Testimony Before the

Subcommittee on Oversight and Investigations
Committee on Financial Services,
U.S. House of Representatives
"The Stanford Ponzi Scheme: Lessons for Protecting Investors from the Next Securities Fraud"
May 13, 2011

by

Robert Khuzami
Director, Division of Enforcement

and

Carlo di Florio
Director, Office of Compliance Inspections and Examinations
U.S. Securities and Exchange Commission

Chairman Neugebauer, Ranking Member Capuano, Members of the Subcommittee, thank you for the opportunity to testify today on behalf of the Securities and Exchange Commission.

The Commission commends the work of the Inspector General and his staff investigating this matter and drafting the report, *Investigations of the SEC's Response to Concerns Regarding Robert Allen Stanford's Alleged Ponzi Scheme*, OIG-526 (the "Stanford IG Report"). This extensive investigation clearly identified missed opportunities for protecting investors, and we deeply regret that the SEC failed to act more quickly to limit the tragic losses suffered by Stanford's victims.

The Stanford IG Report, which was released last year, made important recommendations identifying areas for improvement throughout the SEC and, as we will discuss today, both the Division of Enforcement and the Office of Compliance Inspections and Examinations ("OCIE") have instituted various measures to implement all of those recommendations.

In addition to the Inspector General's recommendations, each of us has, since joining the Commission within the last two years, engaged in a top to bottom review of our respective Division and Office, and implemented measures to reform our organizational processes and improve our effectiveness. We have streamlined management; put seasoned investigative attorneys back on the front lines; improved our examiners' risk-assessment techniques; revised our enforcement and examination procedures to improve coordination and information-sharing; leveraged the knowledge of third parties; instituted new initiatives to identify fraud; expanded our training programs; hired staff with new

skill sets; and revamped the way that we handle the tremendous volume of tips, complaints, and referrals that we receive annually.

Although our reform efforts are ongoing, the Inspector General's recent report, *OCIE Regional Offices' Referrals to Enforcement,* Report No. 493 ("Referral IG Report"), issued on March 30, 2011, indicates that enhanced coordination between Enforcement and OCIE is proving effective in many respects, particularly in the area of handling referrals from OCIE to Enforcement. In addition, strengthened collaboration between OCIE and Enforcement has resulted in a number of notable enforcement actions in the past two years.

Despite the many changes, more work remains. This will require commitment and creativity. We embrace the challenge and commit ourselves to enhancing investor protection and the integrity of our financial markets.

Status of the Stanford Case

In February 2009, the SEC filed an emergency civil action to halt sales of Stanford Certificates of Deposit ("CDs") and seek the return of funds to harmed investors. Shortly thereafter, the SEC filed an amended complaint against Robert Allen Stanford, James M. Davis, Stanford International Bank ("SIB"), and others alleging a massive Ponzi scheme in the sale of SIB CDs.

By the end of 2008, SIB had sold more than $7.2 billion of CDs by touting the bank's safety and security, consistent double-digit returns on the bank's investment portfolio, and high rates of return on the CDs that greatly exceeded rates offered by U.S. commercial banks. The SEC's complaint alleged that Stanford and Davis misappropriated billions of dollars of investor funds and invested funds in speculative, unprofitable private businesses controlled by Stanford. In an effort to conceal their fraudulent conduct, Stanford and Davis allegedly fabricated the performance of the bank's investment portfolio and lied to investors about the nature and performance of the portfolio. The SEC alleged that, rather than making principal redemptions and interest payments from earnings, Stanford made purported interest and redemption payments from money derived from CD sales.

Working in close coordination with the SEC, the Department of Justice, on June 19, 2009, unsealed indictments against Stanford, Davis and three other former Stanford employees, alleging that they committed securities, wire and mail fraud and obstructed the SEC's investigation. On June 30, 2009, the court ordered that Stanford be detained in jail pending his criminal trial.

In June 2009, the SEC also sued Leroy King, the former Administrator and Chief Executive Officer for the Antigua Financial Services Regulatory Commission ("AFSRC"), alleging that Stanford bribed King to help him conceal his fraud and thwart the SEC's investigation. As alleged in the SEC's complaint, while King received bribes from Stanford, he rebuffed SEC inquiries into Stanford's conduct by stating, among other

things, that further investigation of Stanford was "unwarranted," and that his bank was "fully compliant" with Antiguan bank regulations.[1] King also allegedly permitted Stanford to, in effect, "ghost write" the response by the AFSRC to the SEC, which rejected the SEC's demand for information. The alleged bribing of King permitted Stanford to keep his alleged fraud alive for years. In addition to the SEC's charges, the Department of Justice indicted King on charges, including obstruction of justice, for allegedly accepting tens of thousands of dollars in bribes to facilitate the scheme.

The SEC is vigorously pursuing its case against Stanford and the others charged in this massive Ponzi scheme. In addition, the staff's investigation into possible misconduct by others (including former employees and third parties) is ongoing.

Status of Recovery for Stanford Investors

The SEC's focus in the Stanford litigation is to hold wrongdoers accountable while working with the Receiver to trace and recover the money that investors lost in this egregious fraud. We are proceeding on several fronts.

First, after filing its civil action in February 2009, the SEC filed a motion requesting that the district court appoint a Receiver over the defendants' assets to prevent waste and dissipation of those assets to the detriment of investors. Second, to complement the Receiver's efforts, the SEC, in coordination with the DOJ, moved to freeze SIB assets held in international financial institutions. Freezing assets in international jurisdictions poses complex litigation challenges, but this step was crucial to ensure the protection of investor funds. Third, the SEC is working with the Receiver, DOJ, and securities regulators and law enforcement agencies in the United Kingdom, Switzerland, Canada, Mexico, and in several countries throughout Central and South America, to identify, secure, and repatriate for the benefit of investors over $300 million in cash and securities held in non-U.S. bank accounts.

In a status report filed February 11, 2011, the Receiver identified several categories of major assets for possible distribution to harmed investors:

- $94.7 million in cash on hand;
- $30.4 million in private equity investments already recovered and liquidated;
- $1 million in coins and bullion inventory;
- $6 million in real estate sale proceeds, with an additional $11.7 million expected from sales of other identified properties; and
- $594.9 million in pending fraudulent transfer and unjust enrichment claims.[2]

In conjunction with the SEC, the Receiver is focused on identifying and liquidating the largest possible pool of obtainable assets for distribution to harmed investors.

---

[1] SEC v. Stanford International Bank Ltd. et al., No 3:09-cv-0298-N (N.D.Tex), Second Amended Complaint at ¶88.

[2] This figure includes amounts claimed in lawsuits filed or intended to be filed by the Receiver; actual recovery may vary depending on litigation outcome.

The SEC has been and will continue to closely monitor the Receiver's costs, and we have strongly urged the Receiver to stringently apply a cost-benefit analysis and to pursue only those legal claims that could generate maximum proceeds for investors while minimizing the Receiver's legal fees and expenses. We also have cautioned the Receiver that we are carefully scrutinizing all bills requesting payment for fees and expenses. In fact, on at least three occasions, the SEC has formally challenged the Receiver's bills. We will continue to do so where appropriate.

Status of SIPC Determination in Stanford

The Commission oversees the activities of the Securities Investor Protection Corporation ("SIPC"), which plays a critical role in protecting customer property when a broker-dealer enters liquidation under the Securities Investor Protection Act ("SIPA"). In the Stanford matter, SIPC has indicated that, in its view and based on the facts presented, there is no basis for SIPC to initiate a proceeding under SIPA.[3] The Commission is taking the concerns of the Stanford Victims Coalition ("SVC") members, and all other Stanford victims, very seriously, and the staff is investigating closely their status under SIPA. Commission staff has devoted substantial time and effort to analyzing the issues surrounding a potential SIPA liquidation of SGC. As part of this review, the staff has met with representatives of the SVC and other Stanford victims on multiple occasions to discuss this matter. The staff also has been reviewing documents relevant to the investigation, including account information received from the SVC. The staff is finalizing its investigation and review of the relevant facts relating to the Stanford case, and we anticipate that the Commission will make a determination regarding these issues in the near future.

Enforcement and OCIE Responses to Inspector General Recommendations

On April 16, 2010, the SEC released the report by the Inspector General concerning the investigation of the Stanford matter ("Stanford IG Report"). The report identified the need for reforms in the Division of Enforcement and in the Office of Compliance Inspections and Examinations. As described in more detail below, we have taken actions to respond to each of these recommendations, and as a result, all seven recommendations from the report have now been closed with the Office of Inspector General's concurrence.

Division of Enforcement

Stanford IG Report

The Division of Enforcement has taken action on all seven of the formal recommendations identified in the Stanford IG Report. On July 20, 2010, Enforcement submitted a closing memorandum to the Inspector General containing information that we believed fully addressed all seven recommendations. Recommendations 2, 4, 6 and 7 were closed by the Inspector General on October 8, 2010 and, following additional

[3] *See* http://www.stanfordfinancialreceivership.com/documents/SIPC_Letter.pdf

actions by Enforcement, recommendations 1, 3 and 5 were closed by the Inspector General on March 9, 2011.

First Recommendation. The Inspector General recommended that we evaluate the potential harm to investors when deciding whether to bring an enforcement action that also may involve litigation risks. The Division's Enforcement Manual,[4] developed in October 2008, provides that staff should consider several factors when determining whether to open an investigation, including: (i) the potential losses involved or harm to investors and (ii) the egregiousness of the potential violation. In addition, the Enforcement Manual also states that first among the factors the staff should consider before closing an investigation is the seriousness of the conduct and potential violations. As these Enforcement Manual provisions indicate, prior to the Stanford IG Report, the Division encouraged staff to carefully assess factors such as potential harm to investors and seriousness of potential violations when deciding whether to open or close investigations. In response to the Report, we have instituted mandatory Enforcement Manual training for all Division staff to ensure compliance.

In addition to its Enforcement Manual provisions and related training, the Division regularly files actions in federal court seeking emergency temporary restraining orders and asset freezes to prevent imminent investor harm and protect assets for the benefit of investors – actions that often present litigation risk given the exigent circumstances of the very early stages of an investigation. In fiscal year 2010, Enforcement obtained 37 emergency temporary restraining orders to halt ongoing misconduct and prevent imminent investor harm and 57 asset freezes to preserve funds for the benefit of investors.

Second Recommendation. The Inspector General recommended that we consider promulgating and/or clarifying staff and regional office performance evaluation procedures that recognize the significance of bringing difficult cases focused on investor protection. The Enforcement Division has revised the metrics used to manage and evaluate the performance of its staff. Rather than emphasizing the number of actions filed, we place a particular focus on the programmatic priority of the case, which reflects a consideration of multiple factors, including whether the matter:

(1) presents an opportunity to send a particularly strong and effective message of deterrence, including with respect to markets, products and transactions that are newly developing, or that are long established but which by their nature present limited opportunities to detect wrongdoing and thus to deter misconduct;

(2) involves particularly egregious or extensive misconduct;

(3) involves potentially widespread and extensive harm to investors;

(4) involves misconduct by persons occupying positions of substantial authority or responsibility, or who owe fiduciary or other enhanced duties and obligations to a broad group of investors or others;

[4] *See* http://www.sec.gov/divisions/enforce/enforcementmanual.pdf

(5) involves potential wrongdoing as prohibited under newly-enacted legislation or regulatory rules;

(6) involves potential misconduct that occurred in connection with products, markets, transactions or practices that pose particularly significant risks for investors or a systemically important sector of the market;

(7) involves a substantial number of potential victims and/or particularly vulnerable victims;

(8) involves products, markets, transactions or practices that the Enforcement Division has identified as priority areas (i.e. conduct relating to the financial crisis; fraud in connection with mortgage-related securities; financial fraud involving public companies whose stock is widely held; misconduct by investment advisers; and matters involving priorities established by particular regional offices or the specialized units); and

(9) provides an opportunity to pursue priority interests shared by other law enforcement agencies on a coordinated basis.

We further consider in our evaluations the difficulty, complexity and investigative challenges of the case, as well as the efficiency of the resources used, the swiftness of the action, and the success of the outcome.

In addition, the Division now generates a national priority case report that identifies and tracks cases deemed programmatically significant to ensure that appropriate resources are devoted to these cases. Finally, the SEC's Strategic Plan for Fiscal Years 2010-2015 identifies the performance standards that it will use to gauge the success of its enforcement program. Those performance measures are not exclusively focused on the number of cases filed per fiscal year, but rather include: (i) the percentage of enforcement cases successfully resolved; (ii) the percentage of enforcement cases filed within two years, and (iii) our success in collecting and returning money to investors in a timely fashion.

Third Recommendation. The Inspector General recommended that we consider promulgating and/or clarifying procedures regarding the significance of the presence or absence of U.S. investors in determining whether to open an investigation or bring an enforcement action that otherwise meets jurisdictional requirements. As previously described, the Division's Enforcement Manual indentifies a number of factors that the staff should consider when deciding whether to open an investigation including, but not limited to, potential losses and harm to any investor, namely: (i) the egregiousness of the potential violation; (ii) the potential magnitude of the violation; (iii) whether the potentially harmed group is particularly vulnerable or at risk; (iv) whether the conduct is ongoing; (v) the size of the victim group; and (vi) the amount of potential or actual losses to investors. As demonstrated by these provisions, prior to the Stanford IG Report, the Division encouraged its staff to assess victim losses and victim impact when deciding to open an investigation. In response to the Stanford IG Report, the Division revised the Enforcement Manual to further clarify that the presence or absence of U.S. investors

itself should not in itself control the decision whether to open a MUI, to open an investigation, or to close an investigation.

In addition, the Division is evaluating the impact of a recent Supreme Court decision, Morrison v. National Australia Bank, that placed jurisdictional limitations on securities fraud claims involving conduct and activities outside the U.S. In connection with the Inspector General's recommendation, we are working with other SEC offices to determine whether additional formal guidance should be provided to Enforcement staff. Our Office of Chief Counsel regularly consults with investigative staff on these issues.

Fourth Recommendation. The Inspector General recommended that we consider promulgating and/or clarifying procedures regarding coordination between Enforcement and OCIE on investigations, particularly those investigations initiated by a referral to Enforcement by OCIE. As a result of various Enforcement/OCIE initiatives, there now exists a significantly increased level of collaboration between Enforcement and OCIE staff. Enforcement and OCIE, together with the other divisions, hold regular monthly meetings to, among other things, discuss issues raised in ongoing examinations. In addition, the many risk-based investigative initiatives undertaken as part of the overall restructuring of the Enforcement Division require early and frequent contact between Enforcement and OCIE to: (i) identify entities with risk profiles indicative of the need for a risk-based examination; (ii) discuss the findings of ongoing examinations; (iii) discuss the scope and nature of referrals to Enforcement for investigation; and (iv) develop analytic tools as needed. As a result of this collaboration, the following inquiries, among others, have been launched:

- **Suspicious Performance**. This inquiry focuses on suspicious performance returns posted by both registered and unregistered hedge fund advisers. Analytics have been developed to review performance data of hedge fund advisers and identify candidates for examination or investigation.

- **Bond Funds**. This inquiry focuses on disclosure and valuation issues in mutual fund bond portfolios. Based on practices identified in an exam of a significant bond fund complex, risk analytics were created that identify possible subjects for investigation and/or examination.

- **Mutual Fund Fees**. This is a set of inquiries into potential excessive fee arrangements by mutual funds, their advisers, and boards of directors. This initiative has resulted in examinations and investigations of advisers, funds and their boards focused on possible violation of the Investment Advisers Act and Investment Company Act.

- **Problem Advisers**. This is a risk-based approach to detecting problem advisers by conducting due diligence checks on certain types of advisers. As part of an ongoing prophylactic program to identify potentially problematic advisers before they cause investor harm, Enforcement and OCIE are evaluating information about hundreds of investment advisers that are believed to be high-risk advisers.

- **Investment Adviser Compliance**. This is a coordinated effort to identify and bring cases against registered investment advisers who have lacked effective compliance programs and procedures, in violation of the Advisers Act. Effective compliance programs and personnel are instrumental to protecting the investing public from investment adviser fraud.

Lastly, as part of the Chairman's initiative to improve the handling of tips, complaints and referrals ("TCRs"), Enforcement has established the Office of Market Intelligence ("OMI") and staffed it with market surveillance specialists, accountants, attorneys and other support personnel, and additional hiring is expected. OMI's mission is to ensure that we collect all TCRs in one place, combine that data with other public and confidential information on the persons or entities identified in the TCRs, and then dedicate investigative resources to the TCRs presenting the greatest threat of investor harm. OCIE's referrals to Enforcement are tracked through this new TCR system to ensure proper Enforcement staff assignment. The new TCR system allows staff across the Commission to review, analyze, archive and route TCR information from a centralized database and processing platform. The system is designed to improve the Commission's ability to obtain relevant information from the public while providing the staff with workflow tools to better correlate, prioritize, assign and track the progress of TCRs from intake through resolution.

We currently are in the midst of a procurement to build an analytics component to the TCR system that will enable us to better link data among various Commission databases and to automate based on risk characteristics the initial review of TCRs to ensure timely prioritization. Finally, we continue to strengthen our policies and training to ensure that every member of the agency understands his/her role when receiving or handling TCRs.

Fifth Recommendation. The Inspector General recommended that we consider promulgating and/or clarifying procedures regarding when to refer a matter to state securities regulators. Prior to the Stanford IG Report, the Enforcement Manual identified factors to guide referrals to federal or state criminal authorities, SROs, the Public Company Accounting Oversight Board, or state agencies, including: (i) the egregiousness, extent and location of the conduct; (ii) the involvement of recidivists in any suspected conduct; and (iii) the potential for additional meaningful protection to investors upon referral. In response to the Stanford IG Report, we now require mandatory Enforcement Manual training for all Enforcement staff.

In addition, as indicated, Enforcement has created the Office of Market Intelligence to oversee and coordinate Enforcement's collection, analysis and distribution of TCRs. OMI staff has been directed to provide relevant information and data obtained in its initial triage of TCRs to the appropriate state or federal agencies or other regulatory partners. Additionally, we are working with SROs to update the manner in which those organizations submit referrals to the Commission in an effort to achieve uniformity in our TCR intake system. Further, in connection with our work on the Financial Fraud Enforcement Task Force, we continue to work closely with our law enforcement and

regulatory partners, including state securities regulators. These strengthened relationships facilitate effective information-sharing and provide us with clear points of contact for referrals to state securities regulators.

Sixth Recommendation. The Inspector General recommended that we consider promulgating and/or clarifying procedures regarding training of Enforcement staff to strengthen staff understanding of the laws governing broker-dealers and investment advisers. Newly-created specialized units in the Enforcement Division, including one dedicated to asset management issues (including investment advisers) have unveiled intensive training modules in their respective specialty areas, which have been made available to all staff throughout the Division. In addition, Enforcement has strengthened training both for new hires and for existing staff, including training specifically focused on the laws governing broker-dealers and investment advisers. Enforcement also has created a new formal training unit led by a senior Enforcement official. This training unit will coordinate further training for the staff and has created a training site on our intranet to allow staff to easily find training opportunities and materials from prior training events. These formal training initiatives are complemented by Enforcement staff's efforts to take advantage of substantive expertise within other Divisions and Offices. We believe, and the Inspector General has concurred, that these initiatives address the Inspector General's recommendations related to the staff's working knowledge of the laws governing broker-dealers and investment advisers.

Seventh Recommendation. The Inspector General recommended that we consider promulgating and/or clarifying procedures regarding coordination with the Office of International Affairs ("OIA") and RiskFin, as appropriate, at the early stages of investigations where relevant documents, individuals or entities are located abroad. As indicated above, the Division has adopted new guidance concerning written investigative plans that requires the staff to identify issues appropriate for coordination with other Divisions or Offices, such as OIA or RiskFin. In addition, Enforcement has established a formal quarterly case review process to assist the staff in identifying whether and when to consult with experts in OIA and RiskFin.

Also, both OIA and RiskFin have designated Enforcement liaisons to serve as a point of contact for staff with questions requiring investigative assistance. Enforcement staff regularly consults with and seeks assistance from OIA to obtain documents and information from foreign regulators, to locate and freeze assets abroad, and to assist with other international enforcement issues. Moreover, OIA and RiskFin provide training to Enforcement staff concerning their available resources.

Office of Compliance Inspections and Examinations

Stanford IG Report

While the Stanford IG Report did not include recommendations directed to OCIE, its findings show a clear need for improved coordination between Enforcement and OCIE on investigations of potential violations of the federal securities laws, particularly those investigations initiated by a referral from OCIE to the Enforcement Division. OCIE has undertaken specific policy changes in its National Examination Program and instituted procedures to improve coordination and communication between the Enforcement Division and OCIE.

Through a number of structural and process reforms, OCIE and the Enforcement Division are working to identify misconduct earlier and to move to shut it down more rapidly. OCIE and Enforcement staff and leadership have been directed to evaluate potential referrals from the OCIE Exam staff against Enforcement's criteria (referenced above) regularly and determine the disposition of referrals. If there is disagreement on a case at the regional level, Exam staff has been instructed to escalate the matter to the attention of senior leadership in Washington. These processes ensure that concerns can be escalated in a timely manner to senior leadership of both the Exam and Enforcement programs for appropriate review and resolution.

Exam and Enforcement coordination with respect to particular matters is also the subject of periodic reviews. OCIE policy now requires that OCIE Exam staff in each office hold quarterly Exam Reviews, in which the progress and status of <u>every</u> exam in the office is discussed and evaluated for several factors, including evaluating any significant issues with the firm that is the subject of the exam, determining whether more staff resources are needed on the exam and deciding if the exam is a potential referral to the Enforcement Division. These reviews are an opportunity to summarize and preview findings that appear likely to trigger possible Enforcement referrals, as well as to flag any potential differences in the assessment of urgency, potential harm to investors, or other issues that can then be raised at the joint regional meetings or to OCIE senior management.

Finally, OCIE Exam staff is working closely with Enforcement's specialized units to identify key risks presented by entities registered with the SEC and key risks to the markets. As previously described, this partnership with the specialized units has already resulted in new approaches to joint efforts to identify risky firms that may warrant examination or an Enforcement investigation. In addition, OCIE recently announced the creation of several Specialized Working Groups that will focus on areas where OCIE plans to increase its specialization and market knowledge.

<u>Recent SEC Actions Demonstrate Enhanced Enforcement-OCIE Coordination</u>

During fiscal years 2010 and 2011, nearly 200 Enforcement investigations have been opened as a result of OCIE examination referrals. Highlighted below are some of the more significant SEC cases brought during this period based on referrals to Enforcement

from the National Exam Program or involving substantial assistance from OCIE examiners. These cases involved allegations of a wide range of illegal activities ranging from Ponzi schemes, churning, and misappropriation of funds and involved, in total, hundreds of millions of dollars. The investors injured by these cases range from wealthy individuals to pension funds, from hospitals and school endowments to investors of modest means such as municipal bus drivers.

A few of these recent cases include:

> ***SEC v. Mitchell, Porter & Williams, Inc***.: SEC action based on work of OCIE's exam staff alleging a Ponzi scheme that raised nearly $15 million from 82 investors, many of whom were retired municipal bus operators.
>
> ***SEC v. Marlon Quan, et al***.: SEC action against Marlon M. Quan charging him with facilitating a Ponzi scheme and funneling several hundred million dollars of investor money into the scheme. The SEC alleges that Quan and his firms invested hedge fund assets in the scheme, run by Thomas Petters, while pocketing more than $90 million in fees. According to the SEC's complaint, Quan falsely assured investors that their money would be safeguarded by "lock box accounts" to protect them against defaults. When Petters was unable to make payments on investments held by the funds that Quan managed, Quan and his firms allegedly concealed Petters's defaults from investors by concocting sham round trip transactions with Petters. In addition, the SEC successfully obtained an emergency injunction halting an attempt by Quan to divert to himself and others settlement funds intended for U.S. victims of the scheme. OCIE's National Exam Program staff assisted Enforcement in the investigation leading to this action.
>
> ***SEC v. Francisco Illarramendi et al.***: SEC action charging Illarramendi with engaging in a multi-year Ponzi scheme involving hundreds of millions of dollars. According to the Commission's amended complaint, Illarramendi allegedly misappropriated assets and used two hedge funds for Ponzi-like activities in which they used new investor money to pay off earlier investors. The alleged fraud was first unveiled by Commission examiners during a risk-based exam of an SEC-registered adviser with which Illarramendi was affiliated. Despite efforts by Illarramendi to allegedly obstruct the examination and mislead the staff – conduct that led to a criminal charge of obstruction of justice by the United States Attorney for the District of Connecticut – OCIE staff and their colleagues in the Enforcement Division obtained evidence of the alleged fraud.
>
> ***SEC v. AXA Rosenberg***: SEC action charging three AXA Rosenberg entities ("AR") with securities fraud for concealing a significant error in the computer code of the quantitative investment model that they use to manage client assets. The error caused $217 million in investor losses. AR agreed to settle the SEC's charges by paying $217 million to harmed clients plus a $25 million penalty, and hiring an independent consultant with expertise in quantitative investment techniques who will review disclosures and enhance the role of compliance

personnel. AR disclosed the error to OCIE staff in late March 2010 after being informed of an impending SEC examination.

SEC v. Tamman: SEC action against a lawyer for allegedly altering documents provided to the Commission to conceal allegedly fraudulent conduct by his client, NewPoint Financial Services, Inc. Separately, the SEC brought an enforcement action against NewPoint for the allegedly fraudulent offer and sale of over $20 million of debentures to over 100 investors. The case arose from an unannounced OCIE cause exam of NewPoint.

SEC v. Warren Nadel: SEC action charging a money manager with a fraudulent investment program inducing clients to invest tens of millions of dollars in order to generate more than $8 million in illicit commissions and fees. This case arose out of OCIE's risk-based exam program focused on advisers with unusual returns.

OCIE-Enforcement Referral IG Audit Report

On March 30, 2011, the Inspector General issued *OCIE Regional Offices' Referrals to Enforcement*, Report No. 493 ("Referral IG Report"). This audit report suggests that our efforts at improved coordination are meeting with success. The report notes that a survey of all OCIE examiners throughout the SEC's regional offices concerning their view of Enforcement responses to examination-related referrals found that "when combining the responses for 'completely satisfied' and 'somewhat satisfied' for respondents, the majority of SEC regional offices had a combined level of satisfaction ranging from 70 to 87 per cent."[5] The Report further found that where there was dissatisfaction with the referral process, the level of concern dramatically dropped over time, particularly in fiscal year 2010, with some respondents identifying Enforcement's newly created Asset Management Unit as having significantly assisted with the acceptance rate of OCIE referrals.[6] The Report also found that the large majority of examiners "do not believe that Enforcement will only take referrals that involve high dollar value amounts and can easily be brought against the violator."[7] In addition, many of the survey participants who did believe that Enforcement was particularly concerned with dollar thresholds or "stats" noted that this approach was more evident in the past, "prior to Madoff."[8]

While identifying improvements, the OIG audit also noted certain aspects of the referral process that would benefit from improvement and made certain recommendations to improve those processes. Both OCIE and Enforcement concurred with all these recommendations, and will be working diligently to implement them in the coming months.

[5] Referral IG Report at v.
[6] *See id.*
[7] *Id.*
[8] *Id.*

Additional Significant Enforcement and OCIE Reforms

In addition to the reforms prompted by the Stanford IG Report and the recent Referral IG Report, we are engaged in a number of significant initiatives designed to enhance our performance.

Division of Enforcement

The Division is embracing a range of initiatives designed to increase our ability to identify hidden or emerging threats to the markets and act quickly to halt misconduct and minimize investor harm. As described earlier, across the Division, including through the work of new national specialized units, we are launching risk-based investigative initiatives, tapping into the expertise of our colleagues in OCIE and other SEC offices and divisions, hiring talent with particularized market expertise, and reaching out to academia, law enforcement, and the regulated community to collect data on fraud hotspots.

In addition, the completion of other organizational reforms – such as streamlining our management structure and obtaining delegated authority from the Commission to allow us to swiftly obtain formal orders and related subpoena power – has enabled our staff of attorneys and accountants to focus on investigating and stopping securities fraud. Across all our offices, our staff has responded to challenging times by concentrating on making smart investigative decisions, obtaining key evidence, tracing investor funds and aggressively pursuing wrongdoers.

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

Office of Compliance Inspections and Examinations

In addition to specific Exam/Enforcement coordination reforms, OCIE has instituted several recent changes to its examination program and has plans for additional strategic initiatives, all to increase the effectiveness and efficiency of the National Exam Program.

In March 2010, OCIE launched an intensive nationwide self-assessment program. We reviewed the OCIE Examination Program by looking at the five components of Strategy, Structure, People, Process and Technology. Since then we have moved quickly to implement reforms from the self-assessment. For example, our project teams are well along in implementing reforms in the following areas:

- enhancing our ability to identify high-risk firms;

- improving means of collaboration both within the SEC and with other federal and state regulators;
- strengthening the quality of information filed by regulated entities;
- expanding risk-based scoping prior to commencing examinations;
- developing a complete inventory of third-party databases and methods for gathering intelligence on potential examination issues; and
- strengthening management training and tools.

OCIE has focused its strategy to identify the areas of highest risk and deploy our examiners against these risks in order to improve compliance, prevent fraud, monitor risk and inform policy-making. We have implemented a new central Risk Analysis and Surveillance Unit to enhance our ability to target those firms and practices that present the greatest risks to investors, markets and capital formation. Once we select firms for examination, OCIE Exam staff are more rigorously reviewing information about these individual firms before sending examiners out to the field, so that we can use our limited resources more effectively and target key risk areas at those firms. We have reinforced our strategy by developing a specific set of Key Performance Indicators which we have shared with Enforcement.

We have introduced new mechanisms to drive consistency and effectiveness across our National Exam Program. Examples include a National Exam Manual that sets forth updated policies and procedures governing examinations nationwide and a standardized National Exam Workbook to strengthen nationwide consistency in the exam process. We also have redesigned our exam team structure to redeploy the expertise and experience of managers from office administration to on-site exams in the field. These changes will help ensure that managers spend additional time and attention on supervision and oversight in the field.

OCIE also has implemented a new governance structure, which is transforming our lines of communication and accountability. As mentioned above, the OCIE National Leadership Team now includes Directors of the Regional Offices, who manage both the Enforcement and Examinations programs in each Regional Office. This strengthens the OCIE/Enforcement partnership and speeds alerts, information sharing, and transitions from OCIE Exam staff to the Enforcement Division when warranted. OCIE governance also forges interrelated bonds of policy making, information sharing, and communication among staff in our Washington Home Office and our mission-critical examination teams in the 11 Regional Offices.

In addition, OCIE has outlined a new "open architecture" structure for staffing exams that will enable management to reach across disciplines and specialties to better match the skills of examination teams to the business models and risk areas of registrants. The New York Regional Office, for example, has adopted a protocol that integrates examination teams to make sure people with the right skill sets are assigned to examinations. Under the protocol, a single team of examiners, drawn from the broker-dealer and investment management units, jointly examines selected dually-registered firms to ensure that the

examination team includes those personnel relevant to the subject of the exam. In addition, the examination program has expanded opportunities for examiners to cross-train and increase coordination between broker-dealer and investment management staff on their examination plans. Finally, the examination program has begun to include a broader range of experts from other SEC divisions and offices in exams to ensure we are leveraging SEC expertise and knowledge across the exam process. For instance, we recently involved RiskFin colleagues with algorithmic model experience in exams of high frequency trading firms.

Our self-assessment concluded that we needed not only to streamline our processes and policies, but also to create an environment for our staff of open, candid communication and personal accountability for quality, in order to build on OCIE's core strengths and eliminate systemic weaknesses that could contribute to situations like the Stanford case. Accordingly, OCIE has accelerated enrollment of OCIE managers in the SEC's Successful Leaders Program and volunteered as the pilot site for many of the SEC's Office of Human Resources' new initiatives on professional development.

OCIE is placing continuous, focused attention on technology, another area that our self-assessment identified as essential to a healthy examination program. We have developed a standardized examination tool across the national exam program and are working to move the tool to a web-based platform, with a phased rollout beginning in August 2011. We are also upgrading equipment and connectivity for examiners, important capabilities that have lagged behind examiners and auditors at other regulatory agencies and in the private sector.

We also have instituted measures to improve the ability of examiners to detect fraud involving theft of assets and other types of violations. OCIE Exam staff across the country now routinely reaches out to third parties such as custodians, counterparties and customers during examinations to verify the existence and integrity of all or part of the client assets managed by the firm. The measures also include expanded use of exams of an entire entity when firms have joint or dual registrants such as affiliated broker-dealers and investment advisers.

Finally, OCIE has begun to recruit experts to expand its knowledge base and improve its ability to assess risk, and to detect and investigate wrongdoing. We have hired new Senior Specialized Examiners – and plan to bring on board more – who have specialized experience in areas such as risk management, trading, operations, portfolio management, options, valuation, new instruments and forensic accounting. We have also launched new specialty groups that will bring deep technical experience to our exam program in areas such as derivatives and structured products, hedge funds, credit rating agencies, high frequency trading and risk management. These new skill sets will complement our existing talented and dedicated staff.

Conclusion

The scope and egregiousness of Stanford's conduct and the resulting injury to investors underscores that it is essential for us to push forward with our efforts to hold the wrongdoers accountable and to work with the Receiver so that the Receivership is able to recover, as much as possible, the money that investors lost in this egregious fraud. The Stanford IG Report identified numerous areas for reform, and we have moved aggressively to implement these reforms. More remains to be done, but as demonstrated by the largely positive results of the recent Referral IG Report, we have made great strides to put in place the people and structures to prevent another occurrence of Stanford-type problems.

Finally, we note that both the SEC and the Department of Justice continue to have open investigations and ongoing litigation regarding the Stanford matter. Our efforts to bring potential wrongdoers to justice in this case are still very much ongoing, and the defendants vigorously contest our allegations. In responding to your questions today, we will be as forthcoming and candid as possible, but will identify when we are concerned that disclosure of information through an answer could compromise the Commission's ability to bring the wrongdoers to justice or to recover investor funds.

We thank you for the opportunity to appear before you today.