

Testimony Concerning the SEC's Failure to Identify the Bernard L. Madoff Ponzi Scheme and How to Improve SEC Performance

by

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I. Introduction

Chairman Dodd, Ranking Member Shelby, and Members of the Committee, thank you for the opportunity to testify today on behalf of the Securities and Exchange Commission (SEC) regarding the agency's failure to detect the massive fraud perpetrated by Bernard Madoff. We share the Committee's desire to identify and remedy the causes of this failure and appreciate your support for improving the agency's enforcement and examination roles. We are committed to making every change necessary to fulfill our mission.

Before we begin, the Commission would like to recognize the work of the Inspector General and his staff investigating this matter and drafting the report, *Investigation of Failure of the SEC to Uncover Bernard Madoff's Ponzi Scheme* (OIG-

509) (“IG Report”). We and others at the Commission are closely studying the report and will continue to analyze and learn from its findings and conclusions.

Having read the IG Report and its litany of missed opportunities, it is clear that no one can or should defend, excuse, or deflect responsibility for the SEC’s handling of the Madoff matter. Stated simply, in this case we failed in our fundamental mission to protect investors, and we must continue vigorously to reform the way we operate. We have read letters from harmed investors that were filed with the court in connection with Madoff’s sentencing. It is a sobering and humbling experience.

The IG Report traces the SEC’s failure with Madoff to shortcomings in a number of areas, including insufficient expertise, training, experience and supervision by management; inadequate internal communication and coordination among and within various SEC divisions; deficiencies in investigative planning and prioritization; lack of follow-through on leads; and insufficient resources.

We deeply regret our failure to detect the Madoff fraud and pledge to continue to fix the problems that contributed to this failure. Today we commit to you, investors across the country and the public generally, that we will carefully study the content and findings of the IG Report and any forthcoming audit reports and continue to implement the changes necessary to strengthen our enforcement and examination programs. We also each personally pledge our unwavering commitment to establish heightened levels of expertise and tenacity within both the Office of Compliance Inspections and Examinations (“OCIE”) and the Division of Enforcement (“Enforcement”) in an effort to restore the trust of the investors we are charged to protect.

In this testimony, we would like to describe in detail some current initiatives and future programmatic commitments of Enforcement, OCIE and the Commission overall to address the issues raised in the IG Report.

Even before the report was issued, the agency already had begun instituting extensive reforms, including vastly expanding our training programs, hiring staff with new skill sets, streamlining management, putting seasoned investigators on the front lines, revising our enforcement and examination procedures, restructuring processes to ensure better sharing of information, leveraging the knowledge of third parties, revamping the way we handle the hundreds of thousands of tips we receive annually, and improving our risk-assessment techniques so that examiners are knocking on the right doors and delving into the right issues.

Despite the many changes we recently have initiated, we nevertheless recognize that much more needs to be done. This will require commitment and creativity. In addition, while we sincerely appreciate the support that Congress has provided the Commission, it is clear that addressing key problems identified by the IG's Report will also ultimately require additional resources. The acquisition of specialized skill sets and needed technology will require the agency and Congress to work together to make these priorities a reality.

In the coming weeks, we will continue to review the full report closely in order to learn every lesson we can, and to help build upon the many reforms that we have already begun to put into place.

II. Current Initiatives

While the Commission has awaited the results of the IG investigation and audits, we have not waited to implement changes needed in our structure and process. Prior to the release of the IG Report, Enforcement, OCIE and the Commission as a whole have taken decisive and comprehensive steps to address self-identified deficiencies, in addition to filling gaps in our rules, which we will address later.

The Enforcement Division:

With respect to Enforcement, since Mr. Khuzami joined the Commission as Director of Enforcement in March of this year, he has been undertaking what has been referred to as “the unit’s biggest reorganization in at least three decades.”¹ Upon his arrival, his first mission was to establish nine working groups comprised of Enforcement Division staff and charge them with a top-to-bottom self-assessment of Enforcement’s operations. Phase One of this self-assessment is now complete, and the resulting recommendations are now in the implementation phase. The recommendations, which will begin to address many of the issues identified in the IG Report, include:

- creating five national specialized investigative groups comprised both of in-house experts and newly-hired staff with practical trading, market, and other specialized skills;
- adopting a flatter organizational structure by reducing current management by 40% and deploying those personnel to the mission-critical work of conducting front-line investigations;
- establishing structures and procedures to enhance training and supervision;
- eliminating needless bureaucratic approvals and process;
- hiring the Division’s first-ever chief operating officer and beginning the task of transferring administrative and infrastructure tasks from investigative personnel to centralized operations personnel;

- establishing an improved structure to gather, analyze, assign and monitor the hundreds of thousands of complaints, tips and referrals received by the SEC annually; and
- seeking more resources to help achieve these goals.

Office of Compliance Inspections and Examinations:

With respect to OCIE, Mr. Walsh became Acting Director last month and will continue to serve in that capacity while we are conducting a search for permanent leadership. The first task for any new leader will be to conduct the same kind of top-to-bottom review of OCIE that was conducted by Enforcement in order to fundamentally rethink how it conducts business. Since his appointment, Mr. Walsh's most important goal has been to push forward several significant reforms that are reshaping the examination program. These include: placing an emphasis on fraud detection in addition to the program's overall goal of identifying potential violations of specific securities laws and rules; strengthening procedures and internal controls to better ensure we are maximizing limited resources, staffing examinations with the right skill sets, and improving oversight and communication throughout OCIE; recruiting examiners with specialized skills; increasing expertise through enhanced training and widespread participation in certified training programs such as the Certified Fraud Examiner credential; and ensuring that examiners know that they have management's full support as they follow the facts wherever they lead.

A. Expertise, Experience and Supervision

Across the SEC, there is significant focus on hiring staff with specialized expertise, greater experience and new skill sets within the confines of our current budget. These efforts should address some of the issues identified in the IG Report.

The Enforcement Division:

The Division of Enforcement is undergoing a fundamental restructuring. We are creating five national specialized units that will be dedicated to high-priority areas of securities enforcement, with a particular emphasis on complex products, markets, transactions or practices. In order to help the agency keep pace with the complexity of the markets and market practices, staff assigned to these specialized units will receive advanced training, including training customized to reflect market developments and particular investigative challenges in those subject areas.

With the help of Congress, Enforcement is assigning to these units and seeking to hire specialists with practical market experience and expert skills. Approximately seven positions of the 23 allocated from reprogrammed 2009 funds are being used for specialists to be assigned to the specialized units. Of course, current market conditions make this an opportune time to recruit staff with this expertise, and additional funding would allow us to hire more quickly specialists with significant market experience.

Unit members will acquire the expertise and investigative insights that can only be developed by conducting investigations in the same subject area, combined with ready access to others with specialized skills. With increased focus, training, and access to

specialized expertise, investigative staff will make better investigative decisions and be less likely to be misled by those using complexity to conceal their misconduct.

Below is a description of the five specialized units. Future units may be added as experience and priorities dictate.

- **The Asset Management Unit** will focus on investment advisers, investment companies, hedge funds and private equity funds. Asset managers are responsible for an ever-growing percentage of invested assets, and the lines between different entities involved in these markets are blurring and overlapping. We anticipate that this unit will work closely with colleagues in OCIE and in the Division of Investment Management who also have substantial expertise in investment adviser and investment company issues.
- **The Market Abuse Unit** will focus on large-scale market abuses and complex manipulation schemes by institutional traders, market professionals, and others. We expect to build some of our own technological tools and screening programs to ferret out suspicious trading activity as well as working with others within the Commission who have expertise with the firms and products we investigate. Using these tools, our staff will analyze trading and other activity across markets, including equities, debt securities, and derivatives, and across different corporate announcements and other market events. This should allow us to detect patterns, connections and relationships that might otherwise remain hidden if we simply analyzed a single security or announcement.
- **The Structured and New Products Unit** will focus on complex derivatives and financial products, including credit default swaps, collateralized debt obligations and securitized products. These are huge, opaque markets. Staying current with these markets, and whatever new products are next devised, requires specialized knowledge and commitment. This unit will benefit from the hiring of staff with new skill sets as well as working closely with our colleagues in the Division of Trading and Markets who have significant expertise in these areas.
- **The Foreign Corrupt Practices Act Unit** will focus on new and proactive approaches to identifying violations of the Foreign Corrupt Practices Act, which prohibits U.S. companies from bribing foreign officials for government contracts and other business. Although the SEC has been quite active in this area, more needs to be done, including working more closely with foreign counterparts, and taking a more global and proactive approach to investigating violations.

- **The Municipal Securities and Public Pensions Unit** will focus on problems in the municipal securities market including offering and disclosure issues, tax and arbitrage-driven activity, unfunded or underfunded liabilities, and “pay-to-play” schemes in which money managers pay kickbacks and provide other favors in return for being selected to advise funds.

Of course, there are investigations that will cut across a number of these specialized areas such as insider trading, financial fraud, and Ponzi schemes. Each specialized unit and its personnel will be available as a source of expertise to the extent the unit is not handling the investigation. Specialization will therefore better enable the entire Enforcement staff to develop and benefit from particular subject-matter expertise within the agency.

In addition, the Enforcement Division is creating a searchable database listing staff members with particular securities industry background, professional experience, academic degrees, certifications, specialized investigative expertise, and other relevant credentials. Staff will be able to use this resource – in addition to the specialized units – to identify those with the relevant skills and experience to answer questions and provide advice. This information sharing occurs now, but on a more informal and less comprehensive basis. This database also will be used to identify potential gaps in expertise and to develop both an enhanced initial core training program for new hires, as well as an expanded range of advanced training for more senior staff members.

In addition, Enforcement is planning to implement a new and more rigorous performance evaluation process for staff and supervisors alike. In contrast to the current system, this new approach will incorporate a five-level measure of performance, with objective performance goals established at the front end of the performance cycle. These

goals will be oriented to results and not simply the accomplishment of tasks, and will identify the knowledge, skills and behaviors that need to be demonstrated to achieve those results. Individual professional development plans will also be incorporated into the new system. Further, supervisors in the Enforcement division will be required to review regularly caseload reports generated by the Division's newly enhanced case management database (discussed below in more detail under the heading "Examination and Investigative Planning and Follow-Through").

Additionally, Enforcement is focused on improving training. While there already is formal training consisting of a program for new hires supplemented by sessions for experienced staff on substantive topics offered by SEC or outside experts, a systematic approach to training has not been a sufficiently high priority. This is changing. Enforcement is creating a formal training unit and will prioritize training by including in the evaluation of staff and supervisors the extent of their participation in formal training programs.

Our new hire training, which will be expanded, already includes sessions on, among other things, the use of forensic technology; investigating financial fraud, market manipulation, Ponzi schemes and offering frauds; and coordination among SEC offices. Since April, our sessions for experienced staff have included, among other things, forensic and investigative accounting; investigating offering frauds and market manipulation; Ponzi scheme investigative techniques; understanding and investigating certain insurance products; and hedge fund investigation issues. In the last three months, an increasing number of Enforcement staff has signed up to participate in Certified Fraud

Examiner Training. In addition, substantial training resources are available to staff on shared internal websites. Training comes from a variety of sources, including seminars led by senior SEC staff, other government agencies (e.g., Federal Law Enforcement Training Center) and private industry experts, interactive offerings, and courses directed to regulatory (Series 7) and other certifications (Certified Fraud Examiner).

Enforcement's forward focus will be to establish and implement a comprehensive training strategy to ensure that staff members receive regular training, have access to thorough and timely training materials and effectively apply training resources to their enforcement responsibilities. Upcoming training will emphasize current financial services topics as well as investigative techniques. Specialized training for managers also will include a focus on leadership and managing investigations.

The Office of Compliance Inspections and Examinations:

OCIE, which leads the Commission's examination program, will support Enforcement's specialization initiative, primarily through risk-targeted or "sweep" examinations. In an examination sweep, multi-disciplinary teams of examiners draw on their specialized experience to take a focused look at a single compliance issue. Recently, for example, examiners have been vigorously reviewing custody practices and the safety of client assets generally at a number of firms, including both advisers and broker-dealers.

Generally, in a sweep, the examiners review several firms according to a single examination plan, which has been developed with the cooperation of other offices and

divisions within the SEC. Now, working with Enforcement's specialized units, OCIE is forming multi-disciplinary sweep teams to provide focused examination expertise that would support the Enforcement units.

OCIE also has begun to increase the expertise and skills of its examination staff. Chairman Schapiro has authorized a new type of position – a Senior Specialized Examiner – to attract experienced industry professionals with specialized experience in trading, portfolio management, valuation, complex products, sales, compliance, and forensic accounting. As vacancies arise, OCIE also is recruiting other staff with similar skills. Current market conditions make this an opportune time to recruit staff with this expertise. We received to date over 380 applications for only six Senior Specialized Examiner positions advertised. Thus, additional resources would allow us to bring on more specialists without waiting for attrition. These new skills should enhance OCIE's ability to detect sophisticated and well-hidden frauds.

Further, OCIE is strengthening the expertise of its staff through enhanced training, including:

- providing training by internal and external industry experts on complex issues such as hedge funds, options trading, and credit default swaps;
- enrolling its examiners in other certification programs such as the Certified Fraud Examiner (in which one-third of examiners are participating), Chartered Financial Analyst, and Chartered Alternative Investment Analyst certification programs;

- conducting joint training programs with other regulators, such as a recent specialized program designed to permit examiners to better identify red flags and uncover potential fraud; and
- establishing an internal training program focusing on establishing third-party verification of customer assets.

In addition, supervisors in the examination program will be required to review regularly the status of examinations (discussed in more detail under the heading “Examination and Investigative Planning and Follow-Through”).

Agency-wide:

On an agency-wide basis, the SEC is also working to enhance its risk assessment capabilities. As part of that effort, the agency has recently created the *Industry and Market Fellows Program*, through which it is hiring highly-seasoned financial experts to help it keep pace with the practices of Wall Street and protect investors. These experts should provide staffers with the information and perspectives necessary to identify emerging issues and understand ways the industry is changing.

B. Communication and Coordination

The IG Report described weaknesses in coordination among Enforcement, OCIE, and other SEC offices and divisions, as well as among and within divisions or regional offices, and with third parties. In the Madoff matter, this lack of effective coordination resulted in missed opportunities, miscommunications, and a failure to share knowledge and evidence. Over the past year, we have been addressing this weakness.

Office of Compliance Inspections and Examinations:

Traditionally, the OCIE examination program has been divided along the lines of registrants, with some examiners focusing on broker-dealers and others focusing on investment advisers and investment companies. This organization is a legacy of the program's origins in two different operating divisions. While this structure allowed examiners to develop particular expertise, the IG Report illustrates how there has not been enough interaction between the two operational groups, especially since many entities that are examined operate as both a broker-dealer and an investment adviser.

We are moving to address this issue. For example, the New York Regional Office already has adopted a protocol under which a single team of examiners, drawn from the broker-dealer and investment management units, will jointly examine selected firms to ensure that the examination team includes those most expert in the subject of the examination. The examination program in other regional offices has been consolidated under the leadership of a single senior manager to ensure consistent supervision on their coordination, collaboration and communication. In addition, regional offices are evaluating additional initiatives – like the initiative underway in New York – to better integrate the broker-dealer and investment adviser examiners as necessary.

OCIE also is emphasizing enhanced planning of examinations that involve firms jointly registered as broker-dealers and advisers to ensure they have staff with the right skill sets and adequate information to understand the firms' businesses. OCIE has prepared new guidance to assist examiners in their review of broker-dealers with advisory affiliates or operations. The guidance includes detailed procedures for examiners to

follow when reviewing such firms, including lines of inquiry regarding supervision, referral arrangements, advertising and trading. This new guidance already has been used in selected examinations to field-test its effectiveness and will soon be deployed to the entire examination program. Also, OCIE recently held a variety of training programs to cross-train examiners and examination managers in each others' specializations.

The Enforcement Division:

Similarly, the Enforcement initiatives described above will improve coordination and communication. National specialized units will discourage the existence of separate regional "silos" that could develop based solely on a regional organization. National specialized units, as opposed to exclusively geographically-defined units, will foster a more comprehensive and coherent national program that encourages communication and collaboration. Effective communications with other SEC offices or divisions is essential to ensure that Enforcement is benefitting from our collective agency resources.

In addition, Enforcement senior management has re-emphasized to Enforcement staff the importance of consulting with other SEC offices and divisions early and often to identify and resolve issues. Enforcement also has a formal process by which it seeks review and comment from other offices and divisions before it submits an enforcement recommendation to the Commission, and it will continue to use this important resource.

Further, Enforcement is creating an Office of Market Intelligence to improve the Division's handling of tips and complaints. This new office dovetails with the agency-wide effort to revamp the way in which it handles the hundreds of thousands of tips and

complaints the SEC receives each year. (This is described below in further detail under the heading “Additional Initiatives to Protect Investors.”) The Office of Market Intelligence will be responsible for the collection, analysis, risk-weighting, triage, referral and monitoring of the hundreds of thousands of tips, complaints, and referrals the SEC receives each year. The office also will draw on the expertise of the agency’s various offices to help analyze the tips and identify wrongdoing while greatly increasing our communication with other divisions and offices about how to respond to tips and complaints. Through this effort, we hope to have a unified, coherent, coordinated agency-wide response to the huge volume of information we receive every day.

C. Examination and Investigative Planning and Follow-Through

The IG Report also found that the Madoff investigation suffered from poor examination and investigative planning and follow-through. The Commission has been working on these very issues over the past year. Where they can be addressed by new procedures, we are adopting them. Beyond procedures, however, the leadership of enforcement and examination programs at all levels are enhancing planning and follow-through as a management priority.

For example, the Commission is deeply concerned about the IG’s findings that Madoff attempted to intimidate investigators and examiners. We are addressing this unacceptable tactic by sending a consistent internal and external message. When junior investigators or examiners believe they are being subjected to intimidation tactics, they should immediately notify their supervisors. OCIE, for example, has created a new internal Hotline for examiners to immediately reach a senior attorney in headquarters

when a firm is being uncooperative, unreasonable, or otherwise resisting appropriate oversight. Supervisors at all levels *will* back up more junior personnel. We will not be successful if we tolerate intimidation tactics directed against our staff. Indeed, we will train our staff to view these tactics as a red flag, and instruct to dig deeper, and look harder, at the firms that try to use them.

Office of Compliance Inspections and Examinations:

OCIE is reviewing its written procedures and internal guidance to make sure it provides clear and consistent practices across the examination program. The guidance concerns pre-examination planning, document requests, responses to red flags, tracking managing findings, organizing and retaining work papers, preparing closing reports, and making enforcement referrals. OCIE is paying particular attention to procedures governing the scope of for-cause examinations, including procedures for more careful (and documented) examination planning and supervisory involvement. Specifically, the procedures help ensure that complaints and tips are appropriately examined.

OCIE also has implemented new procedures for obtaining third-party verification of information obtained in examinations. As the IG Report notes, third-party verification is a critical examination technique. OCIE now requires examiners to utilize third-party verification techniques routinely to ensure that asset and account information is accurate. As appropriate, examiners contact counter-parties, custodians and customers.

As noted earlier, we are also implementing mandatory Quarterly Reviews in which supervisors will formally review progress on examinations with assigned staff.

The Quarterly Reviews will enable supervisors to assess each new matter and its examination scope and plan, to identify and address roadblocks to achieving the scope and plan, as well as new issues that could require a modification to the scope and plan, and with respect to an aged examination, to assess the examination work to date and develop a plan for resolving the open issues and bringing the examination to an appropriate conclusion. The Quarterly Reviews will provide direct supervision at regular intervals of all examinations open in an office or supervisory unit. Supervisors will be instructed, in all such reviews, to consider whether an examination could benefit from the deployment of new or different expertise or assistance from other offices, divisions, or functional units within the SEC.

The Enforcement Division:

The Enforcement Division's efforts toward specialization and reducing process and administrative burdens will improve investigative planning and execution. Enforcement's initiative to streamline its structure through a 40% reduction in management will result in a redeployment of highly-experienced staff to front-line investigations, the heart-and-soul function of the division. It should be emphasized, however, that this streamlining will not come at the cost of appropriate levels of investigative supervision. At the same time Enforcement is redeploying its branch chiefs to the front lines, it is expanding the number of Assistant Directors in order to maintain staff to manager ratios that allow for close substantive consultation and collaboration.

As noted earlier, we also are implementing mandatory Quarterly Reviews in which senior supervisors will formally review progress on investigations with assigned

staff. The Quarterly Reviews will enable supervisors to assess all new matters and their investigation plans; to devise strategies to overcome investigative roadblocks and challenges; and, with respect to aged investigations, to assess our findings and develop plans to obtain the proper and sufficient evidence to either proceed to an enforcement recommendation or close the matter. The Quarterly Reviews will provide senior direct supervision at regular intervals throughout an investigation to ensure comprehensive oversight and the swiftest possible completion. In conducting these reviews, supervisors will benefit from the use of our newly-updated case management database that shows at a glance key progress milestones in the matters under review.

D. Resources

The IG Report identifies a number of shortcomings that will require additional resources. Nevertheless, we are aggressively reallocating existing resources into areas that maximize our ability to achieve our mission.

The Enforcement Division:

A number of initiatives underway in the Division of Enforcement seek to address, directly or indirectly, serious resource-constraint issues. Specialization and a flatter management structure will increase Enforcement's investigative capacity and permit a greater focus on programmatic priorities. Eliminating or streamlining internal processes will give staff more time to dedicate to core investigative work, as will improved training and information technology capability. Creating incentives for witnesses to cooperate in

investigations, or for whistleblowers to provide information on ongoing frauds, should also increase efficiency by permitting Enforcement to obtain high-quality evidence from insiders. Each of these is a current initiative within the Division of Enforcement.

In addition, Enforcement is seeking to deploy newly-available resources as thoughtfully as possible. Enforcement allocated recent headcount increases among market specialists, trial attorneys, paralegals and paraprofessional support, and training personnel.

Enforcement also is committed to reducing administrative burdens on our attorneys so they can spend more time on the front lines. In fact, just last week, Enforcement hired the division's first-ever chief operating officer, who will oversee improved coordination and centralization of various infrastructure and administrative tasks. Many of these tasks currently are handled by lawyers in Enforcement. Similarly, future resources have been committed to more than tripling the number of full-time paralegals and support personnel in Enforcement and to dedicating significantly greater resources to ongoing technology initiatives. Leveraging resources is critical given the breadth of the agency's responsibility to enforce the securities laws as to more than 35,000 registrants and monitor for fraud involving all categories of investors.

Office of Compliance Inspections and Examinations:

Over recent years, recognizing the need to best use its limited inspection resources in contrast to the vast number of regulated entities, OCIE has developed risk-based processes for selecting firms and activities for examination in order to ensure that it

is deploying its resources most effectively. One process currently relies on registration information that firms must file with the SEC or self-regulatory organizations (SROs), information from past examinations, and information OCIE can obtain from public sources. OCIE has also developed a second process that identifies key risks observed by staff and assesses each risk's probability of occurrence and potential impact. We focus on risks such as fraud, abuse, misappropriation, manipulation and unregistered firms and offerings. OCIE is exploring a variety of ways to enhance these processes, and we look forward to working with this Committee on any necessary legislative foundations.

Risk-based processes are critical because the number of entities subject to SEC examination has grown much faster than the number of staff available to examine them. The SEC's examination program has approximately 790 staff dedicated to examining approximately 11,300 investment advisers, approximately 8,000 mutual funds, approximately 5,000 broker-dealers (with more than 170,000 branch offices), as well as hundreds of other entities such as SROs, transfer agents, credit rating agencies, and clearing agencies.

E. Additional Initiatives to Protect Investors

In the wake of the Madoff fraud, the SEC also has embarked on a number of initiatives in addition to those discussed above aimed to enhance its capacity to detect and prevent similar frauds. For example:

- The SEC has contracted with Mitre, a federally-funded research and development center, to help the agency revamp its processes to improve the handling of hundreds of thousands of complaints, tips, and referrals it receives each year. After reviewing and analyzing its intake procedures, the SEC is now beginning to

improve upon its processes for collecting, recording, investigating, referring and tracking this information. Among other things, the agency is creating a centralized system for handling this information. Once the information and processes are centralized, the agency will apply risk analytics to better enable it to reveal links, trends, statistical deviations and patterns that might not be observable when each complaint is examined one at a time and provide a platform for greater communication about tips and complaints throughout the agency.

- The SEC has advocated for expanded authority from Congress to reward whistleblowers who bring forward substantial evidence to the agency about significant federal securities violations. Under proposed legislation, money collected from wrongdoers that is not otherwise distributed to investors would be used to establish a fund to reward whistleblowers whose contributions lead to successful enforcement actions. We welcome the opportunity to work with Congress as it considers this important legislation.

- In May the Commission proposed two rules that are designed to better protect clients of investment advisers from theft and abuse. The rules are designed to provide assurance to these clients that their accounts contain the funds as represented by their investment adviser and account statements. Among other things, these rules are designed to encourage investment advisers to place their clients' assets in the custody of an independent firm, or obtain an independent custody controls review, commonly referred to as a SAS-70 review, by a PCAOB-registered and examined independent accounting firm. In addition, the rules would require investment advisers with custody of their clients' assets to undergo an unannounced exam by an independent accounting firm in order to verify clients' assets. These asset-verification exams would occur on an annual basis at the time of the accountant's choosing. As with all our rule proposals, the Commission looks forward to reviewing and evaluating the comments on these rule proposals. The proposed rules provide for:
 - *Surprise Exams:* One proposal would require all investment advisers who control or have custody of their clients' assets to hire an independent public accountant to conduct an annual "surprise exam" to verify those assets actually exist. This surprise examination would provide another set of eyes on the clients' assets, thereby offering additional protection against the theft or misuse of funds.

 - *Third Party Reviews:* A second proposal would apply to investment advisers who do not use independent firms to maintain their clients' assets. Such advisers would be required to obtain a third party written report assessing the safeguards that protect the clients' assets. The report — prepared by an accountant registered and inspected by the Public Company Accounting Oversight Board — would, among other things,

describe the controls that are in place to protect the assets, the tests performed on the controls, and the results of those tests. Existing rules make no distinction between an investment adviser whose affiliate holds its clients' funds and an investment adviser that uses a truly independent custodian.

- Finally, working with senior SEC staff, FINRA has committed to establish a new system to enhance the oversight and professional requirements of personnel performing back-office functions at broker-dealer firms. "Back-office" personnel typically perform critical custody, accounting, transfer agency, and account maintenance functions. Under the new regime, certain back-office personnel would be subject to licensing and education requirements as well as enhanced oversight. The new regime will further promote the qualifications and professionalism of those performing back office functions so that client accounts are better protected.

III. Recent Enforcement Efforts

As Chairman Schapiro previously observed before this Committee, the SEC is the only agency focused primarily on the protection of investors. As the agency's most public face, a strong Division of Enforcement is critical to the investing public's confidence in the integrity of our markets. Over the past year, while the criticism surrounding the Madoff fraud has been sharp and steady, our organizational response in light of these acknowledged errors is exactly what taxpayers and the public have every right to expect. We have taken the lessons to heart and implemented a far-reaching program of change and improvement. Our investigators have not been complacent or hesitant to take on the most difficult and challenging investigations aggressively and intelligently.

Although numbers do not tell the whole story, the metrics demonstrate the hard work of our staff. Comparing the period from late January to the present to the same period in 2008, Enforcement has:

- opened more investigations (1377 compared to 1290);
- issued more than twice as many formal orders of investigation (335 compared to 143);
- filed more than twice as many emergency temporary restraining orders (57 compared to 25); and
- filed more actions overall (458 compared to 359).

The justified criticism of the SEC arising from the Madoff fraud should not obscure the 75-year tradition of vigorous enforcement resulting from the dedicated efforts of public servants who work tirelessly and with impressive results to protect the investing public. Here is a small sample of Enforcement's recent actions:

- ***Credit Crisis-Related Cases:*** The SEC charged the former CEO of Countrywide Financial and two other former executives with fraud for allegedly deliberately misleading investors about the significant risks it was undertaking.² The SEC's charges allege that Countrywide portrayed itself as underwriting mainly prime quality mortgages, while privately describing as "toxic" certain of the loans it was extending. The SEC's complaint also charged the former CEO with insider trading.

In other mortgage-related cases, the SEC brought actions against former mortgage-lending company executives for accounting fraud and allegedly making false and misleading disclosures relating to the risk of the mortgages originated and held by the company as the credit crisis began to unfold.³ The SEC sued registered representatives of a broker-dealer firm for allegedly making false statements in marketing investments in mortgage backed securities as safe and suitable for retirees and others with conservative investment goals.⁴ The SEC also charged a registered investment adviser and its affiliate with allegedly overstating the value of a mutual fund that invested primarily in mortgage-backed securities and for selectively disclosing problems with the fund to favored investors, allowing them to bail out early to avoid losses.⁵

And in the Reserve Fund matter, the SEC charged the managers of a \$62 billion money market fund whose net asset value fell below \$1.00, or "broke the buck" based in part on investments in Lehman-backed paper, for their alleged failure to properly disclose to the fund board all material facts relating to the value of the Lehman-backed paper.⁶

- ***Ponzi Schemes:*** The SEC investigates and prosecutes many Ponzi schemes cases each year, the majority of which are brought as emergency actions — seeking a temporary restraining order and an asset freeze — both to prevent

new victims from being harmed and to maximize the recovery of assets to investors. Since January, the SEC already has filed 45 enforcement actions involving Ponzi schemes or Ponzi-like payments, a significant increase over the same period last year.

- **Public Trust:** Working with the New York State Attorney General, the SEC pursued placement agents and others for allegedly extracting kickbacks from investment management firms seeking to manage the assets of New York's largest pension fund, the New York State Common Retirement Fund.⁷
- **Derivatives and Structured Products:** We have been looking aggressively at fraudulent schemes involving structured products. In May, the SEC charged a former portfolio manager at hedge fund investment adviser Millennium Partners and a salesman at Deutsche Bank for alleged insider trading in credit default swaps on international holding company VNU. In this case, bank employees allegedly tipped the portfolio manager about an anticipated change in VNU's underlying bond structure that substantially increased the price of the credit default swap, which allowed the defendants allegedly to profit from their purchase of credit default swaps when the restructuring was announced⁸ In addition, the SEC filed a civil injunctive action late last year against four individuals for allegedly engaging in a fraudulent scheme to overvalue the commodity derivatives trading portfolio at Bank of Montreal (BOM) and thereby inflate BOM's publicly reported financial results.⁹
- **Accounting Fraud:** The SEC charged General Electric with using improper derivative accounting methods to increase its reported earnings and revenues and avoid reporting negative financial results.¹⁰ The SEC also charged Terex Corporation with accounting fraud for allegedly making material misstatements in its financial reports to investors, as well as allegedly aiding and abetting a fraudulent accounting scheme at United Rentals, another public company.¹¹
- **Abusive Short Selling:** In two separate actions, the SEC charged two broker-dealers and two options traders for alleged "naked" short sale rule violations.¹² In these actions, the SEC alleged that the respondents improperly claimed that they were entitled to an exception to the Regulation SHO requirements that broker-dealers must locate a source of borrowable shares prior to selling short and circumvented the requirement to deliver securities sold short by a specified closeout date.
- **Foreign Corrupt Practices Act:** Late last year, the SEC filed a civil injunctive action charging Siemens Aktiengesellschaft (Siemens), a Munich, Germany-based manufacturer of industrial and consumer products, with violations of the anti-bribery, books and records, and internal controls provisions of the Foreign Corrupt Practices Act. In this settled action, Siemens offered to pay a total of \$1.6 billion in disgorgement and fines, which

is the largest amount a company has ever paid to resolve corruption-related charges.¹³

Enforcement is continuing to investigate rigorously cases in all of these areas and more: misconduct relating to the credit crisis, accounting and financial fraud, structured product fraud, suspected Ponzi schemes, hedge fund and investment adviser fraud, insider trading, market abuse, and market manipulation based on complex use of technology and advanced trading systems.

IV. Conclusion

Our mission is critical. We are thus committed to using all of our energies, efforts, experience, expertise, and a sincere dedication to investor protection to continue to revitalize and improve our programs. These are challenging times, but we believe they are also times of great opportunity for improvement. We are aggressively pursuing long-term changes in our structure and processes, while at the same time working hard to continue our vigorous enforcement and examination efforts. We can say without reservation that we are proud to be part of this institution, and we are confident of our future success.

We appreciate the opportunity to appear before you today. We would be happy to answer your questions.

¹ David Scheer, *SEC Never Did 'Competent' Madoff Probe, Report Finds (Update 2)*, Bloomberg.com, Sep. 2, 2009, <http://www.bloomberg.com/apps/news?pid=20603037&sid=aBHQkUqCQppk>.

² *SEC v Angelo Mozilo, David Sambol, and Eric Sieracki*, Lit. Rel. No. 21068A (June 4, 2009).

³ *SEC v. Michael Strauss, Stephen Hozie and Robert Bernstein*, Lit. Rel. No. 21014 (April 28, 2009).

⁴ *SEC v William Betta, Jr., et al.*, Lit. Rel. No. 21061 (May 28, 2009).

⁵ *In the Matter of Evergreen Investment Management Company, LLC and Evergreen Investment Services, Inc.*, AP File No. 3-13507 (June 8, 2009).

⁶ *SEC v Reserve Management Company, Inc., Resrv Partners, Inc., Bruce Bent Sr. and Bruce Bent II*, Lit. Rel. No. 21025 (May 5, 2009).

⁷ *SEC v. Henry Morris, et al.*, Lit. Rel. No. 20963 (March 19, 2009), Lit. Rel. No. 21001 (April 15, 2009), Lit. Rel. No. 21018 (April 30, 2009).

⁸ *SEC v. Jon-Paul Rorech, et al.*, Lit. Rel. No. 21023 (May 5, 2009).

⁹ *SEC v. David Lee, et al.*, Lit. Rel. No. 20811 (Nov. 18, 2008).

¹⁰ *SEC v General Electric Company*, Lit. Rel. No. 21166 (August 4, 2009).

¹¹ *SEC v. Terex Corporation*, Lit. Rel. No. 21177 (August 12, 2009).

¹² *In the Matter of TJM Proprietary Trading, LLC, Michael R. Benson and John T. Burke*, AP File No. 3-13569 (August 5, 2009) and *In the Matter of Hazan Capital Management, LLC and Steven M. Hazan*, AP File No. 3-13570 (August 5, 2009).

¹³ Siemens agreed to pay \$350 million in disgorgement to the SEC. In related actions, Siemens agreed to pay a \$450 million criminal fine to the U.S. Department of Justice and a fine of €395 million (approximately \$569 million) to the Office of the Prosecutor General in Munich, Germany. Siemens previously paid a fine of €201 million (approximately \$285 million) to the Munich Prosecutor in October 2007. *SEC v. Siemens Aktiengesellschaft*, Lit. Rel. No. 20829 (Dec. 15, 2008).