulatory effectiveness. For more than twenty years, reducing the time to obtain an exemptive order has been an SEC goal.

It is a goal that has gone largely unmet. In 1985 the Division announced a goal of responding to applications with comments within 45 days. In 2006, the SEC Inspector General found that only 13 of 83 applications sampled complied with the goal. In 2007 the Division changed the goal from 45 days to 120 days. In 2008, as part of the Chamber study, we looked at the question. Because we did not have access to the dates of the initial comment letter, we calculated the time between the filing of the application and the order of approval. The median time in 2008 was 190 days.

The exemptive application review process is a useful case study of how changes in process can free up staff resources and better serve the public. In the study we made four recommendations:

- An expedited process should be created for routine exemptive applications that mirror prior exemptive orders.
- Incomplete applications should be rejected with "bedbug letters," consistent with published standards explaining the grounds for rejecting deficient filings.

- Internal compliance deadlines should be adopted for staff review and action, and apply to applicant responses or revisions based upon staff comments.
- Expanding the use of exemptive rules could substantially reduce the number of routine applications.

Improving the quality of the SEC policy development process

Rethinking the rule-making process at the SEC

Smart regulation requires a re-thinking of the process for developing and implementing regulations. In 2006, I described my proposal for a new system for developing regulations in a letter published in the *Wall Street Journal.*[10] I will restate it: Instead of assuming, as lawyers do, that rules are self-effectuating, the SEC should adopt a scientific approach: Consider rules working hypotheses. Whether the anticipated reaction occurs, and at what cost, is the empirical question. Under this approach, when the Commission votes to adopt a rule it would also vote to direct its staff to conduct a thorough quantitative examination of the rule's impact:

1) The SEC's Division of Risk, Strategy and Financial Innovation ("Risk Fin") would submit a plan to collect data on compliance with the rule, associated costs, and goals achievement. Merely developing such a plan will require the staff to articulate and the SEC to accept a statement of anticipated consequences.

2) It would also provide a plan for examining the data collected to enable the agency to examine the impact, costs and benefits of the rule. Making the Risk Fin division the focal point of this assessment would provide the agency's economists and industry specialists with substantially greater leverage in shaping rules in the first instance.

3) A timetable for the presentation of the results of these studies, in a published report.

This approach offers several advantages. In addition to compelling the staff to examine the rule's impact, it would fundamentally change how rules are developed. Knowing rules will be empirically examined will force the staff to carefully consider how this will be done and to develop internal discipline in the drafting process. Institutionalizing a meaningful evaluative role for the Chief Economist will strengthen its hand during drafting of the rule. Finally, requiring the examination staff to consider these issues at the outset will cause it to be more pro-active in its inspection program, less inclined to focus on after the fact disasters and provide the Commission with more oversight of its function.

A final regulation is the start of the process, not its completion. Cost-benefit analyses are and will always be fundamentally flawed. They require estimates of the impact of events that have not yet happened. How does one measure the cost of compliance before one knows how the industry will achieve compliance?

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[10] Jonathan G. Katz, Letter to the Editor, WALL ST. J., Aug. 8, 2006.

These recommendations will not result in more or less regulation, but instead they will achieve better regulation. Decisions should never be based upon a bias towards more or less regulation. Regulation must be based upon sound, fact-based understanding and intellectual honesty. Most importantly, it must recognize that a free market is always changing in ways that can rarely be anticipated. There will rarely be a single correct answer. Regulators must accept that they will have a choice between reasonable alternatives. And when the markets move, the choice may change. So, regulation must be nimble, and regulators should never believe that they cannot or should not change as well.

Improving the Enforcement Program

The enforcement program of the SEC is seen as the face of the agency and its most prominent responsibility. When the Enforcement Division acts, it makes headlines. When it's successful, the agency is viewed as effective. When it is unsuccessful, the agency is viewed as ineffectual. Needless to say the past decade has not been good for the division or the SEC. But it is not the first time that SEC enforcement has been found wanting. An objective review of the history of the SEC demonstrates that the recent failures are not unique. In fact, for each of these notable scandals and failures there is an important historical parallel in the history of the SEC. These historical parallels are described at length in the Pitt Law Review article. While one might conclude from this recurring pattern of frauds and failures that no set of reforms will ever eliminate periodic financial disasters and frauds, I believe a different lesson can be learned. The recurring pattern may be evidence that there are fundamental characteristics of how the SEC functions which contribute to its historic tendency to wait for events to happen before acting.

Mark Twain once said that history doesn't repeat itself, but it often rhymes. The recent and not-so-recent history of the SEC confirms the wisdom of Twain. In every decade since the fifties there has been major frauds that went undetected until it was too late. In fact, for each of the scandals of the recent past one may find an analogous scandal from an earlier time. Before the NASDAQ market makers and New York Stock Exchange specialists, there was the Re and Re scandal in the late fifties. Before Bernard Madoff there was Bernard Cornfeld. Before Enron and Worldcom there was Equity Funding. Before the SEC failed to listen to Harry Markopoulos, they failed to listen to Ray Dirks.

In the Pitt Law Review article I describe these past failures to demonstrate certain recurring patterns in the way enforcement functions at the SEC. Today I would like to focus on five aspects of the program that require improvement:

- Enforcement must change from being reactive to proactive
- Enforcement must be structured on functional lines
- Enforcement must develop quantitative empirical investigation capacity
- Enforcement's mission must be refocused

- National criminal prosecution of financial fraud requires a fully staffed office in the Criminal Division of the Justice Department

Investigating yesterday's problems, not tomorrow's

The one common thread of NASDAQ, Enron/Worldcom, and Madoff is that each of these cases became public knowledge before the SEC began its investigation. In essence, the SEC investigated and put out the fire after it was clearly visible on the horizon, and by then, the damage was done. This is a systemic problem that is rooted in the SEC. It reflects the traditional perspective of a lawyer; a preference to wait for "cases and controversies."

While the Division of Enforcement may begin an investigation as "a matter of official curiosity," in reality it has slowly, over time, adopted the approach of criminal authorities. It begins an investigation only after it has obtained information that is analogous to probable cause. As a result, it investigates discrete instances of wrongdoing, rather than examining broad market events or questions. If someone doesn't provide a credible tip, if information is not disclosed in a public filing, if aberrant trading is not observed and reported, or if a newspaper article is not written about a matter, there is no catalyst for beginning an inquiry.

This reliance upon third parties to provide the impetus for an investigation also reflects the fact that there are always plenty of cases to investigate.[11] The Division of Enforcement invariably has more open investigations than it has manpower to assign. No one needs to develop new techniques for finding matters to investigate. In fact, the opposite is the case. There were so many open cases that important investigations not infrequently languish as a result of staffing shortages or staffing turnover.[12]

Thinking reactively means more than just beginning investigations after the fraud collapses. It also manifests itself in the recurring staff tendency to open new investigations that mirror the hottest case of the moment. Because of the surplus of matters to investigate, the staff has a great deal of flexibility in selection of cases to investigate. Not surprisingly, everyone wants to conduct the hot investigation. During the eighties, every member of the staff wanted to do insider trading or penny stock cases. In the nineties, the staff looked for Internet frauds to investigate, no matter how small. A few years later, it was mutual fund late trading cases. After that it was option-backdating cases.[13] Today, post-Madoff, it is Ponzi schemes. And post financial crisis, it is sub-

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[11] One may speculate that the new whistleblower provisions of Dodd-Frank will further increase the number of possible investigations from which to choose.

[12] One SEC Chairman attempted to solve the problem by instructing the Division to refer all investigations involving a single person at a broker-dealer to the appropriate SRO for action. When that Chairman resigned, the referral program ended.

[13] In 2006, Chairman Cox disclosed that the SEC had more than 100 open investigations of option backdating. *Stock Options Backdating: Hearing Before the Comm. on Banking, Housing, and Urban Affairs*, 109th Cong. 12 (2006) (testimony concerning options backdating by U.S. Securities and Exchange Commission Chairman Christopher Cox). Other public comments brought the number of open investigations up to 170.

prime securities. In effect, every branch and every attorney is in competition with each other to bring the "fraud du jour."

The obvious problem with this reactive "hot case" mentality is that it focuses reactively on the past. It diverts attention and resources away from what may be on the horizon. In the military, this is often referred to as "fighting the last war." The consequences to regulatory efficacy are substantial. Open investigations that are not "hot" frequently are ignored or backburnered. Unusual or complex facts or circumstances that may not be understood, or those that do not fit neatly into a known type of fraud, are never opened or, if they are opened, they languish until they are closed.

Both phenomena are highlighted in the SEC Inspector General Report on Madoff. In one instance, an attorney in the Office of Compliance Inspections and Examinations (OCIE) was instructed to drop her interest in Madoff and focus on one of the many mutual fund late trading investigations. Another member of the OCIE staff only considered the possibility of a front-running violation by Madoff, explaining that front-running was *his* unit's area of expertise.

The lack of specialized units has contributed to the failure to identify and pursue complex investigations

Historically, the Division of Enforcement and the regional enforcement programs[14] have operated with minimal or no specialization. Within the home office, each investigating branch has the ability to investigate any matter that it identifies, regardless of the subject area or its complexity. The reason for this structure is based upon two beliefs: (1) that all investigating attorneys are qualified to investigate any type of violation, and (2) that staff turnover, a continuing problem, will increase if attorneys are pigeonholed into one subject area and restricted to only one type of investigation. Because there is no meaningful specialization or assignment of specific areas of responsibility, each investigating branch works in parallel, competing for the best and highest profile cases.[15] This practice directly contributes to several significant and equally important adverse consequences.

One unfortunate consequence is the delay and lack of uniform treatment that results when too many different, and often inexperienced, attorneys independently tackle

[14] One must be careful in generalizing about the regional office operations. Because they function with minimal direct oversight, there is no one organizational structure. For example, in New York, the largest regional office, there is an enforcement office but the office responsible for broker-dealer examinations also has its own enforcement group. As in the home office, both units operate independently and occasionally overlap. Another interesting operating difference between the home office and the regions is the separation of investigation and litigation responsibility. In the home office, if an investigation results in litigation, the matter is transferred to a trial attorney, who must learn the case from scratch. Conversely in most of the regional offices, the attorney who investigated the case tries the case. Of course, this means that any other open investigations assigned to that attorney are put on hold during litigation.

[15] To illustrate, imagine a national real estate agency in which each local office is a separately owned franchise with each agent in that franchise competing with the other agents in the office to sell or find buyers for the best houses in the community.

difficult and complex cases. Without any meaningful specialization, or the ready availability of in-house experts, new attorneys tackling complex investigations must "reinvent the wheel." One, or occasionally two, attorneys working for a branch chief[16] (who must supervise four to six attorneys), must learn the law, learn the market or the product, and conduct the investigation all at once. Consider difficult corporate accounting frauds, generally the most complex and time-consuming investigations. An attorney assigned to a complex corporate accounting fraud may be required to learn quickly the Talmudic nuances of revenue recognition accounting for "percentage of completion" construction projects; or the circumstances that determine whether the developmental costs for new products must be expensed or capitalized.

When the case deals with complex accounting issues, a staff attorney has the benefit of in-house accountants in the Division who can explain, advise, and guide an investigation. When the case involves highly sophisticated trading in esoteric securities, the result can be a long and arduous investigation followed by litigation that may rely upon untested theories or, worse yet, theories that do not entirely correspond with the underlying facts. Attorneys assigned to these investigations don't have access to internal experts analogous to the Division's accountants. The result is, not infrequently, different investigations of similar or analogous violations that achieve different results. Also not infrequently, these disparities are not obvious until the matter is scheduled for submission to the Commission. When the different treatment becomes obvious, the staff is occasionally instructed to re-negotiate a settlement to achieve some degree of parity.

A second adverse consequence is the tendency, already highlighted, to over-emphasize one area of misconduct and fail to investigate more important but less obvious areas. This is the more serious consequence. Because of the excess of cases available to the staff, decisions must be made quickly on whether to begin or continue an investigation or whether to focus on a completely different investigation that may be more promising, more important, more interesting, or more high profile. If a particular investigation appears highly complex, or difficult to understand, and it may require literally a year or more of investigation and be unlikely to produce a case, it will generally be closed or back-burnered in favor of another available case.

The "fraud du jour" problem, previously described, also contributes to this tendency to apply too many resources to one area. Whenever a case is completed that generates significant publicity or attention, it creates a strong incentive for other staff to actively pursue a matter with the same fact pattern. Because the staff have great latitude on what to investigate, it is easy for many different branch chiefs and assistant directors to simultaneously decide to investigate a certain type of case. As a result other important but difficult open investigations may not be fully investigated. In the Pitt Law Review article I describe three prominent cases at the SEC where this may have occurred – Michael Milken, Charles Keating and Mr. Madoff.

[16] In 2009, the Enforcement Division eliminated the branch chief position. Instead of an Assistant Director supervising two or three branch chiefs, who in turn supervised four to six attorneys, under the new structured each assistant director directly supervises six to eight attorneys.

A third unfortunate consequence is that because everyone chooses to investigate the same types of cases, other less visible potential investigations are never considered. The recurring failure to look out at the horizon is a serious problem. As previously explained, it has its roots in the prosecutor's mentality to act after the crime has become apparent. During the 1990's, while the Commission was suing teenagers who posted ridiculous claims on the Internet, Enron, Worldcom, Sunbeam and other frauds were growing to enormous proportions. Also, at the same time, the hot IPO's of the nineties and the false statements of securities analysts were contributing to the Internet bubble. During the past decade, when a staff attorney in OCIE became interested in the Madoff allegations, she was told to make mutual fund late trading a priority instead. While the staff investigated backdated options, billions of dollars were being invested in complex securities like collateralized debt obligations (CDOs), which in turn were based upon pools of mortgages with little or no disclosure of the questionable assumptions. The extent to which these instruments were sold on the basis of false and misleading statements remains to be determined.[17]

In January 2010, SEC Director of Enforcement Robert Khuzami announced the creation of five specialized units: asset management; market abuse; structured and new products; foreign corrupt practices; and municipal securities and public pensions. At first impression, this appears to be a commendable step in the right direction. However it may be only a partial step that doesn't address the underlying problem. Informally, I have been told that only 25% of the enforcement staff is assigned to these units. The remaining 75% continue to work in the traditional generalist structure. If so, the problem will continue. Furthermore, this partial change may suffer from three other problems. The first is that the focus of these units may not be sufficiently broad to provide responsibility for emerging problems and, thus will focus only on the identified problems of the immediate past. This latter approach has been used, with limited success, repeatedly in the Division. It is a variation on the "flavor of the month" mentality of searching for specific frauds after one such fraud has been exposed. This fraud-specific approach is too narrow and backward, not forward, looking. The second problem arises from the creation of a coordinating rather than centralizing responsibility. While the coordinator may become expert in the area of responsibility, the staff conducting the investigation will continually change and never develop a depth of expertise. When the coordinator leaves the division, the expertise leaves as well. Finally, if 75% of the staff continues to work in the traditional manner, the problem of staff focusing on the hot case and the cases they understand rather than the difficult or emerging cases will continue.

The SEC has Never Developed the Capacity to do Empirical Analysis

The SEC receives tens of millions of pages of documents from corporate filers annually. In addition, it receives regular reports from broker-dealers, investment advisers and institutional investors. The regulated equity and options markets provide electronic reports on trading activity. While the data is available for computer analysis, no office or

[17] In its 2008 Annual Performance and Accountability Report, then-Chairman Cox disclosed that there were 50 open investigations concerning sub-prime securities offerings.

unit at the SEC is assigned responsibility for conducting this sort of research.[18] The SEC has rarely begun an investigation on the basis of its own quantitative analysis of public data. The problem has three components: (1) a bias against this type of non-specific inquiry, (2) a lack of IT capacity, and (3) a lack of professional staff with the correct skills to conduct this type of inquiry.

The first component is another manifestation of the lawyer-centric mindset of the SEC.[19] Attorneys find it difficult to draft a formal order of investigation memo that lacks information pointing to specific misconduct by specific persons. Because the goal of every investigation is to find a violation and bring a case, broad open inquiries that do not initially focus on a specific possible violation are less appealing. The Enforcement Division staff is not interested in conducting an investigation that might shape regulatory policy without the prospect of receiving credit (a "stat") for a case brought. Conversely, while the regulatory divisions might have an interest in developing information to support regulatory action, they do not think in terms of opening an investigation or issuing subpoenas; that is the job of Enforcement.[20] OCIE through its "examination sweep" program attempts to look firsthand at significant issues in the financial industry. But OCIE lacks the subpoena authority to compel testimony.

The second component—the acquisition and development of automated analytical systems—has been an oft-stated goal of the SEC. Since the advent of computers, the SEC has proposed developing automated systems to collect and analyze this volume of data. In the late seventies, the SEC proposed to develop an automated Market Oversight and Surveillance System (MOSS). MOSS was designed but never built, due to a change in administration and a change in priorities. In the eighties, the EDGAR system for electronic filing was developed. It has operated successfully for more than two decades as a system for filing and disseminating these records. People forget that the "A" in the EDGAR acronym originally stood for "analysis." The original pilot EDGAR system included a component for companies to file a preformatted schedule of key items from its financial statement. The formatted data schedule would have enabled the SEC and the public to easily extract the data for automated analysis. That component of EDGAR was abandoned before the system became operational. Since 2005, the SEC has promoted the use of XBRL tagging conventions as a method of conducting automated analysis of

[18] The Special Study Report identified this failure and recommended that the SEC develop this internal capability: Eight years later, the Institutional Investor Study made the same recommendation "If the Commission is to be fully cognizant of the economic implications of developments in the securities markets under its jurisdiction, including those that result from its own actions, a substantially larger internal economic research capability, fully staffed and supported, is required." H.R. DOC. NO. 92-64, at XI (1971).

[19] The dominance of the lawyer's perspective at the SEC was described by former SEC Chairman Harvey Pitt in an op-ed column in the Wall Street Journal aptly titled "Over-Lawyered at the SEC." Harvey L. Pitt, Editorial, *Over-Lawyered at the SEC*, WALL ST. J., July 26, 2006, at A15.

[20] On rare occasions, regulatory divisions have obtained formal orders from the Commission to conduct investigations for regulatory purposes. A "recent" instance of one such investigation, by the Division of Investment Management resulted in the 2003 publication of its report and recommendations on the regulations of hedge funds. U.S. SEC. AND EXCH. COMM'N, IMPLICATIONS OF THE GROWTH OF HEDGE FUNDS (2003), http://www.sec.gov/news/studies/hedgefunds0903.pdf. This report was primarily a legal analysis rather than a quantitative analysis.

company filings. While the submission of XBRL-tagged documents is progressing, the capacity of the SEC to conduct the analysis is an open question.

Following the 1987 stock market collapse, Congress appropriated special funds so that the SEC could develop an automated, large trader reporting system. That project never progressed beyond the preliminary planning stage, as the appropriated funds were used to build EDGAR.[21] More recently, the SEC received special funding from Congress to develop an Internet surveillance system to find securities frauds on the web. Those funds were expended, but the system as developed produced so few results that it was cancelled.

The inability to conduct, on an ongoing basis, quantitative analysis-based investigations is not solely, or even primarily, due to insufficient IT capacity. The more significant component of the problem is the lack of staff with the necessary skills to do this work. In the past two decades, two of the most significant instances of industry-wide misconduct were uncovered by academics, not the SEC. In one case, William Christie and Paul Schultze, two Vanderbilt University economists, published an academic paper demonstrating that there must be collusion in setting bid-ask spreads by NASDAQ market makers.[22] The study was based not on an informant's tip, but on quantitative analysis of public quotations for an extensive number of companies for an extended number of years. A second and more recent example of an academic study that demonstrated a pervasive pattern of misconduct was the widespread corporate practice of backdating option prices for corporate executives to ensure profitability.[23] These papers were based upon an empirical analysis of data filed with the SEC. The SEC had access to the same information, and it had the IT power to perform the analysis. It lacked the people and the incentive.

The mission and purpose of SEC enforcement must be refocused

While the SEC as a law enforcement agency is a widely accepted opinion today, it has not always been the case. For much of its history, the SEC described itself as a regulatory agency. Until 1971, the SEC did not have a separate enforcement division. Instead, each of the principal operating divisions had its own enforcement unit to investigate and enforce its regulatory responsibilities. Each enforcement program was integrated into regulatory functions and often conducted investigations designed to advance regulatory agendas rather than to take disciplinary action.

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[21] The benefit of systematically tracking the trading patterns of individuals for patterns of misconduct was demonstrated in 2009. A major insider trading case was identified by reviewing trading activity in several companies prior to takeover announcements by the companies. Unlike most insider trading cases, this investigation did not begin with an analysis of trading in a specific company. It began by analyzing trading patterns by the individuals. In its press release, the SEC obliquely stated, "These enforcement actions are the direct result of innovative investigative techniques that the SEC is using to identify patterns of unlawful trading and suspicious relationships among traders who, in this case, live around the world." SEC Press Release 2009-18, available at http://www.sec.gov/news/press/2009/2009-18.htm

[22] William Christie & Paul Schultze, *Why do NASDAQ Market Makers Avoid Odd-Eighth Quotes?*, J. FIN., Dec. 1994, at 1813.

[23] Erik Lie, *On the Timing of CEO Stock Option Awards*, 51 Mgmt. Sci. 802, 803 (2005).

Historically, this subordinated role for enforcement reflected the limited enforcement powers of the agency. Prior to 1990, the SEC lacked broad authority to seek money penalties,[24] to issue cease and desist orders, or to bar officers and directors. Even its authority to directly suspend or bar individuals from the securities industry only dates back to 1975.

Because its range of powers was limited, the SEC did not focus on punishment. It focused on specific remediation and general prospective guidance. Instead of looking backward, it used enforcement to look forward and enunciate what the securities industry must do in the future. Because its resources were also limited, it focused its attention on bringing significant cases rather than bringing the largest number of cases. In 1979 then Chairman Harold Williams explained "Our enforcement resources would be utterly inadequate to the task of policing all securities law violations which may take place. As a result, our enforcement activities are designed not only to correct specific wrongdoing, but also to alert the private sector as to the kinds of activities which we believe to be illegal. We also tend to be programmatic in our enforcement efforts, concentrating on a particular area of concern in order that the parameters of appropriate conduct in that area may be fleshed out. In this way, we hope to stimulate the private sector to self-police inappropriate conduct."[25]

The Commission's enforcement program fundamentally has changed since passage of the Remedies Act in 1990. Prior to then the Commission had only limited power to punish. It could only seek fines in insider trading cases. It could only bar or suspend people who were registered. The ability to obtain disgorgement of illegal profits or to bar an individual from being a corporate director were creative interpretations of general equitable remedies.

During the past twenty years, as its powers to punish have increased and expanded and the size of its staff has multiplied, the Enforcement Division has changed its focus. As Chairman Williams noted, in 1979 the division did not define its responsibility to be policing all securities law violations. Today it appears to believe that it must do just that. The yardstick of success is now the total number of cases brought in a year and the significance of a case is measured by the dollar amount of penalties imposed. Not surprisingly, the increase in the size of the Division has resulted in more cases, but not necessarily better cases. Today it appears that the Division believes its mission is to bring every case where evidence of a violation exists, rather than devoting its staff to investigating a smaller number of matters that may have a greater significance for the fair operation of the capital markets.

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[24] Prior to 1990, the SEC could obtain a money penalty only in insider trading cases, authority that it first obtained in 1983.

[25] THE STATE OF THE SECURITIES AND EXCHANGE COMMISSION - - 1979. An Address by Harold M. Williams, Chairman. Available at http://c0403731.cdn.cloudfiles.rackspacecloud.com/collection/papers/1970/1979_0302_Speech_Williams.pdf

Effective regulation must be forward-looking. The SEC enforcement division should reestablish that its primary mission is effective regulation of the capital markets, and that prospective remediation of broad problems in the market is frequently preferable to a series of discrete actions involving multi-million dollar penalty payments by public companies.

The history of the SEC demonstrates how regulatory actions can provide more effective and more efficient solutions to massive and widespread patterns of misconduct. Compare for example, the SEC response to the options backdating problem with its response in the seventies to the even more widespread problem of illegal corporate payments to politicians, both in the U.S. and overseas.

During the height of the options backdating scandal, it was reported that the SEC had opened investigations of more than 170 companies that had engaged in the practice. Think of the resources that 170 investigations required, in addition to the money spent by corporations conducting internal investigations to ascertain if there was a problem. The illegal corporate payments scandal was even larger, and it occurred during a period when the Division of Enforcement was less than half its current size.

Recognizing that the SEC did not have the resources to investigate literally hundreds of other companies, the Divisions of Enforcement and Corporation Finance created an innovative solution. Nearly four hundred companies avoided enforcement action by participating in a novel voluntary disclosure program. If a company conducted an independent investigation of its questionable payments, supervised by its non-employee directors, and filed a detailed report of the investigation under Form 8-K, it could avoid further SEC action. In preparing its report, a company could meet with SEC staff from Enforcement and Corporation Finance and obtain informal private guidance on the disclosures that had to be made.

Refocusing the enforcement program will require more than a statement of policy. It will require reorganization of the division along functional lines as described. It will also require the development of performance metrics that motivate and reward staff who investigate and bring important forward-looking cases rather than routine cases. In the Pitt Law Review article I describe how the reliance on counting the total number of cases brought each year contributes substantially to the problems I have described. The development of better measures of performance should be the responsibility of the SEC Chief Operating Officer.

The Division of Enforcement must reestablish that timely remediation is as important as punitive sanctions and that its performance should be evaluated by its success in bringing the most important cases, rather than the most cases.

National criminal prosecution of financial fraud requires a fully staffed office in the Criminal Division of the Justice Department

Refocusing the enforcement program on remediation rather than money penalties does not mean that wrongdoing should go unpunished. Rather, it reflects the view that punishment is inherently a matter for criminal prosecution by the Justice Department. Until the early eighties the Enforcement Division worked closely with a specialized office in the Criminal Division of the Justice Department and routinely referred cases to this office, which had national jurisdiction.[26] During the eighties, as insider trading became a priority and these cases could be brought by the U.S. Attorney's Office for the Southern District of New York, a close working relationship with this office developed. Over time, it became the focal point for most criminal referrals. Notwithstanding the many successful criminal actions brought by the Southern District, it has limitations. It does not have national jurisdiction. It has other important priorities, such as organized crime, and international terrorism. These other priorities frequently divert its attention and resources. Some critics even suggest that, because the office is in New York, it may be more sympathetic to large financial institutions headquartered there and so less inclined to bring criminal actions against them.

Whether these criticisms of the Southern District are accurate is subject to disagreement. However its lack of national jurisdiction and the competition for its resources are significant limitations. The solution is simple. A national securities crime office in the Criminal Division would be a sound solution, provided it is adequately funded and staffed.

THE NEED FOR A SECOND SPECIAL STUDY OF THE SECURITIES MARKET

The final recommendation is, in my opinion, the most important. Fifty years ago, the SEC went through a similar period when it was viewed as ineffectual, understaffed and outgunned. At the recommendation of then Chairman William Cary, Congress appropriated funding for a special team of experts to conduct a special study of the U.S. securities markets. At the end of its eighteen-month life, the Special Study team produced a five-volume report that formed the intellectual foundation for the SEC for the next twenty years. This is an appropriate occasion to undertake a second special study. Among the issues that should be addressed are the future of the U.S. and global secondary market structure, the interaction of the equity, debt and derivatives markets both in the U.S. and globally, and the development of a corporate disclosure system that reflects the needs of investors and the information technology of the present and future. An integral component of each of these issues is the regulatory agenda and operations of the SEC.

In conclusion, I would like to thank the subcommittees for providing me with this opportunity to offer my suggestions on reinvigorating the Securities and Exchange Commission. I look forward to answering your questions.

[26] This unit continues to function but lacks sufficient staff.

Mr. McHenry. Thank you, Mr. Katz.

Mr. Crimmings, you are recognized for 5 minutes.

STATEMENT OF STEPHEN J. CRIMMINS

Mr. Crimmins. Thank you, Mr. Chairman.

Chairman McHenry, Chairman Platts, Ranking Member Quigley and Ranking Member Cummings, thank you for hearing us today.

Over the last decade, we have seen an explosion and the size and complexity of our capital markets, exponential increases in trading volume, workers doing thousands of trades in a few seconds instead of maybe a hundred trades a day, high speed, computer driven trading strategies, fragmentation of trading away from the exchanges and into dark pools and ECNs and 24/7 globalized stock trading.

We have seen investment products become so complex that the sophisticated traders that trade them don't always fully understand what they are and scary systemic risk that threatens recurring crises.

Now after the crash, we see many investors pulling out and staying out of stocks and mutual funds. Investors are still scared and sidelined with their decimated 401(k)'s. Investor perceptions are critical. These people will be unwilling to continue to risk their capital or risk their capital again if Wall Street's cop on the beat becomes the cop on furlough.

Last summer, in the depths of the worst financial crisis in 80 years, Congress recognized that the Securities and Exchange Commission needed twice the budget to be relevant in today's huge, complex and hyper-charged markets. Whatever issues anyone in Congress has with the SEC, I would respectfully suggest that the answer is not to starve in the wake of the crash, the answer is not to create an environment where it will be easier for the frauds just to prey on investors.

Instead, the answer is for all of us, here and now, to commit firmly to do whatever it takes to make the SEC the strong and smart overseer that our capital markets deserve to recover and grow.

One thing is of paramount importance. Nobody is asking the taxpayer for one dime to fund the SEC. What is often forgotten in the discussion is that American taxpayers pay absolutely nothing to run the SEC each year. Under 1996 legislation adopted by a Republican Congress and a Democratic President, the money to run the SEC comes entirely from Wall Street transaction fees and assessments designed to cover the entire cost of the SEC's budget.

Because of this a substantially increased SEC appropriation paid for with this successful 15-year old funding mechanism would require no tax dollars whatsoever and would add nothing to the deficit. In short, the Wall Street user fee money is already there. Congress just has to let the SEC use it to police Wall Street.

Madoff was a tragedy. The SEC missed Madoff and Chairman Schapiro and others have not tried to evade or run away from that fact, but so did FINRA whose predecessor installed Madoff as its vice chairman, and so did the Justice Department, and so did the New York attorney general with Madoff right in his own backyard, and so did how many others, including the sophisticated financial services firms that regularly interacted with him. Madoff was an industry icon and idol and nobody knew that he was really a crook.

Yet, through thick and thin, the SEC was out there bringing almost 700 complex cases for enforcement every year against almost 2,000 defendants every year and with greater funding, could have brought far more.

We hear criticism of the SEC's recently departed general counsel, David Becker. His power, I suggest, is misunderstood. He was not the Secretary of some Cabinet level department. Instead, he was the general counsel, one of multiple senior advisors at a five member, bipartisan commission, composed of two Republicans, two Democrats and one independent.

Whatever his power, the point is that he did not use it to benefit himself. The month after he left the agency still to this day, it remains unclear exactly how any of the Madoff related claims are ultimately going to be calculated. In any event, the Madoff Trustee, Irving Packard reports to the court, not to the SEC, and he will make his own decisions on what he wants to claim.

Finally, we need some perspective. What we are talking about is whether the Dorothy Becker estate will get to keep the $500,000 that Dorothy originally invested or whether it will also get to keep some small amount on top, the inflation adjustment. That seems to be where this is all breaking down and being discussed.

The senior ethics official with whom Becker consulted ruled that whatever theoretical conflict this may actually have presented, it did not create such a conflict that he needed to recuse himself, based on what was known at that time. The possibility of a claim against this estate of a particular type at some future date was at that time speculative. Now we know more, of course.

[The prepared statement of Mr. Crimmins follows:]

House of Representatives Committee on Government Oversight and Reform
Subcommittee on Government Organization, Efficiency and Financial Management
and Subcommittee on TARP and Financial Services Joint Hearing

"Financial Management, Work Force and Operations at the SEC:
Who's Watching Wall Street's Watchdog?"
Thursday, March 10, 2011, 1:30 pm
2154 Rayburn House Office Building

Testimony of Stephen J. Crimmins

(Mr. Crimmins is a partner in K&L Gates LLP and was a senior officer of the SEC's Enforcement Division until 2001.)

For the good of America's investors, both its large institutional investors and its many small retail investors, for the capital formation America's companies need for recovery and future growth, and for the continuing dominance of America's trading markets in a competitive global environment, Congress should give our capital markets – truly one of America's great national treasures – the kind of overseer they really need.

Last summer, in the depths of the worst financial crisis in 80 years, Congress determined that the budget of the Securities and Exchange Commission needed to be doubled. Specifically, Congress took the elaborate step of formally amending Section 35 of the Securities Exchange Act of 1934 to authorize SEC budgets of $1.3 billion for fiscal 2011 (to begin on October 1, 2010, just 10 weeks later); $1.5 billion for fiscal 2012, $1.75 billion for fiscal 2013, $2 billion for fiscal 2014, and $2.25 billion for fiscal 2015.

Today, almost halfway through the new fiscal year, Congress has still not appropriated any SEC budget. The agency hobbles along at pre-Dodd-Frank funding levels, despite substantial new obligations and deadlines imposed by Congress. Worse yet, Congress is now talking about freezing or even cutting the SEC's pre-Dodd-Frank budget. The answer to any Congressional concerns is not to starve the SEC, but rather to do what is necessary to make it a strong and smart overseer that has the resources to help our capital markets recover and grow.

1. Conserving Taxpayer Dollars in a Time of Deficits

What is often forgotten in the consideration of SEC funding is that ***the American taxpayers pay absolutely nothing to run the SEC each year.*** The SEC "self-funds" 100% of its annual appropriated budget with Wall Street user fees. Under a 1996 amendment to Section 31(a) of the Securities Exchange Act – adopted by a Republican Congress and a Democratic President – the money to run the SEC comes entirely from "transaction fees and assessments that are designed to recover the costs to the Government of" the entire SEC budget. Under this provision, the SEC adjusts its fee levels up or down several times each year (to take account of fluctuations in transaction volume) to fully cover its budget.

Thus, a substantially increased SEC appropriation paid for with the successful and 15-year old SEC self-funding mechanism would ***require no tax dollars*** whatsoever, and it would

add nothing to the deficit. Over the years, there has been no serious objection to the these registration and filing fees, as they are miniscule in amount relative to the transactions involved. And to avoid any perception of conflict, the SEC funds itself only out of its registration and filing fees, and never out of the disgorged profits and penalties it recovers from securities violators and turns over to investors or the Treasury.

2. "Shoestring" Financing for Capital Markets Oversight

The budget increases the SEC has gotten since Enron mean simply that it is now running on two shoestrings instead of just one. The SEC is still woefully underfunded to be the overseer of America's capital markets, surely one of our national treasures. Other national priorities – defense, agriculture, etc. – get adequate funding. But on the nation's capital markets – which one would think also merit funding – Congress has historically gone extremely cheap. Indeed in 2009 testimony, the SEC's chairman told senators that beginning in 2005, the SEC "experienced three years of flat or declining budgets, losing 10 percent of its employees and severely hampering key areas like our enforcement and examination programs."

Times have now changed. Running the SEC on a shoestring will no longer work if America wants to maintain the strength and world dominance of its markets. A strong and well-funded regulator is critical to deal with such recent phenomena as: (1) the explosion in the size of our capital markets – exponential increases in trading volume (with brokers doing thousands of trades in seconds instead of maybe a hundred trades a day), vastly more securities professionals and entities to oversee, and an influx of unsophisticated retail investors with 401(k) money to deploy; (2) trading and markets radically different and more complex than anything seen before – sophisticated and often computer-driven trading strategies, market fragmentation, and globalization of trading; (3) investment products so complex that sophisticated traders don't always fully understand what they are trading; and (4) really scary systemic risk that threatens recurring crises.

3. The Madoff Scandal

Sure the SEC missed Madoff. But so did FINRA, whose predecessor NASD installed Madoff as its vice-chairman. And so did the Justice Department. And so did the New York Attorney General – certainly no shrinking violet. And so did how many others, including the sophisticated financial services firms and professionals who regularly interacted with him. Madoff was an industry icon and idol, and nobody knew he was really a crook. Yet the SEC did bring 681 enforcement cases against 1,817 defendants in fiscal 2010, 664 cases against 1,787 defendants in 2009, 671 cases against 1,635 defendants in 2008, and 656 cases against 1,449 defendants in 2007, and with greater funding could have brought far more.

If we want to dwell on failures, we could criticize any government or private sector organization. The State Department, despite sincere efforts, regularly has its diplomatic failures, but we don't talk about defunding the State Department. And General Motors for years made cars that had trouble competing against certain foreign makes, but with GM in bankruptcy Congress came to its financial rescue. The Madoff mess is no reason to defund the SEC. It is instead a reason to give the SEC the resources it really needs to do the number of inspections and enforcement cases that America's huge capital markets – the biggest and finest in the world – really need to function efficiently and cleanly, and to encourage the capital formation that America's businesses will need for us to see our economy grow again and create jobs and wealth.

4. The SEC's Management

The SEC's new Chairman Mary Schapiro promised and delivered on a substantial ongoing restructuring of the agency and the installation of strong new leadership. This critically important effort should not be stopped dead in its tracks for any of the particular criticisms that have been advanced to date.

(a) Pornography: The overseer of America's capital markets should not be defunded because a small number of its employees viewed pornography under a previous SEC chairman, Christopher Cox, an honorable former Member of this House. America's capital markets should not be punished for the acts of a few individuals. Nor is workplace pornography a problem unique to this agency among the many federal, state and local government agencies and among large and small private sector employers.

(b) David Becker: In early 2009, David Becker was a very successful partner in the Cleary Gottlieb law firm, where average profits per partner are reportedly $2,385,000 annually (according to statistics published in the "Amlaw 100" survey by American Lawyer magazine, a legal services industry benchmark), and given Becker's seniority, he likely earned considerably more, probably around $3 million. Based on his knowledge of securities regulation and decades of experience, he was asked to become the SEC's new general counsel at a salary of about $175,000. This would not help Becker's career, as he had already been SEC general counsel several years earlier, and for him this would be simply a repeat engagement. All it meant was that, for again serving the SEC, he would be out-of-pocket an amount likely around $6 million in lost Cleary Gottlieb compensation over the next two years he committed to serve.

Several years earlier, on his mother's death, he and his brothers had to liquidate her Madoff investment as part of closing her estate; no one has suggested this was in any way suspect, as Madoff's criminality was then still concealed. But being a careful person, on re-entering SEC service in 2009, Becker disclosed all this and got an opinion from senior ethics counsel that the speculative possibility of a future clawback claim should not in any way limit his service as general counsel. Up to the present, there is no evidence that anything Becker did as general counsel in any way hindered the Madoff trustee's recent decision to file a clawback claim against him and his brothers over their mother's estate (*Picard v. Estate of Dorothy Becker*). Notably, the trustee's clawback claim in total (with Becker potentially liable for at most a third, as he has two brothers) is far less that the approximately $6 million Cleary Gottlieb compensation Becker gave up to serve the SEC for the last two years.

(c) Updated Spreadsheets: Nor should the overseer of America's capital markets be starved of resources because the Government Accountability Office criticized things like how the SEC has kept track of the disgorged profits and penalties it collected from defendants and safely deposited in court bank accounts for investors or in the U.S. Treasury. In this regard, the GAO's problem was primarily that SEC spreadsheets tracking what it had collected were not rigorously updated, not that the funds were really at risk. If the SEC were not run on such a shoestring for so long, it would be able to hire more green-eyeshade types to prepare beautiful spreadsheets for GAO. Instead, operating on a shoestring as it long has, it puts as many of the troops as it can on the front lines fighting the fraudsters.

(d) Leases – 9/11 Shelter and Congressional Orders to Expand: The SEC's leasing activity is likewise no reason to cut the oversight of America's capital markets. The money spent on unused New York space arose from the fact that the SEC's New York offices, next door to the World Trade Center, were reduced to rubble on 9/11. With everybody out on the sidewalk, the SEC shoe-horned its New York staff into the only available space, which was too small and had an exceptionally inefficient configuration (as this witness personally observed). When suitable space became available (the space the SEC now occupies in New York), they were stuck with some of the space they took in the 9/11 crisis.

The recent lease that the SEC signed for space in a second building in Washington, about 10 blocks from SEC headquarters, came after Congress determined in the statutory text of Dodd-Frank that the SEC's budget would double over five years. Congress gave the SEC new responsibilities over hedge funds, derivatives and credit rating agencies, as well as a strict timetable for mandatory Dodd-Frank rulemaking, and told the SEC to get moving in a hurry. When the SEC looked for space to house the new staff needed to do what Congress ordered, the database of available real estate presented two choices: (1) rent spaces in several buildings and spread the staff around Washington (very inefficient), or (2) rent the one and only available space (before somebody else grabbed it) that would be big enough to hold all of the new people in a single second building (obviously far more efficient). The SEC rationally took the second choice. Now just months later, Congress is threatening to pull the budget rug out from under the SEC. (The building in question is a rehab underway of an old government-tenant office building that long stood vacant, sits in a wasteland of grim-looking government buildings in Southwest Washington, and is certainly not "prime" office space.)

5. The SEC's Need for Additional Funding

This is not about funding Dodd-Frank. This is instead about maintaining at acceptable levels the core activities that have been at the heart of the SEC's Congressional mandate for many decades. Right now, the SEC is running on empty. The SEC's Enforcement Division is cutting back on investigations, letting vacancies in important agency programs go unfilled, and cancelling technology upgrades needed to process the oceans of data it gets each month. Its Inspections Office is being forced to cut the number and frequency of its examinations of financial firms, which were already very infrequent due to historic underfunding of the agency. Its acclaimed plan to bring in Wall Street trading experts with the sophistication to understand and appropriately respond to today's complex trading and markets, including the new technologies and strategies that may have had a role in last year's "flash crash," will never achieve its promise without funding.

Investors sidelined with decimated 401(k)'s will be unwilling to again risk their capital if Wall Street's cop-on-the-beat increasingly comes to be seen by the public as a cop-on-furlough. Investor perceptions are critical, and without the strong return of individual investors and the conservative investment funds that hold much of their remaining wealth, America's road to economic recovery will be far longer and more difficult. Regardless of differing views about certain Dodd-Frank provisions, America's businesses, which now more than ever need to aggressively draw investment capital, will surely be hurt by any investor perception that lack of funding is sharply curtailing the SEC's ability to protect investors and maintain market integrity.

6. Separating Politics From SEC Funding

Over the years, many have suggested putting the SEC on the same footing as the federal banking agencies by adding to the SEC's existing "self-funding" something new – the ability to "self-*budget*." Self-budgeting, which the self-funded federal banking agencies have done for many years, lets the banking agencies set their own budgets on a timely and adequate basis, and without getting lost in the inevitable political complexities of the annual appropriations process. This lets the banking agencies in times of crisis respond quickly to changes in staffing and other program needs, and lets them engage in long-range (multi-budget-year) planning, by setting their own budget levels (self-budgeting) and then paying their own way through user fees (self-funding).

Of course, while benefiting from a self-budgeting process, the SEC would always remain subject to Congressional oversight. If Congress is concerned, it can call hearings to demand explanations, and if still not satisfied Congress can legislate to correct any perceived problems. The banking agencies remain keenly aware that they must use their self-budgeting power prudently, or Congress will modify it or take it away entirely, and the SEC would be just as mindful of this reality. Congress' determination to put the banking agencies on this funding basis has proven to be a success story over many years, and it would be just as successful a means for funding the SEC.

The present dilemma underscores vividly why continuing to involve the SEC in the uncertainties and inevitable delays necessarily inherent in the annual appropriations process is not in the best interest of American business or investors. The situation presently confronting the SEC is indeed serious – with frozen funding levels forcing curtailment of inspections, enforcement and other vital activities, and all at a time of globalized capital markets, more complex and opaque instruments than ever before, and electronic trading techniques that require expertise and intensive broad-based monitoring and evaluation.

Congress has long recognized that the SEC is woefully underfunded, and it has already explicitly amended Section 35 of the Securities Exchange Act to authorize a doubling of the SEC's budget over the next five years. With the SEC already funding itself through miniscule user fees and not through tax dollars, it makes sense to simply adopt for the SEC the self-budgeting approach that has worked so efficiently and for so long for the banking agencies – for the good of investors, the health of our trading markets, and the encouragement of capital formation at a time when it is so seriously needed.

7. Conclusion

Protecting America's investors (large and small) from investment fraud, restoring integrity to the markets, and encouraging capital formation for America's businesses by drawing investors back into the markets are priorities too important to sacrifice. For America's capital markets to maintain their dominance on the world financial stage, Congress should fund the strong, smart and effective SEC that Mary Schapiro and her team are poised to deliver.

Mr. MCHENRY. Thank you for your testimony.

Ms. Chaitman, you are recognized for 5 minutes.

STATEMENT OF HELEN CHAITMAN

Ms. CHAITMAN. Thank you so much for giving me this opportunity to speak to you. I speak on behalf of approximately 500 Madoff investors whom I represent and I speak, as well, on behalf of every American who hopes to save enough money in his lifetime to retire on that money. I speak on behalf of every American who relies upon the brass plaque on his broker's desk, SIPC. We are told when we invest that every account is insured up to $500,000 and yet, SIPC has taken the position in the Madoff case that the law doesn't apply to it.

If I had to grade the SEC's performance with respect to its essential function of protecting investors with respect to the Madoff case, I would give the SEC an "F." The SEC, instead of enforcing the law against SIPC, which it is charged by Congress with the obligation to do, instead of enforcing the law, we now know that in January 2009, the SEC agreed with SIPC that for the first time in its history, it would not pay SIPC insurance to each Madoff victim based upon the investor's last statement.

SIPC is an insurance entity established by Congress which has the power to assess the Wall Street firms who raised the funds to protect investors. The statute doesn't give SIPC the right to define how it is going to allow a claim. The statute mandates that a claim is based upon the customer's last statement. Yet, the SEC joined in SIPC's violation of the statute.

This is not just my opinion, this is the opinion of Chairman Garrett who has proposed H.R. 757 and in proposing H.R. 757, which is simply a clarification of the law, one could view H.R. 757 as a statement to the SEC, you cannot avoid the law and SIPC cannot avoid the law. Mr. Garrett made a statement when he introduced this bill that SIPC has violated the law and the trustee in the Madoff case has violated the law.

If you recall, in 1970 when SIPC was enacted, investors were encouraged to relinquish the protection of having certificated securities. That was something that Wall Street wanted. In exchange for relinquishment of that protection, investors were promised SIPC insurance. SIPC insurance was raised to $500,000 in 1978; it was never raised thereafter.

In the Madoff case, SIPC decided that was going to be too expensive for its Wall Street members and so it was going to try to come with an entirely new basis for insuring accounts. For the first time in SIPC's history, it decided it didn't insure the balance on the last statement, it only insured the net investment over the life of the account which might have been 20 years, 30 years, 40 years.

There is no evidence that any investor in today's stock market has or what he owns other than the statements he receives from his broker. We don't have the luxury of going back to certificated securities. The Internal Revenue Service relies upon those statements, every investor relies upon those statements for planning their retirement, for their estate plans for their children. There is no basis in law for what the SEC did in this case.

This is not a question of insufficient funding for the SEC. This is a question of doing its mission which is to protect the investor.

I am not here to opine on whether or not Mr. Becker had a conflict of interest. I don't think there can be any doubt about it. Whether he advocated the constant dollar adjustment, which obviously reduced his own exposure, or whether he said to the SEC when he came onboard in February 2009, you have made an illegal agreement with SIPC which would have worked to his advantage, his judgment was clouded because everyone in the SEC forgot the law.

There is one way to remedy this and to restore confidence in the capital markets for the average American. That is to enact H.R. 757.

Thank you.

[The prepared statement of Ms. Chaitman follows:]

Written Testimony of Helen Davis Chaitman

March 10, 2011

My name is Helen Davis Chaitman. I am a partner with the law firm of Becker & Poliakoff LLP in New York City. I represent approximately 500 people who lost their life savings in Bernard L. Madoff Investment Securities, LLC. I myself lost my retirement savings in Madoff.

My clients were victimized by the inexplicable failure of the SEC to shut Madoff down, despite seven investigations of Madoff over a 16-year period.

My clients have been further victimized by the inexplicable failure of the SEC to enforce the Securities Investor Protection Act against the Securities Investor Protection Corporation. SIPC has violated the law and the SEC has allowed it to do so. It is not simply my opinion that SIPC has violated the law. Congressman Scott Garrett has stated his view that SIPC and its trustee, Irving Picard, have violated the law in the Madoff case. Both Ileana Ros-Lehtinen and Peter King have co-sponsored Mr. Garrett's bill, H.R. 757, which will remedy the terrible injustice that the SEC has caused.

The SEC is charged under SIPA with the obligation to go into court and seek an order compelling SIPC to comply with the law. Yet it has failed to do so in the Madoff case. Perhaps the reason for its failure is the conflict of interest of its general counsel, David I. Becker. I leave that conclusion to you, but I want to give you certain facts that may assist in your deliberations.

Bernard L. Madoff confessed on December 11, 2008 and the SEC then filed a liquidation proceeding against his investment firm. It quickly became apparent that SIPC was going to reneg on its statutory obligation to insure each investor's account up to $500,000 based on the investor's last statement. This insurance money was absolutely crucial to thousands of Madoff investors who had invested their savings in Madoff and were left destitute at a time in their lives when they were most fragile because they could no longer work.

On April 2, 2009, I sent a letter to Mary Schapiro explaining that SIPC and Mr. Picard were taking the unlawful position that investors are not entitled to claims in a SIPA liquidation based upon their last statements (as required by SIPA). See Exhibit A hereto. In order to save itself approximately $1 billion, SIPC was taking the position for the first time in its history that Madoff investors' accounts are only insured for their "net investment" over a period of up to 50 years. This deviation from the law allowed SIPC to avoid paying half of the Madoff investors any SIPC insurance. This half happened to be the most elderly and neediest of all the Madoff investors. This deviation also greatly reduced the amount of insurance SIPC would pay to those investors who had a positive net investment.

I explained in my letter to Ms. Schapiro that the SEC has the obligation to enforce SIPA in situations where SIPC is violating the law. After all, SIPC is an insurance entity established by Congress whose members are the SEC-regulated broker/dealers. Investors are the insureds under the SIPA statutory scheme. It is natural that SIPC, like any insurance company, would seek to deny insurance to investors who are entitled to it. Under the statutory scheme, it is the SEC that is responsible to protect investors and enforce the law against SIPC. SIPC's wrongful denial of insurance to investors had been brought to the attention of the SEC in previous liquidations. So this was nothing new.

Instead of protecting Madoff investors and assuring continued confidence in our capital markets, the SEC endorsed SIPC's plan to cheat Madoff customers of their promised insurance, further victimizing them. I explained the law to Ms. Schapiro and asked her to intercede.

In my letter, I raised another issue of vital importance to Madoff victims: Irving Picard, the SIPC trustee, announced in February 2009 that he was going to sue innocent investors for money they withdrew from their accounts on the theory that they were only entitled to keep their net investment over a period of 40-50 years. Mr. Picard's lawsuits have been given the name "clawback" suits. In my April 2, 2009 letter, I asked Ms. Schapiro to propose an amendment to the Bankruptcy Code to clarify existing law so that innocent investors who relied upon the SEC to police the securities markets would not be forced to litigate clawback suits brought by Mr. Picard seeking to force investors to pay back money they withdrew from their Madoff accounts in the honest and legitimate belief that the money was theirs.

The clawback issue was inextricably inter-twined with the issue of how a customer's claim was calculated because the Trustee had announced his intention to "claw back" withdrawals in excess of each investor's net investment. Many Madoff investors were third generation investors. Their grandparents had established their accounts in the 1960's and 1970's. Of course, the money had appreciated and, even if the only withdrawals from the accounts were to pay taxes on the reported appreciation, these investors would have taken out, over three generations, far more than they had invested. But it is grossly inequitable and inconsistent with the law to permit a SIPC trustee to claw back from innocent investors who invested through an SEC-regulated broker/dealer.

Ms. Schapiro had Thomas McGowan of the SEC respond to my letter on April 23, 2009. He invited me to meet with him in Washington, which I did. At the meeting, I explained, again, the position of my clients and asked Mr. McGowan what authority there was to support SIPC's position in this case. He cited to me a 1926 decision of the United States Supreme Court in a case involving a preference claim -- a claim to recover payments received within 120 days of a bankruptcy -- that was decided 44 years before SIPA was enacted and 52 years before the present Bankruptcy Code was enacted. In short, the SEC had no authority for its support of SIPC's unlawful position.

On May 1, 2009, counsel for numerous other investors sent a letter to David Becker, again laying out the legal authority compelling SIPC to insure each account up to $500,000 based on the customer's last statement and urging the SEC to fulfill its statutory obligation to enforce the law against SIPC. See Exhibit B.

On July 14, 2009, Ms. Schapiro testified before the Subcommittee on Capital Markets, Insurance and Government-Sponsored Enterprises. In response to a question from Congressman Ackerman as to when and how much the Madoff victims would be compensated by SIPC, Ms. Schapiro stated:

> I am committed to working as aggressively as we possibly can with SIPC to take the most expansive possible view of how to repay these claims and to do it in as quick a fashion as they possibly can.

7/14/09 Tr. at 18.

The Madoff liquidation was seven months old when Ms. Schapiro made that statement and, by that time, only a handful of investors had received SIPC insurance and only for the net investment over the life of their accounts, going back generations. Thus, up to that point in time, it is difficult to imagine what Ms. Schapiro was referring to when she spoke of her commitment to work as aggressively as possible with SIPC to repay claims as quickly as possible.

Unfortunately, after Ms. Schapiro's testimony, the SEC took precisely the opposite position from her purported commitment. Although SIPA requires SIPC to "promptly" replace securities up to $500,000 of investors whose brokers never purchased the securities shown on their statements, something SIPC has boasted can be done in 60 days, in the Madoff case there are still investors with valid claims who have not been paid their SIPC insurance 28 months after the liquidation was filed.

Moreover, the SEC has supported SIPC in taking the position that investors are only entitled to SIPC insurance if -- over the life of the account spanning as much as 50 years -- the investor, his parents, and grandparents, invested more money in Madoff than they withdrew. This position means that no customer can rely on his account statement. It is simply astonishing that the agency charged with protecting customers would take the position that federally-mandated statements are of no legal significance despite the fact that they are the only evidence any investor has of what he owns.

As an American citizen, I cannot explain the SEC's utter failure to enforce a law that was specifically enacted to protect investors. Nor can I explain the SEC's protection of SIPC in the face of its violation of the law.

We live in an era where investors cannot purchase certificated securities. The only proof any investor has of what he owns is the statement he receives from his broker. If investors cannot rely upon their statements, they cannot safely invest in the stock market. I would have thought that assuring safe investments would be the primary purpose of the SEC.

I am not here to opine on whether Mr. Becker's patent conflict of interest influenced the grossly inappropriate behavior of the SEC in the Madoff case or the incorrect testimony of Ms. Schapiro on July 14, 2009. On the one hand, one could admire Mr. Becker for advocating a position that was adverse to his own personal interests. Clearly, by endorsing SIPC's illegal "cash in/cash out" methodology, Mr. Becker was increasing the chances of his being sued by Mr. Picard. On the other hand, Mr. Becker apparently considered that he had little risk of a clawback suit and I am certain that Mr. Picard would not have sued Mr. Becker if he had realized he was suing the SEC General Counsel. Indeed, Mr. Harbeck issued a statement recently admitting that Mr. Picard did not know he had sued this David I. Becker.

Moreover, the SEC, under Mr. Becker's watch, has advocated a "constant dollar" adjustment to the net investment calculation to mitigate the harshness of SIPC's position. Just as there is no basis in law for SIPC's position, there is no basis in law for the SEC's "constant dollar" proposal. And of course that proposal, if adopted, would certainly have benefited Mr. Becker by reducing his clawback exposure.

In any event, the reason people are not permitted to participate in policy decisions when they have a personal interest is to avoid their judgment being clouded. Clearly, in this case, I can say with confidence that Mr. Becker's judgment was clouded. He advocated a position which, as Congressman Garrett has stated, is a flat violation of the law.

But I do want to impress upon you the devastation that the SEC's position has caused to thousands of Madoff investors. It is impossible to explain to Madoff investors who were victimized by the SEC's failure to shut Madoff down in 1992 how the SEC could victimize them again by depriving them of the $500,000 in SIPC insurance which the law guarantees them, based upon their last statements.

There is one way that Congress can rectify the damage that the SEC's unlawful conduct has caused and that is to quickly enact Congressman Garrett's H.R. 757. Every Madoff investor is entitled to this relief. Every American who invests in the stock market is entitled to this relief. I ask that you provide it.

EXHIBIT A

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April 2, 2009

Commissioner Mary Schapiro
U.S. Securities and Exchange Commission
100 F Street, NE
Washington, D.C. 20549

Dear Commissioner Schapiro:

I write on behalf of approximately 350 investors in Bernard L. Madoff Investment Securities, Inc. ("Madoff"). The revelation of the $64.8 billion Madoff Ponzi scheme has done more to damage the world's view of the American securities markets – and the SEC – than any other event in history. We are living in a time when our government's failure to regulate the unmitigated greed of Wall Street has caused a global economic collapse.

As a result of the SEC's stamp of approval on Madoff in 1992 and thereafter, tens of thousands of innocent Americans have lost their lives' savings. The world is now waiting to see if the American government deals responsibly with the victims of this disaster. The victims are waiting as well. To date, the SEC and Congress have not responded at all, while the Securities Investor Protection Corporation ("SIPC") has grossly misconstrued the Securities Investor Protection Act ("SIPA") for the economic benefit of Wall Street and to the extreme detriment of investors.

I personally lost all of my savings in Madoff. The firm was recommended to me by a friend in 2004 who showed me his brokerage statements which indicated that Madoff went into the market five-six times a year and purchased a portfolio of Fortune 100 company stocks; held the stocks for about a month and then sold them and put the funds in US Treasury securities. Madoff protected against market volatility by buying put and call options. The strategy looked safe and conservative. I told my friend the only risk was that Madoff was a fraud. My friend laughed and said that Madoff had an impeccable reputation in the industry, had been Chairman of the NASDAQ, and that firms who were jealous of his trading strategy had reported him to the SEC who had investigated Madoff on several occasions and found him to be absolutely honest. Naively, I thought there could be no better recommendation.

Whether the SEC's placement of a stamp of approval on Madoff from 1992 on, despite repeated clear indicia of gross impropriety, was the result of utter incompetence or of something worse, the SEC must accept responsibility for the massive losses to innocent people of their lives' savings and assure that SIPC acts consistently with SIPA to fulfill investors' "legitimate expectations" that the balances shown on their brokerage statements belonged to them. In this letter, I ask that the SEC take the following actions:

1. The SEC should immediately intercede to require SIPC to fulfill its statutory obligations to promptly pay all customer claims and to allow those claims at the amounts required by SIPA, *i.e.*, inclusive of "fictitious" income since customers had a legitimate expectation that the securities listed on their customer statements belonged to them. Four months after Madoff's confession, SIPC, to my knowledge, has paid only 15 claims. This is a national disgrace.

2. The SEC should support a cost-of-living increase in SIPC insurance (fixed in 1978 at $500,000) to $1.6 million. This increased coverage should be available to Madoff victims. Wall Street must be forced to police itself. If broker-dealers had to pay the victims of Ponzi schemes, they would not sit by quietly and allow them to continue with impunity. There were a number of Wall Street firms that announced, shortly after December 11, 2008, that they were never fooled by Madoff. Yet, in the almost 30 years of Madoff's illegal operations, they never came forward. If they had to foot the bill for the disaster, they would police their own industry.

3. The SEC should propose an amendment to the Bankruptcy Code to prohibit "claw back" (preference and fraudulent conveyance) litigation against innocent

customers of an SEC-regulated broker-dealer. These customers, and the financial institutions that finance them, have a right to rely upon the balances shown on their brokerage statements. To permit innocent victims to have money "clawed back" after having already lost their lives' savings is double victimization.

The SEC has an obligation to assure that SIPC fulfills its statutory obligations to Madoff investors

The detailed, comprehensive reports delivered to the SEC by Harry Markopolos, which accurately laid out Madoff's scheme, are well known to you, I am sure. However, long before Harry Markopolos wrote to the SEC, the SEC had closed down one of Madoff's early feeder funds. On November 17, 1992, the SEC had charged Frank J. Avellino and Michael S. Bienes with operating an unregistered investment company that managed $441 million. Their business was closed down because they didn't register the promissory notes they gave their investors as securities. The SEC's complaint charged that the money collected from investors was turned over to an un-named broker-dealer who managed the accounts at his own discretion, purportedly putting the investments into listed stocks.

According to a December 1, 1992 article in the Wall Street Journal ("WSJ"), "[n]one of the officials involved in the case would disclose the name of the broker-dealer whose trading apparently produced results good enough to draw in such a large sum of money." However, again according to the WSJ, Martin Kuperberg, SEC Senior Associate Regional Administrator in NY, "said that the returns appeared to have been generated legitimately. **"Right now, there's nothing to indicate fraud,"** he said. See Exh. 1. Any reader of this statement would reasonably have assumed that Kuperberg would not issue such a statement unless the SEC had investigated the un-named broker-dealer.

Although the SEC refused to disclose Madoff's identity as the broker-dealer servicing the accounts for Avelino and Bienes, Madoff's identity was disclosed two weeks later in a December 16, 1992 article in the WSJ:

> Who was the broker with the Midas touch? The SEC, which last month went to court to shut down the operation, won't say. . . . But the mystery broker turns out to be none other than Bernard L. Madoff – a highly successful and controversial figure on Wall Street, but until now not known as an ace money manager.

See Exh. 2.

Of course, we now know, as a result of Madoff's March 12, 2009 plea, that he started his Ponzi scheme in "at least as early as the 1980's and that he never bought stocks for his customers.[1] Yet, SEC official Kuperberg had announced to the world that there was "nothing to indicate fraud" on the part of Madoff. On what basis did Kuperberg make that statement? If the SEC had simply demanded that Madoff produce the documentary evidence of its money management for Avelino and Bienes in 1992, the SEC would have discovered that Madoff never bought securities for his clients and his Ponzi scheme would have been exposed and terminated at that time.

SIPC has violated its statutory obligations

The devastation caused by the Madoff Ponzi scheme could easily have stripped 200,000 people of their lives' savings. The full demographics of Madoff's victims are unknown. Irving Picard, the SIPC Trustee, can certainly provide to you the number of active accounts Madoff had as of December 11, 2008. However, those accounts consisted of (a) direct investors; (b) investors through partnerships or LLC's formed by groups of family members or friends who, alone, could not meet Madoff's minimum

[1] In the allocution that Mr. Madoff read in court on March 12, 2009, he stated that the Ponzi scheme began in the early '90's. However, in response to a question from Judge Chin, Mr. Madoff acknowledged that the government's Information was accurate. The Information alleged that the Ponzi scheme began "at least as early as the 1980's."

investment requirements; (c) investors through feeder funds, including IRA's, 401-K's, and pension funds of which hundreds or thousands of company employees could have been beneficiaries; (d) investors through feeder funds which drew on foreign investment funds and foreign banks; and (e) charities, universities, and foundations, some of which lost their entire endowment.

(a) SIPC has failed to promptly pay customers' claims

The most immediate need for the SEC's intervention is the utter failure of SIPC and its trustee, Irving Picard, to provide immediate payment of SIPC insurance to the Madoff investors. Many of these investors are elderly people who were entirely dependent upon their Madoff investments for their daily expenses. When that funding was cut off in December 2008, these people had literally no ability to buy food or pay for shelter. Many have been forced into nursing homes; many have been forced to try to sell their homes at fire-sale prices, simply so that they do not have to go on welfare.

Despite the catastrophic consequences for so many innocent Americans and despite the fact that SIPC is statutorily mandated to "promptly satisfy all obligations of the member to each of its customers," 15 U.S.C. Section 78fff-4(c), so far as I know **SIPC has, to date, paid SIPC insurance to only 15 investors** – despite the fact that thousands of investors have filed claims.

(b) SIPC has deliberately mis-interpreted "net equity"

SIPC insurance is $500,000 per account for securities and $100,000 per account for cash – amounts that have not been changed since 1978 despite the fact that the cost of living has tripled in that period. SIPC has charged broker-dealers a mere $150 per year for SIPC insurance. Thus, firms like Goldman Sachs have paid $150 per year for the privilege of printing on every trade confirmation that the customer's account is insured by $500,000 of SIPC insurance.

Given the paltry fee that SIPC has charged brokers and dealers for this insurance coverage, SIPC does not have sufficient funds to honor its contractual obligations to the Madoff victims. **Therefore, SIPC has decided to construe its insurance obligation in such a way as to deprive the vast majority of Madoff investors of any coverage.**

SIPC has done this by creating an entirely new – and insupportable – definition of "net equity." The SIPA trustee is required to "satisfy net equity claims of customers" of the failed broker-dealer. 15 U.S.C. Section 78fff(a)(1)(A)-(B). According to Mr. Picard, a Madoff customer's "net equity" is determined by taking the total amount the customer has invested in Madoff and reducing that sum by the total amount the customer has withdrawn from Madoff while entirely ignoring the appreciation in the customer's account over the 20-25 years the customer may have had his Madoff account.

Mr. Picard's convenient definition is directly contrary to SIPA which requires that the customer's "net equity" be determined by taking the balance in the customer's account as of the customer's last statement and reducing it by any funds owed by the customer to the broker. See 15 U.S.C. Section 78lll(11). *See also, In re New Times Securities Services, Inc.*, 371 F. 3d 68, 72 (2d Cir. 2004)("Each customer's "net equity" is "the dollar amount of the account or accounts of a customer, to be determined by calculating the sum which would have been owed by the debtor to such customer if the debtor had liquidated, by sale or purchase on the filing date, all securities positions of such customer" corrected for "any indebtedness of such customer to the debtor on the filing date.").

SIPC's position is directly contradicted by a statement that SIPC's general counsel, Josephine Wang, gave to the press on December 16, 2008 wherein Ms. Wang acknowledged that a Madoff customer is entitled to the securities in his account:

> Based on a conversation with the SIPC general counsel, Josephine Wang, if clients were presented statements and had reason to believe that the securities were in fact owned, the SIPC will be required to buy these securities in the open market to make the customer whole up to $500K each. So if Madoff client number 1234 was given a statement showing

> that they owned 1000 GOOG shares, even if a transaction never took place, the SIPC has to buy and replace the 1000 GOOG shares.

See Exh. 3.

If SIPC had acted in accordance with its general counsel's statement that SIPC would replace the shares in each Madoff customers' account as of November 2008 up to $500,000, every Madoff customer would have received securities worth $500,000 or a check for $500,000. That has not occurred because of Mr. Picard's inventive definition of "net equity."

SIPC's position is also directly contrary to the position it took in the 2002 Ponzi scheme case, New Times Securities Services, Inc., where SIPC elected to provide investors with substitute securities. There, SIPC recognized its obligation to allow "that portion of the mutual fund investors' claims that represent shares of such mutual funds purchased by them **through dividend reinvestment.**" See Exh. 4 hereto at 7, fn. 5; emphasis added. **Thus, the trustee in that case paid SIPC insurance based on the customers' final statements, which included dividend reinvestment, and thereby fulfilled the customers' legitimate expectations.**

SIPC's position is also inconsistent with the Internal Revenue Code and with Rev. Proc. 2009-20, recently issued by IRS Commissioner Shulman, which expressly recognizes the income earned by investors on their Madoff investments and the billions of dollars of taxes that Madoff investors paid to the Internal Revenue Service on phantom income over the last 20-30 years.

The practical effect of SIPC's self-serving interpretation of "net equity" is that SIPC will not pay any money to thousands of people who invested with Madoff in the 1980's and 1990's, whose accounts appreciated substantially and who, after retirement, drew out funds annually to pay taxes on their "phantom" income (at short term capital gains rates), to support themselves, and to satisfy the mandatory withdrawal obligations of their IRA's.

By ignoring the statute's mandate to credit customers with the appreciated balances in their accounts, SIPC does not have to assess its members for any additional funds to compensate Madoff investors in accordance with SIPA's requirements. At the same time, of course, **SIPC is destroying the legitimate expectations of Madoff's customers that the balances shown on their monthly statements represented their assets.** [2]

Surely, this is not the time in our history for SIPC to add to America's disgrace by further enriching Wall Street at the expense of Main Street. Surely, there is no more essential means of re-building the world's confidence in the American securities markets than by recognizing a customer's **legitimate expectation** that the balance on his monthly statement belongs to him.

(c) The SEC has the responsibility to challenge SIPC's interpretation

The Supreme Court held that SIPA invests the SEC with plenary authority to supervise SIPC. *Securities Investor Protection Corporation v. Barbour,* 421 U.S. 412, 417 (1975). As noted by the Second Circuit in the *New Times* case, Congress clearly intended for the SEC to provide "substantial oversight" over the "conduct of the affairs of SIPC." SEC. H.R. Rep. NO. 91-1613, at 11-12 (1970), reprinted in 1970 U.S.C.C.A.N. 5254, 5265. Indeed, the House Committee on Interstate and Foreign Commerce indicated that it "not only directs, but expects the Commission to use oversight in a vigorous, but fair, manner." *Id.* at 5266.

[2] *See, e.g.,* SIPC's Series 500 Rules, 17 C.F.R. 300.500, which provide for the classification of claims in accordance with the "legitimate expectations" of a customer based upon the written transaction confirmations sent by the broker-dealer to the customer. *See also,* 53 F.R. 10368, 1988 WL 263894, Rules of the Securities Investor Protection Corporation (March 31, 1988)(Commission order approving SIPC's Series 500 Rules, agreeing with SIPC that rules will give full effect to the Congressional intent to "satisfy the customers' legitimate expectations."(quoting S. Rep. No. 905-763 at 2.95th Cong. 2d Sess. (April 25, 1978).

In the *New Times Securities* case, the Second Circuit asked the SEC to submit an *amicus* brief with respect to SIPC's position that customers of a broker who operated a Ponzi scheme and, like Madoff, never purchased securities, were entitled to only \$100,000 of SIPC insurance (instead of \$500,000) since they had no securities in their accounts. The customers whose claims were the subject of the appeal had received trade confirmations indicating the purchase of investments in non-existent mutual funds. **Nevertheless, the SEC took a position adverse to SIPC and agreed with the customers that they were entitled to \$500,000 of SIPC insurance because they legitimately expected that they owned securities, regardless of the fact that the broker had never purchased the securities.**

However, the SEC agreed with SIPC that, unlike the *New Times* customers whose trade confirmations indicated the purchase of investments in real securities (whose claims SIPC honored at the amount shown on their last statements), with respect to customers who held non-existent securities in their accounts, the amount of their customer claims should exclude any appreciated amounts. The rationale for this holding was that a customer that purportedly owned non-existent securities could not have legitimately expected any appreciation since the customer could not have verified any appreciated amount. The Second Circuit noted:

> As the SEC indicated in its brief, basing customer recoveries on "fictitious amounts in the firm's books and records would allow customers to recover arbitrary amounts that necessarily have no relation to reality . . . [and] leaves the SIPC fund unacceptably exposed."

371 F. 3d 68, 88 (2d Cir. 2004).

Of course, in Madoff, all of the customer confirmations indicated the ownership of securities in Fortune 100 corporations and customers could easily check the purchase and sale prices of these securities. Thus, the balances shown on customer statements bore a direct relationship to the appreciation in their accounts through the purchase and sale of known securities. **For this reason, the Madoff investors are entitled under SIPA to customer claims in the amount shown as their balance as of November 2008.** [3]

SIPC and Trustee Picard have taken the position that no Madoff investor who has taken more money out than he has put in (over the course of 20-30 years) is entitled to any SIPC coverage, no matter how much his November 2008 statement indicated his assets in Madoff were. Thus, SIPC is refusing to pay insurance to a huge number of long-time Madoff investors whose November 2008 balances showed millions of dollars in assets. **Given the extreme devastation that Madoff victims are suffering, I ask that you intercede with SIPC to assure that SIPC honors customer claims immediately.** It would only extend the calamity for innocent investors to have to wait years for this issue to be resolved in their favor through the court system.

SIPC insurance should be increased to $1.6 million

In 1970, Senator Edward S. Muskie proclaimed, in urging the prompt enactment of SIPA: "after this bill is enacted, no American will lose his savings through a brokerage firm bankruptcy."[4] SIPC insurance was fixed in 1978 at $500,000 and has never been adjusted for the enormous cost of living increase in the past 30 years. If the insurance were adjusted in accordance with the increase in the cost of living, investors would be entitled to $1.6 million of SIPC insurance. It is in our national interest for this adjustment to be made, effective so as to increase the insurance for Madoff investors.

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[3] In the *New Times* SIPC proceeding, 900 claims were filed of which 726 customers had confirmations showing real securities that were never purchased and 174 customers had confirmations showing fictitious securities that were never purchased. SIPC honored the 726 customers' claims, crediting those customers with the appreciation shown in their accounts. It was only the customers whose confirmations showed fictitious securities whose claims were limited to the amounts they had invested.

[4] Federal Broker Dealer Ins. Corp.: Hearing on S2388, 3988 and 3989 before the Subcommittee on Securities of the Senate Com. on Banking and Currency, 95th Congress Cog. 10(1970) at 147.

Brokers and dealers are in the best position to police illegal securities operations. It is absolutely preposterous that Goldman Sachs has paid a mere $150 a year for SIPC insurance. If Wall Street firms were responsible for the losses of Ponzi scheme victims, they would diligently police their industry and protect investors. As a matter of public policy, this would be a crucial step in restoring confidence in the SEC and in the American securities markets.

The SEC should advocate an amendment to the Bankruptcy Code to prohibit clawbacks from innocent investors

Trustee Picard has announced that he intends to "claw back" pursuant to the avoidance provisions of the Bankruptcy Code payments of income that were made by Madoff to investors over the past six years. Investors withdrew income from their accounts at Madoff to support themselves and their families, to pay short-term capital gains taxes on their Madoff income, and to take the mandatory withdrawals from their IRA accounts.

It is totally inconsistent with the purposes and provisions of SIPA to sue innocent investors who received payments from Madoff out of their accounts. I therefore respectfully request that you put the SEC's recommendation behind an amendment to the Bankruptcy Code, which would provide as follows:

> Notwithstanding the provisions of Sections 544, 547 and 548 of this title, no action shall be brought by a SIPC trustee against any customer of an SEC-regulated broker-dealer seeking the recovery of assets in that customer's account, absent a showing that the customer participated in some illegal transaction with the broker-dealer.

SIPA supersedes the Bankruptcy Code where the provisions of the Code are inconsistent with SIPA. 15 U.S.C. § 78fff(b). The underlying purpose of SIPA is to satisfy the "legitimate expectations" of customers of an SEC-regulated broker-dealer. Such a customer has a legitimate expectation that the balance shown on his brokerage statement is his asset. Similarly, the bank from which he borrows money has a right to rely upon the balance shown on the borrower's brokerage statement when making decisions with respect to credit.

The proposed amendment is, thus, absolutely essential in order to restore confidence in the American securities markets. The lives of many long-time Madoff investors are being destroyed by the fear that the meager funds they have left (from the sale of their residences, their furniture, and their jewelry) will be taken away from them by Trustee Picard as he claws back money they took out of Madoff over the years to pay their taxes and to support themselves. No innocent investor should have to worry that, at some point in the future, his assets could be "clawed back" by a bankruptcy trustee.

As a key figure in the Obama administration, I hope that you will accept responsibility to work with the Madoff victims to correct the Trustee's misinterpretation of "net equity," expedite the SIPC payments, and help restore America's confidence that the SEC can be an effective watchdog for the individual investor.

Thank you very much for your consideration of the issues raised in this letter. I would very much appreciate the opportunity to meet with you and your staff to discuss how the concerns of hundreds of Madoff investors can be resolved. I have a number of suggestions for ways that the SEC can prevent such catastrophes in the future. As time is of the essence to many victims, I look forward to hearing from you as soon as possible.

Yours sincerely,

Helen Davis Chaitman

HDC:leb

cc: Irving Picard, Esq.
David Sheehan, Esq.

1076203.1

EXHIBIT 1

SEC Breaks Up Investment Company That Paid Off Big but Didn't Register

By Randall Smith, Staff Reporter [Wall Street Journal 12/1/92]

Two Florida accountants have returned $441 million to investors after regulators charged them with a huge sale of unregistered securities, their lawyer said.

The two accountants, Frank J. Avellino and Michael S. Bienes of Fort Lauderdale, promised, and apparently delivered, annual returns of 13.5% to 20% to their investors. Their main office is located in New York City.

However, in a complaint filed Nov. 17 in federal Court in Manhattan, the Securities and Exchange Commission charged the two men with operating an unregistered investment company because they didn't register as securities the promissory notes they gave their investors.

Investments in Stocks

The SEC complaint said the money collected from investors was turned over to an unnamed broker-dealer, who managed the accounts at his own discretion. One person familiar with the case said the broker put the money into listed stocks. The complaint said Messrs. Avellino and Bienes kept the difference between the fixed interest they paid to investors and the returns generated by the broker's investment decisions.

In an announcement, the law firm for the two accountants, Squadron, Ellenoff, Plesent & Lehrer, said the partnership of Avellino & Bienes is dissolving and had returned all principal and interest due its noteholders as of Nov. 16. Ira Lee Sorkin, a partner in the law firm, said the return was completed Nov. 24.

The SEC said the two men ended their 22-year-old accounting practice and began focusing exclusively on their more-profitable investing business in 1984. Although 13.5% to 20% rates of return are high by historical standards, they wouldn't have been impossible to attain. For example, from Jan. 1, 1984, to Oct. 31, 1992, the Vanguard Group stock index fund showed a 14.85% annual return, according to Morningstar Inc., a mutual fund data service.

As of Oct. 30, the SEC said the two men had nine different trading accounts with the broker-dealer with an equity value of $454 million. At the same time, they had issued notes totaling, $441 million either through new sales to investors or the rollover of interest payments.

Martin Kuperberg, SEC senior associate regional administrator in New20York, said, "The investing public must get the protection afforded by the federal securities laws, such as a prospectus, certified reports, and fidelity bonds." However, Mr. Sorkin said his clients didn't know they were subject to such requirements.

'Nothing to Indicate Fraud'

None of the officials involved in the case would disclose the name of the broker-dealer whose trading apparently produced results good enough to draw in such a large sum of money. However, Mr. Kuperberg said that the returns appeared to have been generated legitimately "Right now, there's nothing to indicate fraud," he said.

Neither Mr. Avellino nor Mr. Bienes, both 56 years old, were available to comment, according to their New York office. Mr. Sorkin characterized the sales of unregistered securities as "technical violations."

The investors' money was ordered returned by federal judge Kenneth Conboy, who named New York attorney Lee Richards as trustee. Mr. Richards, in turn, has hired the accounting firm of Price Water-house & Co. to audit the partnership's financial records.

EXHIBIT 2

The Wall Street Journal
December 16, 1992

Wall Street Mystery Features a Big Board Rival

By RANDALL SMITH

This article was published in the Dec. 16, 1992, edition of The Wall Street Journal.

Here's a tantalizing Wall Street mystery:

The Securities and Exchange Commission recently cracked down on one of the largest-ever sales of unregistered securities. Investors had poured $440 million into investment pools raised by two Florida accountants, who for more than a decade took in money without telling the SEC or making required financial disclosures to investors.

The pair had promised investors hard-to-believe annual returns of 13.5% to 20% -- to be obtained by turning the money over to be managed by an unnamed broker.

Regulators feared it all might be just a huge scam. "We went into this thinking it could be a major catastrophe," says Richard Walker, the SEC's New York regional administrator.

But when a court-appointed trustee went in, the money was all there. Indeed, the mystery money manager was beating the promised returns by such a wide margin that the two accountants ditched their accounting business in 1984 to concentrate on their more lucrative investing sideline.

Who was the broker with the Midas touch? The SEC, which last month went to court to shut down the operation, won't say. Neither will the lawyer for the two accountants, Frank J. Avellino and Michael S. Bienes of Fort Lauderdale.

But the mystery broker turns out to be none other than Bernard L. Madoff -- a highly successful and controversial figure on Wall Street, but until now not known as an ace money manager.

Mr. Madoff is one of the masters of the off-exchange "third market" and the bane of the New York Stock Exchange. He has built a highly profitable securities firm, Bernard L. Madoff Investment Securities, which siphons a huge volume of stock trades away from the Big Board. The $740 million average daily volume of trades executed electronically by the Madoff firm off the exchange equals 9% of the New York exchange's.

Mr. Madoff's firm can execute trades so quickly and cheaply that it actually pays other brokerage firms a penny a share to execute their customers' orders, profiting from the spread between bid and asked prices that most stocks trade for.

In an interview, the 54-year-old Mr. Madoff says he didn't know the money he was managing had been raised illegally. And he insists the returns were really nothing special, given that the Standard & Poor's 500-stock index generated an average annual return of 16.3% between November 1982 and November 1992. "I would be surprised if anybody thought that matching the S&P over 10 years was anything outstanding," he says.

In fact, most investors would have been delighted to be promised such returns in advance, as the accountants' investors were. That's especially true since the majority of money managers actually trailed the S&P 500 during the 1980s.

The best evidence that the returns were very attractive: the size of the pools mushroomed by word-of-mouth, without any big marketing effort by the Avellino & Bienes artnership. The number of investors eventually grew to 3,200 in nine accounts with the Madoff firm. "They took in nearly a half a billion dollars in customer money totally outside the system that we can monitor and regulate," says the SEC's Mr. Walker. "That's pretty frightening."

An SEC civil complaint filed in New York federal court Nov. 17 charged that Messrs. Avellino and Bienes "have operated A&B as an unregistered investment company and have engaged in the unlawful sale of unregistered securities," and ordered the money returned to investors by a court-appointed trustee, New York attorney Lee Richards.

The two 56-year-old accountants declined to comment. Their attorney, Ira Lee Sorkin, says they didn't know that the notes they had issued to their clients should have been registered with the SEC, and he says that investors got their money back and haven't complained.

If the notes had been registered, they would have had to include a description of how the money was being invested, and by whom. In addition, Avellino & Bienes would have had to send investors annual reports and financial statements.

But how did Mr. Madoff rack up his big investment returns? Early investors in the late 1970s were told -- and Mr. Madoff confirms -- that their money was being used to engage in so-called convertible arbitrage in securities of such companies as Occidental Petroleum Corp., Limited Stores Inc. and Continental Corp. Promised annual returns in this period, one investor said, were 18% to 20%. In such a strategy, an investor buys a company's preferred stock or bonds that pay high dividends and are convertible into the company's common stock; the investor simultaneously sells borrowed common stock of the same company in a "short sale" to hedge against a stock-price decline.

The investor earns the spread between the higher dividend paid on the convertible securities and the lower dividend on the common stock, plus interest from investing the proceeds of the stock short sale. Using borrowed money, or leverage, to magnify returns, an investor can reap double-digit returns. But the strategy carries big risks if interest rates rise and stock prices go down.

Mr. Madoff said his investment strategy changed around 1982, when his firm began using a greater variety of strategies tied to the stock market, including the use of stock-index futures and "market-neutral" arbitrage, which can involve buying and selling different stocks in an industry group.

Mr. Madoff said, "The basic strategy was to be long a broad-based portfolio of S&P securities and hedged with derivatives," such as futures and options. Such a strategy, he said, allowed the investors "to participate in an upward market move while having limited downside risk." For example, he said, the Madoff firm made money when the stock market crashed in 1987 by owning stock-market index puts, which rose in value as the market declined.

In the mid-1980s, one investor says, the limited reports that Avellino & Bienes sent to investors changed, and investors stopped being told in which securities their money was invested. The interest rate on some new notes sold by the accountants was also lowered to 16% or less. One investor who complained about the vaguer reports and lower returns was told that if he didn't like them, he could withdraw his investment. He chose to remain.

Perhaps the biggest question is how the investment pools could promise to pay high interest rates on a steady annual basis, even though annual returns on stocks fluctuate drastically. In 1984 and 1991, for example, the stock market delivered a negative return, even after counting dividends. Yet Avellino & Bienes -- and Mr. Madoff -- maintained their double-digit returns.

The answer could be that Mr. Madoff's use of futures and options helped cushion the returns against the market's ups and downs. Mr. Madoff says he made up for the cost of the hedges -- which could have caused him to trail the stock market's returns -- with stock-picking and market timing.

Certainly, the investment pools' returns were less astounding by the standards of the early 1980s, when short-term interest rates briefly topped 20%. But the annual returns on Treasury bills hit a peak of 14.7% in 1981, and remained under 12% in the three other years that bills had double-digit returns, 1979-82, before falling later in the '80s.

One person familiar with the Avellino & Bienes case speculated that having the assets of the investment pools under management may have helped Mr. Madoff's firm by giving him an inventory of securities that could help him to execute other trades for his firm. Not true, said Mr. Madoff: "One thing has nothing to do with another."

As the investment pools swelled, two other accountants, Steven Mendelow of New York City and Edward Glantz of Lake Worth, Fla., started their own pool, Telfran Ltd., to invest in Avellino & Bienes notes. Telfran by itself sold $89.6 million in unregistered notes, a separate SEC civil lawsuit charges. The two men, also represented by Mr. Sorkin, declined to comment. The SEC said Telfran made money by investing in

Avellino & Bienes notes paying 15% to 19% annually, while paying Telfran investors lower rates.

All the while, Mr. Madoff was scoring investment returns that comfortably exceeded the hefty returns Avellino & Bienes was promising its noteholders. That excess return generated big profits for the two accountants, the SEC suit indicates. The SEC has asked that those profits be returned as "unjust enrichment," a demand Mr. Sorkin calls "totally unwarranted." For his part, Mr. Madoff says he charged the investment pools only what he described as standard brokerage commissions. He termed turnover in the accounts "not very active," almost nil in some years.

EXHIBIT 3

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Nasdaq S&P 500 NYSE

Nasdaq	1503.04	
-42.16	(-2.73%)	
S&P 500	793.75	
-22.19	(-2.72%)	
NYSE	4924.60	
-172.04	(-3.38%)	

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Insiders' Blog

SIPC's Role In Madoff-Of-All-Scams Could Save The Stock Market

December 16, 2008 2:14 PM EST

Could the Bernard Madoff fraud actually help the stock market?

The SIPC came out with a statement last night indicating that they will be involved in the Madoff situation. The SIPC maintains a special reserve fund authorized by Congress to help investors at failed brokerage firms. The SIPC reserves are available to satisfy the remaining claims of each customer up to a maximum of $500,000, including a maximum of $100,000 for cash.

It seems likely that most, if not all, of the statements Bernard Madoff delivered to clients were entirely bogus. Based on the SIPC mandate, it could be in the realm of possibility that the *SIPC has to buy securities* to replace those that were faked on statements delivered to Madoff clients.

Based on a conversations with the SIPC general counsel Josephine Wang, if clients were presented statements and had reason to believe that the securities were in fact owned, the SIPC will be required to buy these securities in the open market to make the customer whole up to $500K each. So if Maddof client number 1234 was given a statement showing that they owned 1000 GOOG shares, even if a transaction never took place, the SIPC has to buy and replace the 1000 GOOG shares.

Imagine $50 billion in net buying to the stock market, on behalf of the SIPC, to replace client's stocks that were never bought? While this likely won't happen to this extent, it is in the realm of possibility.

Ms. Wang indicated to us that the SIPC has a budget of just $1.6 billion and a few credit lines worth $2 billion total. While SIPC is a non-profit organization, they have indicated to us that they will try to make as many people as whole as possible. They claim to be free from any conflicts of interest, even if the amount needed would eclipse their budget. When asked if the Madoff claims came in at $5 billion what would be done, Ms. Wang indicated to us that they could look to Congress for the money.

The SIPC said their involvement with the Madoff case strictly involves the broker-dealer. So, one of the main issues the SIPC trustee appointed to the Madoff case will have to address is how Madoff hedge fund clients and other investment management clients will be dealt with. Will they be protected? Also, if a hedge fund that invested in Madoff has 100 clients, will the SIPC pay out $500K just to the hedge fund or $500K to each of the 100 clients?

There are many questions that are still unanswered on the massive Bernie Madoff ponzi scheme, but it would be ironic if the biggest scam in history, that has hurt so many people, turned out to be a slight positive to the market. Our prayers are with all of those who have lost money having faith in Madoff and the system that has failed us.

Stocks Mentioned

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Comments

MS Wang

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Audrey on Mar 29, 2009 03:59 PM

It is absolutely essential that we clarify Ms. Wang's position and then find out who Ms. Wang has to account to. For those who do not realize it, the SEC sanctioned Madoff several times and thus failed to protect the investors against fraud. The tax laws only go back 6 years.

Josephine Wang

Rommie Sue Ambrosino on Mar 29, 2009 03:41 AM

It is my understanding that Ms. Wang is now denying the fact "if clients were presented statements and had reason to believe that the securities were in fact owned, the SIPC will be required to buy these securities in the open market to make the customer whole up to $500K each. So if Maddof client number 1234 was given a statement showing that they owned 1000 GOOG shares, even if a transaction never took place, the SIPC has to buy and replace the 1000 GOOG shares." Can the author of the article clarify this confusion for more than 8000 investors who received SIPC claim forms? Please send to: Info@bernardmadoffvictims.org

WHERE IS THE MONEY?

JOANNE on Jan 5, 2009 02:57 PM

What could have happened to all this money he took? I am sure not all of it went to pay dividends/interest? They should sieze all his assets, sell them and divide amoungst the people let out in the cold. I realize that people were taken by him, but also, they were a little greedy. Something too good to be true usually is.

Institutional Investors?

Benko M on Dec 22, 2008 03:18 PM

Can anybody explained how "sophisticated" Institutional types like HSBC and Santander were dupped by this Madoff Scheme? We have to rename this scheme. Were the credit risk management team on holiday during this endeavor. This whole "staged event", in light of Robert Rubins looting of twice as many sheckels, seems very suspicious. Gee, Robert Rubin is amongst the Obama team. You better wake up Amerika! The depth of this kosher mafia is in ALL aspects of american society!!! http://iamthewitness.com/news/2008.12.18-The.Madoff.Double-Bluff.html

Madoff and SIPC

Thomas Mulloolly on Dec 19, 2008 10:50 PM

The purpose of the SIPC is to protect investors who have been damaged due to a brokerage failure...NOT fraud. Sadly, the SIPC is not designed for this situation. These losses are from theft, not from a brokerage failure. There are tax laws designed to allow write-off for nearly every dollar lost due to theft. This would ultimately be more valuable to investors then getting a potential $500,000 back (whenever that may or may not happen) versus multi-million dollar losses.

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EXHIBIT 4

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ORIGINAL

UNITED STATES BANKRUPTCY COURT
EASTERN DISTRICT OF NEW YORK
---X

In re New Times Securities Services, Inc. Case No. 800-8718 (SB) SIPA

Debtor.

---X

LIMITED OBJECTION TO TRUSTEE'S DETERMINATION OF CLAIM

Claimants Simon Noveck and Helga Noveck (the "Novecks") hereby submit their limited objection to the Trustee's determination regarding a customer claim asserted by them (the "Claim") in this proceeding.

In their Claim, the Novecks assert, for reasons explained below, that they are owed $321,010.08 for purchases of shares of the New Age Securities Money Market Fund ("NASMMF"). In his March 2, 2001 determination with respect to the Claim, the Trustee advised that, while the Novecks had deposited $300,000.00 for the purchase of shares of NASMMF, the Trustee will pay (or satisfy) the claim only to the extent of $100,000. (A copy of the Novecks' Claim is annexed as Exhibit A hereto; a copy of the Trustee's determination is annexed as Exhibit B hereto).

As explained below, the Novecks are entitled to have their claim satisfied in the amount of $321,010.08, which is the value of their "net equity" claim for shares of NASMMF held for their account by the Debtor. The Trustee's determination here is contrary to applicable

Exhibit A Exhibit B Exhibit C

[illegible] the Novecks respectfully represent as follows:

BACKGROUND

1. On February 17, 2000, the United States Securities and Exchange Commission ("SEC") filed a Complaint (the "SEC Complaint") in the United States District Court for the Eastern District of New York (the "District Court") against William Goren ("Goren"), New Age Financial Services, Inc. ("New Age") and New Times Securities Services, Inc. ("NTSSI"). The SEC Complaint alleges that Goren conducted a long-running "ponzi" scheme, defrauding hundreds of investors and causing investor losses currently estimated by the SEC at $32.7 million. NTSSI was named as a relief defendant in the SEC action, *inter alia*, because of its receipt of transfers from the New Age "ponzi" scheme account at Fleet Bank of not less than $1,243,000 in 1998 and $340,000 in 1999. On March 9, 2001, Goren, who had pled guilty to his criminal conduct, was sentenced to a prison term of 87 months for his role in the "ponzi" scheme.

2. By application, dated May 16, 2000, to the District Court, the Securities Investor Protection Corporation ("SIPC") sought the issuance of a Protective Decree adjudicating that the customers of NTSSI were in need of the protection afforded by the Securities Investor Protection Act of 1970 ("SIPA"). By Order of the District Court, (i) all proceedings relating to NTSSI were transferred to this Court; (ii) NTSSI was placed into liquidation; and (iii) James W. Giddens, Esq. of Hughes Hubbard & Reed LLP was appointed as Trustee for the liquidation of NTSSI.

3. By motion, dated November 6, 2000, the Trustee sought an order substantively consolidating the NTSSI and New Age estates. The District Court subsequently authorized the Receiver for New Age to consent to the Trustee's substantive consolidation motion, and this Court approved the Trustee's motion and entered an Order, dated November 27, 2000 (the

[illegible] to be pooled, all intercompany liabilities [illegible] and the combined estate is to be administered by the [illegible] with SIPA and the Bankruptcy Code under the jurisdiction of this Court. [illegible] Pursuant to the Consolidation Order, for purposes of determining "customer" claims under SIPA, the "Debtor" includes NTSSI and New Age for claims arising after April 19, 1995, the date that, according to the Trustee, NTSSI became an SEC registered broker-dealer and SIPC member. The consolidated entities are referred to herein collectively as the "Debtor".

THE CLAIM

5. Simon and Helga Noveck reside in Flushing, Queens, New York. Simon Noveck is 80 years old, in extremely poor health, and disabled.[1] Both Simon Noveck and Helga Noveck are retired. After coming to the United States after World War II, Simon and Helga both worked, living modestly, and Simon Noveck ultimately managed to start his own small business, designing, constructing, and assembling parts for printing press machines for use by newspapers.

6. After their youngest son graduated college, the Novecks finally were able to begin to save some money. Having been introduced to William Goren by Adriane Berg of WABC, who endorsed and touted investing with Goren, the Novecks began investing with Goren in September 1998. The Novecks advised Goren, consistent with the endorsement of Goren by Adriane Berg (upon which they relied), that they wanted to invest in the safest and most conservative investment available. They informed Goren of their personal circumstances; Goren knew that the Novecks were Holocaust survivors, whose life savings were the result of years of honest, hard work, and that such savings were needed for the Novecks' retirement. Goren placed

[1] After several operations, Simon Noveck underwent a hemipelvectomy when his youngest son was 8 years old. Simon Noveck today is in most fragile health, and is only able to walk with extreme difficulty.

[illegible]

[illegible] Between September 1998 and April 1999, [illegible] entire life savings, $300,000, with Goren, believing that they had purchased [illegible] NASMMF. For each purchase, the Novecks received a confirmation. At all times, the shares of the Fund maintained a price per share of $1.00. The Novecks' investments were made as follows, on or about the following dates:

8. September 4, 1998. The Novecks invested $120,000 to purchase 120,000 shares of the NASMMF.

9. December 8, 1998. The Novecks invested $80,000 to purchase 80,000 shares of the NASMMF.

10. January 25, 1999. The Novecks invested $67,696.07 to purchase 67,696.07 shares of the NASMMF.

11. February 4, 1999. The Novecks invested $32,363.93 to purchase 32,303.93 shares of the NASMMF.[2]

12. As indicated on the Novecks' New Times Securities Corporation statements, relevant copies of which were supplied in support of their Claim and which are annexed as Exhibit C hereto, dividends on shares of NASMMF were automatically invested in additional shares of NASMMF. As reflected in the last brokerage statement received by the Novecks, as of December 31, 1999, the Novecks owned 321,010.08 shares of NASMMF, including 21,010.08 shares purchased through dividend reinvestment.

---

[2] On April 7, 1999, Goren "transferred" $26,379.30 to a NTSSI account held by the Novecks to pay for the purchase of certain stocks. On or about April 15, 1999, Goren "transferred" $26,379.93 back to the Novecks' New Age Securities Corporation account. The Novecks also paid taxes for the purported dividends received in 1998 on their investments.

[illegible] 2001 (the "Notice") [illegible] finding that the Novecks had deposited $300,000.00 with the Debtor for the purchase of shares of NASMMF and that the Claim, to the extent of such deposit, was a "valid customer claim." *See* Exhibit B hereto. Based upon such finding and determination, the Trustee allowed the Claim "as a claim for cash in the amount of $300,000.00." The Notice also communicated the Trustee's disallowance of the balance of the claim ($21,010.08), representing the value of shares acquired by the Novecks through dividend reinvestment. Notwithstanding the allowance of the Claim to the extent of $300,000.00, the Novecks were advised pursuant to the Notice that the Trustee will pay the claim only to the extent of $100,000. As explained in the Notice, the difference between the portion of the Claim allowed and the amount undertaken to be paid by the Trustee is based upon the application by the Trustee to the Claim of the payment limitation found in 15 U.S.C. § 78fff-3(a)(1). Such section, which applies only to a claim "for cash," limits the payment obligation of the Trustee to $100,000.

OBJECTIONS

14. The Novecks object to the Notice to the extent that it characterizes the Claim as one "for cash" rather than "for securities" and, based upon such characterization, applies the $100,000 statutory limit to the Trustee's payment obligation in respect of the Claim. Upon characterization of the Novecks' claim as one "for securities," the $500,000 statutory limit would be applicable and the Trustee would therefore be obligated to satisfy the full amount of the Novecks' claim. 15 U.S.C. § 78fff-3(a). The Novecks also object to the disallowance of that portion of their claim having a value of $21,010.08, representing shares of NASMMF purchased by them through dividend reinvestment.

[illegible] "net equity" [illegible] 15 U.S.C. § 78lll(11) [illegible] as the dollar amount of the account or accounts of a customer, to be determined by calculating the sum which would have been owed by the debtor to such customer if the debtor had liquidated by sale or purchase on the filing date, all securities positions of such customer..." *Id.* As established by the Novecks' account statements, the Novecks' net equity as of the February 17, 2000 filing date was $321,010.08 based upon ownership of 321,010.08 shares of NASMMF having a value of $1.00 per share. *See* Exhibit C hereto.

16. After receipt of a statement of claim, SIPA requires that a trustee promptly discharge "all obligations of the debtor to a customer relating to, or net equity claims based upon, securities or cash, by delivery of securities or the making of payments to or for the account of such customer." 15 U.S.C. § 78fff-2(b).

17. SIPA defines "security" broadly. 15 U.S.C. § 78lll(14). It is not disputed by the Trustee or SIPC that the statutory definition of a security covers shares of a money market fund.[4]

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[3] The Trustee has determined that the Novecks were customers of the Debtor for purposes of SIPA and accordingly, such status is not at issue. "Customer" is statutorily defined as "any person (including any person with whom the debtor deals as principal or agent) who has a claim on account of securities received, acquired, or held by the debtor in the ordinary course of its business as a broker or dealer from or for the securities accounts of such person for safekeeping, with a view to sale, to cover consummated sales, pursuant to purchases, as collateral security, or for purposes of effecting transfer. The term customer includes any person who has a claim against the debtor arising out of sales or conversions of such securities, and any person who has deposited cash with the debtor for the purpose of purchasing securities..." 15 U.S.C. § 78lll(2).

[4] Shares of money market funds have been acknowledged by SIPC to be securities within the protection of the statute. As stated by SIPC:

> Shares of money market funds, although often thought of by investors as cash, are in fact securities when such funds are organized as mutual funds. When held by a SIPC member in a customer's securities account, such fund shares are as protected as any other covered security.

Publication of SIPC, "How SIPC Protects You," at page 7.

characterized all claims based upon purchases of shares of NASMMF, including the Noveck's Claim, as cash claims based upon the fictitious nature of NASMMF. In contrast to its classification of NASMMF claims as "cash claims," net equity claims which have been asserted by customers of the Debtor based upon account statements showing holdings of mutual funds having names conforming to, similar to or close to actual funds, are being treated by the Trustee as claims for securities.[5] Thus, in classifying claims as either "for cash" or "for securities" the Trustee is making a critical distinction between sham transactions involving sham securities — *i.e.*, the "fictional" NASMMF, shares of which never existed (but which are fungible with hundreds of other money markets) — and sham transactions involving the purported purchases of mutual funds denominated on account statements with names of actual funds *or* mutual funds with names similar or close to mutual funds which may be quoted in the newspaper, in which neither investors nor the Debtor ever acquired an interest. The Novecks, like the other victims of Goren, do not dispute the Trustee's conclusion that the NASMMF was never actually organized as a money market fund. However, at the same time, the Trustee does not dispute that the Novecks were entirely innocent of any culpability in connection with their purchase of shares of the NASMMF and concedes that the Novecks had no knowledge or suspicion of the non-existence of the NASMMF, which was confirmed to the Novecks and shown on their statements as a legitimate money market fund.

19. Although the Trustee has identified the fictitious nature of the NASMMF as determinative of the classification of the Noveck's claim as one "for cash" for the purposes of application of 15 U.S.C. §78fff-3 (a)(1), it has not specified any authority for reliance on this factor.

[5] As a consequence of the characterization of the claims of mutual fund investors as claims for securities, the Trustee has undertaken to pay such claims to the extent of the $500,000 statutory maximum. In addition, whereas the Trustee has disallowed that portion of the claims of NASMMF investors representing shares of NASMMF purchased through dividend reinvestment, the Trustee has allowed that portion of the mutual fund investors' claims that represent shares of such mutual funds purchased by them through dividend reinvestment.

[illegible] reliance [illegible] characterization of the Claim is contradicted by the rules adopted by SIPC for determining whether a customer claim is for cash or for securities. 17 C.F.R. §§ 300.500 - 300.503 ("Series 500 Rules").

20. Rule 501 - "Claim for Cash" provides in applicable part that:

> Where the Debtor held cash in an account for a customer, the customer has a "claim for cash," notwithstanding the fact that the customer has ordered securities purchased for the account, *unless: (1) the Debtor has sent written confirmation to the customer that the securities in question have been purchased or sold to the customer's account.*

17 C.F.R. § 300.501(b)(1) (emphasis supplied).

21. Rule 502 – "Claim for Securities," is the corollary of Rule 501 and provides that "Where the Debtor held cash in an account for a customer, the customer has a 'claim for securities' with respect to any authorized securities purchase: (i) if the Debtor has sent a written confirmation to the customer that the securities in question have been purchased for or sold to the customer's account[.]" 17 C.F.R. § 300.502.

22. Accordingly, the Series 500 Rules direct that where a customer has authorized a purchase of securities, it is the sending of a confirmation of that purchase or sale, rather than the execution of a trade, that determines whether the customer's net equity claim is for cash or securities. Here, the Notice includes the Trustee's determination that the Novecks authorized purchases of the NASMMF for their account. Moreover, it is not disputed that the Novecks received written confirmation of their initial purchase of shares, and, in the form of monthly or regular account statements, received confirmation of subsequent purchases by means of dividend reinvestment. In characterizing the Claim as one for cash, the Trustee disregards the apparent purpose and effect of the Series 500 Rules, *i.e.*, to bind the investor to and to allow the investor's reliance upon, written confirmation of his securities transactions. By apparently relying on the distinction between a fictitious money market fund and the fictitious purchase of shares of a money market fund (a distinction without substance) as the basis for the cash/securities determination, the

[illegible] objective, mechanical criteria provided by the Series 500 Rules.

23. The Trustee's misapplication of the Series 500 Rules is demonstrated within this proceeding by the disparate impact on the claims of similarly-positioned customers of the Debtor. In contrast to the NASMMF claimants, the Trustee apparently has determined that customers of the Debtor who entrusted funds to the Debtor for the purchase of shares of mutual funds with names (as denominated on customers' statements) similar or close to mutual funds which may be quoted in the newspaper, but whose transactions were never effected, will have their claims treated as claims for securities even though they never had any actual interest in the securities shown on their account statements. As a result, the Trustee is apparently allowing as valid customer claims "for securities" claims of customers who purchased shares of other non-existent mutual funds, while at the same time denying as valid customer claims "for securities" claims such as that of the Novecks for the purchase of shares of the NASMMF. There is nothing in the Series 500 Rules that suggests this result.

24. Moreover, the radically disparate and inequitable treatment of the NASMMF investors, on the one hand, and the mutual fund investors, on the other, results in undue and unseemly consequence given to the capricious and criminally motivated conduct of Goren rather than to any criterion reflected in the Series 500 Rules or pertaining either to customer conduct, losses or expectations. This disparate treatment is not, however, either required or contemplated by SIPA. Such disparate treatment flies in the face of the expressed Congressional intent for SIPA to satisfy customers' legitimate expectations. *See* S. Rep. No. 763, 95th Cong. 2d Sess. 2 (1978), reprinted in [1978] U.S. Code Cong. & Admin. News 764, 765. It is, in fact, absurd to suggest that Congress, in passing SIPA, intended for the scope of protection afforded to the investing public

[illegible]

25. Like the mutual fund investors, the NASMMF investors, including the Novecks, provided funds for the purchase of securities. As with respect to the funds provided by the mutual fund investors, no securities were ever actually purchased. Like the mutual fund investors, the NASMMF investors, including the Novecks, received confirmations of their purchases and monthly statements showing their security positions. Like the mutual fund investors, the NASMMF investors, including the Novecks, had no basis to question the representations made to them that securities had been purchased for their account and were being held for them by the Debtor. Indeed, the "legitimate expectations" of the NASMMF investors, including the Novecks, are indistinguishable in every respect from those of the mutual funds investors.

26. The equities in favor of treating the NASMMF investors no less favorably than the mutual fund investors are compelling. Like other NASMMF investors, the Novecks chose to purchase money market shares believing that such investment was the most conservative available. It is respectfully submitted that to allow a small group of victims to bear crushing financial loss, while others with indistinguishable claims and expectations receive full statutory protection, is unconscionable. The inequitably disparate treatment reflected by the Trustee's determination of their claims is not mandated by SIPA or the rules promulgated thereunder.

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[6] The inequity of the Trustee's approach to characterizing claims is highlighted by the Trustee's apparent willingness to overlook discrepancies in the names of mutual funds (some of which actually existed and others with fictitious names), or pricing information with regard to purchases of certain mutual funds, appearing on account statements of certain investors and to nonetheless recognize such claims as securities claims. As arbitrary and unfair as it would be to deny a claim merely because Goren was less than meticulous in accurately identifying the mutual fund that he fraudulently represented had been purchased by an investor, it is equally arbitrary and unfair to penalize the NASMMF investors for having been duped into purchasing sham securities.

[illegible] the Court direct the [illegible] to satisfy the full amount of [illegible] claim ($321,010.08) and to satisfy the entire amount of such claim as a claim for securities.

Dated: Uniondale, New York
March 26, 2001

FARRELL FRITZ, P.C.

By: Ted A. Berkowitz

Ted A. Berkowitz (TAB-3384)
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Dated: New York, New York
March 26, 2001

HELLER, HOROWITZ & FEIT, P.C.

By: [signature]

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Helga Noveck

EXHIBIT B

May 1, 2009

David Becker, Esq.
General Counsel and Senior Policy Director
U.S. Securities and Exchange Commission
100 F Street, NE
Washington, D.C. 20549

Re: Madoff Securities SIPA Proceeding

Dear Mr. Becker:

We write on behalf of customers of Bernard L. Madoff Investment Securities LLC ("Madoff Securities" or "Madoff"), a debtor in a proceeding under the Securities Investor Protection Act ("SIPA"), to respectfully request that the Securities and Exchange Commission ("SEC") exercise its plenary authority to supervise the Securities Investor Protection Corporation ("SIPC") with respect to one of the most important and central issues in the Madoff SIPC proceeding: the calculation of customers' net equity claims.[1]

SIPA states that a customer's net equity claim is the value of the "securities positions" in her account as of the filing date of the SIPA liquidation, less any amount the customer owes the debtor as of that date. In this case, the Madoff Trustee (the "Trustee") has taken a contrary position. He contends that the customers' net equity claims are to be determined by netting the total deposits against total withdrawals in their accounts since inception. As explained in this letter, while such a "cash in, cash out" valuation methodology can be appropriate in circumstances where the securities the broker-dealer had purportedly purchased were "fictitious" (i.e., non-existent securities that could never be purchased), it is entirely improper in circumstances where the securities purportedly purchased were "real" (i.e., actual securities that exist and could have been purchased). In taking this "cash in, cash out" netting position in the Madoff case – which involved purported purchases of "real" securities – the Trustee is advocating an approach that is contrary to (1) the statutory definition of "net equity" in SIPA, (2) the legislative history and intent of SIPA, (3) SIPC precedent, and (4) the leading Second Circuit authority on this issue.

In addition to being wrong as a matter of law, the Trustee's position raises significant policy questions. Not only would it impair the claims of thousands of Madoff Securities customers, it would also radically alter the perception of securities investors everywhere as to what SIPC protection means. The

[1] As the Supreme Court stated in *Securities Investor Protection Corporation v. Barbour*, SIPA invests the SEC with "'plenary authority' to supervise the SIPC." 421 U.S. 412, 417 (1975) (citing SIPA's legislative history); *see also In re New Times Sec. Servs., Inc.*, 371 F.3d 68, 77 (2d Cir. 2004) (citing SIPA's legislative history and other case law evidencing the SEC's "substantial" oversight authority with respect to SIPC).

consequence of such a changed perception would be to further erode investor confidence at a time when the securities industry and markets can least afford it.

Finally, given the July 2, 2009 bar date in this case, as well as the fact that many Madoff customers are currently in the process of considering or entering into settlements (with accompanying releases) with the Trustee based on the Trustee's incorrect statement of the law, this is an extremely time sensitive matter. Inaction on this issue will likely result in irreparable injury to hundreds, if not thousands, of customers.

1. The Trustee's View of "Net Equity" Is Directly At Odds with SIPA

SIPA defines a customer's net equity claim as the value of the customer's "securities positions" in her account, less any amount the customer owes the debtor, as of the date of the filing of the SIPA liquidation:

> "The term 'net equity' means the dollar amount of the account or accounts of a customer, to be determined by –
>
> (A) calculating the sum which would have been owed by the debtor to such customer if the debtor had liquidated, by sale or purchase on the filing date, all securities positions of such customer . . .; minus
>
> (B) any indebtedness of such customer to the debtor on the filing date . . ."[2]

15 U.S.C. § 78lll(11); *see also In re Adler Coleman Clearing Corp.*, 247 B.R. 51, 62 n.2 (Bankr. S.D.N.Y. 1999) ("'Net equity' is calculated as the difference between what the debtor owes the customer and what the customer owes the debtor on the date the SIPA proceeding is filed."); Madoff Securities SIPC Customer Claim Form (defining the customer's claim in terms of the cash and/or securities Madoff Securities owed to the customer and the cash and/or securities the customer owed to Madoff Securities as of December 11, 2008).

This statutory definition is clear and easily applied to the Madoff Securities liquidation. The typical Madoff customer received written trade confirmations, as well as detailed monthly account statements, reflecting the

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[2] The "indebtedness" of the customer to the debtor refers to cash or securities owed to the debtor, which is most often in the context of a customer having borrowed from the debtor on margin. *See, e.g.*, H.R. Rep. No. 95-746, at 21 (1977) (describing customers owing cash or securities to the stockbroker as "margin customers"); *Rich v. NYSE*, 522 F.2d 153, 156 (2d Cir. 1975) (noting that, under the 1970 statutory regime, when there were shortages in available securities to satisfy "net equity" claims, customers received cash for their securities "less, in the case of holders of margin accounts, amounts owed" to the broker); *In re First Street Sec. Corp.*, 34 B.R. 492, 497 (Bankr. S.D. Fla. 1983) (offsetting against claim amount of indebtedness customer owed to the debtor where unauthorized stock purchase was funded in part by borrowing on margin).

customer's "securities positions" in real and publicly verifiable securities (e.g., IBM, AT&T).[3] SIPA explicitly provides that the customer's "net equity" is the amount "owed by the debtor to [the] customer," determined by calculating what the value of the customer's "securities positions" would have been had those positions been liquidated on the filing date.

The fact that the securities were never purchased does not affect this analysis. SIPA necessarily assumes – and as discussed in Section 2 below, the legislative history of SIPA expressly contemplates – that the "securities positions" reflected in the customer's statements may reflect securities that were never actually purchased. That the securities were not actually purchased does not in any way alter the fact that the broker "owes" the customer the value of those "securities positions." Thus, because under SIPA the only permitted offset to the value of the customer's "securities positions" is any indebtedness of the customer to the debtor, absent any margin loans or other such indebtedness, a Madoff customer's "net equity" claim is the value of the "real" securities identified in the customer's confirmations and account statement as of December 11, 2008, the date of the Madoff filing.

By contrast, the Trustee's view on this critical, threshold issue for every claimant in the Madoff SIPA proceeding has no textual support in the statute.[4] To interpret "net equity" as the Trustee does would not only result in claim valuations that are completely inconsistent with SIPA's express language, it would also render the SIPA "net equity" provision entirely superfluous, in contravention of firmly established canons of statutory construction.[5] SIPA expressly includes a clear definition of "net equity" and the Trustee is not free to ignore it. The SEC can and should exercise its authority over SIPC to preclude the Trustee from attempting to engraft upon the SIPA regime a wholesale replacement of its statutory definition with an unprecedented and unsupportable "cash in, cash out" valuation methodology.

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[3] Indeed, each monthly account statement Madoff customers received included a specific section entitled "Security Positions," which set forth (1) the list of securities held in the account at the end of the calendar month, (2) the number of shares of each such security, (3) the price per share of each security position, and (4) the total market value of all the security positions (for both stocks and options).

[4] The Trustee's position also runs counter to what any rational investor would believe she is "owed" by her broker-dealer. Certainly no such investor could conceive that once she has withdrawn over the life of her investment account more money than she had deposited, her broker-dealer no longer "owed" her anything.

[5] *See State St. Bank & Trust Co. v. Salovaara*, 326 F.3d 130, 139 (2d Cir. 2003) ("It is well-settled that courts should avoid statutory interpretations that render provisions superfluous: 'It is our duty to give effect, if possible, to every clause and word of a statute.'") (quoting *Duncan v. Walker*, 533 U.S. 167, 174 (2001)).

2. The Trustee's View of "Net Equity" Runs Counter to SIPA's Legislative History and Purpose

The Trustee's "cash in, cash out" definition of net equity is also inconsistent with the legislative history of the statute. The paramount concern of the statute, as made clear by its legislative history, is to meet the legitimate expectations of broker-dealer customers. Such legitimate expectations almost always begin and end with what customers see in their written confirmations and monthly account statements, as well as in publicly available information about the securities reflected in those records. In the case of the Madoff Securities customers, these information sources gave them every legitimate expectation that their accounts, in fact, held the securities reflected therein at the prices and values set forth. By disregarding the plain language of the statute, the Trustee has wholly ignored those legitimate expectations, and, in so doing, has acted in direct contravention of the purpose of the statute.

SIPA was enacted in 1970 to protect investors and maintain their confidence in the financial markets. H.R. Rep. No. 91-1613, at 3-4 (1970) ("This legislation [SIPA] . . . is designed to effect two aims. It will establish immediately a substantial reserve fund which will provide protection to customers of broker-dealers . . . . This will reinforce the confidence that investors have in the U.S securities markets. In addition, [it] will provide for a strengthening of the financial responsibilities of broker-dealers.").[6] Under its original statutory scheme, SIPA aimed to do this by satisfying customers' "net equity" securities claims with actual securities, but only if the debtor had securities of the appropriate class and kind available in sufficient quantities to satisfy customers' claims.[7] Otherwise customers would receive the cash equivalents of the filing date value of the securities purportedly held.[8]

In 1978, Congress proposed amendments to SIPA to "satisfy more adequately customer expectations."[9] As Congressman Robert Eckhardt

[6] *See also In re New Times*, 371 F.3d at 87 ("[T]he [SIPA] drafters' emphasis was on promoting investor confidence in the securities markets and protecting broker-dealer customers."); *Appleton v. First Nat'l Bank of Ohio*, 62 F.3d 791, 794 (6th Cir. 1995) ("'Congress enacted [SIPA] to . . . restore investor confidence in the capital markets[] and upgrade the financial responsibility requirements for registered brokers and dealers.'") (citing *Barbour*, 421 U.S. at 415)); *Sec. Investor Prot. Corp. v. Morgan, Kennedy & Co.*, 533 F.2d 1314, 1318 n.5 (2d Cir. 1976) (same).

[7] SIPA § 6(c)(2)(B)-(D), Pub. L. No. 91-598, 84 Stat. 1636, 1648-50 (1970); H.R. Rep. No. 95-746, at 39 (statement of SIPC Chairman Hugh F. Owens). Under its original enactment, SIPA defined "net equity," in relevant part, as "the sum which would have been owing by the debtor to the customer had the debtor liquidated, by sale or purchase on the filing date, all other securities and contractual commitments of the customer," minus any indebtedness of the customer to the debtor. SIPA § 6(c)(2)(A)(iv), Pub. L. No. 91-598, 84 Stat. at 1648.

[8] SIPA § 6(c)(2)(B)-(D), Pub. L. No. 91-598, 84 Stat. at 1648-50; H.R. Rep. No. 95-746, at 41 (statement of SIPC Chairman Hugh F. Owens).

[9] D 922 Cong. Rec. H. 36326 (daily ed. Nov. 1, 1977) (statement of Representative Robert C. Eckhardt).

commented at the time, "[o]ne of the greatest shortcomings of the procedure under the 1970 Act, to be remedied by [the 1978 amendments], is the failure to meet legitimate customer expectations of receiving what was in their account at the time of their broker's insolvency." *Id.*[10] Those expectations were that the customers owned actual securities, as reflected on their statements, which would be returned to them, whenever possible, "in the form they existed on the filing date." H.R. Rep. No. 95-746, at 21. Thus, SIPA was amended to provide that "[t]he trustee shall, to the extent that securities can be purchased in a fair and orderly market, purchase securities as necessary for the delivery of securities to customers in satisfaction of their claims for net equities . . . ." 15 U.S.C. § 78fff-2(d); SIPA § 8(d), Pub. L. No. 95-283, 92 Stat. 249, 263 (1978).

Perhaps most importantly to the Madoff proceeding, the SIPA legislative history confirms Congress's intention that broker-dealer customers have valid net equity claims even when the securities reflected on their confirmations and account statements were never purchased. Both the Senate and House reports on the 1978 amendments clearly reflect that a customer's net equity claim is not at all dependent on whether the securities were actually purchased by the broker-dealer:

> "Under present law, because securities belonging to customers may have been lost, improperly hypothecated, misappropriated, *never purchased* or even stolen, it is not always possible to provide to customers that which they expect to receive, that is, securities which they maintained in their brokerage account. . . . By seeking to make customer accounts whole and returning them to customers in the form they existed on the filing date, the amendments . . . would satisfy the customers' legitimate expectations . . . ."

S. Rep. No. 95-763, at 2 (1978) (emphasis added).

> "A customer generally expects to receive what he believes is in his account at the time the stockbroker ceases business. But because securities may have been lost, improperly hypothecated, misappropriated, *never purchased*, or even stolen, this is not always possible. Accordingly, [when this is not possible,

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[10] *See also, e.g., Hearing on H.R. 8064 Before the Subcomm. on Consumer Protection and Finance of the H. Comm. on Interstate and Foreign Commerce*, 94th Cong. 63 (1975) ("The basic framework of the 1970 Act in regard to satisfaction of customers' claims should be modified to better meet the legitimate expectations of customers.") (report to the SIPC Board of Directors by the Special Task Force to consider possible amendments to SIPA); *Hearing on H.R. 8331 Before the Subcomm. on Consumer Protection and Finance of the H. Comm. on Interstate and Foreign Commerce*, 95th Cong. 81 (1977) ("The proposed [1978] amendments carry out the Task Force recommendations and are designed to make the Act more responsive to the reasonable expectations of investors.") (statement of SIPC Chairman Hugh F. Owens); *Hearing on H.R. 8064 Before the Subcomm. on Consumer Protection and Finance of the H. Comm. on Interstate and Foreign Commerce*, 94th Cong. 161-62 ("[T]he principal purpose of these amendments is to meet more nearly the reasonable expectations of brokerage firm customers.") (statement of SEC Commissioner Philip A. Loomis, Jr.).

> customers] will receive cash based on the market value as of the filing date."

H.R. Rep. No. 95-746, at 21 (emphasis added).

Neither the 1970 statute, nor the 1978 amendments, nor the legislative history of SIPA provides any support for the Trustee's "cash in, cash out" net equity theory.[11] Rather, it is the straightforward and statutorily based "securities positions" definition of net equity, and not the Trustee's "cash in, cash out" theory, that is in full accord with SIPA's purpose. That "securities positions" definition gives broker-dealer customers the critical comfort that SIPA was intended to provide: knowledge that the securities positions in their accounts – the values of which are publicly verifiable – are protected by SIPC up to $500,000 per account. Importantly, this is so regardless of whether the securities had ever, in fact, been purchased, and regardless of whether, over the life of the account, the customer had taken out more money than she had deposited.

Until this case, an investor did not have to worry – and certainly has never been warned – that SIPA might not mean what it says, that it might not cover what it was intended to cover, and that it might only cover accounts in which the investor's lifetime deposits exceeded her lifetime withdrawals (and then only up to the net of those amounts). Such a drastic departure from a clear statutory provision, that is also so contrary to the underlying purpose of the statute, must not be allowed in any case, including this one.

3. SIPC Precedent and the Leading Second Circuit Authority Are Contrary to The Trustee's Position

SIPC faced very similar circumstances in the New Times Securities Services, Inc. ("New Times") liquidation. There, the New Times Trustee's position on "net equity" was in full accord with SIPA, and thus directly contrary to the Madoff Securities Trustee's position in this case. Specifically, with respect to any claims that were based on confirmations and account statements reflecting securities positions in "real" securities that could have been purchased (i.e., securities that actually existed on the public market and whose valuations were objectively and publicly verifiable by the customers), the New Times Trustee

[11] As then-SIPC Chairman Hugh F. Owens further explained by way of a hypothetical: "[C]ustomers generally expect to receive what is in their accounts when the member stops doing business. If John Q. Investor has 100 fully-paid shares of IBM and a credit balance of $200 in his account, he expects to receive from the trustee a stock certificate for 100 shares of IBM and a check for $200. But in many instances that has not always been possible because securities have been lost, improperly hypothecated, misappropriated, never purchased, or even stolen." H.R. Rep. No. 95-746, at 39 (explaining that where John Q. Investor only receives the filing date cash value of his IBM securities, he will fail to realize any rise in the IBM stock price since that time). Implicit in Owens' hypothetical is the premise that "John Q. Investor" has a "valid claim" for the number of shares of IBM stock identified in his account statement as of the filing date, even when the brokerage had "never purchased" the stock for him. Nothing in Owens' hypothetical suggests that John Q. Investor's claim should be reduced to the extent he has withdrawn funds from the account over time.

allowed all such net equity claims to the full extent of the filing date valuations of those securities, even though none of the securities identified in those records had ever, in fact, been purchased by the broker-dealer. The Madoff investors are in precisely the same position as the "real" securities claimants in New Times and should be treated no differently.

As with Madoff Securities and Bernard Madoff, New Times Securities and its principal, William Goren, defrauded scores of investors by providing them with confirmations and account statements reflecting purported securities investments made on their behalf when, in fact, no such investments had been made and their money had, instead, been misappropriated for other purposes. Two of the investment opportunities Goren purported to offer were: (1) money-market funds that were entirely fictitious (the "Fictitious New Age Funds"); and (2) mutual funds that were entirely real, such as those offered by The Vanguard Group and Putnam Investments (the "Real Securities"). *See In re New Times Sec. Servs., Inc.*, 371 F.3d 68, 71-72 (2d Cir. 2004) (*"New Times I"*). Goren's was "a classic Ponzi scheme," *Id.* at 72 n.2, wherein new investors' money was used to pay earlier investors.

Approximately 900 customers filed claims in the New Times liquidation: 726 for whom the "Real Securities" were purportedly purchased; 174 for whom the "Fictitious New Age Funds" were purportedly purchased. Consistent with SIPA and its legislative history, the New Times Trustee appropriately applied SIPA's net equity definition to the "Real Securities" customers' claims – meaning he paid them according to the full value of those securities positions as of the date of the liquidation filing. When challenged by "Fictitious New Age Funds" customers who had objected that they had not received the same treatment, SIPC and the New Times Trustee (with the apparent concurrence of the SEC) vigorously defended their approach with respect to the "Real Securities" customers' claims:

- "[O]ur view [is] that when possible, SIPA should be interpreted consistently with a customer's legitimate expectations based on confirmations and account statements." (Br. of the SEC, Amicus Curiae, In Partial Support of the Position of Appellants and In Partial Support of the Position of Appellees ("SEC Amicus Curiae Brief") at 13, *New Times I* (No. 02-6166));

- "In every case [of a 'Real Security' customer], the Trustee has been able to identify the actual mutual fund in question by cross-checking the information supplied by Goren on the customer statements, including share price information, with publicly available information and then been able to purchase that security." (Joint Mem. of Law in Support of Trustee's Motion for an Order Upholding the Trustee's Determinations With Respect to Claims Filed for Investments in Non-Existent Money Market Funds and Expunging Objections to Those Determinations ("Joint Mem. in Support of Order Upholding Determinations") at 26, *SEC v. Goren*, 206 F. Supp. 2d 344 (E.D.N.Y. 2002) (No. 00-CV-970));

- Where customers' statements reflected securities positions in closed mutual funds, "the Trustee properly gave the customers cash equal to the filing date values of the closed mutual funds." (Reply Mem. in Further Support of Trustee's Motion for Order Upholding Determinations at 20, *SEC v. Goren*, 206 F. Supp. 2d 344 (E.D.N.Y. 2002) (No. 00-CV-970));

- "In those cases [that concern the payment of interest/dividends on bona fide mutual funds] the claimants had an objectively legitimate expectation of receiving interest/dividends *because the security in question had actually earned them.* Here, the bogus mutual fund [the Fictitious New Age Fund] was never organized as a mutual fund and had no assets or investments."[12] (Br. for Appellants James W. Giddens as Trustee for the Liquidation of the Businesses of New Times Securities Services, Inc. and New Age Financial Services, Inc. and Securities Investor Protection Corporation ("Br. for New Times Trustee and SIPC") at 38, *New Times I* (No. 02-6166) (emphasis added)).

The New Times Trustee, SIPC and the SEC were not alone in their view that SIPA provides that "real" securities claimants have "net equity" claims based on the value of their "securities positions" as of the filing date, notwithstanding that those securities had never been purchased by the broker-dealer. Two separate panels of the Second Circuit have also considered this issue in the context of the New Times liquidation and similarly endorsed according "real" securities claimants more favorable treatment than "fictitious" securities claimants.

New Times I involved two basic issues: (1) should "fictitious" securities claimants be treated as (a) "cash" claimants who could receive a maximum of up to $100,000 in SIPC advances, or (b) "securities" claimants who could receive up

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[12] SIPC and the New Times Trustee also valued claims by "Real Securities" customers in accordance with SIPA's definition of "net equity," even when those claims included mutual fund shares purportedly purchased through "dividend reinvestments," notwithstanding that no such purchases had, in fact, taken place (precisely because there had not, in fact, been any "dividends" to "reinvest"):

- "[I]nvestors who believed that their accounts held shares of mutual funds that actually existed (but were never purchased for their accounts) are having their claims (both as to shares of mutual funds never purchased by Goren *and shares shown in customer statements as purchased through dividend reinvestment*) satisfied by the Trustee up to the statutory maximum of $500,000." (Claimants' Joint Mem. of Law in Opposition to Joint Motion of Trustee and SIPC for Order Upholding Determinations at 3, *SEC v. Goren*, 206 F. Supp. 2d 344 (E.D.N.Y. 2002) (No. 00-CV-970) (emphasis added)).

- "[W]hereas the Trustee has disallowed that portion of the claim of [the Fictitious New Age Funds] investors representing shares of [the Fictitious New Age Funds] purchased through dividend reinvestment, *the Trustee has allowed that portion of the mutual fund investors' claims [i.e., "Real Securities" investors' claims] as represents shares of such mutual funds purchased by them through dividend reinvestment.*" (Limited Objection [of Myrna K. Jacobs] to Trustee's Determination of Claim at 6 n.4, *SEC v. Goren*, 206 F. Supp. 2d 344 (E.D.N.Y. 2002) (No. 00-CV-970) (emphasis added)).

to $500,000 in SIPC advances; and (2) how should "fictitious" securities claimants' (*not* "real" securities claimants') "net equity" be calculated. Before answering these two questions, the court took note of the disparate treatment the Trustee had afforded the "real" and "fictitious" securities claimants, and why he had done so:

> "Meanwhile, investors who were misled by Goren to believe that they were investing in mutual funds that in reality existed were treated much more favorably. Although they were not actually invested in those real funds – because Goren never executed the transactions – the information that these claimants received on their account statements 'mirrored what would have happened had the given transaction been executed.' [Br. for New Times Trustee and SIPC] at 7 n.6. As a result, the Trustee deemed those customers' claims to be 'securities claims' eligible to receive up to $500,000 in SIPC advances. *Id.* The Trustee indicates that this disparate treatment was justified because he could purchase real, existing securities to satisfy such securities claims. *Id.* Furthermore, the Trustee notes that, if they were checking on their mutual funds, the 'securities claimants,' in contrast to the 'cash claimants' bringing this appeal, could have confirmed the existence of those funds and tracked the funds' performance against Goren's account statements. *Id.*"

New Times I, 371 F.3d at 74.

Ultimately, the court concluded, with the benefit of the SEC's views, that (1) a customer's "legitimate expectations," as evidenced by the written confirmations she receives, are paramount, and therefore the "fictitious" securities claimants should have been treated as "securities" claimants who could recover up to $500,000 in SIPC advances, but that (2) "fictitious" securities – which were non-existent and therefore had no publicly verifiable market value and could not be purchased anywhere – would have to be valued simply based on the amount of money those "fictitious" securities customers had initially provided to the debtor.

As to the first conclusion, the Second Circuit agreed with the SEC that it is a customer's legitimate expectations based on written confirmations and account statements that control how a net equity claim is determined. In doing so, the court considered, *inter alia*, SIPC's Series 500 Rules, 17 C.F.R. §§ 300.500-300.503, which were promulgated by SIPC and approved by the SEC, and which confirm the critical importance of written confirmations. The court explained that "the premise underlying the Series 500 Rules [is] that a customer's 'legitimate expectations,' based on written confirmations of transactions, ought to be protected." *New Times I*, 371 F.3d at 87. Although not determinative of the issue facing the court, it nonetheless found the Rules supportive of and consistent with its holding because, "[u]nder the Series 500 Rules, whether a claim is treated as one for securities or cash depends not on what is *actually* in the customer's account but on what the customer has been told by the debtor in written confirmations." *Id.* at 86 (emphasis in original). *See also In re Oberweis Sec., Inc.*, 135 B.R. 842, 847 n.1 (Bankr. N.D. Ill. 1991) ("The court agrees with the trustee's argument that Congress did not intend to treat customers without confirmations [in a SIPA liquidation] the same as those with confirmations; that customers with confirmations have a legitimate expectation of receiving securities, but customers without confirmations do not have the same expectation.").

With respect to the valuation question, the SEC argued to the Second Circuit that the "net equity" of "fictitious" securities claimants should equal the amount of money invested minus any withdrawals, reasoning that, although "net equity" is equal to the sum that the debtor would have owed the customer had the customer liquidated his or her securities positions on the filing date, "a *fictitious* security cannot be 'liquidated.'" SEC Amicus Curiae Brief at 15 (emphasis added). Accordingly, the values ascribed to such "fictitious" securities on customers' account statements would "necessarily have no relation to reality" because they would be merely "subject to the whim of the broker-dealer who makes up fictitious values for securities and dividends." *Id.* at 16-17. The Second Circuit agreed, finding that basing customer recoveries on "fictitious amounts in the firm's books and records would allow customers to recover arbitrary amounts that necessarily have no relation to reality." *New Times I*, 371 F.3d at 88 (quoting SEC Amicus Curiae Brief at 16).

In short, under *New Times I*, it is only where the "securities positions" reflected on the confirmations and account statements have "no relation to reality" – because they are not objectively and publicly verifiable or capable of replacement – that a "cash in, cash out" valuation methodology is the only reasonable proxy for that customer's legitimate expectations. That is obviously not the situation for Madoff customers.

Two years later, a different Second Circuit panel considered related issues in the New Times liquidation and expressed the very same views regarding the importance under SIPA of meeting a customer's legitimate expectations. *In re New Times Sec. Servs., Inc.*, 463 F.3d 125, 128 (2d Cir. 2006) ("*New Times II*") ("It is a customer's legitimate expectations on the filing date . . . that determines the availability, nature, and extent of customer relief under SIPA."). *New Times II* concerned claim determination objections brought by purchasers of a third type of instrument sold by Goren: fraudulent promissory notes. Those promissory note purchasers were challenging the trustee's position that, as noteholders, they did not qualify as "customers" under SIPA. Of particular relevance to the Madoff case is SIPC's repeated statement that customers' legitimate expectations control even when no securities were ever purchased:

> "[R]easonable and legitimate claimant expectations on the filing date are controlling even where inconsistent with transactional reality. Thus, for example, where a claimant orders a securities purchase and receives a written confirmation statement reflecting that purchase, the claimant generally has a reasonable expectation

> that he or she holds the securities identified in the confirmation and therefore generally is entitled to recover those securities (within the limits imposed by SIPA), *even where the purchase never actually occurred and the debtor instead converted the cash deposited by the claimant to fund that purchase*. . . . [T]his emphasis on reasonable and legitimate claimant expectations frequently yields much greater 'customer' protection than would be the case if transactional reality, not claimant expectations, were controlling, as this Court's earlier opinion in this liquidation well illustrates."

Br. of Appellant SIPC at 23-24 (citing *New Times I*) (emphasis added), *New Times II*, (No. 05-5527).

As the court in *New Times II* explained, it is only in the context of "fictitious" securities claims that the "cash in, cash out" valuation methodology makes sense:

> "*Because there were no such securities*, and it was therefore impossible to reimburse customers with the actual securities or their market value on the filing date (the usual remedies when customers hold specific securities), the [*New Times I* Court] determined that the securities should be valued according to the amount of the initial investment. The court declined to base the recovery on the rosy account statements telling customers how well the *imaginary* securities were doing, because treating the fictitious paper profits as within the ambit of the customers' 'legitimate expectations' would lead to the absurdity of 'duped' investors reaping windfalls as a result of fraudulent promises made on *fake* securities. . . . The court looked to the initial investment as the measure for reimbursement because the initial investment amount was the best proxy for the customers' legitimate expectations."

New Times II, 463 F.3d at 129-30 (citations omitted)(emphasis added).

The "cash in, cash out" valuation methodology employed in *New Times I* with respect to "fictitious" securities claimants has no place in the Madoff case, where customers' confirmations and account statements reflected "real," well-known and publicly verifiable securities. Because the prices and values ascribed to the "securities positions" on those records "mirrored what would have happened had the given transaction been executed," Br. for New Times Trustee and SIPC at 7 n.6, the liquidation filing date value of those "securities positions" is the "best proxy for the customers' legitimate expectations." *New Times II*, 463 F.3d at 130.

The Madoff investors are no different than the "Real Securities" investors in *New Times I*. They received written trade confirmations and monthly account statements that reflected "security positions" for securities that actually existed, and the names and prices of those securities, as reflected on the confirmations and account statements, were verifiable based on publicly available information. Because they had legitimate expectations that their accounts held bona fide securities, and were earning profits on those bona fide securities, they should be treated just as the "Real Securities" claimants were in *New Times I.*

4. The Trustee's Position Would Materially Erode Investor Confidence

If accepted, the Trustee's interpretation of "net equity" would have significant and far-reaching negative implications well beyond the Madoff proceeding. For the last forty years, individual and institutional securities investors have placed great reliance on a host of statutory and regulatory safeguards. The protections afforded by SIPA and SIPC have been near or at the top of those safeguards since 1970. Acceptance of the Trustee's rejection of SIPA in the Madoff case would not go unnoticed. To the contrary, it would necessarily and materially erode investor confidence in the SIPA regulatory regime, and, as a result, the securities markets and industry as a whole. It would also very likely lead to concerned broker-dealer customers employing a variety of inventive and potentially troublesome techniques to game the system and engage in various self-help efforts to maintain at least some SIPC protection for their accounts. Such actions would be extremely disruptive to the customer and harmful to the securities industry, and would serve no purpose other than to attempt to get around a lawless precedent that would have been set by the Trustee in this case.

For example, if customers are informed that, contrary to SIPA, SIPC may well calculate their "net equity" on a "cash in, cash out" basis, many could decide that they have to take steps on their own to enhance whatever protection they might be entitled to. To the extent they have not been chilled entirely from investing, many could conclude that as soon as their "cash out" level comes within $500,000 of their "cash in" level, they should close their accounts and transfer their holdings to a new broker-dealer.[13] It would only be through that type of convoluted process – wherein the customers are, in effect, hitting the "reset button" – that brokerage customers can believe that they have done what they could to try to salvage at least some of the protection they had thought they were being afforded when SIPA was enacted. We should not need to describe the havoc that such actions would play on the securities industry and markets.

A short example may be helpful to illustrate this concern. Consider a customer with a brokerage account having the following characteristics:

- she opened the account 20 years ago with a $500,000 deposit (and this is the only deposit she ever made into the account);

[13] Smaller-scale customers, whose accounts are worth less than $500,000, may have even more complicated concerns. Those customers will know that every dollar they withdraw – starting with the very first such dollar – will potentially reduce their SIPC protection. As a result, such customers may either decide not to invest at all (because the protection scheme is so complicated and, it turns out, weak), or try to devise some method for spreading their investment activity amongst multiple brokers and/or opening and closing accounts on a regular basis.

- the broker purportedly purchases "real" securities such as IBM, etc.;
- over the life of the account, each year she withdraws anywhere from $25,000 to $50,000 in order to:

  (a) pay taxes on the profits reported on the account, and

  (b) pay living expenses;
- the broker never in fact purchased any securities because he was operating a ponzi scheme; and
- by the time the broker's ponzi scheme is uncovered, the value of the investor's "securities positions" as reflected in the written confirmations and account statements she received – and which were verifiable through publicly available information – had grown to $2,000,000.

According to the Trustee's position, because over the life of the account the customer had withdrawn more than she had deposited, she would have no "net equity" claim and would not be entitled to anything from the SIPC fund. According to SIPA, she would have a "net equity" claim of $2,000,000, thus entitling her to $500,000 from the SIPC fund, as well as her pro rata share of any customer property collected by the trustee. Clearly, if the Trustee's position is upheld, customers such as this hypothetical one would be far better off by closing accounts and switching brokers on a regular basis.

Finally, the Trustee's net equity position would not only provide no compensation to customers who had withdrawn more money than they had deposited, but it would also significantly disadvantage customers who had never taken anything out of their account. Thus, for example, a customer who deposited $100,000, never withdrew anything, and received account statements showing her investment had grown to $400,000 would be made whole under SIPA, but would only receive $100,000 under the Trustee's "net equity" view.

Although the Trustee's approach would undoubtedly result in much of the SIPC reserve fund remaining untapped and unavailable to thousands of Madoff victims, achieving such a result is not the purpose of SIPA and should not be the purpose of the Trustee. To the contrary, SIPA's and the Trustee's purposes are very simply to assist customers in realizing as closely as possible their legitimate expectations.

CONCLUSION

For the reasons set forth above, we urge the SEC to exercise its oversight authority in this matter, not only to ensure that SIPC discharges its obligations as it is required to under the law, but also to ensure that SIPA's purposes are furthered, Madoff customers' legitimate expectations are protected, and all securities investors' confidence in SIPC protection is maintained. Specifically, we ask that the SEC (1) attempt to persuade the Trustee to follow SIPA, and (2) in the event that effort is unsuccessful, seek a court order requiring him to do so. *See* 15 U.S.C. § 78ggg(b) ("Enforcement of actions. In the event of the refusal of SIPC to commit its funds or otherwise to act for the protection of customers of any member of SIPC, the Commission may apply to the district court of the United States in which the principal office of SIPC is located for an order requiring SIPC to discharge its obligations under this Act and for such other relief as the court may deem appropriate to carry out the purposes of the Act.").

One final observation: It is not too late to correct the Trustee's error, but soon it will be. The bar date in this case is July 2, 2009. Claims not filed by then likely will never be allowed. The Trustee's numerous public and inaccurate assertions of what the law is with respect to whether Madoff customers have allowable "net equity" claims have undoubtedly influenced and will continue to influence thousands of customers in deciding (1) whether to file any claim at all, and (2) whether to settle their claims (if filed) in accordance with the Trustee's erroneous representation as to what they are entitled to (with the standard accompanying releases to such settlements precluding them from later recovering what they are actually entitled to). Thus, an ultimate court victory by private parties as a result of litigation on this issue will do such customers no good, because that victory will have been too late for them.

We very much appreciate your consideration of this critically important and time sensitive issue which – if resolved in accordance with SIPA – will have a materially positive impact on thousands of Madoff customers, as well as on the broader investing public and securities industry. We respectfully request the opportunity to meet with you and your colleagues at your earliest convenience to discuss this matter with you.

Respectfully,

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(continued below)

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Irving H. Picard, Esq., Madoff Securities Trustee
Josephine Wang, Esq., General Counsel, SIPC

Mr. MCHENRY. Thank you for your testimony. I thank the panel for its testimony. With that, we will begin questioning on our side by Dr. Gosar of Arizona. He is recognized for 5 minutes.

Mr. GOSAR. Chairman Schapiro, when David Becker, your brand new general counsel, first came to you in February 2009 and said, my mother had an account with Bernie Madoff, why didn't you ask him any questions about it? Why didn't you even ask simple questions like, how much money?

Ms. SCHAPIRO. Congressman, to the best of my recollection, and just so I can be clear, I haven't looked at any emails or whether there might be any contemporaneous notes or anything like that in this period of time, so I am recalling back because our inspector general is looking at all that, so I am recalling 2 years ago.

The best of my recollection was that Mr. Becker told me that his mother, who had passed away years ago, had an account at Madoff. Because the account was closed years before, I did not think that the account of a long deceased relative would raise an issue of a conflict of interest in Mr. Becker's work.

I did expect that he would go to the ethics counsel, an experienced government official, a government lawyer who served under three Chairmen at the SEC, and we use our ethics counsel all the time for their advice. I expected him to run it by the ethics counsel and to follow their advice and that is the way it went forward.

Mr. GOSAR. It seems that if the same situation existed in a publicly trade company that you were investigating, would you have such a cavalier approach to that?

Ms. SCHAPIRO. It is hard for me to imagine this situation. These are the government ethics rules.

Mr. GOSAR. An ethics rule nonetheless.

Ms. SCHAPIRO. It is very hard to answer in the abstract. It would depend on the rule.

Mr. GOSAR. It just seems there is a very different aspect that what is good in the private sector and publicly trade situations is not going well for the government.

Let us go to my next question. Ms. Chaitman, do you believe the account valuation method that David Becker recommended to the Commission as its attorney would have befitted his personal financial interest?

Ms. CHAITMAN. There is no question that the constant dollar approach, which apparently Mr. Becker invented, would benefit him personally and reduce his clawback exposure, but the more significant problem with the conflict of interest Mr. Becker had is that it clouded his judgment. The law is absolutely clear that every investor is entitled to SIPC insurance based on his last statement. Mr. Becker had an obligation, as general counsel of the SEC, to make sure that the SEC complied with the law and enforced it against SIPC. That is the great failure which has caused devastation to all of my clients.

Mr. GOSAR. Chairman Schapiro, your agency's inspector general compiled a 457-page report about the SEC's failure to uncover Madoff's ponzi scheme. That report devotes 2 sections out of 11 to describing in great detail every possible connection between SEC employees and Madoff.

Do you think that your general counsel's receiving funds from a Madoff account would have been appropriate material, the inspector general or not?

Ms. SCHAPIRO. That would be a much better question for the inspector general. I have a pretty high level of confidence that he did quite a thorough report on the agency's failures with respect to Madoff.

Mr. GOSAR. The Inspector General's Madoff report mentions on page 382, that two family members of an employee in the Office of Internet Enforcement invested $1½ million and $500,000 respectively with Madoff. The inspector general found it necessary to make sure that this employee had no involvement in any Madoff examination.

Do you think that the inspector general would have been interested in a similar situation involving your chief lawyer, a senior SEC official who served as general counsel from 2000 to 2002 while the SEC was ignoring whistleblower complaints about Madoff?

Ms. SCHAPIRO. I can't predict. I can imagine that he might have been and of course he is looking at all of these issues now. I expect that he will thoroughly explore that.

Mr. GOSAR. I understand that you inherited a horrific problem but it always starts with top down. Private sector, businesses always look at accountability within the hierarchy. It seems like we have a two-edge sword here that we should have demanded better accountability. Would you agree?

Ms. SCHAPIRO. Congressman, I would agree that from where I sit now and understanding all the things that I understand now that I didn't understand in 2009, having arrived at the SEC and discovered that I had an agency in absolute ruin in some regards on my hands to manage and not knowing obviously all the steps that would be taken by the Trustee or the decisions the Commission would make down the road, but knowing those things now, I wish that Mr. Becker had recused himself, absolutely.

Mr. MCHENRY. The gentleman's time has expired.

The gentleman from Illinois, Mr. Quigley, is recognized for 5 minutes.

Mr. QUIGLEY. Thank you, Mr. Chairman.

Madam chairman, the New York Times reported on March 5th of this year that the SEC has declined to enforce the requirement from Dodd-Frank that would make rating agencies subject to expert liability under the securities law. This would make rating agencies liable for faulty ratings. Could you comment on the timeline for implementing this measure?

Ms. SCHAPIRO. Yes, I would be happy to. The way the rule works is that if a rating is included in a registration statement for securities, then the rating agency must consent to having liability. That is the Dodd-Frank requirement.

We had preexisting SEC rules that require for AXA-backed securities registration statements, that if a rating was used to sell the securities, the rating needed to be included in the registration statement. Rating agencies have absolutely, unequivocally—at least the ones that are in existence now—refused to consent. That made public offerings of AXA-backed securities impossible because they couldn't get the consent of the rating agencies to include the ratings, but they used the ratings to sell the securities.

We temporarily set aside our rule, our requirement that the AXA backed issuers disclose the ratings in the registration statements because we didn't want to be holding up all public offerings of AXA-backed securities and pushing them into the private markets which we felt were not as good for investors.

Right now, our staff is working through reconsideration of our disclosure requirements. I believe they will recommend that we eliminate our preexisting requirement for including the ratings and therefore, the liability provisions can go forward.

We are also hopeful that some of the newer rating agencies that have indicated an interest in becoming registered with us will actually be willing to consent, which is I think how Congress hoped the law would work.

Mr. QUIGLEY. Can you guess on the timeframe for that?

Ms. SCHAPIRO. I can't but I would be more than happy to. I would say over the next couple of months, but I would be happy to get you a more definitive answer right away.

Mr. QUIGLEY. Thank you. You talked about the agency that you inherited and you talked to a certain extent about the reforms necessary and those you have implemented. As to Mr. Katz's point, whether or not more assets, and I think you need the assets to do your job, help more than the need for in a sense restructuring, reforming and reinventing yourself.

Are you looking at the agency from that perspective and the broader picture? If you were to start over, what would you do and how would you do it?

Ms. SCHAPIRO. Absolutely. I actually would do again many of the things we have already done. This has been an agency that has been sort of taken upside down and shaken pretty hard over the last 2 years—new leadership across the board in every major office and division, a new chief operating officer, a new chief ethics counsel, our first ever chief compliance officer.

We also restructured our Enforcement Division and put people into specialized groups where they could get deep expertise to bring enforcement cases more quickly in particular areas like structured products or the Foreign Corrupt Practices Act or insider trading.

We have also restructured our examination program, both of those, enforcement and examination, largely in response to the failures that were so vividly demonstrated in the inspector general's report on Madoff.

We have also brought new technology, which is going to be critical to us. We have too many people doing low value work because we don't have the technology.

Mr. QUIGLEY. What do you mean low value work?

Ms. SCHAPIRO. For example, when we bring enforcement cases, we bring in massive amounts of electronic data so that we can look at trading records or we can look at email transmissions between parties who might be sharing non-public information.

We need to be able to use analytics to find the important information and all of that, not have people plowing through all that information. When the markets fell so dramatically on May 6th, it took us 5 months to reconstruct trading data because we don't have the capacity in the SEC.

Mr. QUIGLEY. That was the final question we have limited time. Are you a technological match for those that you are regulating?

Ms. SCHAPIRO. Not at the moment, we aren't. We have a phenomenal new chief information officer who is making real progress, I think, but we are a long way from the people that we are regulating in terms of our technical capability, but I think we can get there. I think we can put up a good fight anyway.

Mr. QUIGLEY. Thank you. I yield back.

Mr. MCHENRY. I thank the gentleman. I now recognize the Vice Chair of the TARP, Financial Services and Bailouts Subcommittee, Mr. Guinta of New Hampshire, for 5 minutes.

Mr. GUINTA. Thank you very much, Mr. Chairman.

Mr. Katz, thank you and thank all of the witnesses for being here today. wanted to direct my first question to you, sir.

In your testimony, you talked about the size, structure and complexity of the U.S. capital markets and financial companies that have grown substantially in the past 30 years. I think your position is that you are comparing the SEC over that same period of time and the fact that it has not grown, changed or modified substantially. I wanted to get a little clarification on that first, if you would.

Mr. KATZ. Obviously I think everyone would agree that the capital markets of today are exponentially greater, but my point was more directed to the way the SEC is structured. It is not just a question of size; it is a question of a structure that corresponds to the entities you are regulating. The point I was making is that in the early 1970's when basically the current organizational structure of the SEC was last reformed, you had market regulation that focused on stock exchanges and broke dealers. You had a Division of Investment Management Regulation which focused on mutual funds and investment advisors. They were two very separate components of the industry and there really was very little overlap.

That no longer exists. Because of consolidation in the industry and the blending of the roles, the fundamental distinction between a stock broker who is a commission-based seller of securities and an investment advisor, who is an under management advisor on a comprehensive portfolio, is a historical artifact. It doesn't exist.

Because you have two divisions upon two different laws, according to a model that no longer exists, you get these anomalies. The fight over fiduciary duty differential was embedded in the laws but more importantly, you had two different divisions who had different ways of thinking about it and neither of them wanted to compromise. They both wanted to maintain their piece of it.

Mr. GUINTA. Does that speak a little bit to the silo effect that you have been referring to?

Mr. KATZ. Absolutely. I used to joke that the silos at the SEC were so real that in fact, that they had locked doors and that because all the paper in the agency used to have to come through my office, I actually had a skeleton key that occasionally allowed me to unlock each of the silo doors and get inside. Most people don't. Turf is a real issue in any organization, no matter what the size. It is compounded because remember you have different securities laws that were written at different points of time for different segments of the industry. Each division sort of jealousy guards the law that it controls. The market has changed.

Mr. GUINTA. I listened to what Chairman Schapiro mentioned in her earlier comments about some of the improvements, modifications and changes that she has made and they sound laudable and responsible. That being said, I wonder what type of congressional action may or may not be necessary given the systemic problem that we have seen within the SEC. I don't want to get into the specifics, but the things we have been talking about here. We have to prevent these from happening again. People in our Nation need to have confidence, not just in the SEC, but in the markets as well. I wonder what you could say about the type of intervention you feel Congress should be considering?

Mr. KATZ. That is a very difficult question for me to answer. The reason is I spent virtually my entire career at the SEC and I think it is very different for Congress to micromanage the internal organization and operations of a government agency. You can set policy, you can give direction, but I think it is dangerous when Congress tells the agency this is how you get it done. I think the agency really has to take this responsibility on. Chairman Schapiro has brought in an entirely new team of senior people. I don't know most of them. They seem very competent.

My hesitation is this. If you rely exclusively on a team of people coming in to effect change, when those people walk out the door, the change walks out with them. You need to change the structure, you need to change the culture and most importantly, you need the agency to define what it is it is trying to do and how do you measure whether it has gotten it done. You need that discipline, but that is for the agency to do.

Mr. GUINTA. Thank you, sir.

Chairman Schapiro, I only have a few seconds left, but what assurance can you give us that new management team is effectively managing and maintaining the necessary changes?

Ms. SCHAPIRO. I have to say I think change starts with leadership absolutely and having a whole new leadership team makes an enormous difference. They are very committed to working together and institutionalizing cooperation and collaboration among all of the divisions.

For example, we now have the College of Regulators for the largest financial institutions. It is no longer just the Trading and Markets Division that looks at them, it is no longer just the examination group. There is a group of people drawn from all over the agency who could have potential interest in the health of that financial institution who meet regularly to talk about what is going on in that company, to look at the financials, to meet with the staff of that financial institution. So the College of Regulators is just one example. We have task forces across the agency. We are merging, in some of our offices and will eventually in all of them, our examination programs for investment advisors and broker dealers which Mr. Katz mentioned.

Finally, I should say that we have just commissioned, and I believe it is going to be released today, Dodd-Frank required us to hire an independent consultant to do a very in-depth study of the

SEC's organizational structure. That will be released today. I fully expect that there will be some really helpful ideas there for us to further improve how we operate.

Mr. McHENRY. The gentleman's time has expired. With that, I recognize the ranking member, Mr. Towns.

Mr. TOWNS. Thank you very much, Mr. Chairman.

Let me thank all of you for being here. I really appreciate you taking the time to come.

Chairman Schapiro, the SEC plays a critical role in protecting investors and ensuring that our financial markets operate effectively. You have stated that freezing the SEC budget impedes the agency's ability to meet its mission, which is to protect investors, to maintain fair, orderly and efficient markets, and facilitate capital information. Can you put that in concrete terms for us?

If the SEC does not have the budget to properly oversee capital markets, how would this effect your staffing?

Ms. SCHAPIRO. Yes, sir, I would be happy to. I think the two things that are most severely impacted by a limited budget at the SEC are capability to hire the new kinds of talent and expertise we need, economists, people who worked in hedge funds on trading desks, financial analysts, the new expertise that will help us keep up with what is going on in the marketplace.

The second is the fact that it will slow down and really hurt our efforts at reforming our technology and bringing it up to speed and giving us the capacity to do the things we need to do in order to keep up with Wall Street. I know we will never meet their budgets. I understand that. I have no expectation and don't believe the American public should pay for us to have a $3 billion a year technology budget, but we have to do much better than we have been able to do.

I think those are the two primary things that are really impacted. It plays out in lots of other ways. When we don't have a sufficient travel budget, examiners can't travel to go into that mutual fund where most Americans hold their investing wealth, and examine the mutual fund's books and records. They can't go to the investment advisor or to the broker dealer.

In little ways, the lack of resources plays out but the real fundamental ways are bringing in those people that we need to really reform and transform the agency so people know that we have at least a fighting chance at staying on top of what is happening on Wall Street so we can also respond when the emergencies come along as we saw on May 6th when the market absolutely fell apart, scared people very badly in the retail investing public and in the institutional investing public as well. We need the capability to respond to those things very, very quickly.

Mr. TOWNS. What about the flexibility? Do you have that? For instance, if there is a crisis situation and you need a specific type of person and in order to get that person, you might need additional resources to be able to track who you need to do the job at that particular time, do you have that kind of flexibility?

Ms. SCHAPIRO. We have had some flexibility over the last 2 years because Congress has been generous in our budget, but if we continue with the CR level or are cut, the answer to that is no. May 6th required us to go out and bring in experts to help us analyze and go through all the trading data so we could reconstruct for the public to see what was happening every second in the marketplace when the Dow dropped 500 points in a matter of a few minutes.

Responding to emergencies is one of the things I do worry about. That is where we lose flexibility if we don't have a sufficient appropriation.

Mr. TOWNS. Thank you, very much. On that note, I yield back.

Mr. MCHENRY. Thank you. With that, I recognize Mr. Mack from Florida for 5 minutes.

Mr. MACK. Thank you, Mr. Chairman. I also want to thank the panel for being here today to give us an opportunity to get your insights and to ask a few questions on a very serious topic.

I would like to start with Chairman Schapiro, if I might. Do you feel as Chair of the agency that ultimately it is your responsibility to ensure that all of the employees are acting in accordance with SEC employee conduct standards?

Ms. SCHAPIRO. I have responsibility for the agency in that sense. I cannot tell you that with 3,800 employees, I can take individual responsibility for each and every one to ensure that they are following the requirements the way they should be.

Mr. MACK. Ultimately, it is your responsibility as the Chair of the SEC?

Ms. SCHAPIRO. Ultimately, I am responsible for the agency's conduct.

Mr. MACK. If I could direct your attention to slide No. 4, Chairman Schapiro, are you familiar with the rule that is being presented on the screen?

Ms. SCHAPIRO. Yes.

Mr. MACK. After reading through my material and hearing your testimony, it seems to me that you weren't completely knowledgeable of this rule at the time you hired David Becker. Please allow me to read it so everyone in the room can understand the entire rule.

"The Securities and Exchange Commission has been entrusted by Congress with the protection of the public interest in a highly significant area of our national economy. In view of the effect which Commission action frequently has on the general public, it is important that members, employees and special government employees maintain unusually high standards of honesty, integrity, impartiality and conduct. They must be constantly aware of the need to avoid situations which might result either in actual or apparent misconduct or conflicts of interest and to conduct themselves in the official relationships in a manner which commands the respect and confidence of their fellow citizens."

Chairman Schapiro, were you familiar with this rule at the time that you received David Becker as your general counsel?

Ms. SCHAPIRO. I can't tell you whether I had read it. I have been in and out of government most of my career, so I am generally aware of the ethics rules.

Mr. MACK. I only have a little bit of time. A moment ago, you said you were familiar with the rule.

Ms. SCHAPIRO. I am but you just asked me was I aware of it at the time that David Becker arrived at the Commission. I am telling you I can't recall whether I had reread the rule recently at that point or not.

Mr. MACK. Throughout your time in the 1980's and 1990's, you were familiar with this rule?

Ms. SCHAPIRO. Yes, I am generally aware of the ethics rules and that it is each employee's obligation.

Mr. MACK. Regarding David Becker's work with the Madoff case, do you believe that Mr. Becker was sufficiently aware of the need to avoid actual or apparent conflicts of interest?

Ms. SCHAPIRO. I want to be very careful. I believe he did what he thought was appropriate and what was required of him, going to the ethics counsel and seeking advice, getting that advice and following it. Do I wish now that he had been more sensitive to the potential for this issue to raise an appearance of a conflict? Yes, I wish that had happened.

Mr. MACK. A few more questions. Do you think that you were sufficiently aware of the need to avoid actual or apparent conflicts of interest?

Ms. SCHAPIRO. On my part, yes. I believe I am.

Mr. MACK. You said now a couple times, I think, that you wished Mr. Becker would have recused himself. Is that because of the fallout or do you really believe he should have recused himself?

Ms. SCHAPIRO. I believe, as I said, at the time from my perspective, a close account from a long since deceased relative didn't appear to me to raise a conflict of interest, but I believe now, knowing what we know now, not because of the fallout, though that is very real, but because if we could connect the dots and look ahead and see what all the steps would have been, yes, it would have been appropriate to have recused.

Mr. MACK. Let me say this. Also earlier, you kind of referred to the budget as kind of the reason why some of these mistakes happened. How much does it cost to follow that rule?

Ms. SCHAPIRO. That is a personal initiative. It doesn't really cost anything.

Mr. MACK. So the argument about the budget as it pertains to this rule, doesn't hold water? The argument about the budget in your opening statement that you talked about really doesn't pertain to this rule?

Ms. SCHAPIRO. No, and I didn't mean to suggest in any way that it did.

Mr. MACK. Thank you.

Mr. MCHENRY. The gentleman's time has expired. With that, I recognize the ranking member of the full committee.

Mr. CUMMINGS. I don't want that to be left hanging. I never heard you, and I heard all of your testimony and I have read your testimony, Ms. Schapiro, you never made that allegation. I want to make that clear. I haven't heard it. I think it is a very unfair statement.

Let me go on. Chairman Schapiro, I must tell you that when I was talking to my staff—as a matter of fact, when we were emailing back and forth at 4 a.m. this morning about this case, because it does trouble me to a degree with regard to the appearance of a conflict of interest.

I think when we hear what Ms. Chaitman had to say, that shows you why, and I am sure you see it, we have to make sure that we don't even have the appearance because what happens is that every decision made by Mr. Becker then becomes suspect. It is my favorite author, Covey who in the book, "The Speed of Trust," says that "Once trust is lost, everything moves more slowly." So I cannot begin to tell you how pleased I was when you walked in here today and said we will go beyond what may be required. That is so very, very important.

In my office, I have five people that whenever there is an ethics question, they all have to agree and if one vetoes, it is out the door. Why? Because the public is looking over our shoulders, we want to do the right thing and we want to make sure that it is right.

This has been a major wake up call, hasn't it. Here in this committee, it is so easy for us to get into a gotcha mode, but I must tell you, after I read about what you had done at the SEC since you have been there, and having sat on this committee and watched Mr. Cox and what he did with this organization and how it went down under him, to see you come and try to sweep up the mess, I must commend you.

The sad part about it is that one of these little incidents basically can almost destroy that trust. Do you understand what I am saying?

So I want you to commit to this committee, if you will. Tell me, if these incidents come up again, tell us the difference in how you might approach it. I understand what you did. A fellow comes to you, he tells you, years ago, I got an inheritance and he wants to know about a conflict. You listened to it for a while. You have 3,800 employees to deal with, you hear him and then you say, you know what, the expert on this is the ethics guy. Make sure you check with him and he got an opinion.

How would you deal with this differently now, looking backward?

Ms. SCHAPIRO. We have a new ethics counsel, first of all, who is doing sort of a top to bottom review of our program, but I think I need to work with all of our employees and communicate with all of our employees about a heightened sensitivity to issues like this.

I have worked so hard in the last 2 years to try to put this agency back on the right path and to earn the trust of the public. You are right, a small thing like this, not so small thing like this, can really set us back. It is not fair to 3,800 hardworking employees.

It is just like when somebody mentioned in their opening statement that employees had viewed pornography at the SEC. It infuriates me because most people there are working their hearts out day and night to try to do the right thing. It hurts the reputation of every single one of us.

I have to work with our employees to make sure that we increase their sensitivity to issues like this. I think with our new ethics counsel and their review of the program and how it might be strengthened, we will get some good advice. I think the inspector general is likely to have some recommendations that will be very helpful too.

Mr. CUMMINGS. I read in your testimony where you talked about technology and trying to keep up with these ever changing transactions and how complicated they have become. I want to make sure you have all the resources you need to address this because so many of our constituents on both sides lost a lot of money. Like Mr. Crimmins said, they need confidence to reenter this system of stocks.

Ms. SCHAPIRO. I agree.

Mr. CUMMINGS. Thank you.

Mr. MCHENRY. I thank the ranking member. With that, we yield for 5 minutes to Mr. Ross of Florida.

Mr. ROSS. Thank you, Mr. Chairman.

As a kid, I always wanted to be a lawyer and fortunately I found a law school that would take me. I went to law school and I always had a deep seated respect for the sanctity of the law, so much so that I was gratified that the American Bar Association and my state bar association required not only a course but an examination on the Code of Professional Responsibility.

Ms. Schapiro, I understand that you too are a lawyer and that even though you inherited quite a mess at a time of great disarray at the SEC, my question is as a lawyer, when Mr. Becker came to you, did you not think that a further investigation should be made? As a lawyer, we do conflicts checks, we make sure of that and it just seems to me that if further inquiries had been made at that time, this might have been avoided.

Ms. SCHAPIRO. I don't disagree with you that if further inquiries had been made, this might have been avoided. I can only say what I said at the beginning, that when he raised it with me, that he had a closed account, I didn't know if it had been a net winner account, a net loser account or anything else, from a deceased relative, it didn't raise for me a conflict of interest question.

Mr. ROSS. The fact that he asked for a waiver from his subordinate is indicative of a problem, an inherent internal problem there from an ethical standpoint.

Ms. SCHAPIRO. I don't know that he asked for a waiver and I again, I have no access to any contemporaneous documents of any sort. He asked whether or not he had a conflict and was advised that he did not have a conflict.

Mr. ROSS. Did you know who was advising him that there was no conflict?

Ms. SCHAPIRO. It was the ethics counsel of the SEC at that time who is no longer the ethics counsel.

Mr. ROSS. As general counsel, that would be under him, would it not?

Ms. SCHAPIRO. I believe that is the case in most agencies.

Mr. ROSS. Do you feel this would be avoided again in the future?

Ms. SCHAPIRO. I would love to say absolutely without a doubt, but it would be my very strong hope that with a very strong new ethics counsel that we hired from the Treasury Department with long government experience, with a revamping of our programs and with some additional education and training for our people, I would hope and expect that we could avoid this.

Mr. ROSS. I think the American public needs that assurance that credibility is going to be there.

Mr. Risinger, with regard to human resources, are your employees all part of the general schedule in terms of compensation?

Mr. RISINGER. Congressman, actually we have a separate pay schedule that we received from legislation of Congress back in 2001, 2002.

Mr. ROSS. Were you subject to the pay freeze that the President issued?

Mr. RISINGER. Yes, we are.

Mr. ROSS. That just really affected the cost of living increases, didn't it?

Mr. RISINGER. It does affect the cost of living increases.

Mr. ROSS. What about within pay grade or step increases? Did it affect that?

Mr. RISINGER. We have a merit pay process that is the equivalent of step increases for the rest of the government, so that is technically affected by the pay freeze.

Mr. ROSS. In your disciplinary procedures, let me ask you this. What is the probationary period for any employee?

Mr. RISINGER. It is generally a year.

Mr. ROSS. One year. After 1 year, if there is a disciplinary situation, is a presumption in favor of the employee if they have been found in violation or alleged violation of any personnel policies?

Mr. RISINGER. The Federal laws that we have to follow in terms of disciplining employees set out a number of standards that we have to go through. There are actually 12 factors that you have to look at when you are issuing discipline and one of them is a factor that says, is this the level of discipline that is necessary to stop the behavior and not more than that. So there is a presumption that you are taking a preventive or corrective step, not necessarily a punitive step.

Mr. ROSS. These would have been the same procedures employed in those involved in the viewing of pornography, correct?

Mr. RISINGER. That is correct.

Mr. ROSS. Only one person was fired as a result of that?

Mr. RISINGER. Of the cases we have had since 2005, 50 percent or 51 percent have either resigned, retired or have proposed removals in place. We have had a number of suspensions and reprimands as well.

Mr. ROSS. What is the attrition rate in your agency?

Mr. RISINGER. In the agency, in normal years, it is 7 to 8 percent. In the last couple of years because of the economy, it has been in the 3½ to 4 percent range.

Mr. ROSS. How does that compare with Federal agencies overall?

Mr. RISINGER. If we are talking just attrition in general, I think that is pretty equivalent with other agencies.

Mr. ROSS. Last question. Ms. Chaitman, with regard to the Madoff situation specifically, I saw where you put them on notice, what was going on. What action do you think would have requested be done in order to avoid this conflict?

Ms. CHAITMAN. Under the statute, Congress mandated that the SEC go into court and enforce the law against SIPC. That is precisely what I asked Ms. Schapiro to do in my April 2, 2009 letter. In fact, when Ms. Schapiro testified on July 14th before the Subcommittee on Capital Markets that she was going to do everything in her power to provide the maximum SIPC coverage for all investors, I assumed that she was, in fact, going to follow my request.

Now I have learned that in January 2009, the SEC had already agreed with denial of SIPC insurance to more than half of the victims.

Mr. ROSS. Thank you. I yield back.

Mr. MCHENRY. Thank you. Mr. Yarmoth of Kentucky for 5 minutes.

Mr. YARMOTH. Thank you, Mr. Chairman.

Thanks to all the witnesses for your testimony.

Over the last couple weeks I have been plowing my way through the Financial Crisis Inquiry Report which is anything but bedtime reading. It will not put you to sleep, I guarantee you that—as a matter of fact, quite the contrary.

I am sure, Chairman Schapiro, that you are aware of what the report concluded, particularly with regard to the SEC. I was interested in an assessment of where you think you still need to go to make sure that the failings in the system as it concerned your agency won't recur?

Ms. SCHAPIRO. As I have not looked at the report recently, it obviously focused a lot on the failures of the SEC's Consolidated Supervision Program for the five largest investment banks, all of which during the financial crisis essentially disappeared or converted to bank holding companies under the regulation of the Fed. I think there are a lot of lessons. I testified before the FCIC about the failures of the agency with respect to that program.

There are a couple of things. One is that it was a voluntary program, a voluntary regulatory program which, in my view, doesn't work very well. We had insufficient resources devoted to the regulation of the five largest investment banks. We didn't have people with the right kind of expertise and I think in some ways perhaps the most important thing is it required a very different kind of supervision than the SEC has traditionally done. It required prudential supervision as opposed to the SEC's going onsite, doing an examination, leaving and then perhaps bringing an enforcement case.

We didn't have the right mindset within the agency I think for that kind of constant prudential oversight approach that was really necessary. There was a lack of management focus, I think, with respect to the program. There was a willingness to believe what our people were being told by some of the leaders in some of those financial institutions that failed, a lack of skepticism which I think really hurt us as well. That program was discontinued by my predecessor, Chairman Cox.

Mr. YARMOTH. With regard to the present situation, because most people who observe the situation now, agree I think that the situation in terms of too big to fail, the largest investment banks have, in fact, gotten larger and that the wild west atmosphere in terms of risk taking and so forth may not have been curtailed at all. Is this a concern that you share? Anyone else on the panel is welcome to respond as well.

Looking at the Wall Street profit picture and so forth, it looks like there hasn't been a whole lot of change in behavior.

Ms. SCHAPIRO. I do think I can speak perhaps most particularly to the over-the-counter derivatives market where we have a very direct responsibility, although much progress is being made internationally with respect to accounting standards and other prudential measures.

Getting the over-the-counter derivatives market into a transparent marketplace so that regulators can understand the buildup and concentration of risk in financial institutions I think is going to be a very, very important piece of this. We are working through those rules as is the Commodities Futures Trading Commission. About half of them or so have been proposed and I would expect while we are going to miss for some of them the July 21st deadline, we will get them over the finish line over the course of the rest of this year. Then there will be implementation and phasing periods to go through. I think that will make a difference.

I think the work the FDIC is doing with the Fed and others on living wills and plans for financial institutions to wind down their business appropriately will also make a very big difference and then, of course, the capital requirements.

Mr. YARMOTH. A final question on that subject. We talked about the problem potentially with resources and the dangers that would ensue if your budget was cut. Are you confident that the legislative action that was taken, Dodd-Frank, is sufficient or that there are things that we yet need to do to make sure that we don't have a situation recur as it did 2 years ago?

Ms. SCHAPIRO. I think it makes large strides toward filling the gaps that existed in the regulatory regime. I will say that one of my concerns about the budget is that we don't have the capacity to operationalize the rules that we are putting into place—getting swap markets participants registered and the swap data analyzed and market surveillance taken care of. Those are things that we will have to put off, but I think it is incumbent upon all of us as regulators who see these markets close up to continue to tell Congress where we think the issues are, where perhaps Dodd-Frank wasn't the right approach and where we think there are still gaps.

Mr. YARMOTH. Thank you very much.

Mr. MCHENRY. I thank the gentleman. With that, I yield 5 minutes to the chairman of the full committee, Mr. Issa.

Mr. ISSA. Thank you, Mr. Chairman.

Madam Chair, I just went over to the Business Roundtable and back, so I had the opportunity to see about one-third of corporate America's profits in that room, almost all public companies, probably all public companies except one, all regulated by the SEC. I was there talking about impediments to job creation.

I am going to give you a little relief from the question de jour for a moment and ask, Dodd-Frank is not perfect and it was not what you might call a low cost, low budget way to get better performance with less cost. You have asked for 28 percent budget increase. In fact, if you had only the budget increase necessary to do the work you were not doing as well as you wanted to without all the new losses, what would that budget increase be in your estimation? In other words, what would it cost to do it right without piling on new regulations when there is no question there have been problems properly enforcing your existing portfolio?

Ms. SCHAPIRO. Mr. Chairman, I would have to actually do the math but maybe this helps.

When we did our 2012 request, we viewed 40 percent of the positions and it was a total of 780 positions or 584 full-time equivalents. We viewed 40 percent of those as going to our ongoing programs—that is 312 positions—and 60 percent going to Dodd-Frank in limitations, so hedge funds, oversight, over the counter derivatives, municipal advisors, whistleblower programs, clearing agencies and so forth.

Mr. ISSA. To followup on that quickly, the transparency elements that were asked for and agreed on by SEC and other agencies never got into Dodd-Frank, so you don't have a common mandate for reporting for transparency that had been worked out in the conference and then didn't happen.

From this committee's standpoint we are interested, and you can answer for the record if you are not completely ready today, how much savings could you get if, in fact, there was transparent interoperability both inward and whenever possible, out to the public for oversight?

Ms. SCHAPIRO. That is a great question and I would like to answer it for the record because I do think it is important, particularly when you have a market like the over-the-counter derivatives market with two regulators in the same space, that we try to be as consistent as we possibly can and leverage each other as effectively as we can. If I can come back to you on that, I would like to.

Mr. ISSA. I appreciate that and I want to give you an opportunity to be thoughtful because that is a major initiative of this committee on a bipartisan basis in the last Congress that didn't happen and we would like to renew it but would certainly take your input.

In the remaining 2 minutes, I do want to ask, Mr. Becker's conduct in retrospect was not a good idea. It certainly has not led to confidence in the independence, transparency and non-biased behavior of the SEC when we look through the tail light.

How can we know that the changes you are asking to be reviewed are going to clearly eliminate anything like this in the future? Where do we get the confidence in that?

Ms. SCHAPIRO. Mr. Chairman, I think it is a fair question. You and I have had many conversations and I try to be very transparent and up front. We will obviously be public about what our inspector general finds and what recommendations he makes, what our new ethics counsel finds as she reviews our program and recommendations she makes. We will be happy to come back and talk to Congress about those findings and those recommendations and see if we can develop some metrics that would actually help us figure out whether we are getting it right.

Mr. ISSA. Your ethics counsel served under the general counsel, a career position but under the general counsel, correct?

Ms. SCHAPIRO. Yes.

Mr. ISSA. Would you consider moving that to be independent direct report so that there would only be one person, a political appointee like yourself, that would be between the public and ethics questions rather than having a general counsel who has a number of jobs?

You don't have to answer that today but I would like you to consider that. In so many different HR situations in the private sector, there is a clear independence of HR which is a lot of the questions. A question of conflict was more than a legal question, particularly when it included somebody who was the boss of the person they went to for this 25 minute session and clearance, so give that some thought. I won't ask for an answer today.

Ms. SCHAPIRO. I will do that.

Mr. ISSA. Finally, as the time runs out, we on the committee want to work to try to be helpful. We realize we only have a portion of the portfolio that you see; you see much more of the regulatory and financial oversight of another committee, but the question I have for you is, in our conduct of this investigation, as we look at Mr. Becker's total portfolio of money, other things he may have done and how this might have affected or not affected the Madoff Trust, will you promise your cooperation to this committee today?

Ms. SCHAPIRO. I will promise my cooperation to the fullest extent I can. I don't know that I can compel him in any way to do anything.

Mr. ISSA. He has already come in voluntarily. We have the ability to compel him but it is really making sure that we can have a quick and transparent. Your IG would normally be willing to share any information that was not directly related to a criminal referral and so on. Anything you can do to pledge to help us will allow us to move from where we are as quickly as possible onto something else. That is why I ask today.

Ms. SCHAPIRO. Yes, of course I will help.

Mr. ISSA. Thank you. I thank you all for your indulgence and I yield back.

Mr. MCHENRY. Thank you.

Mr. Connolly of Virginia for 5 minutes.

Mr. CONNOLLY. Thank you, Mr. Chairman.

Chairman Schapiro, aren't you the chairman who appointed the inspector general who, in fact, is charged with investigating Mr. Becker?

Ms. SCHAPIRO. No, sir. He was appointed by my predecessor.

Mr. CONNOLLY. By your predecessor. That investigation continues?

Ms. SCHAPIRO. Yes. I requested the investigation.

Mr. CONNOLLY. You requested the investigation?

Ms. SCHAPIRO. Yes.

Mr. CONNOLLY. We just heard a line of questioning asking you to look at a budget without additional regulation that was burdensome and so forth. The Dodd-Frank legislation added some regulation in areas that heretofore had not been regulated at all, is that correct, Chairman Schapiro?

Ms. SCHAPIRO. Yes, that is absolutely correct.

Mr. CONNOLLY. For examples, take derivates. How big are derivates? What is the value of the derivatives market?

Ms. SCHAPIRO. The last number I saw was $600 trillion, I believe.

Mr. CONNOLLY. I am sorry, did you say trillion?

Ms. SCHAPIRO. Yes, sir.

Mr. CONNOLLY. It is entirely unregulated until Dodd-Frank passed, is that correct?

Ms. SCHAPIRO. Yes, it is largely unregulated.

Mr. CONNOLLY. Whatever could go wrong with an entirely unregulated $600 trillion market?

Ms. SCHAPIRO. We saw some things that went wrong and presumably that is what motivated the Dodd-Frank Act.

Mr. CONNOLLY. So maybe that is one of those burdensome additional pieces of regulation we are just going to have to put up with. That burdensome additional regulation requires SEC to staff up and to acquire the requisite expertise to enforce the regulation you are now charged with, is that correct?

Ms. SCHAPIRO. Yes, we believe so. We are able to do the rule writing that has been ongoing this year but to operationalize those rules, we need additional staff.

Mr. CONNOLLY. We heard Mr. Katz in his testimony say that simply having more SEC staffers do the same thing would not protect investors or promote capital formation. How many areas of additional or new regulation are requiring you to ramp up in terms of expert staffing?

Ms. SCHAPIRO. We obviously have derivatives, hedge fund regulation, we are creating a new whistleblower office although that is work that we need more help with but it is not unknown to us. We have to increase our oversight of credit rating agencies under the act and we have to register a whole new category of registrant in the municipal securities markets called municipal advisors, so there are half a dozen or so new areas for us to undertake regulation.

Mr. CONNOLLY. Just listening to you tick off that list, none of those sound like frivolous burdensome additional pieces of regulation. They sound like thoughtful additions to the regulatory framework in light of the biggest meltdown on Wall Street in 80 years. Would you share that view?

Ms. SCHAPIRO. I do think all of these areas are ones that needed to be addressed. As we write the rules, we are working very hard in collaboration with other regulators, but also with the public, with investors and the industry to make sure that we write as sensible rules as we possibly can.

Mr. CONNOLLY. Mr. Katz, would you share that view or is this just another example of having simply "more SEC staffers doing the same thing?"

Mr. KATZ. There is a quantitative nuance difference in what I said and the way I think you characterized it. The agency has an enormously large number of new areas of regulatory authority. The question is, when you go about regulating hedge funds, or regulating municipal securities markets, are you going to regulate hedge funds exactly the way you regulate investment advisors, which is arguably what they are, or investment companies, which is sort of a close cousin?

My point is that if you look at the way the Commission has regulated advisors, and regulated mutual funds, it hasn't been terribly effective. If you take the same approach for hedge funds, yes, that would be doing the same thing in those approaches, even if it is a new substantive responsibility with a new category of registrant.

Mr. CONNOLLY. Would you say, Mr. Katz, that some of the problem preceding the Wall Street meltdown in September 2008, for example, had to do frankly with the quality of the appointees, namely a whole bunch of people who didn't believe in regulation in the first place and therefore, didn't do it?

Mr. KATZ. I have to tell you that there is an old saying at the SEC that the Commissioners decide the policy, but ultimately, it is the staff that decides what it means and how it gets done. One of the interesting things about the SEC, the relationship between Commissioners and the staff is that it is a close relationship. Because the Commission is a bipartisan body, you are always going to get five people with diverging points of view, some of whom will support the staff, some of whom will disagree with the staff.

I can't think of an occasion where you had five Commissioners on one side of the table and the staff on the other side at loggerheads. That doesn't happen. You invariably get some supportive of Commissioners, some Commissioners who are critical and you also get that divergence of view among the staff.

Financial regulation is never a question of identifying a single right answer.

Mr. CONNOLLY. Thank you, Mr. Katz. Unfortunately, my time is up but I would love to pursue this further, but I certainly believe that the narrative that somehow SEC is treading into waters it has no business treading into is fallacious. If anything, we needed more people guarding the hen house. If we are going to talk about the fox guarding the hen house, that may have been true in the 2008 period of time but is not true today.

I thank the Chair.

Mr. KATZ. Excuse me, Mr. Chairman, if you might indulge me? There is one very quick point I wanted to make that Mr. Yarmoth brought up.

Mr. MCHENRY. Please.

Mr. KATZ. That was the question of the consolidated supervised entities regulatory process at the SEC. There is a lot of confusion about that. There was a voluntary process. The reason it was a voluntary process is not because of a deregulatory attitude at the SEC; it is because the Commission sought from Congress the authority to make it a mandatory process as part of the Gramwich Bill, which eliminated glass eagle.

Congress explicitly prohibited the Commission from making it a mandatory process. The Commission had a weak hand, it played the weak hand as best it could.

Mr. PLATTS. Thank the gentleman.

I will yield 5 minutes to myself.

I chair the Subcommittee on Government Organization, Efficiency and Financial Management, so I am going to focus on a related but slightly different area that relates to our jurisdiction. I had the privilege of chairing the same subcommittee from 2003 to 2007.

We had a subcommittee hearing July 2003 about the SEC, about financial management at the SEC, about internal controls and we heard testimony at that point they had just put in a new financial management system in 2002. In the testimony of the Executive Director, James McConnor at the time in July 2003, he said we have this new system and we are going to be certified basically in January 2004 for audited financial statements. Here we are 7 years later, plus, and we are now talking about the same thing, a new system using DOT Enterprise system to put in place a new system.

Chairman Schapiro, I appreciate the changes you have made, the COO, the new chief operating officer and other leadership changes and systemic changes within the SEC. Why should the American people believe when we were told 7 years ago we got it right and we were going to be able to go forward; how is it different today?

Ms. SCHAPIRO. Thank you. My understanding is that was the Momentum system, I believe, and it was deployed 9 or 10 years ago and in the beginning, it did meet the agency's needs, but then over time, the agency deferred upgrading over many years and as a result, it began to lack the functionality that was necessary to do the job. Gaps were created, work arounds were developed and as a result, the SEC ended up with two material weaknesses in its controls over financial reporting in our audit which is a disgraceful position for the Securities and Exchange Commission to be in.

With our new chief operating officer, our new chief financial officer and our new information officer, we made the decision that rather than incur the risks of developing a new system at the SEC, perhaps not really a core competency for us, that we would be better served by outsourcing financial management.

We went through a process and identified the Department of Transportation, which is an authorized Federal Share Service provider used by the GAO for their financial management system, and made the decision that the best way for us to remediate our material weaknesses, generate the kind of reporting that we need, minimize all these manual workarounds and all of this would be to outsource to them. I think it is the right decision for the taxpayer, I think it is the right decision for the SEC.

Mr. PLATTS. The followup related to that is, in the audit that was done at the end of this past year, a clean opinion, but failure to sign off on the internal controls, two related questions.

First, how would you describe the internal effort to get the clean opinion other than the internal controls and I ask in the sense of in July 2003, SEC said it was a heroic end of the year effort, it wasn't because we had a system in place, here is the data, we are ready to go. Was there again a heroic end of the year effort to be able to have that audit?

Ms. SCHAPIRO. I think there were some heroics involved. I can't compare to 2003 but I think we did put together a senior team of people to really shepherd the process through. They were diligent and they stuck with it, but they are also very much onboard for this decision to outsource.

Mr. PLATTS. Interim controls, not until last year in Dodd-Frank did it require the auditor to sign off on the internal controls. For almost 20 years under the Federal Managers Financial Integrity Act adopted in 1982, actually over 20 years, that we have to have strong internal controls. Although that wasn't required to be signed off, I assume you are really conscious of the fact that it wasn't a new requirement that you have good internal controls, it was just a new requirement that it be signed off by the auditor and whoever has been overseeing those internal control systems, clearly were not fulfilling their responsibilities?

Ms. SCHAPIRO. Absolutely, and under our chief operating officer, we will deal both with the audit issues with respect to internal controls, but also the attendant business processes, so it is not just a technology answer for us. It is going to have to be business process, free engineering process as well.

Mr. PLATTS. I am going to try to squeeze in two more questions in 20 seconds.

In your testimony, you talk about the follow-on person that you have for the audit recommendations of your IG and GAO. In your testimony, you state that you appointed an audit followup official and empowered her to ensure that agency managers are held accountable for timely and appropriate followup.

How are they being held accountable? One thing that frustrates me is when we find something that went wrong and I have asked for many years now, was anyone disciplined, was anyone fired for not doing what they were supposed to do? In what way are they being held accountable?

Ms. SCHAPIRO. We are very closely tracking audit recommendations, both from GAO and from our inspector general. I can tell you that in my 2 years as chairman, we have successfully closed 350 inspector general recommendations compared to 190 in the prior 2 years. We are aggressive about doing it and I will tell you that in the inspector general's semiannual report, he also talks about our progress with respect to closing recommendations and whether there has been any management disagreement with his recommendations. He is quite on top of it and quite transparent.

Mr. PLATTS. I think that is critical going forward. My subcommittee is especially going to look at staying on top of those recommendations and special internal controls. It goes to the broader issue discussed here about ethics and if you don't have internal controls, that is the foundation for not just good financial management, but for a good ethics environment.

Ms. SCHAPIRO. I agree completely.

Mr. PLATTS. We, as a subcommittee, and partner with Chairman McHenry here today, that is what we are going to be looking at.

I will yield back and yield now to Ms. Speier from California for 5 minutes.

Ms. SPEIER. Thank you, Mr. Chairman.

I thank you all for your participation in this hearing. I was particularly impressed by the testimony of Mr. Katz and Mr. Crimmins.

I am somewhat surprised because I am looking at the title of the hearing and the sign above the chairman's head that reads, "Can American Taxpayers Trust Today's SEC to Manage Itself and Do Its Job." I thought it might be interesting to substitute Congress and ask the same question and see if we would fare as well.

Chairman Schapiro, having served over 2 years on the Financial Services Committee, I have watched you and I think you are truly committed to doing the right thing. Before you came back as Chair, under Chairman Cox, the number of actual enforcement actions at the SEC was reduced by 80 percent and the number of disgorgement actions were reduced by 60 percent—a stunning failure at a time when all the mischief was going on with Wall Street.

We look back at the savings and loan crisis and we recognize that referrals from various regulators, there were 10,000 of them, and of those 10,000, there were 1,000 that turned into convictions and 500 people went to jail. These were CEO level folks that went to jail.

The American people are looking at us, looking at Congress, looking at you and saying, who is going to jail? Who is being charged? The truth is there hasn't been a lot. My first question is, have you made any referrals to the Justice Department, to the U.S. attorney, as a result of the Wall Street meltdown?

Ms. Schapiro. I am confident that we have. I guess I would like to supplement the record, if I might, on that. I just don't know the numbers or the details about it because, as you know, we don't have criminal prosecution authority, although we have continued to bring a relatively high number of cases and some very large impact cases coming out of the financial crisis in the past year.

Ms. SPEIER. So you will get back to the committee and actually tell us how many referrals you have made?

Ms. SCHAPIRO. I would be happy to.

Ms. SPEIER. The CEO of Galian is being tried now. Mr. Kupta who is a director of a significant Wall Street firm, evidently is being looked at as having shared insider information, although he didn't appear to have acted on it. Have any actions by the SEC been taken against those two individuals?

Ms. SCHAPIRO. We filed a proceeding against Mr. Kupta last week and we have filed multiple proceedings coming out of the Galian investigation over the course of the last 6 months or so.

Ms. SPEIER. In 2004 and 2005, the GAO said to the SEC that it should take a look at and close its revolving door. The SEC then reported back to the GAO that it had done that, although the GAO now says that never happened. The reverse situation of Mr. Becker is the fact that you have staff that work within the SEC and then they are lured away by lucrative salaries outside and oftentimes, the people that are lured away are lured away by the companies that they were actually investigating.

We need to do something about the lack of a revolving door and I want to know, first of all, have you made any policy changes in an attempt to deter these revolving door practices?

Ms. SCHAPIRO. We have instituted requirements that senior employees seek ethics counseling before they leave the agency. We require all employees to have a post employment briefing so they don't violate ethics rules when they are leaving. Of course we are subject to the governmentwide restrictions and we have some unique to the SEC restrictions, but our inspector general in looking at a specific revolving door incident has given us last week some additional recommendations for tightening up our rules. We are going to look at those very seriously and I hope to go forward with them.

Ms. SPEIER. What about a cooling off period? Why not require that persons within the Commission that have the authority to make determinations and were investigating are not allowed to be hired by those who they have investigated for a period of 2 years?

Ms. SCHAPIRO. I think there is a lot of appeal to that. The only hesitation I have is that we are so dependent on getting people to come to us, even if it is just for a few years just to bring us current industry expertise, we have to get the balance right.

Ms. SPEIER. I don't disagree, because that is precisely the problem.

Mr. MCHENRY. The gentlelady's time has expired.

I recognize myself for 5 minutes.

Chairman Schapiro, I want to get this out of the way. I know there have been a number of questions about the David Becker conflict of interest question. I just have a couple of questions, yes or no. I want to proceed with it because I have some other issues I do want to touch on beyond this.

After David Becker told you that he received proceeds of a closed Madoff account, did you suggest that he recuse himself from the Madoff case, yes or no?

Ms. SCHAPIRO. I am sorry, the premise isn't exactly right. My recollection is that he told me that his mother had a Madoff account before she died and that it had been closed. I don't honestly recall whether he told me he had received proceeds or not. He may well have, I just can't recall. As you know, I haven't been able to look at anything.

Mr. MCHENRY. But he brought this up that he received proceeds from a Madoff account?

Ms. SCHAPIRO. He brought up that his mother had had a Madoff account.

Mr. MCHENRY. In light of that, did you suggest he recuse himself?

Ms. SCHAPIRO. No, I didn't.

Mr. MCHENRY. Did you suggest that he settle with the Trustee as other Madoff investors were doing at the time?

Ms. SCHAPIRO. No.

Mr. MCHENRY. Did you suggest that Mr. Becker disclose his interest to other SEC staff or Commissioners who relied on his advice?

Ms. SCHAPIRO. I did not. I expected him to go to the Ethics Office and get ethics counsel and follow their advice.

Mr. MCHENRY. You are aware that the ethics counsel of the SEC reported to the general counsel?

Ms. SCHAPIRO. Yes, although the Ethics Officer is a career employee.

Mr. MCHENRY. But his direct report.

Ms. SCHAPIRO. Yes.

Mr. MCHENRY. Did you suggest that Becker do any research to determine the amount or the character of interest that he had?

Ms. SCHAPIRO. No.

Mr. MCHENRY. Later when Becker was providing advice about the net equity evaluation method, did you direct Mr. Becker to take any actions with respect to this potential conflict of interest?

Ms. SCHAPIRO. No, because it didn't occur to me that this long ago closed account would be in any way impacted, it just didn't occur to me.

Mr. MCHENRY. So he didn't disclose to you that he was, in fact, the trustee who closed the account?

Ms. SCHAPIRO. I don't recall.

Mr. MCHENRY. I understand. I am just trying to get to the heart of this. This raises major questions and I think you can understand the public's interest and the investors' interest.

To that same degree, when Mr. Becker was filing briefs in court that took recommendations in terms of the net equity position valuation method, you didn't direct Mr. Becker to recuse himself?

Ms. SCHAPIRO. No.

Mr. MCHENRY. OK. I just wanted to get those out of the way. Obviously we care deeply about transparency and disclosure both here in Congress and with regulators.

Chairman Schapiro, Mr. Risinger, thank you for your public service, but we need to get to the heart of this issue. I think that is why we are asking these questions today and why I am.

Ms. SCHAPIRO. I agree, Mr. Chairman. It is why I have asked the inspector general to do a review, so we can get all the information.

Mr. MCHENRY. The point is you said you wish you had known then what you know now and had you asked any of these questions, you would have known it then. That is at the heart of this issue. That is what is disappointing and of great concern in terms of public policy.

Ms. Chaitman, in dealing with this Madoff valuation question, I understand the insurance piece, I do, would it have changed your dealings with SEC's legal counsel had you known that Mr. Becker was the trustee of a Madoff account?

Ms. CHAITMAN. If I had known that, I would have, myself, demanded that he recuse himself and that the SEC take steps to clarify its position because as I say, both Congressman Garrett and I believe that the SEC has taken an illegal position in supporting SIPC. If I had know that Mr. Becker had a personal interest, I certainly would have asked Ms. Schapiro to do something about it.

Mr. MCHENRY. Thank you.

Mr. Katz, this raises a larger management issue. We are talking about capital formation, we are trying to be the world's markets, which we have been. When you have a dysfunctional agency like this with these management problems that you described, you said the SEC has never engaged in serious self examination of its performance or used appropriate measures of performance. Is that still the case?

Mr. KATZ. Not having seen this Boston consulting group report that is apparently due out, I think yes, that is the case. It has been a long time since the agency took a hard look at itself in the mirror.

Mr. MCHENRY. My time has expired. With that, I recognize Ms. Maloney for 5 minutes.

Votes have been called on the floor, we have 11 minutes remaining in the votes, so I would defer to my colleagues on that side of the aisle if they want to work something out in terms of time.

The gentlelady is recognized now for 5 minutes.

Mrs. MALONEY. First of all, I would like to welcome all the panelists and thank the chairman for this important hearing. Certainly honesty and transparency is very important in government.

I would like to get further clarification from Chairman Schapiro. As I understand, the controversy around Mr. Becker's alleged conflict of interest is about an SEC decision that appears to be against his financial interest. As I understand it, prior to Mr. Becker's return to the SEC, he was working at a private law firm, correct?

Ms. SCHAPIRO. Yes, he was.

Mrs. MALONEY. When he arrived at the SEC, you testified he took steps to notify both you and the SEC's ethics counsel of his inheritance from his mother which had been liquidated long before Madoff's ponzi scheme had been discovered, correct?

Ms. SCHAPIRO. That is my understanding.

Mrs. MALONEY. The ethics official said it was OK for him to work on Madoff-related issues. That is what is in the memo and information that I read, that the Ethics Committee is there to be consulted, he consulted them and they said there was no conflict, that is fine, go to work. Is that your recollection?

Ms. SCHAPIRO. Yes, I believe.

Mrs. MALONEY. Your memory is the same as the Ethics Committee. Chairman Schapiro, it appears that the basic question the SEC faced was whether to support an asset valuation method used by the Madoff Trustee called the cash-in, cash-out method, or a different evaluation method used by several law firms called the last statement method. Is that correct?

Ms. SCHAPIRO. Yes.

Mrs. MALONEY. Under the first method, Mr. Becker's inheritance would be subject to clawback litigation and under the second method, his inheritance would not have been subject to clawback. The SEC choose to support the first, the decision was against the financial interest of Mr. Becker. This meant that the Trustee could sue Mr. Becker and his brothers to recover some of his mother's inheritance which is exactly what happened, correct?

Ms. SCHAPIRO. That is right. The SEC did take the position that was cash-in, cash-out in constant dollars to reflect that some very elderly people who had long held Madoff accounts would be able to get some more money from SIPC under that formulation, but it was not the final statement approach that you mentioned that would have potentially prevented the clawback.

Mrs. MALONEY. But the decision was to allow the clawback, so I assume he participated in a decision allowing the clawback that was against his financial interest?

Ms. SCHAPIRO. The decision to clawback is one of the Trustee, not of the SEC.

Mrs. MALONEY. The SEC did not make that decision, the Trustee made that decision?

Ms. SCHAPIRO. The Trustee makes that decision.

Mrs. MALONEY. The Trustee makes that decision, but it was a decision that affected Mr. Becker.

Ms. SCHAPIRO. Yes.

Mrs. MALONEY. I would like either you or Mr. Crimmins to answer. Basically, Mr. Becker or the SEC sided with the Madoff Trustee. The SEC actually took action that was potentially detrimental to Mr. Becker's financial interest and it exposed him to a potential litigation worth roughly $1½ million because that was the proceeds, correct, in addition to the $500,000. Everybody seems to be criticizing Mr. Becker, but Mr. Becker and the SEC's decision appears to have been completely against his financial interest.

I understand you have an IG report coming out and that eventually will clarify things more, but in first reading the information, it appears that the decision made was against him and against his financial interest and what he or the SEC thought was the right way to go.

If the SEC had supported the banks' interpretation or the law firm's interpretation instead of the Trustee's interpretation, Mr. Becker might not have had any exposure at all, is that correct? Mr. Crimmins.

Mr. CRIMMINS. The point is that the $500,000 that Dorothy Becker invested was going to come back. The $1½ million, as you indicated, was the Madoff fictitious profit was going to Picard's claim as the Trustee, independent reporting to the court, not to the SEC, that dealt with a little bit of difference is whether there should be some modest rate of return, whether there should be some adjustment for inflation.

That is still not finally determined. A month after Becker has left the agency, it is a small amount and to an individual who was compensated at $3 million a year, roughly, and gave that up to go work in the public service, it is totally inconsequential and I would respectfully submit to the subcommittee, be a distraction.

Mrs. MALONEY. May just complete with one observation for 2 seconds.

Basically, if someone in Mr. Becker's position wanted to help himself financially, he would have taken the opposite point of view than the one that he took or the one that the SEC took.

Mr. MCHENRY. The gentlelady's time has expired. We have votes on the floor, Madam.

Mrs. MALONEY. I look forward to the IG's report.

Mr. MCHENRY. I think we all do. I appreciate the gentlelady wrapping up. We do have votes on the floor.

I want to thank the panel.

Ms. SCHAPIRO. Mr. Chairman, I am so sorry, I wanted to just say one thing. I want to make it very clear, I don't recall specifically whether Mr. Becker told me he had inheritance from the account or whether his mother had had an account and I made that assumption. Because it is 2 years ago, I just don't recall. I want to be so clear about that.

Mr. MCHENRY. We will let the record reflect that.

Ms. SCHAPIRO. Thank you.

Mr. MCHENRY. Certainly. I think it is important the record accurately reflect what happened. The findings of this hearing are very important. We are interested in management issues. The Members certainly took a specific direction today dealing with this conflict of interest of Mr. Becker, the general counsel for the SEC because of the fact he was a trustee of a Madoff account a few years before, and the decision, as Ms. Chaitman mentions, that was a very different valuation than was existent under law and the decision he made that in some ways benefited him disproportionately than the other two methods.

In terms of the budget, I think it is appropriate that SEC have a sufficient budget and we have strong management practices to make sure there is transparency and disclosure, safety and soundness in investing in our markets.

In the wake of the Enron scandal, in February 2003, the SEC was given the largest spending increase in its history. The GAO said in testimony before this subcommittee in 2003, it was a 45 percent increase at that time. This was supposed to prevent a future crisis, yet Madoff still occurred and the excuses cannot always be based on money. We would ask that we tighten up management practices, do what is appropriate in terms of bringing technology to the fore and do the best possible of any regular.

It isn't wrong to use a crisis to request more. It is wrong to use a crisis just to request more money. So with that, the committee stands adjourned. Thank you for your testimony.

[Whereupon, at 3:40 p.m., the subcommittee was adjourned.]

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