What REALLY Needs to be Done

Henry Markopolos' Testimony: Part II: Rebuilding the SEC
http://www.house.gov/apps/list/hearing/financialsvcs_dem/hr020409.shtml

Herny Markopolos spent nine years trying to gat the attention of SEC regulators to look into the massive fraud perpetrated by Bernie Madoff. In his February 4, 2009 testimony before House Finance Committee, Mr. Markopolos leveled both barrels at the SEC. Most journalists read his exciting Part I: what I learned and how I tried. Almost all journalists fell asleep when they got to Part II which is much more important because it tells Chair Mary Shapiro and Congress exactly what they had better do to fix the mess that is the regulatory quagmire in New York and Washington, DC.

The mission of the SEC is to ensure that markets are fair, efficient and transparent in order to work properly and that there is a constant availability of credit at affordable rates.

Today, nobody trusts the American financial marketplace: "investors are afraid and do not trust the banks, insurance companies, brokerage firms, credit ratings agencies, investment managers, hedge funds, or other financial institutions."

Investors and consumers also do not trust the quagmire of regulators that Mr. Markopolos describes as Keystone Kops.

Regulations are a pot pouri of segmented, isolated interests, which the financial market can easily cherry-pick: the Federal Reserve Bank (FED), the US Treasury (which includes the IRS, the Office of Thrift Supervision, the Office of the Controller of the Currency, the Justice Department), the Securities Exchange Commission, the Commodity Futures Trading Commission, the Federal Deposit Insurance Corporation, the Federal Home Loan Banking System, the National Federal Credit Union Administration, the Federal Housing Administration, and the Federal Housing Finance Agency (replacing the FHFM and OFHEO, overseeing Fannie Mae and Freddie Mac), plus state insurance regulators. Not to mention Pension Benefit Guarantee Corporation.

The gist of his mandate to Congress and Chair Shapiro is this:

1. **tell the truth about the solvency of our largest financial institutions: either close or nationalize "the zombies"**

2. **reduce the number regulators: there currently is no communication or connectivity, rather only isolation, duplication, overlap and too many regulatory gaps through which abuse seeps daily.**

3. **create one super-regulator, Financial Supervision Authority (FSA),** "to combine regulatory functions into as few a number as possible to prevent regulatory arbitrage, centralize command and control, ensure unity of effort, eliminate expensive

duplication of effort, and minimize the number of regulators to which American businesses have to answer."

He proposed that under the FSA would be the Federal Reserve, (with all banking regulation), a strengthened SEC, (with new combined pension, futures and commodities regulatory authority), a new national insurance regulator, a combined Treasury / DOJ law enforcement function with litigation staff for criminal and civil enforcement on behalf of all FSA entities. Cross functional audit teams would conduct joint investigations.

4. Rebuild the SEC from the bottom up:

Dramatically Upgrade SEC Employee Qualifications & Educational Budgets

- replace lawyers with financially experienced and certified professionals
- order a skills, degree, and certification inventory of the current SEC staff
- expand the SEC's tuition reimbursement program to pay 100% of relevant post-graduate education courses with one year of additional government service for each year of graduate education
- encourage staff (through reimbursals) to attend industry conferences, particularly those venues where brand new securities are being featured
- send SEC staff to conferences with a written information collection plan, under the supervision of a senior person, with the goal of obtaining information and marketing literature about new products and querying attendees about frauds within the industry
- have staff participate in financial analyst societies and economic clubs which hold educational meetings in major regional financial centers
- allow credentialed SEC staffers to have their professional designations printed on their business cards.
- pay for subscriptions to industry publications for its staff
- recruitment necessary, efficient and competent human resources: those with demonstrated capability to do derivatives math, portfolio construction math, arbitrage pricing theory, the Capital Asset Pricing Model, both normal and non-normal statistics, financial statement analysis, balance sheet metrics, or performance presentation formulas
- recruit foxes to join the SEC staff in senior, very high paying positions that offer lucrative incentive pay to catch fraudsters and bringing them to justice; to lead

mission-oriented task forces dedicated to closing down these previously undiscovered frauds, restoring trust in the marketplace, thereby lowering the cost of capital and minimizing the regulatory burdens for honest American businesses

Adopt Industry Compensation Guidelines in order to compete:

- Compensation at the SEC needs to be both increased and expanded to include incentive compensation tied to how much in enforcement revenues each office collects.
- Fines to be triple the amount of actual damages; guilty transgressors should pay the actual costs of the government's investigation; and SEC staff bonuses should be paid for by the guilty transgressors.
- institute quantifiable metrics to measure the new, 21st Century regulatory effectiveness. Obvious metrics are revenue from fines, dollar damages to investors recovered, dollar damages to investors prevented, fine revenues per employee per regional office, and the number of complaints from Congress to the regulators complaining about the severity of the fines or the thoroughness of the government's investigations.

Raise the Enforcement Bar to Incorporate Good Ethics into the SEC's Mission focus

Revamping the Examination Process:

- Inspection team should interact with traders, not just the inspected firm's compliance team; also portfolio managers, client service officers, marketing staff, information technology department or management. The SEC should not only examine paperwork, but also the tremendous human intelligence available.
- the use and need for Bloomberg machines are an inherent industry requirement for SEC compliance and examinations
- Alternatively, turn over the SEC work to New York Attorney General's office (NYAG) and the Massachusetts Securities Division (MSD).
- Alternatively, assign the NYAG & MSD to enforce large, industry-wide cases and let the SEC conduct the routine, paperwork inspections.
- Give the new Chair one year to deliver or replace.
- The new SEC Chair needs to come in and clean house with a wide broom, sweeping out the top ranks and bringing in a new, results-driven senior leadership team
- spend one week each month at each of the eleven (11) different Regional Offices during the first year, spend each day that week with a different examination team

looking at how they do their jobs; then make sure senior staff pushed those tools and resources down to the examination teams on an expedited basis

- consider moving the SEC out of Washington because Washington is a political center not a financial center (either West Chester County, NY or Connecticut)

- Reinvigorate and reform the Office of Risk Assessment:

- Devise new inspection checklists for every new financial product, structured product, derivative security, hybrid security, corporate entity – and all before these products are sold into the marketplace.

- Totally rebuild examination audit checklists

- Develop base audit checklists for each type of firm that's out there; then develop specific additional audit checklists that test for new and different, even never before seen frauds; and tested in the field

- Establish a Center for All Lessons Learned (CALL): collect and sort through every fraud that the SEC finds

- Adopt the Association of Certified Fraud Examiner's Fraud Tree contained in Volume I of the Certified Fraud Examiner's Manual

- Create a National Financial Safety Board as a investigative unit to diagnose exactly what went wrong and in what sequence that led these institutions to fail

- Add an Office of the Whistleblower, to centralize the handling and investigation of whistleblower tips. Whistleblowers are the single largest source for fraud detection according to the Association of Certified Fraud Examiner's (ACFE) 2008 Report to the Nation (Chapter 3, page 22, www.acfe.com).

- Offer bounty payments to be paid for by the guilty defendants.

- False Claims Act (31 USC Sections 3729-3733): For every $1 spent in enforcement, the False Claims Act returns $15 in recoveries from fraudsters.

- each tip, upon receipt, should be logged in, given a case number, and for credible tips with real evidence behind them, the whistleblower and whistleblower's counsel be put in contact with the relevant SEC operating unit that is best able to investigate the complaint.

- Generate an annual report to Congress of whistleblower complaints, with mandatory SEC's follow-up actions.