

REFORM AT THE SEC: FICTION OR REALITY?

In the 16 years preceding Bernard Madoff's arrest for perpetrating a \$65 billion Ponzi scheme, the Securities and Exchange Commission (SEC) received numerous complaints and tips about his actions, some supported by substantial detail. Although the SEC conducted five major investigations and examinations of Mr. Madoff during that period, it still failed to detect his massive fraud.

This failure exposed systemic problems within the SEC, particularly in the Enforcement Division. In response, newly appointed SEC Chairman Mary L. Schapiro promised fundamental reforms to that division. But promises of reform are only that – promises – that are meaningless until fully implemented. Over a year later, it is time to assess precisely what kinds of reforms the SEC has implemented, a first step in assessing whether the agency is better equipped today to detect the kind of fraud perpetuated by Mr. Madoff and others. Through the Freedom of Information Act, CREW has acquired documents and information, including the SEC's responses to written questions, that chart the progress the SEC has made to date on key promised reforms in the Enforcement Division.¹

As outlined below, the SEC has made progress in implementing a number of key reforms, such as the establishment of specialized units and expanding training. But bringing on board the necessary expertise has consumed many months, so it is not yet possible to gauge the effects of the reforms the SEC has made to the Enforcement Division. The slow pace of some reforms is hard to fathom. Why, for example, will it take the SEC years to establish an appropriate and effective database? Moreover, while the SEC can point to some progress such as its recent lawsuit against Goldman Sachs, its inspector general continues to document other missed opportunities, such as Robert Allen Stanford's Ponzi scheme, that have caused great economic harm.² At bottom, the central question of whether the SEC has instituted significant and effective reforms to address the systemic problems uncovered in the wake of Mr. Madoff's undetected Ponzi scheme still cannot be answered.

Tips, Complaints, and Referrals

As the Madoff scandal revealed, the SEC mishandled or failed to act on tips, complaints, and referrals (TCRs in SEC parlance). As part of its promised reforms, the SEC committed to reviewing its processes for receiving, tracking, analyzing, and acting on TCRs. More specifically, the SEC promised to create a centralized system for managing TCRs that will apply "risk analytics" to "help to reveal links, trends, and patterns that might not be visible when each

¹ These documents and the SEC responses are available at http://www.citizensforethics.org/node/42694/related#content_attachment.

² See Report of Investigation, United States Securities and Exchange Commission Office of Inspector General, Case No. OIG-526, Investigation of the SEC's Response to Concerns Regarding Robert Allen Stanford's Alleged Ponzi Scheme, March 31, 2010, available at <http://www.sec-oig.gov/news/studies/2010/oig-526.pdf>.

complaint is examined one at a time.”³ In addition, the SEC promised to establish a special unit to carefully screen and assign tips to the proper investigators.

So what has the SEC actually done to date? On March 5, 2009, the SEC announced it had hired the MITRE Corporation to help conduct an agency-wide review of the Enforcement Division’s processes and procedures for handling TCRs. One year later, the SEC unveiled the Transitional Repository, a temporary central database for TCRs. Although touted as new, the Transitional Repository is based on existing systems and adds few, if any, additional data fields. Under this temporary system, determining the status of a specific TCR will still require using multiple systems. But for the first time, all complaints the SEC receives from field offices are now in the same database. Further, the Enforcement Division can now search information provided to the investor assistance hotline in the Office of Investor Education and Advocacy (OIEA) as well as complaints received by the markets hotline in the SEC’s Division of Trading and Markets, all of which are now available in the Transitional Repository. On March 10, 2010, the SEC issued a new intake policy on TCRs for all staff.

In addition, on January 13, 2010, the SEC announced the creation of the Office of Market Intelligence (OMI) within the Enforcement Division to coordinate handling of TCRs, following up on a February 2009 recommendation from senior Enforcement Division officials. As of April 30, 2010, the SEC had dedicated 36 employees to OMI, and allocated an additional 5-10 slots for FY2010.

What remains to be done? Most critically, the SEC needs to complete the remaining two phases of its database development. The second phase will allow the agency to track how TCRs are being used and is not expected to be operational until late 2010 or early 2011. The SEC is just beginning to design the third and final phase of the system, which is intended to incorporate the promised risk-weighted or “risk analytics” approach to assessing tips and complaints. At present, the SEC does not expect this phase to be completed until sometime in 2011.

Bottom line: Despite the outside assistance of MITRE, the SEC has only begun the development of a central database and is many months away from its completion.

Specialized Units

To address the systemic failings revealed by the Madoff scandal, Enforcement Division Director Robert Khuzami promised in May 2009 to create specialized units dedicated to particular highly specialized and complex areas of security law. Each of the five units was to be headed by a unit chief and staffed by individuals in the Enforcement Division who either already have the necessary expertise or the desire to acquire it.

³ The Security and Exchange Commission Post-Madoff Reforms, Sept. 3, 2009, available at <http://www.sec.gov/spotlight/secpostmadoffreforms.htm>.

Eight months later, on January 13, 2010, the SEC named the unit chiefs for the five units. On March 16, 2010, the Enforcement Division assigned 50 assistant directors to the five specialized units, and has now completed staffing each unit with front-line investigators. Their work already has yielded results; according to OMI head Thomas Sporkin, the Goldman Sachs case grew out of the new Structured and New Products unit as well as a predecessor working group.⁴

The SEC has not yet fully staffed these specialized units. As discussed below, the Enforcement Division is in the process of hiring 17 Industry and Market fellows. In addition, each of the units will have 30 to 65 employees.

Bottom line: The SEC has made significance progress in making the specialized units a reality, but staffing has consumed an inordinate amount of time, and the units likely are months away from being fully staffed.

Industry and Market Fellows Program

As part of its effort to recruit staff with more specialized experience, the SEC announced on April 30, 2009, it was creating the Industry and Market Fellows Program. Intended to bring on board “highly-seasoned financial experts,” the program was to allow the agency “to keep pace with the practices of Wall Street and protect investors.”⁵

One year later, the SEC has yet to hire a single fellow for the Enforcement Division. While the agency created 17 fellow positions for Enforcement, to be divided among the five specialized units, it had not closed the job postings for seven of those positions until April 30, 2010, and had not hired any fellows for the 10 positions for which the postings were closed. For the newly created Division of Risk, Strategy, and Financial Innovation the SEC has hired four experts for the fellows program, made 12 outstanding offers, and anticipates six to ten of those offerees will accept.

The SEC conceived of the Industry and Market Fellows Program initially as a way to “bring in 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.”⁶ The agency has now scaled back that concept, stating more recently it anticipates only that

⁴ See Bruce Carton, [A Glimpse Into SEC Enforcement by Way of Goldman](http://www.complianceweek.com/article/5933/a-glimpse-into-sec-enforcement-by-way-of-goldman), *Compliance Week*, May 11, 2010, available at <http://www.complianceweek.com/article/5933/a-glimpse-into-sec-enforcement-by-way-of-goldman>.

⁵ [The Security and Exchange Commission Post-Madoff Reforms](http://www.sec.gov/spotlight/secpostmadoffreforms.htm), available at <http://www.sec.gov/spotlight/secpostmadoffreforms.htm>.

⁶ *Id.*

“many of these people will be hired from outside of the agency.”⁷

Bottom Line: As of the end of April, the SEC had yet to hire any industry expert fellows for the Enforcement Division, despite its recognition that without this expertise, Enforcement cannot keep pace with the practices of Wall Street and protect investors. The SEC also appears to be backtracking on its promise to bring in outside experts.

Streamlining Management Structure

Last year the SEC announced its intention to streamline or flatten its management and internal processes to eliminate unnecessary internal review and increase resources available for direct investigative efforts. The agency’s main planned reform was to redeploy branch chiefs – those it considers its best and brightest – to be full-time investigators.

As of April 30, 2010, the SEC had redeployed 53 of the 117 branch chiefs to be front-line investigators. The rest of the branch chiefs, however, were promoted to assistant director management positions. Thus, while the SEC has delivered on its promise to eliminate the branch chief management level and has redeployed some former branch chiefs as front-line investigators, it has diverted many of them to other mid-management level positions.

Bottom Line: The SEC’s progress on this promise is mixed. On the one hand, the SEC has eliminated the branch director positions, a key component of its plan to streamline the management structure of the Enforcement Division. On the other hand, however, the SEC has diverted more than half of the individuals filling those slots to other management positions, a move that runs counter to its promised streamlining efforts.

Senior Specialized Examiners

The SEC also promised to hire new staff for the examination unit with “specialized experience in areas such as trading, operations, portfolio management, options, compliance, valuation, new instruments and portfolio strategies, and forensic accounting.”⁸ As with the Industry and Market Fellows Program, the SEC hoped these new additions would improve its ability to “assess risk, conduct examinations, detect and investigate wrongdoing, and focus [its] priorities.”⁹

⁷ SEC letter to CREW, April 30, 2010, available at http://www.citizensforethics.org/files/20100430%20-%20CREWResponse_0.pdf (emphasis added).

⁸ The Security and Exchange Commission Post-Madoff Reforms, available at <http://www.sec.gov/spotlight/secpostmadoffreforms.htm>.

⁹ *Id.*

As of April 30, 2010, the SEC had hired seven senior specialized examiners, and is in the process of hiring 21 more.

Bottom Line: Here, as in other areas of reform, it has taken the SEC many months to complete the hiring process for a small number of senior specialized examiners. At this point it is far too early to measure what, if any, impact their addition will have.

Integrating Examinations

The SEC's post-Madoff reforms included adopting a protocol that would integrate examination teams drawn from the broker-dealer and investment management units into a single team to jointly examine selected firms. The SEC has been unable to identify how many, if any, joint examinations it has conducted because its current databases do not generate this information.

Bottom Line: It is impossible to measure the extent, if any, this reform has been implemented and yielded tangible improvements.

Expanded and Targeted Training

The SEC promised to create a new formal training unit in the Enforcement Division and to expand and target training related, among other things, to hedge funds and specialized products, derivatives and options, complex trading, and investigations of regulated entities.

The SEC now claims to have expanded its training under the new Office of Managing Executive, an apparently new training unit. The Enforcement Division also has two employees responsible for coordinating training. In addition, the Enforcement Division has created and expanded training programs in the following areas:

- target training programs conducted by the five specialized units;
- a nationwide "Coordination Conference" for state and federal regulators to share information and provide joint training;
- a new agency-wide training initiative with other SEC divisions to facilitate cross-training;
- a number of joint training sessions with other federal regulators and prosecutors;
- coordinated forensic investigative accounting training;
- anti-money laundering enforcement training.

The SEC also has enhanced its Office of Compliance Inspections and Examinations training, including:

- specialized training on complex issues such as hedge funds, options trading, and credit default swaps;

- conducting a joint training program with other regulators;
- training programs focused on clearance and settlement systems and third-party verification of assets;
- enrolling examiners in certification programs to become certified fraud examiners and certified financial analysts;¹⁰
- adding a week-long Series 7 class to new examiner training that requires attendees to take a simulated Series 7 test.

In addition, the SEC conducted 31 fraud-related training sessions for examiners from December 11, 2008 through October 31, 2009.

Bottom line: The SEC has made great strides in beefing up its training programs agency-wide.

Tolling Agreements

The SEC also promised to change its policy on tolling agreements, which it characterized as “far too common,” resulting in “a significant cost of delay” and “undermin[ing] our message of prompt accountability for wrongdoing.”¹¹ To address this problem, the SEC planned on requiring the approval of the Enforcement Division director for all future tolling agreements.

The most recent SEC Enforcement Manual of January 13, 2010, now requires the approval of the Director of Enforcement to enter into tolling agreements. But it is impossible to determine the effects of this change, as the SEC does not record the number of tolling agreements in its databases.

Bottom Line: While the SEC now claims to have entered into 18 tolling agreements under the new policy as of February 28, 2010, there is no way to ascertain how this number compares to the number of tolling agreements the SEC entered into under its old policy.

¹⁰ According to the SEC, 352 employees have become certified fraud examiners.

¹¹ Robert Khuzami, Director, SEC Division of Enforcement, Remarks Before the New York City Bar: My First 100 Days as Director of Enforcement, Aug. 5, 2009, available at <http://www.sec.gov/news/speech/2009/spch080509rk.htm>.

SUMMARY OF CREW'S FINDINGS

The SEC's progress in the seven key areas includes the following:

- The SEC has begun the development of a central database to manage tips, complaints, and referrals and is many months away from its completion;
- The SEC has made considerable progress in establishing specialized units, but staffing them has consumed an inordinate amount of time and the units are months away from being fully staffed;
- Implementation of the SEC's promised Industry and Market Fellows Program, which would allow the agency to keep pace with Wall Street, is underway but as of the end of April, the agency had yet to hire any industry expert fellows for the Enforcement Division, which lacks this critical expertise;
- The SEC has made some progress in streamlining the management structure of the Enforcement Division by eliminating the branch chief positions, but many of the former branch directors have been deployed to other management positions, a move that runs counter to the promised streamlining;
- The SEC has now hired a small number of the promised senior specialized examiners, a process that has consumed many months;
- The SEC has now adopted a protocol integrating examinations teams from multiple units into a single unit, but it is impossible to measure the effectiveness of this report as the SEC cannot identify how many, if any, joint examinations it has conducted;
- The SEC has made the most progress in beefing up and expanding its training programs agency-wide;
- The SEC has changed its policy on tolling agreements to require the approval of the Director of the Enforcement Division and claims to have entered into 18 tolling agreements under this new policy. But because the SEC does not record the number of tolling agreements in its databases, there is no way to ascertain how this number compares to the number of tolling agreements under the old policy.