Questions for Robert Khuzami, Esq., Director of the Division of Enforcement, U.S. Securities and Exchange Commission, from Senator Specter:

Mr. Khuzami, we've repeatedly heard from the SEC that the Madoff Ponzi Scheme resulted from a 'perfect storm' or a confluence of incidents that led to a catastrophe. What, if anything, are you doing to ensure that there are no more perfect storms and to ensure that Enforcement staff follows up on leads like those of Mr. Markopolos?

Thank you for the opportunity to clarify this point. I referred to the Madoff fraud as a "perfect storm" during my testimony before the U.S. Senate Committee on Banking, Housing and Urban Affairs on September 10, 2009. By that phrase, I meant to convey the point that in most organizations, including the Division of Enforcement, there are redundant systems or processes that protect against failure, even if one or more of those systems or processes don't perform as expected. The same is true for the Division of Enforcement. We typically seek to assign cases to persons with experience in the particular area under investigation. Where that is not possible, due to resource constraints or other issues, we look to team investigators up with others who have the relevant experience. Supervisors add another layer of protection, in that they have experience in a broad range of investigations and can provide the necessary advice and guidance, or know where to get it. Needed expertise can also be obtained through other members of the Enforcement Division who have relevant experience, or by reaching out to members of other SEC offices or divisions or third parties, including whistleblowers and other complainants. Training also is important, as are investigative checklists and other materials. In the Madoff case, however, none of these "redundancies" operated to prevent our failure to detect Madoff's fraud (even though many were utilized). Aggravating the situation in my view was poor communication with our Office of Compliance Inspections and Examinations and Madoff's stature. Thus, all the normal "redundancies" failed. That is what I meant by the reference to a "perfect storm." It was not an excuse, not a suggestion that we don't need to remedy these problems, and not a suggestion that or that the situation was beyond anyone's control. As I have acknowledged unambiguously, the Madoff investigation was a tragic failure with terrible consequences and we cannot excuse or deflect our responsibility for the handling of the Madoff matter.

We are, however, vigorously responding to the lessons from Madoff. We are implementing a number of significant and far-reaching reforms in the Division to address the deficiencies revealed by the Madoff matter. These changes have been described as the Division's "biggest reorganization in at least three decades,"[1] and are intended to maximize our resources, to gather and utilize expertise across the Division and the agency, to bring cases more swiftly and more efficiently, and to increase strategic analysis and proactive investigations. Highlights of the current changes include the following:

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

- We are establishing an Office of Market Intelligence, which will (1) oversee, coordinate, and implement a system for the handling of complaints, tips and referrals that come to the attention of the Division; (2) coordinate the Division's risk assessment activities and act as a liaison for risk management issues with other SEC divisions and offices, as well as with federal, state, and foreign regulators; and (3) support the Division's strategic planning activities by providing analysis and information and making recommendations to my office. This week, we announced the appointment of the new Office of Market Intelligence Chief, Thomas A. Sporkin. Mr. Sporkin assumes this new role after serving as Deputy Chief in the Office of Internet Enforcement at the SEC since 2001.

- We have created five new national specialized investigative groups that will utilize enhanced training, hiring of and consultation with individuals with specialized industry experience or other specialized skills, and targeted investigative approaches to conduct more efficient investigations that focus on detecting, preventing, and enforcing securities law violations in newly-emerging and complex markets, transactions and products. Members of the specialized units will acquire the expertise and investigative insights that can only be developed by conducting investigations in the same subject area, combined with ready access to others with specialized skills. These units will enable investigative staff to make better investigative decisions and be less likely to be misled by those using complexity to conceal their misconduct. In addition, the national focus of these units will help to break down silos that inevitably develop when an organization, such as the Enforcement Division, is organized along regional lines, and will help to cultivate a sense of common mission and mutual support among Division personnel in different offices. We announced the appointment of the five new Unit Chiefs this week:

    - Asset Management – This unit will be led by Co-Chiefs Bruce Karpati and Robert B. Kaplan and will focus on investigations involving Investment Advisors, Investment Companies, Hedge Funds, and Private Equity Funds. Mr. Karpati was founder and head of the SEC's Hedge Fund Working Group, and has served as Assistant Regional Director for the New York Regional Office of the SEC. Mr. Kaplan has served as Assistant Director of the SEC's Division of Enforcement. He previously held positions as Assistant Chief Litigation Counsel and Senior Counsel/Staff Attorney in the Division.

    - Market Abuse – This unit will be led by Daniel M. Hawke, and will focus on investigations involving large-scale market abuses and complex manipulation schemes by institutional traders, market professionals and others. Mr. Hawke is the Director of the SEC's Philadelphia Regional Office.

    - Structured and New Products – This unit will be led by Kenneth R. Lench and will focus on complex derivatives and financial products, including credit default swaps, collateralized debt obligations and securitized products. Mr. Lench has served as Assistant Director, Branch Chief, Assistant Chief

Counsel, and Senior Counsel/Staff Attorney with the SEC's Division of Enforcement.

- Foreign Corrupt Practices – This unit will be led by Cheryl J. Scarboro and will focus on violations of the Foreign Corrupt Practices Act. Ms. Scarboro has served as Associate Director, Assistant Director, Deputy Assistant Director, and Staff Attorney in the SEC's Division of Enforcement. She also was Counsel to SEC Chairman Arthur Levitt, Jr.

- Municipal Securities and Public Pensions – This unit will be led by Elaine C. Greenberg and will focus on misconduct in the large municipal securities market and in connection with public pension funds. Ms. Greenberg is the Associate Regional Director of the Philadelphia Regional Office of the SEC and has served as the Co-Chair of the Division's national Municipal Securities Working Group.

- We announced this week a new initiative that establishes incentives for individuals and companies to fully and truthfully cooperate and assist with SEC investigations and enforcement actions, and provides new tools to help investigators develop first-hand evidence to build the strongest possible cases. This cooperation initiative is expected to result in invaluable and early assistance in identifying the scope, participants, victims and ill-gotten gains associated with fraudulent schemes. This is crucially important, as an "insiders" cooperation can be the key that unlocks how a fraudulent scheme operates, and can greatly save resources and provide expertise to our investigators. As part of the initiative, we have authorized our staff to use new tools to encourage individuals and companies to cooperate. These tools, which are described in the Division's revised Enforcement Manual,[2] include the following:

  - Cooperation Agreements – Formal written agreements in which the Enforcement Division agrees to recommend to the Commission that a cooperator receive credit for cooperating in investigations or related enforcement actions if the cooperator provides substantial assistance such as full and truthful information and testimony.

  - Deferred Prosecution Agreements – Formal written agreements in which the Commission agrees to forego an enforcement action against a cooperator if the individual or company agrees, among other things, to cooperate fully and truthfully and to comply with express prohibitions and undertakings during a period of deferred prosecution.

  - Non-prosecution Agreements – Formal written agreements, entered into under limited and appropriate circumstances, in which the Commission agrees not to pursue an enforcement action against a cooperator if the individual or

[2] *See* http://www.sec.gov/divisions/enforce/enforcementmanual.pdf (Section 6).

company agrees, among other things, to cooperate fully and truthfully and comply with express undertakings.

In addition, the Commission has set out, for the first time, the way in which it will evaluate whether, how much, and in what manner to credit cooperation by individuals to ensure that potential cooperation arrangements maximize the Commission's law enforcement interests.[3] This pronouncement is expected to provide guidance and serve as an incentive for individuals to report violations and to cooperate fully and promptly in enforcement cases. It is similar to the so-called "Seaboard Report" that was issued in 2001 and detailed the factors the SEC considers when evaluating cooperation by companies.

Finally, the SEC has streamlined the process for submitting witness immunity requests to the Department of Justice for witnesses who have the capacity to assist in its investigations and related enforcement actions.

This cooperation initiative has the capacity to secure the availability of witnesses and information for the Division early in investigations, minimizing the number of harmed investors and enhancing access to persons with strong first-hand evidence of wrongdoing. This will allow us to build stronger cases and to file them sooner than would otherwise be possible.

- We are adopting a flatter, more streamlined organizational structure under which we will eliminate an entire layer of middle management. A thorough top-to-bottom self-assessment revealed that we had a management structure that was too top-heavy, and which resulted in too much process and rework, slow decision-making, and a stifling of creativity, autonomy, and accountability. We will be reallocating a number of experienced investigators back to the mission-critical work of conducting front-line investigations. As a corollary, those who are currently serving at the next level of management (Assistant Directors) will become first line managers, in turn bringing their experience and expertise to the forefront. As part of this effort, the number of Assistant Directors will be expanded in order to maintain staff to manager ratios that allow for close substantive consultation and collaboration – the goal is to have a management structure that facilitates cases, ensures quality control, and provide for the growth and development of the staff – ultimately enhancing the Division's ability to fulfill its investor protection mission. We are currently in the process of filling the additional Assistant Director positions.

- We are implementing a number of structures and procedures further to enhance training and supervision. With respect to training, we are creating a formal training unit and including in the evaluation of staff and supervisors the extent of their participation in formal training programs. We are also creating a searchable database listing staff members with particular background and experience. In addition, we will

[3] *See* http://www.sec.gov/rules/policy/2010/34-61340.pdf#202.12.

be making available model templates and checklists to guide various types of investigations. With respect to supervision, we are implementing a new and more rigorous performance evaluation process for staff and supervisors alike and requiring the regular review by supervisors of caseload reports generated by the Division's newly enhanced case management database. These initiatives will ensure that the staff will be better trained, and will know where to go to get answers to investigative questions, as well as be subject to closer and more informed supervision.

- We are streamlining a number of internal processes and procedures. This streamlining includes the recent delegation of formal order authority (which enables the staff to issue subpoenas for testimony and documents) by the Commission to me, and which was then sub-delegated to senior Enforcement staff, and Chairman Mary Schapiro's abolition of the prior Commission's "penalty pilot program" (which required Enforcement staff to obtain full Commission approval before beginning settlement negotiations regarding civil penalty amounts with public issuer defendants). The Commission also has delegated to me the authority to submit witness immunity requests to the Department of Justice.

- We have hired the Division's first-ever "Managing Executive," who will focus on the Division's operations. Many administrative, operational and infrastructure tasks have been handled by investigative personnel, who did not necessarily have the training or specific skills to handle such matters, and for whom these tasks amounted to distractions from their investigation-related functions. By hiring someone with workflow, information technology and process skills, these tasks can be centralized and more efficiently handled, and will better support the investigative functions.

In addition to these changes, we have hired experienced former federal prosecutors to serve as Deputy Director of Enforcement and Director of the New York Regional Office, two of the most significant positions in the Division. I am confident that these significant changes – and others we will make along the way as we continue to evaluate our program – will reinvigorate our Division, restore investor confidence, and enable us to fulfill our mission of investor protection.

Mr. Khuzami, Senator Grassley and I engaged in an investigation over the course of 2006-2007 into a former Enforcement Division attorney turned whistleblower, Gary Aguirre. After months of taking SEC Enforcement staff depositions and reviewing about 10,000 documents, we concluded that the circumstances leading to Mr. Aguirre's termination were highly suspicious and that the SEC needed to thoroughly investigate the hedge fund there at issue. Are you familiar with the Specter-Grassley interim findings in that investigation? Are you familiar with the final report titled, "The Firing of an SEC Attorney and the Investigation of Pequot Capital Management"? What, if anything, are you doing to ensure that our recommendations are implemented?

I am aware of "The Specter-Grassley Interim Findings on the Investigation Into Potential Abuse of Authority at the Securities and Exchange Commission" and am familiar with the recommendations set forth in the August 2007 final report titled, "The Firing of an SEC Attorney and the Investigation of Pequot Capital Management." The report sets out six specific recommendations for consideration by the SEC, the first three of which were directed specifically to the Division of Enforcement. The Division has taken the recommendations very seriously and has fully implemented the recommendations or undertaken substantial steps towards implementing the recommendations, as set out below:

Standardized Investigative Procedures: Recommendation to draft and maintain a uniform, comprehensive manual of procedures for conducting enforcement investigations.

In response to this recommendation, the Division of Enforcement developed and implemented a comprehensive Enforcement Manual as a guidance and reference tool for Enforcement staff in the investigation of potential violations of the federal securities laws. The manual was prepared under the general supervision of the Division of Enforcement's Office of Chief Counsel in consultation with the Commission's Office of the General Counsel, Office of the Inspector General and Office of the Chairman. It is available on the Commission's website at http://www.sec.gov/divisions/enforce/enforcementmanual.pdf. The manual was first posted in October 2008. We recently posted a revised version of the Manual to reflect, among other things, changes to our procedures as a result of streamlined processes and our new cooperation initiative described above.

Directing Resources to Significant and Complex Cases: Recommendation to develop and apply objective criteria for setting staffing levels and assessing the size, complexity, and importance of cases to ensure that significant cases receive more resources.

Immediately after I became the Director of the Division of Enforcement in March of last year, we began a top-to-bottom self-assessment of our Division's operations and processes, including how our operations and processes ensure that significant cases receive appropriate resources. As a result, we have implemented management tools that are designed to improve our handling of those cases. In particular, we prepare an internal national priority report of matters under investigation for senior officers that summarizes the status of our highest priority investigations nationwide. The report is updated and circulated at least every two weeks. The report is intended to assist senior managers ensure that appropriate resources are dedicated to priority investigations. This report reflects and incorporates the policy developed in response to the recommendation to develop objective criteria, which is set forth in Section 2.1.1 of the Enforcement Manual ("Ranking Investigations and Allocating Resources").

In addition, we have developed procedures under which Associate Directors perform targeted reviews of investigations on a quarterly basis based on age, significance and readiness for filing. This policy is also reflected in Section 2.1.2 of the Enforcement Manual ("Targeted Reviews of Investigations and Status Updates").[4] We have strengthened our Hub case tracking system,

[4] *See* http://www.sec.gov/divisions/enforce/enforcementmanual.pdf (Section 2.1.2)

which tracks key data points. Senior managers use the Hub to monitor cases and generate reports on targeted areas, and investigative staff enter status updates through the Hub.

Finally, we are launching five new specialized investigative units and a more streamlined management structure. These changes are intended to focus our resources on areas where we think enhanced enforcement presence is warranted, to gather, cultivate, and utilize expertise across the Division and the SEC, to bring cases more swiftly and more efficiently, and to increase strategic analysis and proactive investigations. These efforts are more fully described below:

Specialization. We have created five new national specialized investigative groups that are dedicated to high-priority areas of enforcement, including Asset Management (including hedge funds and investment advisers), Market Abuse (large-scale insider trading and market manipulation), Structured and New Products (including various derivative products), Foreign Corrupt Practices Act cases, and Municipal Securities and "Pay-to-Play" issues. Members of the specialized units will acquire the expertise and investigative insights that can only be developed by regularly conducting investigations in the same subject area, combined with ready access to others with specialized skills. With increased focus, training, and access to specialized expertise, investigative staff will conduct more effective, efficient investigations.

Management Restructuring. We are adopting a flatter, more streamlined organizational structure under which we will eliminate an entire layer of middle management. A thorough top-to-bottom self-assessment revealed that we had a management structure that was too top-heavy, and which resulted in too much process and rework, slow decision-making, and a stifling of creativity, autonomy, and accountability. We will be reallocating a number of experienced investigators back to the mission-critical work of conducting front-line investigations. As a corollary, those who are currently serving at the next level of management (Assistant Directors) will become first line managers, in turn bringing their experience and expertise to the forefront. As part of this effort, the number of Assistant Directors will be expanded in order to maintain staff to manager ratios that allow for close substantive consultation and collaboration – the goal is to have a management structure that facilitates cases, ensures quality control, and provide for the growth and development of the staff – ultimately enhancing the Division's ability to fulfill its investor protection mission. We are currently in the process of filling the additional Assistant Director positions.

Transparent and Uniform External Communications: Recommendation to issue written guidance with respect to external communications to ensure that the SEC presents a single and consistent position to parties involved in its investigations.

In response to this recommendation, in February 2008 the Division of Enforcement implemented its policy entitled *External Communications Between Senior Enforcement Officials and Persons Outside the SEC Who Are Involved in Investigations* and incorporated it into the Enforcement Manual in October 2008. (Section 3.1.1 of the Enforcement Manual.). The policy sets forth best practices to ensure that external communications between senior enforcement officials and persons outside the SEC are handled with the appropriate care, sensitivity and transparency.

These best practices concern external communications that are material, relate to ongoing, active investigations, and occur between senior enforcement officials and persons outside the SEC who are involved with investigations. I am confident that the senior leadership of the Enforcement Division recognizes the value and importance of this policy.

Mr. Khuzami, the SEC Office of Inspector General has issued two critical reports that had nothing to do with Gary Aguirre's revelations or Bernard Madoff's frauds. Those reports are titled (1) "Employee's Securities Transactions Raise Suspicions of Insider Trading" (Case no. OIG-481), dated March 3, 2009; and (2) "Allegations of Improper Disclosures and Assurances Given" (Case no. OIG-502), dated September 30, 2009. Without getting into the specific Enforcement Division employees whose conduct was at issue in those two cases, can you assure Congress that someone was officially disciplined in each of those matters?

We take the findings contained in the OIG's reports seriously. As in all cases involving employees' actions, we will perform a careful analysis of the facts and make an independent determination regarding appropriate steps to take.

With respect to the OIG report "Employee's Securities Transactions Raise Suspicions of Insider Trading," as noted in the report, the OIG did not allege that either SEC employee engaged in insider trading or conclude that any such conduct took place. Rather, the OIG referred the employees' conduct to criminal authorities for further investigation. While we await the outcome of the pending criminal investigation, we have taken steps to ensure that the employees are appropriately supervised. Upon completion of the criminal investigation, and to the extent that there is public information that we can provide about any SEC action that may ultimately be taken, we will provide that information at an appropriate time. We remain mindful that we are required to follow certain legal and procedural requirements, including potentially applicable federal statutes protecting the SEC employees' rights to privacy and procedural due process.

Additionally, the Commission has taken steps to strengthen existing rules governing securities trading by all personnel. On May 22, 2009, the Chairman announced that the Commission had (i) proposed a series of new rules and limitations governing securities transactions for all SEC employees, (ii) contracted with an outside firm to develop an automated computer compliance system (the Ethics Program System), (iii) consolidated responsibility for oversight of employee securities transactions and financial disclosure reporting within the Ethics Office, and (iv) created a new Chief Compliance Officer position.. Among other things, the proposed new rules, which are currently under review by the Office of Government Ethics, will, when effective, prohibit the trading of any security issued by a company under investigation by the Commission, whether or not the employee is aware of the investigations. In addition, as part of the new Ethics Program System, all SEC employees are now required to report the account titles and account numbers of all brokerage accounts they or their immediate family members hold and all securities transactions in those accounts, as well as undergo additional ethics training.

With respect to the OIG report "Allegations of Improper Disclosures and Assurances Given," the report included recommendations to initiate disciplinary or performance-based actions against the Enforcement supervisors involved, including the Division Director. In response, the Executive Director of the Commission appointed Administrative Law Judge ("ALJ") Brenda Murray to be the Initiating Official with respect to the OIG's recommendations against these supervisors. ALJ Murray determined that the record did not support any disciplinary or performance-based action against two of the three supervisors involved. Her decision on the OIG's recommendation with respect to the third supervisor was postponed until a future date.

Mr. Khuzami, on pages 12-13 of your written testimony you discuss how the SEC and the New York State Attorney General charged Raymond Harding and Henry "Hank" Morris "for allegedly extracting kickbacks from investment management firms seeking to manage the assets of New York's largest pension fund . . . ." Was Pequot Capital Management among the hedge fund firms implicated in that pay-for-play kickback scheme? Why did the SEC not civilly charge Pequot Capital Management in for those kickbacks?

I cannot comment on the open and ongoing investigation in this matter. However, I can assure you that the Division of Enforcement is carefully reviewing the matter in accordance with the Commission's responsibilities under the federal securities laws to ensure that appropriate parties are brought to justice.

Mr. Khuzami, you cite several disgorgement proceedings where firms were ordered to repay ill-gotten gains and to pay civil penalties but they did so without admitting liability or guilt. Do you find that civil resolution without an admission of wrongdoing—even when coupled with disgorgement and civil penalties—merely amounts to a cost of doing business? Why not debar these individuals or companies?

There are two distinct issues presented by your question: 1) our long-standing policy of entering into settlements with defendants on a neither admit nor deny basis; and 2) seeking the imposition of bars as a remedy in settled cases. A provision stating that the defendant neither admits nor denies wrongdoing has no bearing on whether a settlement includes a bar. In fact, the "neither admit nor deny" settlements we enter into routinely include, as appropriate, a broker-dealer or investment adviser bar, a bar from practicing before the Commission as an accountant, a bar from serving as an officer or director of a public company, or a penny stock bar.

For more than 30 years, the SEC has had a policy allowing defendants to settle without admitting or denying the allegations made by the SEC.[5] This policy strengthens our enforcement program

[5] *See* 17 CFR Section 202.5(e) ("The Commission has adopted the policy that in any civil lawsuit brought by it or in any administrative proceeding of an accusatory nature pending before it, it is important to avoid creating, or permitting to be created, an impression that a decree is being entered or a sanction imposed, when the conduct alleged did not, in fact, occur. Accordingly, [the Commission] hereby announces its policy not to permit a defendant or respondent to consent to a judgment or order that imposes a sanction while denying the allegations in the complaint or order for proceedings. In this regard, the Commission believes that a refusal to admit the allegations is

by encouraging defendants to settle charges more quickly, thus preserving our valuable resources and allowing us to pursue other investigations and enforcement actions.

Settlements made on a neither admit nor deny basis are not negotiated at the expense of the remedies and relief appropriate to address violations of the federal securities laws. To the contrary, settlements often provide investor protections more promptly and with more certainty than protracted litigation. In fact, the deterrent value and concrete remedies provided under settlements, such as disgorgement, penalties and industry bars, are not different from those we seek and obtain through litigated actions. Like the SEC, other government agencies generally do not require admissions of liability in settled civil cases, including the Department of Justice, the Commodities Future Trading Commission, the Federal Trade Commission, the Environmental Protection Agency, and the Federal Communications Commission.

It is important to note that, under our policy, settling defendants also are prevented from publicly *denying* the SEC's allegations. Instead of a cost of doing business, the "neither admit nor deny" provision is an enforceable provision that both the SEC and defendants treat seriously.[6] For example, in April 2003, Morgan Stanley (through its chief executive officer, Philip Purcell) downplayed the seriousness of charges against it in a settlement and attempted to characterize itself as less culpable than other settling firms involved in the same case. In response, SEC Chairman Donaldson sharply rebuked Purcell, reminding him that "the [C]ommission would regard a violation of [the duty to not deny the Commission's findings] as seriously as a failure to comply with any other term of the settlement." Purcell then issued a letter expressing regret, and stating that the firm would not deny the allegations.[7]

In another example, after Lucent Technologies, Inc. reached an agreement in principle to settle a significant accounting fraud action without admitting or denying the Commission's allegations, Lucent's counsel participated in an interview with *Fortune* magazine during which he characterized Lucent's conduct with respect to a central transaction as an unintentional "failure of communication" rather than accounting fraud. Enforcement staff quickly confronted Lucent about the transgression, which undermined the spirit of the settlement in principle. In response, on July 15, 2003, Lucent issued a retraction, acknowledging that the comments in *Fortune* were "both inaccurate and inconsistent with the terms of the settlement in principle." Lucent went on

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equivalent to a denial, unless the defendant or respondent states that he neither admits nor denies the allegations."). The SEC's settlements have included the "neither admit nor deny" provision since 1972. *See* Securities Act Rel. No. 33-5337 (Nov. 28, 1972).

[6] Respondents who offer to settle a SEC administrative proceeding or civil enforcement action must agree in writing: 1) not to take any action or to make or permit to be made any public statement denying, directly or indirectly, any finding in the Order or creating the impression that the Order is without factual basis; and 2) that upon the filing of this Offer of Settlement, Respondent hereby withdraws any papers previously filed in this proceeding to the extent that they deny, directly or indirectly, any finding in the Order.

[7] Floyd Norris, *Morgan Stanley Draws SEC's Ire*, THE NEW YORK TIMES, May 2, 2003, Section A., Col. 1, Business/Financial Desk, p. 1.

to concede that "[t]he transaction involved falsification of documents resulting in improper accounting, both of which were seriously wrong and cannot be justified."

Mr. Khuzami, do you agree with an SEC Enforcement Division attorney from your Fort Worth office who was recently quoted on The Blog of the Legal Times as saying, "There's going to be just a great, great effort to bring people around to recognizing that we need to paint the barn and not the Sistine Chapel"? Is that effort already afoot?

In my view, these comments only serve to underscore the point that the Division already has moved in a new direction. It reflects that fact that more than ever, the need for urgency and the critical nature of our investor protection mission. From top to bottom, the staff's call is to bring cases and to bring them swiftly. Our enforcement of the securities laws should be vigorous, tireless, intelligent and fair.

We also want to bring the right cases, and we want to win. The stakes are high all around: investor protection is essential but we are also a government agency, like all government agencies backed by the power of the federal government, for which fairness and even-handed prosecution are vital. The federal securities laws can be complex and often require painstaking attention to detail. While simplicity is clearly a virtue, our cases can rise or fall on legal or factual details. I agree that we do not need to bring the perfect case, but we owe it to investors and to taxpayers to bring the right cases and to bring good cases. Our current initiatives are designed to meet these objectives. These include:

- ***Focus on national priority cases.*** In an effort to utilize our resources efficiently and to achieve the highest impact for investor protection, we are focusing on a number of national priority cases. These particular cases – ranging from subprime mortgage-related matters to financial fraud and other areas – receive special focus and commitment of resources with the goal that they are brought quickly and with the strongest evidence possible.

- ***Closer supervision.*** As described in more detail above, we are adopting a flatter, more streamlined organizational structure that, among other things, will facilitate closer supervision. We are also implementing a new and more rigorous performance evaluation process for staff and supervisors alike. In addition, we are requiring more regular review by supervisors of caseload reports generated by the Division's newly enhanced case management database.

- ***Cooperation initiatives.*** As described in more detail above, we recently announced new initiatives that establish incentives for individuals and companies to fully and truthfully cooperate and assist with SEC investigations and enforcement actions, and provide new tools to help investigators develop first-hand evidence to build the strongest possible cases.

- ***Better handling of CTRs.*** As described above, we are establishing an Office of Market Intelligence, which will (1) oversee, coordinate, and implement a system

for the handling of complaints, tips and referrals that come to the attention of the Division; (2) coordinate the Division's risk assessment activities and act as a liaison for risk management issues with other SEC divisions and offices, as well as with federal, state, and foreign regulators; and (3) support the Division's strategic planning activities by providing analysis and information and making recommendations to my office. This office will enhance our ability to launch a unified, cohesive, effective, and efficient response to the huge volume of complaints, tips, and referrals we receive.

By implementing these initiatives and improving the way the Division operates, I believe that the Division can employ its finite resources in a way that will serve our critical mission of investor protection by bringing smart, strategic cases swiftly and successfully.

Mr. Khuzami, do you further agree with that same associate regional director that the SEC Enforcement staff had "contorted ourselves over 20 years into this agency that anguishes over the minutiae. We look generally more like a law school debating society than we do like a law enforcement agency, in many respects"? If that were true of the SEC of yesterday, do you pledge to ensure that the SEC of tomorrow looks more like a law enforcement agency?

As a former federal prosecutor, law enforcement is my focus and I, for one, am proud of the Division of Enforcement's reputation for being tough but fair and thorough in its vigorous protection of investors. Our cases are highly complex and it is critical that we make informed decisions. Thus, some degree of thoroughness and detail is necessary.

Having said that, we recognize the need to take important steps toward streamlining its processes and focusing on significant, timely actions that achieve the greatest impact through deterrence and investor protection. As part of this effort, we have begun to develop metrics to better determine the relative significance of our investigations and enforcement actions and the associated use of resources. Among other things, the new metrics will be designed to measure the programmatic importance of enforcement actions, the timeliness of filed or instituted actions, monetary sanctions imposed (disgorgement and penalties), the productivity of our staff's work on each action (including productivity by office or other relevant unit), and the use of litigation resources. As another means of gauging whether we are maximizing our efficacy and resources, we also intend to measure regularly the number of priority investigations and actions as compared to our total caseload. Other changes that I have initiated have given the staff increased latitude that will enhance their ability to bring cases efficiently, including the streamlining of internal processes for review of proposed enforcement actions, the delegation of authority to Enforcement to approve formal orders of investigation, and the streamlining of other internal processes for the issuance of Wells notices and the review of settlement parameters.

Questions for Robert Khuzami, Esq., Director of the Division of Enforcement, U.S. Securities and Exchange Commission, from Senator Schumer:

SEC SELF-FUNDING

The Inspector General's report on the Bernie Madoff scandal exposed how under-staffed and under-funded the Division of Enforcement was under the previous Administration. In recent years, the number of SEC-regulated market participants has exploded to over 35,000 entities, but between 2005 and 2007, the SEC had to cut its staff by 10 percent and its investments in IT by 50 percent. The SEC clearly needs more resources. In your written testimony, you expressed support for the legislation I have proposed in the regulatory reform bill, which gives the SEC self-funding authority like those of the other federal financial regulators, such as the FDIC, OCC and the Fed.

1. **If the SEC were allowed to keep all the transaction and registration fees it collects, do you think this source of funding would be stable enough to help the SEC plan for the long-term and keep pace with the markets it is supposed to police?**

I share Chairman Schapiro's support for independent SEC funding, and appreciate your leadership and hard work on this important issue. I believe that independent funding would allow the SEC to maintain stable, sufficient long-term funding and conduct necessary long-term planning.

The SEC's collections of fees paid by the securities industry are completely independent of, and significantly exceed, its funding level. For example, in 2010, the SEC will collect about $1.5 billion, while its budget is $1.1 billion. Under your proposal, the SEC would be removed from the annual appropriations process, and would cover its own expenses based on its existing fee structure. Although independent of the executive branch in other respects, the SEC lacks an independent source of funding. Other financial regulators have been established as independent entities with bipartisan management and dedicated funding sources, which serves to insulate these financial regulators from efforts to influence inappropriately the supervision of regulated entities or the pursuit of remedial or enforcement action. Unlike most of its regulatory counterparts, however, the SEC's funding is subject to the Executive Branch budget process and to the Congressional appropriations process.

Based on our collections of fees, independent funding would allow us to avoid the significant uncertainties and ups-and-downs that can be caused by the current annual appropriations process. As you point out, after significant increases in 2003-2005, the SEC's funding level was flat or declining between 2005 and 2007. The SEC had to cut its staff by 10 percent and its investments in new IT initiatives by 50 percent. This occurred at the same time the securities markets were growing significantly in size and complexity. Since 2005, when these cutbacks began, average daily trading volume has nearly doubled; the investment advisor industry has grown by over 30 percent in number and over 40 percent in assets under management; and broker-dealer operations have expanded significantly in size, complexity, and geographic diversity.

Now, with about 3,700 people, the SEC must oversee approximately 35,000 entities, including 11,300 investment advisers, 8,000 mutual funds, 5,500 broker-dealers, and more than 12,000 public companies, as well as transfer agents, clearing agencies, exchanges, and others. As a result, for example, we currently only examine about 10 percent of advisers each year. Independent funding is needed to ensure that the SEC has a workforce of sufficient size and skill to oversee the nation's securities markets, as well as the funds to cover potential expansions in the agency's jurisdiction, in areas such as over-the-counter derivatives and private fund advisers.

2. **Can you explain how self-funding authority rather than the current annual appropriations process, which gives the SEC millions less than what it collects in fees, would help the Enforcement Division in attracting and retaining the kind of expertise required to catch sophisticated thieves, and in investing in technology required to detect fraud?**

Independent funding would allow the Division of Enforcement the stability needed to hire additional staff and move forward with long-term planning for investments in information technology. Unfortunately, the vagaries of the congressional appropriations process have often made it difficult for the agency to plan and hire needed personnel, even when the Appropriations Committee leadership strongly supports the needed additional funding, as is currently the case. When the SEC operates under a continuing resolution, as it has many times over the last several years, it makes it difficult to recruit and hire new workers or invest in new technology when the agency is unsure whether and when additional funds will be appropriated.

With the certainty of independent funding, we would be able to recruit and hire staff with appropriate expertise, which is necessary to address increasingly complex financial products and transactions and take prompt action to halt violations and try to recover funds for investors. In addition, the Division is in the process of establishing an Office of Market Intelligence, which will need to be fully staffed to conduct risk assessment and prioritize the hundreds of thousands of complaints, tips, and referrals expected to be received each year. Further, the Division needs staff to litigate an increasing number of trials and perform tasks associated with collections and distributions to investors.

Independent funding would also enable the SEC to develop a robust technology program, a key to effective market oversight. The SEC's current systems are simply inadequate to this task. For example, it often takes us months to organize the massive amounts of electronic documents received as the result of a subpoena, and we have no tools to analyze the contents beyond basic word search. We also lack the type of basic litigation management system that can be found at most law firms.

The SEC must invest heavily in technology in order to keep pace with the firms it regulates and with the law firms we face in litigation. If we were able to plan our budget for more than one year at a time, we would make significant investments in IT in order to build new systems to track tips and complaints, conduct surveillance and risk analysis, and handle electronic evidence

received during investigations, among other functions. Independent funding would give us the predictability and resources necessary to carry out these much needed IT improvements.

SAFE MARKETS / FERA

One of the first bills that I introduced this session of Congress was the SAFE Markets Act, in which I pushed for increased funding for the Department of Justice, the FBI, and the Securities and Exchange Commission to fight financial and mortgage fraud. With the support of Senators Kaufman, Grassley, and Chairman Leahy, we were able to include those funding proposals in the Fraud Enforcement and Recovery Act which was signed into law this year.

At the time that I filed the SAFE Markets Act, I was concerned that the white collar ranks of the FBI had been decimated – for understandable reasons – by the terrorism investigations that followed 9/11. Earlier this year, some reports said that the FBI had transferred as much as 35 percent of its white collar investigators to other areas – over 600 agents.

1. **I was heartened to learn that you have tripled your agents in the mortgage fraud area. Are you also working to beef up your other white collar areas?**

Although I cannot speak for the FBI regarding its plans to add agents in white collar areas, I strongly support an increase in the number of staff dedicated to pursuing securities law violators at both the FBI and the SEC, and I greatly appreciated the funding proposals that were included in the Fraud Enforcement and Recovery Act.

The entire Division of Enforcement staff nationwide, including lawyers, accountants, information technology staff, and support staff, amounts to slightly more than 1,200 employees. In fact, even with the budget increase in 2009, the Division still has significantly fewer staff than in it did four years ago. In contrast, the scope and complexity of the financial industry has grown significantly over the last several years, with the SEC overseeing over 35,000 registrants, including 12,000 public companies, 11,000 investment advisers, 8,000 mutual funds, 5,500 broker dealers, 600 transfer agents, as well as exchanges, clearinghouses, NRSROs, and SROs. An increase in sheer staff numbers would improve the Division's ability to protect investors, even as we recognize our obligation to American taxpayers to use the resources we have as efficiently as possible.

HIGH YIELD INVESTMENT SCAMS

High yield investment scams have risen significantly – by 105 percent in 2009 alone. In a recent Google search for "HYIP," nine out of the ten links on the first page were websites advertising, promoting, ranking and purportedly "monitoring" HYIP's, all promising 1-2 percent daily, 5-8 percent weekly and 20-30 percent monthly returns on investment, if not more. When you type "financial fraud" or "victim of financial fraud" into a search engine, the SEC website does not come up. In fact, the only government websites that comes up are some scattered press releases from the SEC and the FDIC.

How can we increase the visibility of the SEC, the FBI, and the Department of Justice for the average consumer?

The SEC has taken several proactive steps to inform consumers about the dangers of high-yield investment programs ("HYIP"). First, the SEC's Office of Investor Education and Advocacy has published a web page titled "High Yields and Hot Air" that appears within the first ten hits after searching Google for "high yield investment."8 Second, the Office of Investor Education and Advocacy has posted a simulated high-yield website to lure would-be investors in HYIP.9 After reading through website text that promises guaranteed tax-free returns of up to 20% per month, an interested investor who clicks on the "How to Invest" link is directed to a new page titled "If you responded to an investment idea like this . . . You could get scammed!"10 Finally, the SEC's website includes a Division of Enforcement page warning investors about HYIP.11

In addition, the SEC publicizes each HYIP action. Overall, the Division's enforcement actions in the general area of offering frauds have increased over the past three years. In fiscal year 2007, approximately 10% of all enforcement actions concerned offerings frauds, and that percentage has more than doubled in fiscal year 2009, to 21% of all enforcement actions filed.12 Offering frauds such as HYIP may seem particularly attractive to investors during these times, when interest income is low. The Division takes very seriously the federal securities laws violations posed by unlawful HYIP and their threat to investors' capital.

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[8] *See* http://www.sec.gov/investor/pubs/investorfraud.htm. Two other websites, Wikipedia and a website run by a non-profit corporation, Financial & Tax Fraud Education Associates, Inc., are also among the first ten hits. Both sites highlight the SEC's investor education releases about HYIP. *See http://en.wikipedia.org/wiki/High-yield_investment_program; http://www.quatloos.com/stkscams/hyips.htm.*

[9] *See http://www.growthventure.com/parsons/.*

[10] *See http://www.growthventure.com/parsons/invest2.htm.*

[11] *See http://www.sec.gov/divisions/enforce/primebank.shtml.*

[12] *See* Securities and Exchange Commission's 2009 Performance and Accountability Report, http://www.sec.gov/about/secpar/secpar2009.pdf.

I should note that over the years, the Division has expended significant resources and effort on combating fraudulent online offerings. Although we continue to strive to do better – as evidenced by our current and continuing reforms – I believe our efforts have served the investing public well. The Division's Office of Internet Enforcement (OIE) was formed in 1998 in an effort, among other things, to focus on combating online securities fraud. Some years ago, a similar Google search would have turned up Ponzi and other multi-level marketing schemes by the score. Although such scams obviously are still out there – and probably always will be – an investor has to search harder for them on the Internet. One of our goals in this area is for the combination of enforcement actions and more expansive investor education, including the initiatives described above, to create a more skeptical investor such that even when such scams are found on the Internet, the average investor is less likely to invest.

It is my understanding is that there is often an international nexus to HYIP's.

1. **How is this aspect of enforcement being handled?**

Fraudulent activity, including unlawful HYIP, often touches on multiple jurisdictions – in fact, about thirty percent of all of the SEC's enforcement actions include an international component. The Division of Enforcement works closely with the SEC's Office of International Affairs ("OIA") when an investigation or enforcement action involves a foreign jurisdiction. For example, the Division of Enforcement and OIA coordinate to obtain information from other countries during investigations, freeze the proceeds of fraudulent schemes that are located abroad, serve foreign defendants in SEC enforcement actions, and enforce judgments in other countries.

Generally, the tools that OIA uses to obtain information from other countries include the International Organization of Securities Commissions' Multilateral Memorandum of Understanding ("IOSCO MMOU"),[13] bilateral memoranda of understanding,[14] Mutual Legal Assistance Treaties, requests to foreign financial intelligence units ("FIUs"), formal letters rogatory between a U.S. court and foreign judicial authorities, and ad hoc arrangements with foreign countries.

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[13] In 2002, the International Organization of Securities Commissions ("IOSCO") created a Multilateral Memorandum of Understanding ("MMOU"), the first global information-sharing arrangement for enforcement cooperation among securities regulators. The SEC was among the initial signatories to the agreement. The number of signatories to the IOSCO MMOU has grown from 34 signatories to 64 in the past three years. In addition, 46 additional IOSCO members have expressed their commitment to become signatories. The MMOU has significantly enhanced the SEC's enforcement program by increasing the SEC's ability to obtain information from a growing number of jurisdictions worldwide. In particular, the MMOU provides for sharing information and documents held in the regulators' files, obtaining information and documents regarding transactions in and the beneficial owners of bank and brokerage accounts, and taking or compelling a person's statement or testimony.

[14] The SEC has signed bilateral information sharing memoranda of understanding (MOUs) with the securities authorities of 20 different countries, many before the advent of the IOSCO MMOU. Bilateral MOUs are crucial to SEC investigations because their provisions often govern the compulsion of information from third parties, including bank records, brokerage records, beneficial ownership information, and testimony in the foreign jurisdiction.

The ability under the IOSCO MMOU to obtain information about the beneficial owners of bank accounts and the transactions in those accounts is particularly useful when conducting investigations relating to HYIP. OIA's increased work with FIUs is also useful in HYIP investigations because it allows the SEC to gather information in real time about the movement of funds.

With the aid of OIA, the SEC was able to freeze hundreds of millions of dollars of proceeds from fraud during fiscal year 2009 that were located abroad, and repatriate $9 million to the U.S.