



Testimony Concerning Mortgage Fraud, Securities Fraud, and the Financial Meltdown: Prosecuting Those Responsible

by Robert Khuzami

*Director, Division of Enforcement
U.S. Securities and Exchange Commission*

Before the United States Senate Committee on the Judiciary

December 9, 2009

I. Introduction

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

Today's hearing is titled "Mortgage Fraud, Securities Fraud and the Financial Meltdown: Prosecuting Those Responsible." Recovery from the fallout of the financial crisis requires important efforts on various fronts, and vigorous enforcement is an essential component, as aggressive and even-handed enforcement will meet the public's fair expectation that those whose violations of the law caused severe loss and hardship will be held accountable. And vigorous law enforcement efforts will help vindicate the principles that are fundamental to the fair and proper functioning of our markets: that no one should have an unjust advantage in our markets; that investors have a right to disclosure that complies with the federal securities laws; and that there is a level playing field for all investors. The SEC is the only agency in the federal government focused primarily on investor protection; as such, we recognize our special obligation to uphold these principles.

As I will discuss in more detail below, in the enforcement area the SEC is moving on five primary fronts to advance these objectives. First, we are investigating and pursuing enforcement cases based on unlawful conduct related to the financial crisis. Second, we are enhancing our historically close working relationship with other law enforcement authorities, including the DOJ, in order to maximize the efficient use of limited resources, as well as to deliver a united and forceful response to those who would violate the federal securities laws. Third, we are implementing several initiatives, including the creation of national specialized units that will make the Division of Enforcement more knowledgeable and efficient in attacking both the causes of the recent financial crisis, as well as better arming us to address current and future market practices that are a potential cause for concern. Fourth, our staff is proposing various legislative reforms to provide the Division with improved tools to address securities fraud and related misconduct, including nationwide service of process, a whistleblower program and improved access to grand jury material. Last, in light of the

magnitude and importance of the task of regulating and policing our capital markets and financial system, as well as the growing size, complexity, and number of market participants, we are seeking to address the compelling need for additional resources within the Division and throughout the SEC.

II. Recent Accomplishments and Initiatives

The Division of Enforcement has long combatted fraud in the financial markets, and our recent efforts continue this record. Although case statistics cannot tell the whole story, and I caution against placing undue emphasis on them, they are one indicator of the Division's accomplishments. This past fiscal year, the SEC:

- Brought 664 enforcement actions;
- Ordered wrongdoers to disgorge \$2.09 billion in ill-gotten gains (an increase of 170% compared to \$774 million in fiscal 2008);
- Ordered wrongdoers to pay penalties of \$345 million (an increase of 35% compared to \$256 million in fiscal 2008);
- Sought 71 emergency temporary restraining orders to halt ongoing misconduct and prevent further investor harm (an increase of 82% compared to 39 in fiscal 2008);
- Sought 82 asset freezes to preserve assets for the benefit of investors (an increase of 78% compared to 46 in fiscal 2008); and
- Issued 496 orders opening formal investigations (an increase of over 100% compared to 233 in fiscal 2008).

Since January, we already have filed more than twice as many emergency temporary restraining orders in all cases across the board, as compared to the same period last year. In addition, where possible and appropriate, we return funds directly to harmed investors. Overall, since the 2002 passage of the Sarbanes-Oxley Act, the SEC has returned approximately \$6.6 billion to injured investors.¹

A. Cases

We bring enforcement actions in a wide range of areas from accounting and disclosure fraud, to derivatives and structured products, to insider trading and market manipulation. With respect to cases arising out of the financial crisis, a central issue, as in many of the SEC's enforcement cases, is whether investors received timely and accurate disclosure concerning the deteriorating business conditions, increased risks, and downward pressure on asset values experienced by a number of companies and funds during the financial crisis. For example, with respect to mortgage originators, specific issues include the extent and impact of the deterioration of the housing market on future business, and whether loan loss reserves were properly calculated in accordance with generally accepted accounting principles. The SEC also has focused on the possible failures of public companies to disclose the fair asset value of toxic assets and possibly false or misleading disclosures to investors and purchasers of structured products, including mortgage-backed securities and collateralized debt obligations, which have some form of mortgage as the underlying asset. Some examples of our mortgage-related enforcement actions, as well as actions in other areas, over the past year include the following:

Mortgage-Related Cases

- Just this week, the SEC filed charges against three former officers of New Century Financial Corporation, once the third largest subprime lender in the United States, for their alleged roles in including false and misleading information regarding the company's subprime mortgage business and in materially overstating the company's financial results by improperly understating its expenses relating to repurchased loans in Commission filings. The SEC's complaint alleges that New Century failed to disclose material facts necessary to make its financial statements not misleading, including, among other things, dramatic increases in early default rates, loan repurchases and pending loan repurchase requests, and that New Century materially overstated its second and third quarter financial results in 2006 (for example, the complaint alleges that pre-tax earnings in the second quarter were overstated by 165%, while third quarter pre-tax earnings were improperly reported as a \$90 million profit instead of an \$18 million loss).²
- In June 2009, the SEC charged Angelo Mozilo, the former CEO of Countrywide Financial, and two other former Countrywide executives with fraud for allegedly deliberately misleading investors about the significant credit risks the company was taking in efforts to build and maintain market share. Our complaint alleges 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 charges Mozilo with alleged insider trading for selling his Countrywide stock based on non-public information for nearly \$140 million in profit.³
- In April 2009 the SEC brought actions against three former executives at American Home Mortgage Investment Corp. for alleged accounting fraud and allegedly making false and misleading disclosures relating to the risk of its mortgage portfolio. Our complaint alleges that two of the executives fraudulently understated the company's first quarter 2007 loan loss reserves by tens of millions of dollar, converting the company's loss into a fictional profit. One of the executives, Michael Strauss, settled the SEC's charges, without admitting or denying the SEC's findings, by paying approximately \$2.2 million in disgorgement and prejudgment interest and a \$250,000 penalty, and agreeing to a five-year bar from serving as an officer or director of a public company.⁴
- In May and December 2009, the SEC brought two cases involving Brookstreet Securities Corp., a registered but now defunct broker-dealer, in connection with sales of allegedly unsuitable Collateralized Mortgage Obligations (CMOs) to retail customers. In the more recent action filed a few days ago, the SEC sued Brookstreet and its former President and CEO, alleging that from 2004 to mid-2007, the President and CEO helped create, promote, and facilitate an investment program, the "CMO Program," through which Brookstreet improperly sold risky, illiquid CMOs to retail customers (including retirees and retirement accounts) with conservative investment goals. More than 1,000 Brookstreet customers invested approximately \$300 million through the CMO program. Earlier, in the May action, the SEC sued ten registered representatives of the firm for allegedly making false statements when marketing the CMOs, allegedly receiving \$18 million in commissions related to the investments and causing customers losses of over \$36 million.⁵

- In June 2009, the SEC charged registered investment adviser Evergreen Investment Management Company, LLC, and an 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 sell earlier than other investors and avoid losses. The adviser and its affiliate settled with the SEC, without admitting or denying the SEC's findings, by agreeing to pay \$3 million in disgorgement and prejudgment interest and a total civil penalty of \$4 million, as well as make an additional payment of \$33 million to compensate shareholders. The SEC received valuable assistance from the Secretary of the Commonwealth of Massachusetts and the Massachusetts Securities Division in the investigation.⁶
- In May 2009, 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 material facts relating to the value of the Lehman-backed paper. On November 25, a federal judge in New York endorsed the SEC's approach to distributing the fund's assets on a pro-rata basis, which should result in an estimated return of at least 99 cents on the dollar for all shareholders who have not had their redemption requests fulfilled, regardless of when they submitted those redemption requests.⁷

Accounting Fraud

- In July 2009, the SEC charged the former Chief Accounting Officer of Beazer Homes, a homebuilder with operations in at least twenty-one states, with allegedly conducting a multi-year fraudulent earnings management scheme and misleading Beazer's outside and internal auditors to conceal his fraud.⁸ In 2008, the SEC issued a settled order finding that Beazer Homes, among other things, decreased reported net income through improper reserves during a period of strong growth from approximately 2000 to 2005. Then, as Beazer's financial performance began to decline in 2006, along with the housing market, Beazer reversed the improper reserves and increased its net income.⁹

Broker-Dealer, Investment Adviser, and Hedge Fund Misconduct

- Last month, the SEC charged New York-based investment adviser Value Line Inc., its CEO, its former Chief Compliance Officer, and its affiliated broker-dealer Value Line Securities, Inc., in a case involving over \$24 million in allegedly bogus brokerage commissions on mutual fund trades funneled through Value Line Securities, Inc. The parties agreed to settle the SEC's charges, without admitting or denying the SEC's findings, by consenting to the entry of a cease-and-desist order, total payment of nearly \$45 million in monetary remedies, industry and officer and director bars, and other relief.¹⁰
- In August 2009, the SEC took its first enforcement actions for alleged violations of the SEC's rules to prevent abusive "naked" short selling, charging two options traders and their broker-dealers with violating the locate and close-out requirements of Regulation SHO. Regulation SHO requires broker-dealers to locate a source of borrowable shares prior to selling short and to deliver securities sold short by a specified date. In separate cases involving New York-based Hazan Capital

Management LLC (HCM) and Chicago-based TJM Proprietary Trading LLC (TJM), the SEC alleged that the traders and their firms improperly claimed that they were entitled to an exception to the locate requirement and engaged in transactions that merely created the appearance that they were complying with the close-out requirement. The parties agreed to settle the SEC's charges without admitting or denying the SEC's findings. In the HCM case, the SEC ordered the parties to pay disgorgement of \$4 million (deemed satisfied by the orders of NYSE Amex, LLC, and NYSE Arca, Inc., in their related actions) and acknowledged the respondents' undertaking to pay fines totaling \$1 million in the related SRO actions. In the TJM case, the SEC ordered the parties to pay disgorgement of over \$500,000 (deemed satisfied by an order of the Chicago Board Options Exchange Inc. (CBOE), in its related action) and acknowledged the respondents' undertaking to pay a \$250,000 fine to the CBOE. Last month, the SEC followed up with a case against Rhino Trading, LLC, Fat Squirrel Trading Group, LLC, and two individuals for the parties' similar alleged violations of Regulation SHO's close-out requirement. The parties agreed to settle the SEC's charges, without admitting or denying the SEC's findings, and the SEC ordered the parties to pay total disgorgement of \$395,000 (deemed satisfied by an order of the CBOE in its related action) and acknowledged the respondents' undertakings to pay fines to CBOE totaling \$180,000.¹¹

- In April 2009, the SEC charged New York-based investment adviser Hennessee Group LLC and its principal for failing to perform their advertised review and analysis before recommending that their clients invest in the Bayou hedge funds that were later discovered to be a fraud. The parties agreed to settle the SEC's charges, without admitting or denying the SEC's findings, and to pay over \$800,000 in disgorgement and penalties, among other relief.¹²
- Beginning approximately one year ago, the SEC entered into a series of landmark settlements with six large broker-dealer firms — Citigroup Global Markets, UBS Financial Services, Wachovia Securities, Deutsche Bank Securities Inc., Bank of American Securities and RBC Capital Markets Corp. — for allegedly misrepresenting to their customers that auction rate securities (ARS) were safe, highly liquid investments that were equivalent to cash or money market funds. The firms failed to disclose the increasing risks associated with ARS, including their reduced ability to support the auctions. When the ARS market froze, customers were unable to liquidate their securities. Through these settlements the SEC enabled retail investors who purchased ARS to receive 100 cents on the dollar for their investments and restored approximately \$60 billion in liquidity to the ARS market. These settlements were achieved due to the collective efforts of the SEC, the New York Attorney General's Office, the North American Securities Administrators Association, and FINRA.¹³

Insider Trading

- Insider trading continues to be a significant program area, and this fall, the SEC filed charges relating to two complex insider trading rings alleging that more than \$53 million in illegal profits were collectively obtained by 30 entities and individuals, including hedge fund portfolio managers and other Wall Street professionals, attorneys, and corporate insiders, among others. In the action against billionaire Raj Rajaratnam and Galleon Management LP, the SEC filed charges against a total of 21 individuals and entities,

alleging that the scheme cumulatively generated more than \$33 million in illicit gains. In another significant insider trading action, the SEC charged an attorney in the New York office of a major international law firm, another attorney, six Wall Street traders, and a proprietary trading firm for their alleged involvement in a \$20 million insider trading scheme.¹⁴ The Federal Bureau of Investigation and the U.S. Attorney's Office for the Southern District of New York provided invaluable assistance and cooperation in these cases.

- In May 2009, the SEC charged a former portfolio manager at hedge fund investment adviser Millennium Partners and a salesman at Deutsche Bank for alleged "cross-market" insider trading in credit default swaps on international holding company VNU. In this case, bank employees allegedly tipped the portfolio manager about an anticipated change in VNU's underlying bond structure that substantially increased the price of the credit default swap, which allowed the defendants allegedly to profit from their purchase of credit default swaps when the restructuring was announced.¹⁵

Public Trust

- Last month, the SEC brought actions against J.P. Morgan Securities and two of its former managing directors for their roles in an alleged unlawful municipal securities pay-to-play scheme involving Jefferson County, Alabama. The SEC alleged that the firm and its two directors made more than \$8 million in undisclosed payments to close friends of certain Jefferson County commissioners and that the commissioners in turn voted to select the firm as managing underwriter, and its affiliated bank as swap provider. J.P. Morgan did not disclose the payments or conflicts of interest in the swap confirmation agreements or bond offering documents when it passed along the cost of the payments in the form of higher interest rates on the swap transactions. J.P. Morgan settled the case, without admitting or denying the SEC's findings, by paying \$50 million to Jefferson County, forfeiting more than \$647 million in claimed termination fees, and paying a penalty of \$25 million.¹⁶
- Earlier in the year, working with the New York State Attorney General, the SEC charged Raymond B. Harding, the former leader of the New York Liberal Party, as well as Henry "Hank" Morris, a top political advisor, and New York's former Deputy Comptroller 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. Harding allegedly received a total of approximately \$800,000 in sham "finder" fees.¹⁷

Ponzi Schemes

- The SEC investigates and prosecutes many Ponzi scheme 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 the beginning of this calendar year, we have filed 55 cases involving Ponzi schemes or Ponzi-like payments.

Foreign Corrupt Practices Act

- Late last year, the SEC filed a settled 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 (FCPA). The SEC brought this action in conjunction with the DOJ and the Office of the Prosecutor General in Munich, Germany. Siemens paid a total of \$1.6 billion in disgorgement and fines in the three actions, which is the largest amount a company has ever paid to resolve corruption-related charges.¹⁸

B. Cooperation and Coordination with Other Authorities

The SEC historically has had a very close and cooperative working relationship with criminal and other regulatory authorities, including the DOJ, self-regulatory organizations, foreign regulators, state securities regulators, the Commodity Futures Trading Commission (CFTC), the U.S. Postal Inspection Service, the Department of Labor, the Special Inspector General for the Troubled Asset Recovery Program, and banking regulators. The nature and extent of the cooperation and coordination varies as appropriate from case to case and can include referrals, information sharing, simultaneous actions, SEC staff details, or other assistance on criminal cases. For example, in fiscal 2009, more than 150 of the SEC's enforcement cases were filed in coordination with criminal charges filed by the DOJ and others, an increase of 30% over fiscal 2008. Similarly, we coordinated with criminal authorities and other regulators in approximately 75% of our most recent high priority cases. As noted in the cases above, we have brought several significant actions over the past year in which we worked closely with federal and state law enforcement authorities. These include the insider trading cases against Galleon Management LP and an attorney at a major international law firm, the pay-to-play cases against Raymond B. Harding and Henry "Hank" Morris, the FCPA case against Siemens, and the ARS settlements with Deutsche Bank, Citigroup, USB, Wachovia, RBC, and Bank of America.

Finally, last month, as part of the effort to better combat financial crime and mount a more organized, collaborative, and effective response to the financial crisis, the SEC joined the DOJ, the U.S. Department of the Treasury (Treasury), and the U.S. Department of Housing and Urban Development (HUD) in announcing the President's newly-established interagency Financial Fraud Enforcement Task Force (Task Force). The DOJ will lead the Task Force with the assistance of the SEC, Treasury, HUD, and FBI serving on the Steering Committee. The Task Force leadership, along with representatives from a broad range of federal agencies, regulatory authorities, and inspectors general, will work with state and local authorities to investigate and prosecute significant financial crimes, ensure just and effective punishment for those who perpetrate financial crimes, address discrimination in the lending and financial markets, and recover proceeds of financial crimes for victims. The Task Force, which replaces the Corporate Fraud Task Force established in 2002, will build upon efforts already underway to combat mortgage, securities, and corporate fraud by increasing coordination and fully utilizing the resources and expertise of the government's law enforcement and financial regulatory organizations. As an important, early step, the Securities Working Group of the Task Force will convene in New York on December 11, 2009. Attendees include the Regional Directors and Senior Officers of the SEC's 12 offices nationwide, our counterparts from United States Attorney's Offices, and representatives of the FBI, CFTC, and the U.S. Postal Inspection Service. The participants will share substantive expertise, exchange information and approaches for supporting successful organizations, and identify ways to improve coordination.

One of the vital aspects of the Task Force will be to better coordinate criminal and civil enforcement efforts. As a former federal prosecutor with the DOJ — and now as the Director of the Division of Enforcement at the SEC — I have seen first-hand the benefits of coordinated civil and criminal enforcement efforts. I am confident that the Task Force will result in greater opportunities to identify and prosecute wrongdoers, and thereby enhance public confidence in the integrity of our markets.

C. Division Reorganization

Since I became the Director of the Division of Enforcement in March of this year, we have been undertaking a top-to-bottom self-assessment of our Division's operations and processes. We have asked ourselves how can we improve overall and specifically, how can we work smarter, swifter, be more strategic, and more successful. In short, our focus has been on developing as an organization and as individual public servants to fulfill our critical mission of investor protection.

Phase One of our Division self-assessment is now complete, and we have implemented or are in the process of implementing a number of key reforms. These changes have been described as the "the unit's biggest reorganization in at least three decades."¹⁹ Together, these changes are intended to optimize the use of our resources, to gather and utilize expertise across the Division and the SEC, to bring cases more swiftly and more efficiently, and to increase strategic analysis and proactive investigations. Highlights of the current changes include the following:

- **Specialization.** We are creating five new national specialized investigative groups that will be dedicated to high-priority areas of enforcement, including Asset Management (including hedge funds and investment advisers), Market Abuse (large-scale insider trading and market manipulation), Structured and New Products (including various derivative products), Foreign Corrupt Practices Act cases, and Municipal Securities and "Pay-to-Play" issues. Members of the specialized units will acquire the expertise and investigative insights that can only be developed by conducting investigations in the same subject area, combined with ready access to others with specialized skills. With increased focus, training, and access to specialized expertise, investigative staff will conduct more effective, efficient investigations. With a national focus, these specialized groups will help to cultivate a sense of common mission and mutual support among Division personnel in different regional offices.
- **Management Restructuring.** We are adopting a flatter, more streamlined organizational structure under which we will eliminate an entire layer of management. Our self-assessment revealed that we had a management structure that was too top-heavy, which created more process and delay than was optimal. We are reallocating a number of staff who were first line managers — some of our best and brightest in terms of experience and dedication — to the mission-critical work of conducting front-line investigations. As part of this effort, we will be working to maintain staff to manager ratios that will allow for close substantive consultation and collaboration — the goal is to have a management structure that facilitates timely case building, ensures quality control, and provides for the growth and development of the staff — ultimately enhancing the Division's ability to fulfill its investor protection mission.
- **Streamlining.** We are streamlining a number of internal processes and procedures. This streamlining includes permitting senior officers

to approve the issuance of subpoenas for documents and testimony, without having in most cases to secure advance formal authorization from the Commission. With this change, we will be able to move more quickly in ferreting out fraud, and be able to react immediately if confronted by recalcitrant targets or dilatory tactics.

- **Cooperation Tools.** We are developing, for use by the SEC, agreements, similar to those used by criminal law enforcement authorities, to secure the cooperation of persons who are on the "inside" or otherwise aware of organizations or associations engaged in fraudulent activity. These agreements, the most important of which is a so-called "cooperation agreement," provide that such persons must agree to provide truthful evidence and testify against the organizers, leaders, and managers of such wrongful activity, in exchange for a possible reduction in sanctions imposed on them. Such cooperation agreements have the capacity to secure the availability of witnesses and information for the Division early on in investigations. The goal is to allow us to build stronger cases and to file them sooner than would otherwise be possible, thus preventing additional investor harm.
- **Other Initiatives.** In addition to those described above, we are implementing a number of other initiatives designed to improve our processes and overall effectiveness. Among other items,
 - We are enhancing our training and supervision, including creating a formal training unit to ensure that our staff is armed with the knowledge and expertise necessary to confront today's complex market and products;
 - We have hired the Division's first-ever Managing Executive, a COO-type role to focus on the Division's operations. Where previously many administrative, operational, and infrastructure tasks were handled on an ad hoc basis by investigative personnel and could be a drain on investigative functions, those tasks will now be handled more efficiently and effectively by trained staff with the appropriate skill set;
 - We are establishing an Office of Market Intelligence, which will serve as a central office for the handling of complaints, tips, and referrals that come to the attention of the Division, coordinate the Division's risk assessment activities, and support the Division's strategic planning activities. In short, this office will enable us to have a unified, coherent, coordinated response to the huge volume of complaints, tips, and referrals we receive every day, thereby enhancing our ability to open the right investigations, bring the right cases, and ultimately protect investors;
 - We have hired experienced former federal prosecutors to serve as Deputy Director of the Division of Enforcement and Director of the New York Regional Office, two of the most significant positions in the Division.

I am confident that these changes — and others we will make along the way as we continue to self-assess and evaluate our progress — will reinvigorate our Division, restore investor confidence, and enable us to fulfill our mission of investor protection.

III. Continuing to Strengthen the Division

We will continue to strengthen the Division. Some of the challenges we encounter may be addressed by current legislative initiatives, while others may be addressed through our on-going self-assessment and by optimizing our use of limited resources.

A. Legislative Initiatives

To address issues faced by the Division, the staff has recommended several legislative measures to improve its ability to protect investors and deter wrongdoing. Many of these legislative initiatives have the potential to enhance substantially the Division's powers and effectiveness. These include:

- **Establishing a "whistleblower" program.** We have recommended whistleblower legislation that would provide substantial rewards for tips from persons with unique, high-quality information. We expect this program to generate significant tips that we would not otherwise receive from persons with direct knowledge of serious securities law violations. This legislation, along with our cooperation initiatives, would increase incentives for persons to share full information quickly while expanding protections against retaliatory behavior. This proposed legislation has the potential to enable the Division to investigate violations more effectively and efficiently.
- **Obtaining improved access to grand jury materials.** The Division is seeking a narrow modification to the "grand jury secrecy rule" that would enhance the Division's ability to conduct timely investigations and use resources efficiently. The proposed amendment would authorize the DOJ to seek court authorization to release certain limited grand jury information to Commission staff for use in matters within the Commission's jurisdiction consistent with the statutory authority applying to such access by federal bank regulators. It would permit sharing of information only with regard to conduct that may constitute violations of the federal securities laws. With regard to that information, however, the proposed amendment would lessen the burden in obtaining court approval. The court could approve the sharing of the information upon a showing of a "substantial need in the public interest," rather than the higher "particularized need" standard. In addition, under the proposed amendment the judicial proceeding requirement would not apply to the Commission, permitting information to be shared at an earlier stage in an investigation and in connection with an administrative proceeding.
- **Establishing nationwide service of process.** The SEC currently has nationwide service in administrative proceedings. Establishing nationwide service of process in civil actions filed in federal courts would produce a number of substantial advantages, including a significant savings in terms of travel costs and staff time through the elimination of duplicative depositions and the benefits of having live witnesses and party testimony before the trial court. The House recently passed a bill on this subject, and we are hopeful the Senate will support this as well.
- **Additional initiatives.** Additional legislative proposals that would serve to enhance the Division's effectiveness and efficiency include the ability to seek civil penalties in cease-and-desist proceedings, the ability to seek penalties against aiders and abettors under the Investment Advisers Act of 1940, and the ability to charge aiding and abetting violations under the Securities Act of 1933 and the Investment Company Act of 1940.

In addition to the Enforcement-specific legislative initiatives outlined above, I believe that current proposed legislation to regulate OTC derivatives and require hedge funds and other private pools of capital to register with the SEC ultimately would improve the Division of Enforcement's access to information about trades through uniform audit trails, greater transparency, and recordkeeping and reporting requirements. Furthermore, the SEC has undertaken a consideration of a number of issues concerning market structure, such as short selling, flash orders, direct market access, co-location, dark pools, and high-frequency trading.

B. Future Plans for the Division of Enforcement

We continually assess our processes and the way we use our resources. While the current legislative initiatives certainly will help to address some of the practical challenges we face in policing the financial markets, we recognize that there is more work to be done within the Division. We must ensure that we use our resources wisely, both human resources and the vast amount of information that are available to us. Some of the ways we are doing that include:

- ***Improving the handling of complaints, tips, and referrals.*** In March 2009, the SEC hired the MITRE Group, a non-profit, federally funded research and development firm, to conduct a comprehensive review of the SEC's systems and procedures for evaluating and tracking complaints, tips and referrals (CTRs). We are now in the process of drafting new policies and procedures and laying the foundations for a centralized information technology solution that will provide the SEC with an automated mechanism for tracking, analyzing, and reporting the handling of CTRs.
- ***Tracking cases with qualitative metrics.*** As part of our focus on the quality and effectiveness of our enforcement program, we are implementing systems to measure certain qualitative factors of our investigations and cases. These metrics should help us track cases and determine whether our resources are being used effectively to file cases with programmatic significance in a timely manner.
- ***Improving information technology.*** Information technology is a priority for the Division. For example, increasing our electronic document management capacity will allow us to more effectively load, store, and search the millions of documents involved in our investigations. System improvements also will enhance our ability to track data and manage cases.

C. Resources

How to maximize and use resources efficiently is a continuing challenge for our Division. The scope and complexity of the financial industry has grown significantly over the last decade. Currently, the SEC oversees over 35,000 registrants, including 12,000 public companies, 11,000 investment advisers, 8,000 mutual funds, 5,500 broker dealers, 600 transfer agents, as well as exchanges, clearinghouses, NRSROs, and SROs. In contrast, the entire Division of Enforcement staff nationwide, including lawyers, accountants, information technology staff, and support staff, hovers only just above 1,100.

Given the size, complexity, and cross-border scope of the securities industry, and the huge volume of information that the SEC receives, the SEC — and our Division — needs far more resources to improve its ability to protect investors. We recognize our obligation to American taxpayers to

use the resources we have as efficiently as possible — which forms the basis for many of the Division reforms I have described above, including the flattening of management, the streamlining of internal processes, and the increased use of cooperation tools. Even with these and other steps to increase our efficiency, however, our resources are inadequate for the task we confront. Thus, we must, among other improvements, increase the number of qualified staff in the Division and invest in critical information technology initiatives. Because of several years of flat or declining SEC budgets, the SEC has faced significant declines in resources in recent years. Despite the much appreciated budget increase received in 2009, the Division will still have significantly fewer staff than in it did four years ago, and its budget for improvements in technology remains lower than it was in 2005. I join Chairman Schapiro's request for a self-funding mechanism that will allow us the resources and stability to truly police the world's most sophisticated markets.

IV. Conclusion

The Division of Enforcement's mission to vigorously enforce the federal securities laws is critical. As I hope my testimony here today demonstrates, we are aggressively bringing significant enforcement cases in a broad range of areas, including those arising out of the credit crisis. At the same time, we are committed to continue to revitalize and improve our programs, and pursue long-term improvements in our structure and processes. With the dedicated and talented men and women that I work beside each day in the Division, and alongside my colleagues at the DOJ, the FBI, and other law enforcement organizations, I am confident that we will successfully fulfill our mission.

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

Endnotes

¹ During the 2009 calendar year alone, the SEC has distributed more than \$2 billion to harmed investors. Section 308 of the Sarbanes-Oxley Act of 2002, codified at 15 U.S.C. §7246, enabled the Commission to distribute civil money penalties to investors in certain circumstances. In enforcement actions prior to the passage of the Sarbanes-Oxley Act, only funds paid as disgorgement could be returned to investors.

² *SEC v. Brad A. Morrice, et al.*, Lit. Rel. No. 21327 (Dec. 7, 2009).

³ *SEC v Angelo Mozilo, David Sambol, and Eric Sieracki*, Lit. Rel. No. 21068A (June 4, 2009).

⁴ *SEC v. Michael Strauss, Stephen Hozie and Robert Bernstein*, Lit. Rel. No. 21014 (April 28, 2009).

⁵ *SEC v William Betta, Jr., et al.*, Lit. Rel. No. 21061 (May 28, 2009) and *SEC v. Brookstreet Securities Corp. and Stanley C. Brooks*, Case No. SACV 09-01431 DOC (ANx) (C.D. Cal. Dec. 8, 2009).

⁶ *In the Matter of Evergreen Investment Management Company, LLC and Evergreen Investment Services, Inc.*, AP File No. 3-13507 (June 8, 2009).

⁷ *SEC v Reserve Management Company, Inc., Resrv Partners, Inc., Bruce*

Bent Sr. and Bruce Bent II, Lit. Rel. No. 21025 (May 5, 2009).

⁸ *SEC v. Michael T. Rand*, Lit. Rel. No. 21114 (July 1, 2009).

⁹ *In the Matter of Beazer Homes USA, Inc.*, AP File No. 3-13234 (Sept. 24, 2009).

¹⁰ *In the Matter of Value Line, Inc., et al.*, AP File No. 3-13675 (Nov. 4, 2009).

¹¹ *In the Matter of Rhino Trading, LLC, Fat Squirrel Trading Group, LLC, Damon Rein, and Steven Peter*, Lit. Rel. No. 60941 (Nov. 4, 2009); *In the Matter of TJM Proprietary Trading, LLC, Michael R. Benson and John T. Burke*, AP File No. 3-13569 (Aug. 5, 2009); and *In the Matter of Hazan Capital Management, LLC and Steven M. Hazan*, AP File No. 3-13570 (Aug. 5, 2009).

¹² *In the Matter of Hennessee Group LLC and Charles J. Gradante*, AP File No. 3-13454 (April 22, 2009).

¹³ *SEC v. Banc of America Securities LLC and Banc of America Investment Services, Inc.*; *SEC v. RBC Capital Markets Corporation*; and *SEC v. Deutsche Bank Securities Inc.*, Lit. Rel. No. 21066 (June 3, 2009); *SEC v. Wachovia Securities, LLC*, Lit. Rel. No. 20885 (Feb. 5, 2009); *SEC v. Citigroup Global Markets, Inc. and SEC v. UBS Securities LLC and UBS Financial Services Inc.*, Lit. Rel. No. 20824 (Dec. 11, 2008). This testimony refers only to public documents or statements about *SEC v. Deutsche Bank Securities Inc.*, reflecting my recusal from the matter.

¹⁴ *SEC v. Galleon Management, LP, et al.*, Lit. Rel. No. 21284 (Nov. 5, 2009) and *SEC v. Cutillo, et al.*, Lit. Rel. No. 21283 (Nov. 5, 2009).

¹⁵ *SEC v. Jon-Paul Rorech, et al.*, Lit. Rel. No. 21023 (May 5, 2009). This testimony refers only to public documents or statements about *SEC v. Jon-Paul Rorech, et al.*, reflecting my recusal from the matter.

¹⁶ *SEC v. LeCroy and MacFaddin*, Lit. Rel. No. 21280 (Nov. 4, 2009) and *In the Matter of J.P. Morgan Securities Inc.*, AP File No. 3-13673 (Nov. 4, 2009).

¹⁷ *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).

¹⁸ 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).

¹⁹ 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>.

<http://www.sec.gov/news/testimony/2009/ts120909rk.htm>

