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COMMISSIONER

UNITED STATES SECURITIES AND EXCHANGE COMMISSION

Before the

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Committee on Financial Services

Concerning Securities Law Enforcement in the Current Financial Crisis

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Good morning Chairman Frank, Ranking Member Bachus, and members of the Committee. I am Elisse Walter, one of the five Commissioners of the Securities and Exchange Commission, and I am testifying here today on behalf of the Commission as a whole. I appreciate the opportunity to discuss the United States Securities and Exchange Commission's enforcement program, and more specifically, the Commission's vigorous efforts to address violations of the federal securities laws arising out of the current financial crisis. The SEC is fully committed to pursuing wrongdoers and returning as much money as possible to injured investors.

The Commission's enforcement program is in a critical transition period. Our new Chairman, Mary Schapiro, joined the agency in January and has been taking a series of steps to bolster our enforcement efforts and restore investor confidence to our markets. She has hired a new Director of Enforcement, Robert Khuzami, an accomplished former federal prosecutor, who is scheduled to join the agency at the end of this month; began streamlining our enforcement process; and launched an initiative to improve the way we handle the hundreds of thousands of complaints and tips we receive each year.

The SEC's Law Enforcement Authority and Processes

The SEC is a capital markets regulator and law enforcement agency. We are charged with civil enforcement of the federal securities laws, primarily the Securities Act of 1933, the Securities Exchange Act of 1934, the Investment Advisers Act of 1940, and the Investment Company Act of 1940. The SEC's Enforcement Division is authorized to investigate any potential violation of the federal securities laws. In this regard, the anti-fraud provisions of the Exchange Act enable the SEC to take action against any form of fraud in connection with the purchase or sale of securities, regardless of the identity of the perpetrators and regardless of whether they are required to be registered with the SEC. The anti-fraud provisions also apply in areas of the financial markets that are not otherwise regulated by the Commission, such as hedge funds and credit default swaps ("CDSs").

The Enforcement Division initiates investigations based on information from many sources, including referrals from the Commission's examination program and other SEC Divisions and Offices, referrals from other regulators, complaints from investors and others, and tips from the public. In fiscal year 2008, the Enforcement Division received more than 700,000 complaints, tips and referrals. The Enforcement Division has delegated authority to initiate investigations, but, when needed, the staff obtains subpoena power by obtaining Commission approval of a formal order of investigation. In conducting investigations, the staff can take advantage of the full range of the SEC's resources, particularly the examinations conducted by the Office of Compliance

Inspections and Examinations ("OCIE"). OCIE conducts on-site inspections and examinations of broker-dealer and investment adviser firms that are registered with the Commission, and may do so on a periodic or random basis or "for cause". Enforcement Division staff may also consult with the SEC's Divisions of Corporation Finance, Trading & Markets, and Investment Management, as well as with the Offices of Economic Analysis, the Chief Accountant and the General Counsel, about matters within their respective areas of expertise.

The SEC's Enforcement Division has approximately 1100 attorneys, accountants and other staff located in the home office in Washington D.C. and in 11 Regional Offices nationwide who are committed to securities law enforcement and investor protection throughout the United States. In addition, the staff at each of the SEC's offices maintains close working relationships with their colleagues at the securities exchanges and other self-regulatory organizations ("SROs") and in the local, state and federal law enforcement communities.

If after an investigation, staff believes there has been a violation of the federal securities laws, the staff may recommend that the Commission take specific enforcement action against the alleged wrongdoer(s). On Commission approval of the recommendation, the Enforcement Division commences a civil enforcement action against the responsible parties—either by filing an injunctive action in federal court or through administrative proceedings. In most cases, the parties charged agree to settle the action on specific terms before the action is filed. If the Commission approves the settlement, the SEC's enforcement action will be filed and settled at the same time. If the

parties do not reach a settlement, the Enforcement Division files the action and litigates the matter to its conclusion.

In fiscal year 2008, the SEC filed a total of 671 enforcement actions, including 157 issuer reporting and disclosure cases (e.g., financial fraud); 121 securities offerings cases; 52 market manipulation cases and 61 insider trading cases. The total of 671 cases filed last year was the second-highest annual number of cases ever filed by the Enforcement Division in the agency's history.

The remedies available to the SEC in civil enforcement actions are disgorgement of ill-gotten gains,[1] permanent injunctive relief against violations of the federal securities laws, remedial undertakings, civil penalties, revocation of registration, and bars—which may preclude a wrongdoer from serving as an officer or director of a public company or from associating with any broker-dealer or investment adviser—either permanently or for a limited time period. In addition, professionals such as accountants and attorneys may be barred or suspended from appearing or practicing (broadly interpreted) before the Commission. This bar constitutes a substantial limitation on the conduct of any securities-related professional practice—as in practical effect it renders a professional unable to sign documents filed with the Commission and also carries a serious reputational stigma.

The SEC's enforcement actions last year resulted in orders requiring securities violators to disgorge illegal profits of approximately $774 million and to pay penalties of approximately $256 million. The Enforcement Division sought orders barring 132

[1] Disgorgement of a wrongdoer's ill-gotten gain may not be the same amount as the investor's damages, which may be greater. Because of this distinction and because assets are often dissipated in a fraudulent scheme, an SEC enforcement action usually cannot make investors whole for all of their losses. Nonetheless, the Commission seeks to maximize the amount of monies returned to investors in every case.

defendants and respondents from serving as officers or directors of public companies. In addition, the SEC halted trading in securities of 189 issuers about which there was inadequate public disclosure.

In order to halt an ongoing fraud or to prevent dissipation of investor funds, the SEC may seek emergency relief in federal district court, including temporary restraining orders, preliminary injunctions, asset freezes, and the appointment of a receiver to conduct operations during the pendency of the litigation, or to marshal and liquidate any remaining assets in order to make an equitable distribution of the proceeds among injured investors. Last year, the Enforcement Division sought temporary restraining orders to halt ongoing fraudulent conduct in 39 cases. During fiscal year 2009 to date, the SEC has obtained 20 temporary restraining orders to halt ongoing frauds.

Whenever possible, the Commission seeks to return monies to harmed investors under the Fair Funds provisions of the Sarbanes-Oxley Act of 2002.[2] In enforcement actions prior to Sarbanes-Oxley, only funds paid as disgorgement could be returned to investors. In order to make up for any short-fall in the amount going to harmed investors, Sarbanes-Oxley enabled the Commission to distribute to investors the amount obtained in civil penalties where there has been a related disgorgement of ill-gotten gains. In 2007, the SEC created a dedicated Office of Collections and Distributions in the Enforcement Division to facilitate the distribution of Commission recoveries, including Fair Funds, to injured investors. The Office is responsible for the Division's collections and distributions programs and also litigates to collect disgorgement and penalties imposed in Enforcement actions.

[2] *See* Sarbanes-Oxley Act of 2002, Section 308, codified at 15 U.S.C. §7246 (2009).

Since 2002, the Commission has authorized approximately 220 Fair Funds and disgorgement funds, with an estimated total value of more than $9.3 billion. In fiscal year 2008, the Commission distributed over $1 billion to injured investors, bringing total distributions since the passage of Sarbanes-Oxley to an estimated $4.6 billion. The Commission expects significant additional distributions this year from cases including: *AIG* ($800 million),[3] *Invesco*/AIM ($375 million),[4] and *Alliance* ($321 million).[5] In the current financial crisis, the benefits to investors from the authority Congress bestowed on the SEC in Sarbanes-Oxley are more valuable than ever.

Frequently, SEC enforcement actions are pursued and brought in cooperation with other law enforcement authorities. To illustrate, in conjunction with the filing of an indictment by the Attorney General of the State of New York, yesterday the Commission filed securities fraud charges against a former high level public official and a well connected political advisor.[6] These individuals allegedly used their positions and connections to extract kickbacks from firms that were seeking to do business with nation's third largest pension fund, the New York State Common Retirement Fund. The Commission's complaint alleges that the individuals schemed to enrich themselves and their friends at the expense of the Retirement Fund and thereby undermined the integrity of the state's investment decisions. They allegedly extracted millions of dollars of kickbacks from investment management firms seeking to be hired to invest and manage the Retirement Fund's assets.

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[3] *SEC v. American International Group, Inc.* Lit. Rel. No. 19560 (Feb. 9, 2006);.
[4] *SEC v. Invesco Funds Group Inc., et al.*, Exch. Act Rel. No. 50506 (Oct. 8, 2004).
[5] *SEC Announces Start of $321Million Fair Fund Distribution to Investors Harmed by Alliance Capital Market Timing*, Press Rel. No. 2009-21 (Feb. 6, 2009).
[6] These defendants are David Loglisci, New York State's former Deputy Comptroller, and Hank Morris, the top political advisor to former New York State Comptroller Alan Hevesi.

The SEC also has oversight responsibilities with respect to the enforcement and compliance programs of SROs, which are essential partners in the SEC's enforcement efforts. They conduct surveillance with respect to trading activities, make enforcement referrals to the SEC with respect to possible insider trading and other misconduct, and conduct their own examination and enforcement programs with respect to their member firms.

The SROs have a wide array of remedies to address misconduct by member firms and ensure investor protection. Disciplinary action against SRO member firms and individuals associated with SRO member firms may include suspension for a designated period of time, which may be either general suspension from any securities business or specific suspension from a particular aspect of the business (*e.g.,* underwriting suspension against a member firm or supervisory suspension against an associated person); revocation of registration; bars from future association with any SRO member firm, which may be absolute or limited to certain activities (*e.g.,* supervisory or compliance bars against associated persons); expulsion of member firms; and monetary fines that may be imposed against either individuals or member firms. In addition, FINRA handles customer complaints involving broker-dealers. In calendar year 2008, FINRA received 5,405 complaints from investors, filed 1,073 new disciplinary actions, and resolved 1,007 actions, in which 19 firms were expelled, 363 individuals were barred, and a further 321 individuals were suspended.

The Current Financial Crisis

From a regulatory and enforcement perspective, the current financial crisis is exceedingly complex and unprecedented in scope and impact. Our markets now attract a much larger and more complicated group of participants than ever before; feature a myriad of new products that have never before been subjected to such extreme market forces; and have become closely interrelated in complex ways.

In the current crisis, major U.S. financial institutions have played widely diverse and often simultaneous roles, including acting as investment banks, securities underwriters, lenders, prime brokers to hedge funds, investment advisers, executing broker-dealers and even as investors for their own accounts. Other market participants in the current crisis include mortgage lenders, securitizers, credit rating agencies, home builders, mutual funds and hedge funds. The crisis also involves a broad array of financial instruments, including subprime mortgage-backed securities, other collateralized debt obligations ("CDOs" and "CDO^{2}s"), auction rate securities ("ARS"), CDSs and an increasingly complex range of other derivative instruments,[7] some of which

[7] CDOs are securities based on a pool of underlying debt instruments. Financial firms known as "securitizers" create new securities based on distinct pools of mortgages or other debt instruments. The securitizers evaluate all the underlying debt instruments in a pool and then divide them into sub-pools or "tranches" of instruments bearing similar characteristics with respect to the risk of default. The debt instruments are divided into risk layers, ranging from the top layer tranches, which contain instruments having the least risk of default, to the bottom layer tranches, which contain instruments having the greatest risk of default. Securitizers then sell securities representing the right to a proportionate interest in the debt payments stream represented by each tranche. Because the different tranches are designed to represent different levels of risk of default, the securities based on each tranche are typically assigned a separate credit rating by a credit rating agency and priced separately. The securities are said to be collateralized because the homes or other assets associated with the mortgages or other debt instruments, respectively, serve as collateral in the event of default. A CDO^2 is a CDO based on a pool of underlying CDOs. ARS are bonds or preferred stock that have interest rates or dividend yields periodically reset through a process similar to Dutch auctions, typically every 7, 28 or 35 days. CDSs are analogous to insurance arrangements with respect to the risk of default on a corporation's debt. In exchange for one party's payment of a specific sum of money to a counterparty (similar to an insurance premium), the counterparty guarantees payment of predetermined amount ("face value") of a corporation's debt in the event of default. The amount paid as a "premium" for default protection is directly correlated with the perceived risk of default

are not, or may not be, subject to securities regulation.[8] Regulators and law enforcement authorities must confront problems that may include, among other things, lack of transparency, accounting fraud and irregularities, and inaccurate or inadequate disclosures regarding such matters as risk, leverage, credit limitations and investment strategies.

The SEC is fully committed to addressing this crisis: to finding out what went wrong, punishing any wrongdoers and returning as much money as possible to injured investors. There is no doubt that, under Chairman Mary Schapiro's leadership, the agency is moving with the utmost urgency to respond in the most effective manner. As described in greater detail below, we are taking action in a number of areas relating to the crisis. Also, we are committed to an extraordinary level of coordination and cooperation with other securities regulators, including the nation's stock exchanges and other SROs, state securities regulators and our foreign regulatory counterparts, as well as criminal authorities at the state, federal and international levels.

Subprime Enforcement Actions and Ongoing Investigations

The Enforcement Division formed a Subprime Working Group in March 2007 to coordinate its investigative efforts relating to subprime lending and credit market issues nationwide, to solicit assistance from various Divisions and Offices within the Commission, and to serve as a point of contact with the many other federal and state regulators and criminal authorities actively working in this area, including the SROs, the

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by the corporation. In general, derivative securities are securities the value of which is derived from the value of some other underlying payment obligation or asset.

[8] While the SEC has limited direct authority to regulate much of the OTC derivatives market, which includes CDSs, it nonetheless retains antifraud authority over security-based swap agreements including authority over insider trading.

Departments of Justice and Treasury, the Federal Reserve, the TARP program and numerous other federal and state regulators. Approximately 100 enforcement staff members throughout the country participate in this Group.

The Enforcement Division has already filed nine cases involving subprime issues and has many additional subprime matters under active investigation--which may or may not result in further enforcement recommendations. The subjects of these investigations fall primarily into three broad categories: (i) subprime lenders; (ii) investment banks and other large financial institutions; and (iii) others, including securitizers who packaged and resold slices of subprime mortgage debt in the form of various types of derivative securities, credit rating agencies, home builders, and companies that provided mortgages to investors to enable them to finance securities purchases.[9]

With respect to subprime lenders, the SEC is investigating, among other things, improper accounting, disclosure issues, and insider trading. For example, with respect to accounting, the investigations involve improper accounting for loan loss reserves and impairment of asset values, as well as overvaluation of foreclosed property and other assets. The disclosure issues under investigation include false, misleading, inadequate or non-existent disclosures regarding loan quality and credit risks, amounts and types of subprime exposure, understatement of mortgage delinquency and default rates, false favorable predictions about payment of dividends or future financial performance in light of subprime exposure, false representations regarding lending practices and failure to disclose material negative regulatory actions. Several investigations regarding subprime

[9] Three of the nine subprime cases filed to date have been fully settled. Two of the actions have been partially settled with respect to one of defendants and the other defendants in those actions are litigating. In each of the remaining four subprime cases, all of the defendants are continuing to litigate against the SEC.

lenders also raise issues regarding possible insider trading, particularly before the announcement of negative news regarding the lender.

Investigations regarding investment banks and other large financial institutions raise another range of issues. Many of the investigations regarding major financial institutions such as investment banks involve massive write-downs of asset values and other losses related to subprime securities portfolios. The investigations typically involve questions concerning the timing and amount of write-downs and the nature and timing of related disclosures. The investigations also involve possibly false, misleading, inadequate or non-existent disclosures regarding subprime exposure or concentration, financial condition, future financial performance, valuation of assets, intended curtailment of business lines, misrepresentations regarding underlying mortgage quality in securitization prospectuses, failure to disclose material changes in performance of mortgage portfolios underlying certain securities, and failure to disclose negative regulatory actions. Other issues under investigation include possible intentional mispricing of securities and the knowing underwriting of securities based on collateral likely to default. Staff is also investigating the existence and implementation of internal control procedures regarding risk, internal control procedures specific to subprime securities, disclosure of known material weaknesses in such internal control procedures and the efficacy of transactions intended to reduce risk.

Investigations of other entities such as credit rating agencies, home builders and companies that provided retail mortgages to consumers to enable them to purchase securities vary considerably. In investigating retail brokers who assisted customers in obtaining subprime mortgages so they could invest in securities, staff might consider the

suitability of the securities for the customers and whether the broker received any undisclosed compensation in connection with either the mortgages or the securities transactions. Investigations of credit rating agencies might include whether it diverged from its rating methodologies for any particular issuers due to a conflict of interest. An investigation of a home builder might entail possible financial fraud, such as improper quarterly earnings management or improper recognition of revenue on model home sales and leasebacks, as well as possible improper related-party transactions.

Examples of subprime enforcement actions resulting from our investigations include the following:

- Allegation of Misrepresentations in Connection With 2007 Bear Stearns Subprime Hedge Funds Meltdown - In June 2008, the SEC charged two Wall Street portfolio managers with fraudulently misleading investors and institutional counterparties about the financial state of the firm's two largest hedge funds and the funds' exposure to subprime mortgage-backed securities prior to the funds' collapse.[10]

- Allegation of Broker Misrepresentations to Customers re Assets Backing Securities Purchased for Customer Accounts - In September 2008, the SEC charged two Wall Street brokers with making more than $1 billion in unauthorized purchases of subprime-related auction rate securities. The SEC alleges the brokers represented to customers that the securities purchased for their accounts were backed by guaranteed student loans, when in reality the securities were backed by subprime mortgages and other less creditworthy assets.[11]

- Allegation of Brokers Pushing Unsophisticated Investors Into Subprime Refinancings to Pay for Purchase of Unsuitable Securities - In October 2008, the

[10] *SEC v. Ralph R. Cioffi and Matthew M. Tannin*, Civil Action No. 08 2457 (E.D.N.Y. June 19, 2008) (presently in litigation; the defendants deny and dispute the allegations in the civil and criminal proceedings brought against them by the SEC and the U.S. Attorney's Office for the Eastern District of New York, respectively).

[11] *SEC v. Julian T. Tzolov and Eric S. Butler*, Case No. 08 Civ. 7699 (S.D.N.Y. Sept. 3, 2008) (In November 2008, U.S. District Court for the Southern District of New York stayed the Commission's civil action pending resolution of the parallel criminal matter, *U.S. v. Tzolov and Butler* (08 Cr. 370 (JBW)), which is being litigated by in the U.S. Attorney for the Eastern District of New York; Butler and Tzolov each deny and dispute the allegations in both the civil and criminal proceedings brought against them by the SEC and the U.S. Attorney's Office for the Eastern District of New York, respectively.)

SEC charged five Los Angeles-based brokers for putting their customers at risk by refinancing their homes with subprime mortgages they could not afford in order to fraudulently sell them unsuitable securities.[12]

Auction Rate Securities

Through the collective efforts of SEC Enforcement, state regulators and FINRA, over the past year tens of thousands of ARS investors have received, or will receive, over $67 billion of liquidity. In tandem with other regulators, the SEC's Enforcement Division has finalized settlements with three of the largest broker-dealer firms in the ARS market, UBS, Citigroup, and Wachovia,[13] and has entered into settlements-in-principle with three others, Merrill Lynch, Bank of America and RBC.[14] We expect that these settlements-in-principle will be finalized shortly. The ARS settlements involve the largest settlement sums in the history of the SEC.

ARS are bonds or preferred stock that have interest rates or dividend yields periodically reset through an auction process, typically every 7, 28, or 35 days. ARS were first developed in 1984 and, as of 2008, it was estimated that the market had grown to $330 billion.[15] The ARS market is primarily comprised of three types of securities: (1) municipal ARS, bonds issued by cities, counties, and public entities and generally backed

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[12] *SEC v. Kederio Ainsworth, Guillermo Haro, Jesus Gutierrez, Gabriel Pareded, and Angel Romo*, Case No. EDVC 08-1350 VAP (C.D. Cal. October 3, 2008) (presently in litigation; the defendants deny and dispute the allegations of the SEC's complaint).

[13] *SEC v. Citigroup Global Markets, Inc.*, Lit. Rel. No. 20824 (Dec. 11, 2008) (Citigroup and UBS settlements); *SEC v. Wachovia Securities LLC*, Lit. Rel. No. 20885 (Feb. 5, 2009).

[14] *SEC Enforcement Division Announces Preliminary Settlement With Merrill Lynch to Help Auction Rate Securities Investors*, Press Rel. No. 2008-181 (Aug. 22, 2008); *Bank of America Agrees In Principle To ARS Settlement*, Press Rel. No. 2008-247 (Oct. 8, 2008); *SEC Division of Enforcement Announces ARS Settlement In Principle With RBC Capital Markets Corp.*, Press Rel. No. 2008-246 (Oct. 8, 2008).

[15] Last year's trouble in the ARS market also affected the markets for tender option bonds ("TOBs"). TOBs are derivative variable-rate securities based on an underlying pool of insured, fixed-rate municipal securities.

by insurance; (2) student loan ARS, asset-backed securities with ratings based upon the credit quality of an underlying pool of student loans; and (3) auction preferred stock, perpetual preferred stock of closed-end funds. Until mid-February 2008, auction failures were extremely rare, and the market was highly liquid. In February 2008, the auction rate securities market froze, and many auctions have failed. While the underlying bonds on which the ARS were based continued to perform and pay periodic dividends or interest to ARS holders, the derivative ARS instruments themselves became illiquid and could not be sold. After the market froze, many of the municipal ARS and some auction preferred stock were refinanced, repaid or converted to different interest rate modes.

The SEC's investigations revealed that some ARS investors had been misled by securities professionals about the risks in the ARS market and were wrongly led to believe that ARS were as liquid as cash or money market funds. When the ARS market froze, these investors had no access to funds needed for pressing short-term obligations, such as a down-payment on a home, college tuition, or small business payrolls. To address these issues, the Commission's staff formulated a framework for settlement to restore and maximize liquidity in the ARS markets as soon as possible.

In the settlements, many of the aggrieved ARS investors, including retail customers, small businesses, and charitable organizations, will have the opportunity to receive 100 cents on the dollar on their investments within short time frames. (Many of these investors have already accepted these offers and received the full par value of their investments.) UBS and Wachovia have also agreed to provide liquidity to their large institutional customers over a slightly longer period of time. In connection with the ARS settlements, FINRA has established a special ARS arbitration procedure for customers

who suffered consequential damages resulting from the illiquidity of their ARS positions. In these streamlined arbitrations, the firms that sold ARS cannot contest liability, and arbitrators determine the specific amount of damages to be awarded to the customer.

The Enforcement Division is investigating other firms and individuals. FINRA and state regulators have entered into separate settlements with other firms. All of these efforts have significantly reduced the total amount of frozen ARS and has led to a increase in liquidity in the ARS market.

21(a) Rumor and Manipulation Investigation

The SEC filed its first case alleging the circulation of false rumors in combination with a scheme to profit by short-selling in April 2008. In *SEC v. Berliner*, the Commission charged that a Wall Street trader, Paul S. Berliner, intentionally spread false rumors about the Blackstone Group's pending acquisition of Alliance Data Systems ("ADS"), in 2007 while selling ADS short.[16] Through instant messages sent to numerous Wall Street professionals at brokerage firms and hedge funds, Berliner allegedly circulated false rumors that the deal between ADS and Blackstone was being renegotiated at a substantially lower purchase price because of credit difficulties in ADS's consumer banking unit, and that ADS's board was meeting to consider the revised proposal even as the messages were sent.

Berliner allegedly circulated these rumors to artificially depress the price of ADS' stock, in order to profit from short selling. The rumors initially had the intended effect. They were picked up by the media and resulted in heavy trading in ADS's stock. Within half an hour after Berliner's first instant message, ADS's share price plummeted 17%.

[16] *SEC v. Paul S. Berliner*, Lit. Rel. No. 20537 (April 24, 2008).

During the stock's precipitous decline, Berliner profited from short selling in ADS. In response to the unusual trading activity, the New York Stock Exchange ("NYSE") temporarily halted trading in ADS stock, which allowed time for ADS to issue a press release announcing the rumor was false. ADS's stock price recovered the same day. The SEC charged Berliner with securities fraud and market manipulation based on his circulation of false rumors in combination with short selling, and he settled with the SEC by consenting to a permanent anti-fraud injunction and disgorgement of his ill-gotten gains from short selling.

Among other rumors investigations, SEC also opened a group of related investigations into the possible manipulation of the securities of six large financial issuers involved in the recent market turbulence (collectively, the "21(a) investigation"). On September 19, 2008, the Commission approved a relatively uncommon order under Section 21(a) of the Exchange Act that required numerous hedge funds, broker-dealers and institutional investors to file statements under oath regarding trading and market activity in the securities of financial firms. The order covers not only equities but also CDSs and other derivative instruments.

In October 2008, the Enforcement Division formed a nationwide Rumors and Market Manipulation Working Group to analyze data obtained through the 21(a) Order, with particular focus on claims that CDSs were being used to manipulate equities prices. The SEC's 21(a) investigation has been split into six separate investigations, which are proceeding as expeditiously as possible. The SEC's Rumors and Market Manipulation Working Group is also coordinating its investigation with parallel investigations being conducted by FINRA and the NYSE regarding the conduct of their member firms and

marketplaces, as well as with another parallel investigation being conducted jointly by the New York Attorney General's Office and the U.S. Attorney's Office for the Southern District of New York.

Hedge Funds and Institutional Insider Trading

The SEC is focusing on several issues involving hedge funds and other institutional traders, including (i) possible manipulation, abusive short selling and collusion; (ii) valuation concerns with respect to illiquid assets; and (iii) potential insider trading in a host of circumstances, including prior to mergers and acquisitions and in the credit derivatives market. The Enforcement Division has formed a Hedge Fund Working Group to address these and other issues arising in investigations relating to hedge funds. The Hedge Fund Working Group works closely with examiners from OCIE, and also coordinates with outside agencies and foreign regulators. The SEC has dozens of active investigations involving individuals associated with hedge funds. During the current crisis, the SEC has become particularly concerned about possible hedge fund offering frauds, where fraudsters use the non-transparent and largely unregulated status of hedge funds to conceal large Ponzi schemes. The SEC is also concerned with possible misconduct by "funds of funds" and "feeder funds," which invested their own investors' funds with other hedge fund managers, but may have failed to exercise the due diligence and compliance oversight touted to investors regarding such investments.

The huge number of liquidations and suspensions of redemptions by hedge funds in the past year have created particular concern as to whether hedge fund advisers may be favoring their own interests above others and whether principals, employees or favored

investors of the hedge fund adviser may have received "preferential redemptions" from the fund at issue. In addition, to better detect any insider trading before material corporate events, the Hedge Fund Working Group is developing technological tools that will enable staff to more readily capture patterns of unlawful trading by hedge funds and institutional traders.

The Commission has brought a broad range of enforcement actions involving hedge funds and institutional traders. While hedge funds are not required to register with the SEC, the SEC retains limited authority over hedge funds under the anti-fraud provisions of the federal securities laws. Despite the relative lack of regulation in this area, the Commission has brought over 100 cases involving hedge funds in the last five years—primarily under its anti-fraud authority. On February 25, 2009, for example, the SEC filed three separate fraud cases involving unregistered hedge funds based in New York.

In the *Westgate* case, the Commission charged that James M. Nicholson and his company, Westgate Capital Management, an investment management firm based in Pearl River, N.Y., defrauded investors of millions of dollars by significantly overstating investment returns and misrepresenting the value of assets under management in 11 unregistered hedge funds.[17] The SEC's complaint alleges that Nicholson and Westgate solicited new investors with sales materials that claimed a nearly impossible record of investment success, including one Westgate fund that claimed positive returns in 98 of 99 consecutive months. Nicholson also allegedly created a fictitious accounting firm and provided some of his investors with bogus audited financial statements. By late 2008, the funds had sustained such losses that Nicholson and Westgate could no longer honor

[17] *SEC v. James M. Nicholson*, Lit. Rel. No. 20911 (Feb. 25, 2009).

redemption requests. They allegedly hid the losses from investors with misrepresentations, false sales brochures and other deceptive devices. Nicholson closed one fund that was heavily invested in bankrupt Lehman Brothers and folded its assets into another Westgate fund. He allegedly issued bad checks to some investors seeking to cash out, and ultimately suspended all investor redemptions due to what he called investors' "irrational behavior." Nicholson was already barred from the brokerage industry in 2001 for failing to reply or supplying false information in response to inquiries from NASD (now FINRA).[18]

In the *Greenwood* case, the SEC charged two New York residents and three affiliated entities with securities fraud involving the misappropriation of as much as $554 million in investor assets from an unregistered hedge fund.[19] The SEC's complaint alleges that Paul Greenwood and Stephen Walsh promised investors that their money would be invested in a stock index arbitrage strategy. Instead, Greenwood and Walsh allegedly used the investor funds to purchase multi-million dollar homes, a horse farm and horses, luxury cars, and rare collectibles such as Steiff teddy bears. The SEC obtained an emergency court order freezing the assets of Greenwood and Walsh as well as their companies: WG Trading Investors, L.P. ("WGTI"), an unregistered investment vehicle; WG Trading Company, a registered broker-dealer located in Greenwich, Conn.; and Westridge Capital Management, Inc. ("Westridge"), a registered investment adviser located in Santa Barbara, Calif. The SEC alleges that since at least 1996, Greenwood and Walsh solicited a number of institutional investors, including educational institutions and public pension and retirement plans, by promising to invest their money in an "enhanced

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[18] *Id.*

[19] *SEC v. WG Trading Investors, L.P., et al,* Lit. Rel. No. 20912 (Feb. 25, 2009).

equity index" strategy that involves purchasing and selling equity index futures and engaging in equity index arbitrage trading. The Commission alleges, however, that Greenwood and Walsh misappropriated as much as $554 million of the $667 million that Westridge clients invested in WGTI to support their lavish lifestyles.[20]

The last of the three cases, *North Hills Management,* halted an allegedly fraudulent "fund of funds" investment scheme by Mark Bloom and his firm, North Hills Management, LLC, based in Manhattan.[21] According to the SEC's complaint, Bloom, through North Hills, raised approximately $30 million from 40 to 50 investors between 2001 and 2007 by representing that the assets would be invested in a diverse group of hedge funds. Instead, the complaint alleges that Bloom misappropriated more than $13.2 million of investor funds to furnish a lavish lifestyle that included the purchase of luxury homes, cars and boats. The remaining funds allegedly were invested in a single fund ("the Fund"), which itself turned out to be fraudulent.

Bloom and North Hills allegedly sent investors false monthly account statements that portrayed their investments as profitable when, according to the complaint, Bloom was systematically looting the Fund's trading account by making "loans" to himself. Bloom also alledgedly invested in contravention of the Fund's stated investment strategy in an investment known as the Philadelphia Alternative Asset Fund ("PAAF"), in exchange for undisclosed commissions he received from PAAF. PAAF itself was uncovered as a fraudulent scheme in June 2005. In November 2007, one of the Fund's largest investors, a charitable trust (the "Trust") that funds children's schools began to serve Bloom with redemption requests, which Bloom allegedly repeatedly evaded.

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[20] *Id.*

[21] *SEC v. North Hills Management LLC, et al.,* Lit. Rel. No. 20913 (Feb. 25, 2009).

Bloom allegedly failed to honor the Trust's redemption requests in full and claims that he does not have the means to do so. The Trust alone is owed more than $9.5 million on its investment and other investors are owed more than $20 million.[22]

In each of the three cases, the SEC sought and obtained asset freezes and other emergency relief to halt the alleged frauds. In the ongoing actions, the SEC also seeks permanent anti-fraud injunctions, disgorgement and civil penalties. In each instance, the SEC is coordinating its case with parallel criminal proceedings filed by the U.S. Attorneys' Office for the Southern District of New York. *Greenwood* and *North Hills Management* also involve related charges by the Commodity Futures Trading Commission ("CFTC"), as well as cooperation among the SEC, the CFTC and the National Futures Association. *Westgate* was filed with the cooperation of the Rockland County District Attorney's Office. These three cases illustrate the SEC's coordination with other law enforcement agencies, and *Westgate* also illustrates the cooperation between the SEC's regional offices, as it involves investigation of entities from coast to coast in New York and California.

The Commission has also pursued numerous cases involving "information leakage" within the financial markets, particularly with respect to large financial institutions that may possess material non-public information about numerous clients, including hedge funds and other institutional traders. These include cases in which the SEC has charged large broker-dealers with having inadequate information barriers or other internal controls that prevent misuse of confidential non-public information--such as allowing the firm's proprietary traders to have access to confidential information about

[22] *Id.*

upcoming research reports or about clients' upcoming mergers and acquisitions[23]--as well as cases involving alleged misuse of such information about clients' trading activities.[24]

For example, last week the Commission filed its most recent "squawkbox" case against a major broker-dealer for having inadequate policies and procedures to control access to institutional order flow, which allegedly resulted in misuse of that information by day traders who traded ahead of the firm's customers' orders.[25] According to the SEC's order instituting proceedings: retail brokers in three offices of the broker-dealer permitted day traders to listen to announcements broadcast over the firm's internal "squawkbox" regarding large unexecuted block orders placed by the firm's institutional customers; in exchange for compensation paid by the day traders, the brokers put their telephones near the squawkboxes, often for the entire trading day, to provide the day traders with access to information about the firm's institutional customer order flow; this allowed the day traders to trade ahead of the orders placed by the firm's customers. The broker-dealer agreed to a censure, to cease and desist from securities law violations related to the inadequacy of its policies and procedures to limit access to such information, and to pay a $7 million penalty.

Given the dramatic market volatility in recent months and the corresponding increase in major corporate announcements, the Commission remains particularly concerned about misuse of material non-public information of all kinds.

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[23] *In the Matter of Banc of America Securities LLC*, Exch. Act Rel. No. 55466 (Mar. 14, 2007); *In the Matter of Morgan Stanly & Co., Inc. et al.*, Exch. Act Rel. No. 54047 (June 27, 2006).

[24] *See, e.g., SEC v. A.B. Watley Group, Inc., et al.*, Lit. Rel. No. 19616 (Mar. 21, 2006) (alleged misuse of squawkbox information re orders by large institutional customers); *SEC v. Amore, et al.*, Lit. Rel. No. 19335 (Aug. 15, 2005) (same).

[25] *In the Matter of Merrill Lynch, Pierce, Fenner & Smith Incorporated,* Exch. Act. Rel. No. 59555 (Mar. 11, 2009).

Ponzi Schemes and Similar Frauds

The Commission has an enforcement program that seeks to combat Ponzi schemes. Our powers include the ability to seek temporary restraining orders, asset freezes and the appointment of receivers, as temporary relief. In addition, our enforcement and examination programs work closely together to detect Ponzi schemes that involve registered investment advisers and broker-dealers. For example, our examination staff currently is conducting a sweep examining the custody practices of investment advisers.

Over the past two years, the SEC has filed enforcement cases against more than 75 Ponzi schemes, including twelve such cases since December 2008.[26] Since 2002, the SEC has sued over 300 individuals in enforcement actions related to Ponzi schemes, including more than a dozen cases in which the alleged fraud involved $50 million or more.[27] In light of the SEC's ongoing enforcement efforts in this area, the defendants in one case recently filed by the SEC went so far as to tell potential investors that the

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[26] *See, e.g SEC v. John M. Donnelly, et al.*, Lit. Rel. No. 20941 (Mar. 11, 2009) (alleged $11 million Ponzi scheme based in Charlottesville, Virgina); *SEC v. Anthony Vassallo et al.*, Lit. Rel. No. 20943 (Mar. 11, 2009) (alleged $40 million Ponzi scheme based in Northern California); *SEC v. Shelby Dean Martin, et al.*, Lit. Rel. No. 20935 (Mar. 6, 2009) (alleged $10 million Ponzi scheme based in North Carolina); *SEC v. Ray M. White et al.*, Lit. Rel. No. 20925 (Mar. 4, 2009) (alleged $11 million foreign exchange Ponzi scheme based in Dallas); *SEC v. Daren L. Palmer et al.*, Lit. Rel. No. 20918 (Feb. 26, 2009) (alleged $40 million Ponzi scheme based in Idaho Falls); *SEC v. Billions Coupons, Inc.*, Lit. Rel. No. 20906 (Feb. 19, 2009) (alleged Hawaii-based Ponzi scheme targeting deaf investors); *SEC v. Craig T. Jolly et al.*, Lit. Rel. No. 20890 (Feb. 9, 2009) (alleged $40 million internet Ponzi scheme based in Spokane); SEC *v. CRE Capital Corporation and James G. Ossie*, Lit. Rel. No. 20853 (Jan. 15, 2009) (alleged $25 million Ponzi scheme based in Atlanta); *SEC v. Gen-See Corp. et al.*, Lit. Rel. No. 20858 (Jan. 8, 2009)(alleged $0.5 million Ponzi scheme targeting clergy, Catholics and seniors based in Buffalo); *SEC v. Joseph S. Forte, et al.*, Lit. Rel. No. 20847 (Jan. 8, 2009) (alleged $50 million Ponzi scheme operating from Pennsylvania for 15 years); *SEC v.Creative Capital Consortium, LLC et al.*, Lit. Rel. No. 20840 (Dec. 30, 2008) (alleged Ponzi scheme and affinity fraud targeting Haitian-American investors).

[27] *See* J. Larson and P. Hinton, SEC Settlements in Ponzi Scheme Cases: Putting Madoff and Stanford in Context, NERA Economic Consulting, Mar. 13, 2009, available at www.securitieslitigationtrends.com/PUB_Ponzi_Schemes_0309.pdf; *see also SEC v. Joseph S. Forte, et al.*, Lit. Rel. No. 20847 (Jan. 8, 2009) ($50 million Ponzi scheme).

investment opportunity had been audited by an outside accounting firm, which had concluded that it was not a Ponzi scheme (which according to the Commission's complaint, it was).[28] State regulators have also been pursuing an increased number of Ponzi schemes, and their enforcement assistance in this area has been invaluable to investors.

On December 11, 2008, the SEC sued Bernard L. Madoff and his broker-dealer firm, Bernard Madoff Investment Securities, LLC ("BMIS"), for securities and investment advisory fraud in connection with a Ponzi scheme that resulted in substantial losses to investors in the United States and other countries.[29] The SEC's Enforcement Division is coordinating its ongoing investigation with that of the United States Attorney's Office for the Southern District of New York, which filed a parallel criminal action on December 11, 2008.

The SEC coordinated the filing of its action with Mr. Madoff's arrest. By the next day, the SEC staff had obtained full emergency relief against Madoff and BMIS, including the appointment of a receiver for Madoff-related entities, asset freezes, a temporary restraining order and other relief. The SEC staff later obtained a preliminary injunction order extending the emergency relief through the duration of the civil litigation. The SEC also is closely monitoring the liquidation of the Madoff broker-dealer firm by the court appointed trustee and the Securities Investor Protection Corporation ("SIPC").

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[28] *See SEC v. CRE Capital Corporation and James G. Ossie*, Lit. Rel. No. 20853 (Jan. 15, 2009).

[29] The scheme is outlined in the Commission's complaint filed in the United States District Court for the Southern District of New York, captioned *United States Securities and Exchange Commission v. Bernard L. Madoff and Bernard L. Madoff Investment Securities LLC*, 08 Civ. 10791 (LLS) (S.D.N.Y. Dec. 11, 2008).

On February 9, 2009, the SEC settled its civil action against Mr. Madoff with his consent. The Court entered an order permanently enjoining Mr. Madoff from further violation of the federal securities laws, and directing him to pay a civil penalty and disgorgement in amounts to be determined at a later time. On March 12, 2009, Mr. Madoff admitted to operating a Ponzi scheme in open court and pleaded guilty to 11 counts in the criminal indictment against him without entering into a plea agreement. He is presently in jail and faces up to 150 years in prison and billions of dollars in civil and criminal disgorgement, restitution and penalties.

On March 18, 2009, the SEC filed a complaint alleging that, from 1991 through 2008, certified public accountant David G. Friehling and his firm, Friehling & Horowitz, CPAs, P.C. ("F&H") violated antifraud and other securities laws in connection with their purported audits of financial statements and disclosures of BMIS. A criminal fraud case was also brought against Friehling on that date.

The SEC complaint alleges that Friehling enabled Bernard Madoff's Ponzi scheme by falsely stating, in annual audit reports, that F&H audited BMIS's financial statements pursuant to Generally Accepted Auditing Standards (GAAS), including the requirements to maintain auditor independence and perform audit procedures regarding custody of securities. In fact, the complaint alleges, the defendants did not conduct anything remotely resembling an audit of BMIS. F&H also allegedly made false representations that BMIS financial statements were presented in conformity with Generally Accepted Accounting Principles (GAAP). Finally, Friehling allegedly falsely stated that he had reviewed internal controls at BMIS, including controls over the custody of assets, and found no material inadequacies. If properly stated, the BMIS financial

statements, along with related disclosures regarding reserve requirements, allegedly would have shown that the firm owed tens of billions of dollars in additional liabilities to its customers and was therefore insolvent. The complaint alleges that Friehling and F&H obtained ill-gotten gains through compensation ($186,000 per year) from Madoff and BMIS, and also from withdrawing $5.5 million from accounts held at BMIS in the name of Friehling and his family members (with a balance of $14 million as of November 2008).

Since commencing its action in December 2008, the Commission has been probing all facets of Mr. Madoff's scheme to secure assets for investors. The SEC has committed considerable enforcement and examination resources to this effort, including 18 enforcement attorneys and investigators in the New York Regional Office, 30 examiners from New York and three other regional offices around the country, and additional staff from Chicago, the Home Office and the Office of International Affairs in Washington D.C.

We are also coordinating our investigations with numerous domestic and international agencies. In addition to the U.S. Attorney's Office, the FBI and SIPC, the SEC is coordinating its investigation with the Financial Services Authority and a court-appointed receiver in the United Kingdom; European securities regulators and other authorities with respect to the SEC's referrals regarding the location, identity and conduct of certain Madoff "feeder funds"; financial intelligence units in various other countries that have identified funds transferred to their respective countries from Madoff Securities; the Department of Labor with respect to ERISA plans that invested pension

funds with Mr. Madoff; FINRA and Attorneys General and regulators for various states that are also interested in investigating Mr. Madoff.

On February 16, 2009, the Commission took action in the *Stanford* matter, a different alleged Ponzi scheme involving up to $8 billion in fraudulent sales of bank "certificates of deposit" by Robert Allen Stanford.[30] The SEC's emergency action, filed in United States District Court in Dallas, alleges a massive Ponzi scheme by Stanford and three of his companies--Stanford International Bank ("SIB") based in Antigua; as well as Stanford Financial Group Company, a broker-dealer, and Stanford Capital Management, a registered investment adviser, both based in Houston. The Commission's complaint also alleges fraud by James Davis, Stanford's CFO, and Laura Pendergest-Holt, Chief Investment Officer of Stanford Financial Group. At the SEC's request, the Court issued a temporary restraining order and granted the Commission's request to place all Stanford defendants, and their related entities, into receivership, and to freeze their assets.

In addition to running a Ponzi scheme, the Commission alleges that Stanford and Davis misappropriated at least $1.6 billion of investor money through personal loans to Stanford. Despite SIB's contrary representations to investors, Stanford and Davis also allegedly "invested" an undetermined amount of investor funds in speculative, unprofitable private businesses, some of which they controlled. Stanford and Davis allegedly fabricated the performance of the SIB's investment portfolio to conceal their fraud and ensure that investors continued to purchase SIB's CDs. The Commission charges that, using the rate of return fabricated by Stanford and Davis, SIB's accountants reverse-engineered the bank's monthly financial statements to reflect investment income the bank had not actually earned.

[30] *SEC v. Stanford International Bank et al.*, Lit. Rel. No. 20901 (Feb. 17, 2009).

On February 26, 2009, criminal proceedings were commenced in the *Stanford* matter when the FBI arrested Laura Pendergest-Holt, Stanford's Chief Investment Officer, for lying to the Commission about her knowledge of SIB's investments. The SEC continues to work closely with the FBI and the Department of Justice's Fraud Section, as well as several other U.S. and international criminal and civil agencies in pursuing this matter.

The SEC Is Committed To Cooperation with Other Regulators and Criminal Law Enforcement Authorities, As Illustrated By Recent FCPA Cases

In nearly all the enforcement actions the SEC has taken in response to the current financial crisis, the SEC has cooperated with, and received substantial assistance from, its securities and criminal law enforcement counterparts at the SROs, in state and federal government, and at the international level. The SEC seeks to leverage its own resources through close coordination with other regulators and authorities in order to provide the broadest protection possible to investors, to avoid duplication of efforts, and to make the best possible use of its limited resources. Many of the SEC's enforcement actions in recent years would not have been as effective, or in some instances even possible, without the assistance provided by other law enforcement authorities.

The SEC's cooperation with other securities law enforcement authorities is perhaps best illustrated by the global fight against corruption under the Foreign Corrupt Practices Act ("FCPA"), which prohibits bribery of foreign officials to obtain business. For example, on December 15, 2008, the SEC announced a landmark $350 million settlement with Siemens AG charging worldwide bribery in violation of the FCPA—the

largest FCPA settlement in SEC history.[31] The SEC's settlement was part of a $1.6 billion global anti-corruption settlement between Siemens and the SEC, the U.S. Department of Justice and the Office of the Prosecutor General in Munich, Germany. The corruption alleged in the SEC's complaint was a bribery scheme of unprecedented scale and geographic reach, involving more than $1.4 billion in bribes to government officials in Asia, Africa, Europe, the Middle East, and the Americas.

Not only was Siemens the SEC's largest FCPA settlement ever, it also marked a significant advance in the SEC's cooperation with U.S. and international law enforcement authorities and a watershed in the SEC's global anti-corruption campaign under the FCPA. In Siemens, the investigation and resulting actions were jointly pursued by the SEC, the U.S. Department of Justice and the Munich Prosecutor General. These principals were also assisted by the U.S. Attorney's Office for the District of Columbia, the FBI, the IRS, the U.K. Financial Services Authority, and the Hong Kong Securities and Futures Commission.

The SEC Needs Additional Resources and Tools to Achieve its Mission in a Changing Marketplace

As part of our ongoing commitment to aggressively pursuing fraud against U.S. investors, the SEC wants to work in ways that will enable us to detect and stop securities law violations as soon as possible. To that end, the SEC has recently undertaken a number of significant initiatives to enable the staff to work more quickly and efficiently.

Within days after her appointment as SEC Chairman, Mary Schapiro repealed the Pilot Project under which Enforcement staff were required to seek pre-authorization from the Commission before negotiating civil money penalties against public issuers. In

[31] *SEC v. Siemens Aktiengesellschaft*, Lit. Rel. No. 20829 (Dec. 15, 2008).

addition, she streamlined the process of obtaining formal orders that grant the staff subpoena power. Under the revived procedure, such an order can be approved by a single Commissioner, rather than requiring a vote of the Commission as a whole.

Also, the SEC has engaged the Center for Enterprise Modernization, a federally funded research and development center, to begin working immediately with the SEC on a comprehensive review of internal procedures used to evaluate tips, complaints, and referrals. It is also our goal to establish a centralized process that will more effectively identify valuable leads for potential enforcement action, as well as areas of high risk for compliance examinations. It is our goal to leverage the information received from all sources for maximum efficiency in examinations and investigations of potential securities law violations.

But these steps are just the start. The Commission is re-examining its processes from top to bottom and carefully considering other ways to enable the SEC to work even faster and smarter. In this regard, however, it is important to acknowledge that while our job has grown substantially over the past several years, our staffing levels actually declined over that same period. The SEC's examination and enforcement resources are inadequate to keep pace with the growth and innovation in our securities markets.

The dramatic growth in the securities markets over the last decade can be illustrated with a few numbers. For example, the number of registered advisers has grown substantially. In 2002, there were 7,547 advisers registered with the SEC, and there are nearly 11,300 today, some of them advisers to hedge funds. In addition, there has been significant growth in structured financial products and credit derivatives in recent years. The dollar amount of outstanding asset-backed securities reached almost

$2.5 trillion in 2007, compared to just over $1 trillion in 2000. More dramatically, the issuance of CDOs globally reached a high of $521 billion in 2006, up from $157 billion just two years earlier.

The CDS market has experienced similarly dramatic growth in recent years. The explosive growth in these numbers is indicative of the sustained growth rate in our financial markets over the past few years. The Commission's resources have not kept pace with these developments.

Continued investment in technology is a top priority for the SEC's enforcement program in the coming years. To stay current in these challenging times, we need to modernize our technological tools. While we have started to leverage information by creating internal systems for sharing our investigative work nationwide, much more is needed. The SEC must be equipped with the same type of technology as the industry it regulates, and provided with tools similar to those used by the law firms it faces in investigations and litigation. In particular, the SEC's budget for forensic analysis of data produced in the course of its investigations must be increased by orders of magnitude.

We are also in the process at the Commission of considering what additional legislative changes may be needed to help our enforcement and examinations personnel combat fraud and wrongdoing in the market place. We look forward to working with the Committee on any potential legislative reforms we may recommend.

Finally, we need to focus on investor education and the creation of a strong compliance tone and culture in the securities industry. We need to encourage investors to be their own best advocates and to embrace basic safe investing principles, such as skepticism and diversification. And we need to encourage a tone and culture, especially

among those who make their livings from other people's investments, that mere compliance with the law, narrowly viewed, is not the highest goal to which we aspire, but the base from which we start. The securities industry as whole needs to embrace this compliance culture, and in each firm, the tone must be set at the top. We should all work toward a system where those who work in it are responsible stewards of the assets entrusted to them. As the agency uniquely charged with protecting investors, we are committed to restoring the confidence needed for our marketplace to thrive.