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MORTGAGE FRAUD, SECURITIES FRAUD, AND THE FINANCIAL MELTDOWN: PROSECUTING THOSE RESPONSIBLE

HEARING

BEFORE THE

COMMITTEE ON THE JUDICIARY UNITED STATES SENATE

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MORTGAGE FRAUD, SECURITIES FRAUD, AND THE FINANCIAL MELTDOWN: PROSECUTING THOSE RESPONSIBLE

WEDNESDAY, DECEMBER 9, 2009

U.S. SENATE,
COMMITTEE ON THE JUDICIARY,
Washington, DC

The Committee met, pursuant to notice, at 1:58 p.m., Room SD–226, Dirksen Senate Office Building, Hon. Edward E. Kaufman presiding.

Present: Senators Whitehouse, Klobuchar, Franken, and Hatch.

OPENING STATEMENT OF HON. EDWARD E. KAUFMAN, A U.S. SENATOR FROM THE STATE OF DELAWARE

Senator KAUFMAN. I call the Committee to order.

Good afternoon, everyone. I'm honored to call this hearing of the Senate Committee on the Judiciary, and I thank Chairman Leahy for permitting me to chair this hearing.

Today we're going to examine the contributions of financial fraud to our current economic crisis and to explore the efforts of law enforcement to bring out what happened, and bring the perpetrators to justice.

I really mean this when I say three distinguished witnesses join us today to discuss these issues: Assistant Attorney General Lanny Breuer, SEC Director, Enforcement, Robert Khuzami, and Assistant Director Kevin Perkins of the FBI.

Between the spring of 2007 and this past summer, the net worth of the United States' households dropped $14 trillion—that's "t", $14 trillion, with a "t". Of course, an economic collapse of that magnitude was spurred by a wide spectrum of activity. Much of that behavior, though terribly misguided and indeed inexcusable, was not criminal.

The honest homebuyer, enticed by the promise of perpetually rising home prices, took out a mortgage that he could not really afford, may have shown bad judgment, but did not break the law. In all likelihood, neither did the investment manager who lost a great deal of her clients' money because she failed to appreciate the full extent of the risk caused by mortgage-backed securities.

On the other end of the spectrum, however, was conduct that has all the earmarks of financial crime. I'm talking about loan originators who encouraged borrowers to lie on loan applications, or middlemen and banks who knew the loans were bad but accepted them anyway for bundling and reselling of securities, or investment

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banks that stuck with toxic assets as housing prices began to plummet, that consciously failed to disclose their true value or their risks to shareholders. These people should be the target of the FBI, SEC, and DOJ investigations, and if convicted, they should go to jail.

If we want to restore the public's faith in our financial markets and the rule of law, we must identify, prosecute, and send to prison the participants in those markets who broke the law. Their fraudulent conduct has severely damaged our economy and harmed countless hardworking Americans.

That is why, last May, I joined with Chairman Leahy, Senator Grassley, and others to help pass the Fraud Enforcement and Recovery Act. FERA was instrumental in ensuring that additional tools and resources were provided to those charged with enforcement of our Nation's laws against financial fraud.

Since the passage of FERA, some real progress has been made, thanks to the men in this room. The FBI, Department of Justice, and SEC have all redoubled their efforts and redeployed their resources. Just last month, President Obama created an interagency Financial Fraud Enforcement Task Force. His decision to do so reflects the fact that mortgage securities and corporate fraud schemes not only devastated our economy, but also led to the widespread view that Wall Street does not play by the same rules as Main Street.

I'm pleased to see the task force mission is not just to hold accountable those who helped bring the last financial crisis, but also help to prevent another crisis from happening. We must deter those in the mortgage industry, on the trading desks, and the boardrooms who, in the future, might be tempted to put greed ahead of the law, thus setting the stage for another meltdown.

Of course, deterrence comes with successful investigation, prosecution, and then meaningful punishment. Successful investigation of these complex cases means, among other things, being smart about where to look and what to look for.

At lower levels, we're starting to see the results. The FBI reports that mortgage fraud investigations nationwide now total more than 2,800. To give just one example, in northern California, the U.S. Attorney's Office recently secured a 53-count indictment against seven individuals who ran a scheme using straw buyers, appraisers, escrow agents and notaries to obtain millions in fraudulent mortgages from victim banks. In addition, unwitting purchasers were laden with mortgages they had no prospect of paying in amounts that vastly exceeded the values of their underlying homes.

I also read with interest, on Monday, that the SEC filed charges against three former top officers of New Century Financial Corporation for misleading investors, as New Century's prime subprime mortgage business was collapsing in 2006. According to press accounts, a parallel criminal investigation is ongoing.

The messages are being sent that this sort of crime just does not pay, but I, like many Americans, remain frustrated that the responsible agencies have not yet been able to bring more high-level crooks to account. I understand, and I've talked to the three of you, unraveling sophisticated financial fraud is an enormously complex undertaking and these cases can be difficult to make, particularly

when trying to prove criminal intent beyond a reasonable doubt from the historical record alone.

But I've called this hearing because enough time has passed that America deserves a full accounting, though necessarily an interim one, from those who are tasked with enforcing our criminal laws. In the midst of the housing boom and bust cycle, did Wall Street executives and hedge fund managers commit financial fraud? If so, why haven't we seen any convictions yet? Are the agencies being smart and effective in deploying their resources? Do they have the absolute sense of urgency?

Is there enough transparency in the markets for law enforcement even to know whether the laws are being followed? Many of Wall Street have argued there was no criminality, merely a collective delirium brought by soaring profits and faulty assumptions regarding risks.

I have this recurring nightmare in which I see some people in Wall Street inside a burning house. They see smoke, maybe even a flame or two, but instead of sounding an alarm they keep grabbing the money, convinced they still have time to get out before the house burns down. Even if they make it, where does that leave the rest of us? I hope this hearing will provide answers to those questions, and more.

What I would like to do is have testimony. Testifying before us today are three—and I really mean this—top Federal law enforcement officials. All three have highly distinguished backgrounds and are extremely well-qualified to lead their respective agencies. We're grateful for their efforts.

Let's start with Lanny Breuer, who is the Assistant Attorney General for the Criminal Division at the Department of Justice.

Mr. Breuer, please proceed with your testimony.

[All witnesses were sworn prior to going on the record.]

STATEMENT OF HON. LANNY BREUER, ASSISTANT ATTORNEY GENERAL, DEPARTMENT OF JUSTICE, WASHINGTON, DC

Mr. BREUER. Thank you. Good afternoon, Senator Kaufman. Thank you for your invitation to address the Committee, and for giving me the opportunity to discuss the Department of Justice's efforts to prosecute mortgage, securities, and other types of financial fraud related to the financial crisis.

As the Attorney General has made clear, we are committed to reinvigorating the traditional crime-fighting mission of the Department, including redoubling our efforts to fight financial fraud. We face unprecedented challenges in responding to the recent financial crisis. Mortgage, securities, and corporate fraud have eroded the public's confidence in our financial markets and have led to a growing sentiment that Wall Street does not play by the same rules as Main Street.

In the wake of the financial crisis, we must be, as you have said, relentless in our investigation of potential criminality. We must vigorously prosecute mortgage fraud, which appears to have been one of the catalysts of the crisis, and to continue to scrutinize other questionable conduct and practices to ferret out any crimes that may have occurred. We also must continue to protect investors in

our capital markets by aggressively prosecuting securities and commodities fraud.

We have been working very hard to carry out this mission. We've had numerous successes in prosecuting mortgage, securities, commodities, and other forms of financial fraud. We recognize, however, that there is much more to be done.

Just a few weeks ago, as you said, Senator, the President signed the Executive Order establishing a new interagency Financial Fraud Enforcement Task Force, led by the Attorney General, to combat financial crime. The Task Force will strengthen our collective efforts in conjunction with our Federal, State, and local partners to investigate and prosecute significant financial crimes relating to the financial crisis.

The Task Force will lead an aggressive, coordinated, and proactive effort to investigate and prosecute these crimes. We will marshal both criminal and civil enforcement resources to investigate and prosecute financial fraud cases, recover stolen funds for victims, address discrimination in lending and financial markets, and enhance coordination, cooperation, and information sharing among authorities responsible for investigating and prosecuting significant financial crimes and violations.

The Task Force is, thus, an important and significant step forward in our fight against financial fraud. Let me assure you, it is a fight that we have been waging each and every day. To take one example, the Department has redoubled its efforts to uncover abuses involving mortgage fraud. At present, Federal mortgage fraud-related charges are pending against approximately 500 defendants around the Nation, and the FBI is working on more than 2,700 additional mortgage fraud investigations. As described in my written testimony, many of our investigations have ended with successful prosecutions.

In addition, in recent months the Department has successfully prosecuted many high-profile securities fraud cases: the Madoff case brought by the U.S. Attorney's Office for the Southern District of New York the FBI and the SEC and the Stanford case brought by the Criminal Division's Fraud Section and the U.S. Attorney's Office for the Southern District of Texas, the FBI, and the SEC are just two prominent examples. The Galleon insider trading cases brought by the U.S. Attorney's Office for the Southern District of New York, the FBI, and the SEC have used court-authorized wire taps and demonstrate that we will be aggressive in investigating and prosecuting white collar crimes.

We have numerous tools at our disposal to help us accomplish our mission and we will continue to use them. Senator, we will work as hard as we can. We will work with the SEC, the FBI, and with all our State, local, and Federal partners.

Thank you. I look forward to answering your questions.

Senator KAUFMAN. Thank you.

[The prepared statement of Mr. Breuer appears as a submission for the record.]

Senator KAUFMAN. The second witness is Robert Khuzami, the Director of Division of Enforcement at the SEC.

Mr. Khuzami.

STATEMENT OF ROBERT S. KHUZAMI, DIRECTOR, DIVISION OF ENFORCEMENT, SECURITIES AND EXCHANGE COMMISSION, WASHINGTON, DC

Mr. KHUZAMI. Thank you, Senator, members of the Committee. Thank you for the opportunity to testify here today. Oh, sorry. It's on, just not close enough. Sorry.

Senator Kaufman, members of the Committee, thank you for the opportunity to testify here today before the Committee.

My name is Robert Khuzami. I'm Director of the Division of Enforcement of the Securities and Exchange Commission. I'm honored to be here today and to testify alongside my colleagues from the Department of Justice and the FBI regarding enforcement efforts against those involved in the financial crisis.

As the only agency in the Federal Government focused exclusively on investor protection, the SEC has, and accepts, a special obligation to investors. Essential to that obligation is the aggressive and even-handed enforcement of our Federal securities laws. Enforcement actions address the public's fair expectation that those who have violated the securities laws and caused financial loss and hardship will be held accountable for their actions.

Vigorous law enforcement efforts serve to vindicate the principles fundamental to the fair and proper functioning of our markets, including: first, that no one should have an unfair advantage in our financial markets; second, that investors have a right to truthful and accurate disclosure in accordance with the requirements of the securities laws; and third, that there is a level playing field for all investors.

The SEC and the Division of Enforcement are moving on five primary fronts in response to the financial crisis and to further our overall mission of investor protection. First, we are bringing significant cases based on unlawful conduct related to the financial crisis.

For example, just to take this week alone, we filed two such actions. On Monday, we filed fraud charges against three former senior officers of New Century Financial Corporation, once one of the largest sub-prime lenders in the United States. We charged them with manipulating the company's financial results and concealing the company's deteriorating financial performance.

Among other things, the defendants allegedly failed to disclose to investors important negative financial information, including dramatic increases in early loan defaults, loan repurchases, and pending loan repurchase requests, all of which caused substantial investor losses. In fact, the company's stock price dropped to less than $1 when it filed for bankruptcy in April of 2007, down from its previous high of $50 per share in 2006.

The second case, brought yesterday, is against Brookstreet Securities Corporation, a registered but now defunct broker-dealer in connection with the sale of unsuitable collateralized mortgage obligations, or CMOs, to retail customers. In this action, the SEC sued Brookstreet and its former president and CEO, alleging that he helped to create, promote, and facilitate an investment program through which Brookstreet improperly sold risky, illiquid CMOs, including interest-only and inverse floating rate securities to retirees and other retail investors with conservative investment goals.

More than 1,000 Brookstreet customers invested approximately $300 million in this program.

Beyond this week's actions, we have previously filed mortgage-related actions against Countrywide Financial and its CEO, Angelo Mozilo, as well as against three former senior officers of American Home Mortgage Investment Corporation.

Our second initiative is to enhance our traditionally close working relationship with other law enforcement authorities, including the Department of Justice, in order to maximize the efficient use of government resources, as well as deliver a united and forceful response to those who would violate the Federal securities laws.

Third, we are undergoing, in the Division of Enforcement, a top-to-bottom self-assessment and restructuring. We are establishing national specialized units that will focus resources and expertise to improve the Division of Enforcement's abilities to attack the causes of the recent financial crisis, as well as to address current and future troubling trends that may be next year's problems. We are also flattening our organizational structure to reduce a layer of management and reassigning many of these personnel back to the core mission of conducting front-line investigations.

Fourth, the SEC is conducting an aggressive rule-making agenda to correct gaps and deficiencies exposed by the financial crisis, and proposing various legislative reforms to provide the Enforcement Division with improved tools to address securities fraud and related misconduct.

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

Our mission is to vigorously enforce the Federal securities laws. The staff of the Division, and all of us at the SEC, are committed to that end, and to enhancing investor confidence in the Division, our agency, and the financial markets.

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

Senator KAUFMAN. Thank you.

[The prepared statement of Mr. Khuzami appears as a submission for the record.]

Senator KAUFMAN. Our third witness is Kevin Perkins, who is the Assistant Director of the Criminal Investigative Division of the FBI.

Mr. Perkins.

STATEMENT OF KEVIN L. PERKINS, ASSISTANT DIRECTOR, FEDERAL BUREAU OF INVESTIGATION, WASHINGTON, DC

Mr. PERKINS. Good afternoon, Mr. Chairman and distinguished members of the Committee. I want to thank you for the opportunity to testify before you today about the FBI's ongoing efforts to combat significant financial crimes.

Mortgage fraud continues to pose a significant threat to lenders, investors, residential real estate values, and the U.S. economy.

Mortgage fraud, however, is just one component of the recent financial crisis which has left trillions of dollars of losses in its wake.

Since the financial meltdown in the fall of 2007, the FBI has investigated significant financial frauds on various fronts. For example, we have more than 2,100 pending corporate and securities fraud investigations across the country, many with losses exceeding $100 million, and several with losses of over $1 billion. The FBI has also prioritized its efforts to combat the most egregious corporate and security fraud offenders, which resulted in 460 convictions in fiscal year 2009.

The current financial crisis has not only revealed new fraud schemes, but has also exposed established schemes which have been thriving in the global financial system. These schemes, both old and new, highlight the need for law enforcement and regulatory agencies to be ever-vigilant, to increase the collaboration, and continue working as close partners.

The FBI investigates insider trading schemes alongside the U.S. Securities and Exchange Commission. The recent highlighted success came with the indictments, and subsequent arrests, related to allegations of insider trading within Galleon Group. To date, 14 individuals have been arrested and the investigation is ongoing.

The FBI has observed a rise in corporate fraud schemes, and trends such as failures of prominent financial institutions, the falsification of accounting records, and misrepresentation regarding the risk and valuation of complex financial instruments. Over the last 5 years, corporate fraud investigations have increased by 78 percent, to more than 590 open investigations.

Numerous corrupt executives and accounting fraud schemes have also been exposed in more companies experiencing liquidity and cash-flow problems. This is evidenced in recent investigations, including the deferred prosecution agreement obtained against Beazer Homes, an Atlanta-based national home builder.

Market manipulation, or pump-and-dump schemes, are based upon the manipulation of lower volume stocks purchased on small, over-the-counter markets. These schemes generate an estimated $6 billion in losses each year and have the ability to significantly impact investor confidence. The FBI currently has 109 related cases. In fiscal year 2009 alone, 62 individuals were charged in market manipulation schemes following FBI investigations.

Foreclosure rescue scams are particularly egregious because fraudsters take advantage, and illegally profit, from the misfortune of others. As foreclosures continue to rise across the country, so have the number of foreclosure rescue scams targeting unsuspecting victims.

High-yield investment fraud schemes have many variations, all of which are characterized by offers of low-risk investments guaranteeing an unusually high rate of return. The most common form of these frauds is the Ponzi scheme, which uses money collected from new victims rather than profits from underlying business ventures to pay the high rates of returns promised to earlier investors.

In fiscal year 2009, the FBI realized a 105 percent increase in the number of high-yield investment fraud cases over fiscal year 2008, to a total of 314 pending investigations, many of those with losses exceeding $100 million. The most significant of these is the

$64 billion Ponzi scheme perpetrated by Bernard Madoff, which resulted in the longest prison sentence in the history of financial crime, 150 years. Similarly, Robert Allen Stanford of Houston stands charged in an alleged billion-dollar Ponzi scheme, while just recently Thomas Petters of Minneapolis was convicted of defrauding investors of $3.5 billion.

In addition to nearly tripling the number of FBI special agents who investigate mortgage fraud cases in the field, the FBI has invented and implemented a number of innovative and proactive methods to detect and combat mortgage fraud. Foremost is the FBI's development of the Financial Intelligence Component, established in September of 2009.

For its part, the Department of Justice is initiating a mortgage fraud initiative that will utilize, among other tools, Financial Intelligence Component analysis in the prosecution of its cases. Another proactive approach was the development of an analytical computer application to identify property-flipping transactions. The original concept has since evolved into a national FBI initiative.

Some of the best tools in the FBI's arsenal for combatting financial crimes are its longstanding partnerships with Federal, State, and local law enforcement and regulatory agencies. Currently, there are 16 mortgage fraud task forces and another 61 working groups nationwide. We are also a member of the newly formed Financial Fraud Enforcement Task Force, and we work closely with the Special Inspector General for the TARP to guard against fraud in the $700 billion program.

Mr. Chairman, members of the Committee, I appreciate the opportunity to come before you today and share the work that the FBI is doing to combat significant financial crimes. I look forward to working with you and I'm happy to answer any questions you may have.

Senator KAUFMAN. Thank you very much.

[The prepared statement of Mr. Perkins appears as a submission for the record.]

Senator KAUFMAN. Chairman Leahy cannot be here this afternoon, but he asked that I enter his statement in the record, which we'll do, without objection.

[The prepared statement of Chairman Leahy appears as a submission for the record.]

Senator KAUFMAN. Let's start with the questions.

Mr. Breuer, what do you believe are the top four or five types of financial fraud that related to the meltdown?

Mr. BREUER. Senator, I think, in looking at what has occurred, we really have to run the gamut of the conduct. So in the first instance, I think we have to look at those who defrauded the financial institutions, such as the banks. So mortgage fraud that was perpetrated by professionals, whether it was lawyers, appraisers, loan officers, those who, in the first instance, helped those get loans and mortgages that they should not, perhaps those who worked with straw buyers to buy mortgages.

I think if you go from there, Senator, then we have to look at those who made misrepresentations in their underwriting standards, or those who claimed that, at banks or other institutions, mortgage originators, that they had certain standards, and that

they relaxed those standards purposely and misrepresented what they were doing. I think we have to look at those as well, and those who created these mortgages and claimed that the people at the mortgages and the mortgages that they had represented something other than what they were.

Then I think they, of course, sold their mortgages and misrepresented, in many instances, those who securitized the mortgages. I think we have to look at that part of the line-up. We have to see what the securitizers themselves did. What, in fact, did they represent to those who were purchasing these structured vehicles? What did they say about the underlying mortgages, and what did they say? We think that there, too, we have to look hard at the underlying process and determine what was represented.

And then, last, those who bought those vehicles, those securitizations, those CDOs, the institutions; what did they say to their investors about the value of what they were purchasing? So, Senator, when we look at it, we see it as a continuum from the very beginning until the very end, and I think it's that gamut of activity that we're investigating and that we want to pursue, and where we find criminal wrongdoing, prosecute.

Senator KAUFMAN. OK.

Mr. Khuzami, following on that, in the securities fraud area, what do you think are the main potential sources of fraud in the securities area, in your area?

Mr. KHUZAMI. Senator, I agree generally with Lanny. You know, the SEC is primarily focused on accurate disclosure.

Senator KAUFMAN. Right.

Mr. KHUZAMI. So when we look at the problem, we focus both from the shareholders' perspective, did they get proper disclosure with respect to the companies that they had invested in? So were companies, particularly as the mortgage business began to fail, properly disclosing business trends, prospects, liquidity, the reasons for poor results?

Second, from the perspective of those who invested in the financial products, there's questions about whether or not the risks were suitably disclosed, the status of their investments, what kind of risks there were, what were the reasons for losses, for redemptions. The valuation of assets is a troubling area because of a fair degree of discretion in certain types of illiquid investments; accounting fraud, whether or not the accounting rules were followed with respect to the valuation of assets.

A large number of offering frauds and Ponzi schemes, because in a booming market many investors were seduced into making investments that turned out to be improper, as well as hedge fund activity, which we are particularly focused on. So from our perspective, we look at all those kinds of practices in each of the product areas, whether or not they be companies involved in the mortgage business, those who securitize the mortgage, or those who created structured products.

Senator KAUFMAN. Great.

Mr. Perkins, do you have any thoughts about areas that you think are fertile to be looking for in terms of financial fraud beyond——

Mr. PERKINS. Yes, Senator. I, first, have to say that I concur wholeheartedly with my colleagues and the descriptions they've given. We're engaged in what I refer to as a multi-front battle, multiple types of fraud schemes, as Mr. Breuer mentioned, starting with basic mortgage fraud cases and working our way right up the chain, from Main Street to Wall Street and beyond. We have resources deployed in each one of these areas and we prioritize cases in each of these areas depending upon dollar losses, their impact on the integrity of the market itself, the number of victims, and the like. But I concur with Mr. Breuer's statement.

Senator KAUFMAN. You know, look. You're sitting there, you're trying to figure out the priorities on these different cases. Clearly, it's like a lot of other things you deal with, like the drug area. I mean, it's easy to pick up somebody that's got, you know, two ounces of marijuana or something like that, and it's very hard to get the people that actually engineered the whole thing, the drug kingpins.

So in this case, how do you decide between picking the low-hanging fruit and going after the cases which, we admit—I mean, the toughest—I mean, some of these cases, going after some of the people at the top, some of these things, if in fact there was fraud, are extremely well-financed. They have great representation and it's going to be a very complex case. It's going to be hard to do. I mean, how do you—can you just kind of go through the process—start with you, Lanny—on how you kind of measure, you know, I want to get the big guys, but it's a lot easier to get the little guys. How do you go through that?

Mr. BREUER. Senator, it's a great question. It's a very tough issue. I'll tell you what we do, and there's no one right formula. Some of our prosecutors look at the beginning of the continuum, and so we have, for instance, right now, a mortgage fraud initiative where we're working with the U.S. Attorneys, and we're working to send prosecutors to various areas around the country where we think have particularly high rates of mortgage fraud. We try to bring cases in very real time, much in the way we have very successfully done in the health care fraud area, and so we put pressure on those.

And then we have other prosecutors, candidly, who are working on higher parts of this continuum. In part, my goal is, if we put pressure on the lower folks and then they feel the pressure, they're going to talk about the people above them. So if we talk about the people who misrepresent to the banks, they may have information about the banks, or the mortgage originators. They, in turn, may have information about those who did the securitizations and what they said. And one of our goals, frankly, Senator, is that. We also look for tips. We look for whistle-blowers, we look for filings, we look at everything we can. But in doing that, we have different prosecutors sort of focusing on different aspects along this continuum.

Senator KAUFMAN. OK. Let's just hold the thought, Mr. Khuzami, Mr. Perkins, and we'll come back to that when I get to my next round of questioning.

Senator Hatch.

Senator HATCH. Well, thank you, Mr. Chairman. I'm grateful that you'd take the time to do this hearing, and grateful for your leadership in this area.

I just have a few questions for you that I hope will be helpful. I'd like to kind of limit my questions to deliberate abusive short selling. I'm a firm believer that short selling is a legitimate and worthwhile correction and approach toward the market, but deliberate abusive short selling is a real problem.

Mr. Khuzami, in your testimony you stated that the SEC has brought enforcement actions in a wide variety of areas, including market manipulation. Of those cases involving or pertaining to market manipulations, how many of those cases target short selling activities of all kinds?

Mr. KHUZAMI. Senator, I don't have the exact number at my fingertips.

Senator HATCH. Approximately.

Mr. KHUZAMI. We've brought cases with respect to those firms that have violated Regulation SHO and the rules regarding Locates and Fails to Deliver, who have concealed the failure to comply with those rules through various exceptions. We have also brought cases regarding those that short stocks in advance of public offerings and then use the stock that they obtain in those offers to cover the short positions, which are also a violation of the rules.

We have a very active investigation arising out of the financial crisis, particularly focused on the financial institutions in 2008 who were the subject of a great deal of downward pressure on their stock prices, where we have some very extensive investigative efforts going on. So we look at short selling across the spectrum and have brought cases in all of those areas.

Senator HATCH. You have? Regulation SHO allows short sellers to make a short sale if they've borrowed or located the shares to be sold short, as I understand it, or if they merely have a "reasonable belief" that they'll be able to locate the shares prior to the settlement date.

Now, there have been, in my opinion, extremely few enforcement actions brought under Regulation SHO, even though the volume of Fails to Deliver reached levels as high as 2.35 billion of shares on June 22, 2009, and 19.77 billion on September 23, 2009.

Now, do you believe that one of the reasons for the lack of Regulation SHO enforcement is that the "reasonable belief" standard is vague and subjective so as to make successful enforcement actions all but impossible, and would the elimination of the reasonable belief standard make enforcement easier for the Commission than others?

Mr. KHUZAMI. Well, Senator, I guess I would answer the question by saying, what's good for enforcement isn't necessarily the right thing from a market structure perspective. You are absolutely right that a different standard would be easier to prosecute from an enforcement point of view. If you required persons to actually have borrowed the stock before a short sale, then you wouldn't have to get into questions of someone's reasonable belief or what they intended to do. But ultimately that's a tradeoff with what——

Senator HATCH. Do you have any suggestion as to how we might make that standard better than it is?

Mr. KHUZAMI. Well, I think that ultimately it depends on your view of the value of short selling or not. If you think that——

Senator HATCH. I want your view.

Mr. KHUZAMI. I'm sorry?

Senator HATCH. I want your view. I think short selling may be valuable. I don't think that negative short selling that's abusive is valuable. I think it's destructive. And I think we have too much of it, and I don't think that the regulatory bodies really do much to correct it.

Mr. KHUZAMI. Well, the current rules require——

Senator HATCH. Including the SEC.

Mr. KHUZAMI. The current rules, Reg. SHO, which was passed earlier, and then revisions to Reg. SHO require that a party actually has to locate the stock and then close out the fail within, I think, trade date plus four. And as a result of those two rules, my understanding is that the level of fails have dropped very considerably, both in the area of equities, as well as ETFs.

Senator HATCH. They're still way too high.

Mr. KHUZAMI. I'm sorry?

Senator HATCH. They're still way too high.

Mr. KHUZAMI. Well, with respect to the fail rates?

Senator HATCH. Uh-huh.

Mr. KHUZAMI. My understanding is, they've come down quite considerably, Senator. I'm happy to re-check those statistics.

Senator HATCH. I'd like to have those figures. Look, I don't think it's the right thing to allow people to negatively short sell, especially when they do it to a company and knock its stock way down deliberately, and that's part of the process and part of the problem. And although there are some people who may be a little more anxious about that than I am, it's still something that I think is a real problem. And Regulation SHO—do you think Regulation SHO has really worked that well?

Mr. KHUZAMI. Well, I think it's done a good job of bringing down——

Senator HATCH. Better than nothing.

Mr. KHUZAMI. Bringing down the rate of fails. I think it's done a very good job at that. Now, just because there are fewer fails doesn't mean you still don't have people falsely representing whether or not they have the locate necessary for the short sell, and we are undertaking various studies to figure out whether or not something more should be done in that area.

Senator HATCH. Well, I hope you really—and Lanny, I hope you guys in the Justice Department will really look at this too, because I know too many companies that I think have been abused because of negative short selling.

Mr. KHUZAMI. We've seen it across the spectrum as well. In addition to the short sellers—I mean, if you talk to them, the short sellers say that the company is misrepresenting its financial information, or they've issued unregistered shares so there's many more shares out there in the marketplace than the public thinks. So when you see these huge sale volumes, it's because there are more shares in the float than are publicly registered, because some issuers have improperly issued stock. So what is our obligation to

do, is to dissect the various views and figure out who it is that's engaged in the wrongful conduct.

Senator HATCH. Well, do you have any tools that you'd like to get from us that might help you in this endeavor? Any of the three of you could answer that question. What would you like us to do?

Mr. KHUZAMI. I'm sorry? Like I said——

Senator HATCH. What would you like us to do? Because there are abuses in this area.

Mr. KHUZAMI. Uh-huh. What I think would be very helpful, is we're engaged in various efforts to try and simply get better audit trail information about actual trading, better underlying data so that we can determine exactly what is the source, and the volume, and the amount of this kind of trading. So that's one of the efforts that we're taking so that we can make better-informed rules and better-informed enforcement decisions.

Senator HATCH. Mr. Chairman, I want to thank you for your energetic leadership in this area. I want to thank the three of you for the work that you do. But I'd like to see more advice to us up here on what we might do to help you to keep the crooks out of the business as much as you can. It's very difficult. But I'm very concerned about this abusive short selling approach. That's only one of the things that I'm upset about, but that's about all I can ask about today.

Thank you so much. We appreciate your testimony, appreciate you being here.

Thanks, Mr. Chairman.

Senator KAUFMAN. Senator Franken.

Senator FRANKEN. Thank you, Mr. Chairman. I also appreciate all you gentlemen being here today.

I had a question. During all your testimony and in response to what kind of crimes contributed to the financial breakdown or meltdown, one of the things I didn't hear was rating agencies. I'm wondering to what extent—there are a lot of securities that were given AAA ratings that turned out to be complete disasters. And it seems to me, from what I've read, that there were rating agencies that were sort of compromised in that they were receiving business from the people they were rating. That seems to me to be not kosher and illegal. So I'd like to know, to what extent—and this is opened up to anybody, but especially Mr. Breuer and Mr. Khuzami, to what extent are rating agencies in your cross-hairs?

Mr. KHUZAMI. Senator, let me start with that. We are looking very closely at credit rating agencies, for the reasons that you've indicated. Prior to the passage of legislation in 2007, to bring a case against a credit ratings agency, you had to prove that they knowingly or recklessly issued their ratings, essentially. You had a fraud standard.

That can be difficult to show and a challenge, particularly when, while it's clear that the ratings agency may have gotten things very wrong with respect to the diversification of portfolios and how they arrived at their ratings, historical assumptions about default rates that proved to be very wrong given what happened; a fraud knowledge and intent standard can be difficult.

As a result of the legislation in 2007, we now have more tools because now we can bring actions based on false statements in an

application and certain types of conflicts of interest that you identify, where they're issuing a rating for a company that may provide more than 10 percent of their revenues, for an example, or an analyst is rating the securities for a company that he or she serves as a director on and has some relationship with.

So we are focused on that area. You know, there's not a lot of disclosure with respect to credit rating agencies, so it's hard to go on a disclosure theory, that they said they were going to do X, Y and Z with respect to their rating and they didn't, so what you're left with is a theory that they had knowledge about wrongdoing and didn't update their models, or they had certain conflicts of interest. We're looking at those areas.

There's some ambiguity in the legislation, and I think we've proposed that it be cleared up because the legislation that was passed in 2007 actually says that we cannot bring actions based on, I believe, the methodology or the ratings themselves. It says we can't regulate that area. There's an ambiguity as to whether or not that means we simply can't regulate it, or whether or not we can't actually bring an enforcement action. So we've asked for some clarification in that area, but it's something that we are focused on and we hope to be successful in.

Senator FRANKEN. Mr. Breuer.

Mr. BREUER. Senator, taking off from what Rob said, in the first instance, one of the challenges, of course, from the point of view of the Department of Justice, is that the fee structure that you described, of course, was known. It wasn't surreptitious; it was widely known how the rating agencies were charged, and at least under the—it has been—my understanding is it's been permissible in the past.

Second, rating agencies themselves have always had a First Amendment privilege in their ratings, and they've claimed that when they've been challenged in court. But we are looking at them, and we support the SEC and the SEC's suggestions and ways of changing legislation. Obviously the record of the credit rating agencies has been troubling, and it's something we're all looking at, but there are challenges.

Senator FRANKEN. I'm thinking about what you've learned from looking into this. We are—not this Committee, but another committee—going to be changing its way of regulating the financial industry. From what you have learned from this—I don't know how you're confined in your testimony because of your roles—what should we be doing, different, to regulate these financial institutions?

Mr. KHUZAMI. Well, from my perspective, Senator, with respect to enforcement-related regulation, we have some various proposals, including hedge fund registration, for starters, which would allow us to have additional oversight, examination authority, and better transparency into the activities of hedge funds. The same is true with derivatives. I think the proposal to have a central clearing party for derivatives, as well as require registration of the firms—which would again allow us to have better access to——

Senator FRANKEN. Should we have an exchange for derivatives?

Mr. KHUZAMI. I think my view is, as long as we have a central clearing party who stands in the shoes of the counter parties, from

an enforcement point of view, that is a very significant improvement over the current situation. I'm a little reluctant to answer the question on the exchange-related basis. I don't know if the Commission has announced a view on that particular proposal, so I want to be careful.

Senator FRANKEN. I hate to put you in that position.

I'll put you in that position, Lanny.

Mr. BREUER. Senator, I was going to go and continue from what Rob said. One, is that I think we should be supportive of that which increases transparency. I mean, it's just vital.

And second, these structures, some of them, are just, candidly, remarkably complicated. Some of the smartest people we know were involved in this for years and years. From a law enforcement perspective, that requires, now, remarkable resources to figure out what was done, and to figure out who did them. To reconstruct them is hard, so anything that can be done to both increase transparency and to give resources to the regulators, and then, candidly, to law enforcement to follow up would be helpful. We are following up, but to state the obvious, these are great challenges.

Senator FRANKEN. OK. I hope we'll get to a second round.

Thank you, Mr. Chairman.

Senator KAUFMAN. Senator Whitehouse.

Senator WHITEHOUSE. Thank you, Chairman Kaufman. Thank you for your interest in this topic and for the, I think, very helpful legislation that you have proposed.

I have a number of different questions, and so if there is a second round, I hope to stay for it also. But let me start by asking Mr. Khuzami, obviously the tail-end of the Bush administration, and perhaps the entire Bush administration, was not the SEC's finest hour; whether it became a fully captive regulator of the industry or just became a neutered regulator, it certainly fell down on some very, very important responsibilities.

What are the telltales that we should be looking for that give us some assurance that the SEC is back on its feet, energetically doing what the public trusts it to do?

Mr. KHUZAMI. Well, Senator, I think since my arrival in March, as well as the appointment of Chairman Shapiro earlier this year, I think both the pace of enforcement activity, as well as the rulemaking agenda, I think, sends a very clear message that the Commission is reinvigorated toward its primary goal of investor protection.

Just quickly, three things. I mean, the statistics bear out a very significant increase in numbers of temporary restraining orders, opening of investigations, returning money to harmed investors. In addition, as I indicated in my opening statement, a real thorough self-assessment of how we do our operations. I think that's probably the single biggest piece of evidence that shows that we recognize that it's our obligation to do our job as best as we can and we need to restore investor confidence.

So within the Division of Enforcement, we are creating specialized groups, streamlining management, reducing bureaucracy and decentralizing authority, creating whistle-blower—seeking whistleblower legislation, new offices to handle tips and complaints, new tools, like the criminal authorities for being able to offer formal co-

operation agreements to inside witnesses. So, a whole host of reforms on the kind of organizational and structural side.

Senator WHITEHOUSE. Aside from the organizational and structural side, what can you tell me about the personnel of the agency? I think it's a fairly common observation that when a regulator becomes captive to a particular industry and fails to meet its responsibilities, that is very discouraging to a lot of the better, more energetic, more honorable employees who have given up a lot to serve in public service.

And if the goal of—if the psychic reward of feeling that you're doing the right thing isn't being met, they tend to drift away, and so you're left with the slackers and the careerists and people who just want to get their ticket punched. Is that a problem at the SEC? I don't—I didn't mean that as a criticism of the SEC, because I don't know enough.

I just know that, in general, that kind of thing happens. When a regulatory agency goes rotten, it's very hard for honorable people to stay in a rotten regulatory agency. How would you assess the extent to which that took place in the SEC, and what needs to be done if it did take place?

Mr. KHUZAMI. Well, Senator, since I've arrived I have not seen evidence of rot or being captive to the industry; quite the opposite. I've seen a team of people in the Enforcement Division who are as committed as I could have hoped for when I arrived at the Division, as committed as my colleagues in the Department of Justice, when I was a prosecutor in New York. The ability to attract talent has only increased.

The kinds of resumés that we get for open positions has been just incredibly great talent. I see people energized, I see people committed to their cases. I see people excited about the opportunities that are being introduced by a result of our streamlining for more autonomy, less bureaucracy, more ability to bring their cases.

Senator WHITEHOUSE. So you're comfortable that, both from a process and personnel point of view, the SEC is back?

Mr. KHUZAMI. Absolutely.

Senator WHITEHOUSE. Very good. I'm delighted to hear it.

Mr. KHUZAMI. And stronger.

Senator WHITEHOUSE. I'd like to ask both Assistant Attorney General Breuer first, and perhaps you'd like to chime in as well, the question of the honest services standard is about to be before the United States Supreme Court. As a former U.S. Attorney and Attorney General who has looked at cases under that standard, I can very clearly see the concerns that the Supreme Court has and that the opponents of the legislation have.

What would you consider to be the critical elements that you need to see preserved under that standard, either in an argument to the court that you might be recommending to the Solicitor General, or if we have to address this again in legislative language, what are the kind of high points that you think most need to be defended to keep this an effective tool in your arsenal against white collar criminals?

Mr. BREUER. Well, Senator, I was fortunate enough to go to the argument yesterday and heard our Deputy Solicitor General argue *Wyrock* and *Black*. And you're right, these are essential tools for us.

I'd like to come back to more specific issues, but I do think it's essential that in an honest services case, that we have some latitude here, because there are in fact cases, Senator, right now, where—for instance, public officials in particular—I think the real central issue is, we care about everything, but the public official is really what we care about. We need an ability to prosecute a public official who surreptitiously has an interest, doesn't disclose that interest, purports to be doing the public's bidding, but in fact is privately and secretly benefiting from that.

We need to be able to pursue those kinds of cases, so that the public has confidence in their public officials, and we need to be able to do that, even if there is not a specific State statute that, for instance, may require disclosure. That, to me, is one of the core conducts that is essential.

There's more, and I'd be delighted to chat with you. We now also have the *Skilling case*, so it'll be interesting to see how far they go. It looks like the court, the different justices, have different views. But at its core, that's the conduct that we care the most about.

Senator WHITEHOUSE. My time has expired, but I look forward to continuing the discussion.

Thank you, Chairman.

Senator KAUFMAN. Back, Mr. Khuzami, to where we left my questions, which was the whole idea of, how do you make the tough decision between the relatively easy cases, the low-hanging fruit, and the problem you get into if you really go after the big guys because of their incredible resources and the complexity of the cases. How do you kind of make that decision in SEC enforcement?

Mr. KHUZAMI. Well, Senator, there's no shortage of eagerness by SEC personnel, in the appropriate case, to follow the evidence and go as far up the chain as the evidence will permit. I think that one thing that I've tried to do, is we are trying to come up with alternative metrics that rely less on quantitative measures of performance so that we de-emphasize the number of cases brought and try and refocus some of our evaluation and criteria on the quality of the cases, the programmatic priority, and the deterrent effect, and the timeliness, some other factors that I think better capture how effective an enforcement program we're running.

But in terms of the investigative steps, it's a standard process: you start with your evidence, you start where it leads, and you work your way up the ladder. There is typically, push comes to shove, individuals find themselves in the cross-hairs of an enforcement action or criminal investigation, will identify others who are involved in the wrongdoing and we will follow that chain up the ladder. We are also seeking, as I said earlier, whistle-blower legislation and these cooperation tools to better help us get to insiders in organizations. But it's an issue we think about in every case that we bring.

Senator KAUFMAN. So the vast majority of cases, you start at the bottom and work your way up? It isn't like someone comes in—unless you have a whistle-blower or someone like that who comes in the door at the highest levels, you have to—on the mortgage thing, you start with maybe a mortgage broker, finance company, or something like that and work your way up to the people that securitized the mortgages?

Mr. KHUZAMI. Well, it's not quite that. I mean, one, you start where the evidence leads you.

Senator KAUFMAN. Right.

Mr. KHUZAMI. But, two, there's nothing to stop you from starting an investigation based on information you've received at the highest levels. That may not be the smartest investigative approach——

Senator KAUFMAN. Right.

Mr. KHUZAMI [continuing.] But you can start virtually anyplace. What you want to do is start where your evidence is the strongest.

Senator KAUFMAN. OK.

Mr. Perkins, do you have any thoughts on this?

Mr. PERKINS. Yes, sir. Thank you.

We consider—the FBI considers a number of different factors when we're looking at prioritizing what cases we take and which direction we go with them. I mentioned earlier, dollar loss is one particular item. The number of individuals who have been victimized across the board is another one. The actual impact on market integrity or the community at large. There are other things we look at to see if a case should be given a priority status, such as, is there organized crime involvement, is there an organized group or criminal element or is this a one-individual type of deal?

We've actually become good at that simply because we have to focus our limited resources on cases that have the highest impact. A good example: 85 percent of our mortgage fraud cases today are focusing on cases that have losses in excess of $1 million. So, frankly, I have to take my resources and go where the largest dollar impact is.

There's another side we look at too, and we've been very fortunate. I've mentioned resources. In the last several cycles, we have been very fortunate to receive additional resources to work these types of cases. They've been put to work, many of them, in the intelligence area, as far as gathering and doing analysis on these types of cases.

We try to look, both from a tactical and a strategic standpoint and actually try to identify cases before they're actually reported to us through various methods of looking at information, whether it's from confidential human sources, wire intercepts, and the like. So we use that information to also try to bolster these investigations and send out packages to our field offices.

Senator KAUFMAN. You know, kind of taking a different approach and looking at, where was the money? The old Willie Sutton, you know, rob banks because that's where the money is. Where was the big money lost? Obviously the mortgage are and the mortgage-backed securities was where a lot of money was lost, but there was a lot of money also lost in credit default swaps.

I'm just saying, from the standpoint of—you know, when a lot of money is lost there's always the possibility that there was fraud somewhere involved in that. Do you have any thoughts on that, starting with you, Mr. Khuzami, on credit default swaps and a potential there for financial fraud actions?

Mr. KHUZAMI. Well, Senator, we're seeing some types of securities fraud where credit default swaps are being used as one of the means by which the fraud is occurring. So, for example, we've seen

insider trading cases where, rather than buying an equity security based on material nonpublic information, someone might go into the derivatives market and buy protection or buy a credit default swap on a bond issued by a company in anticipation of the value of that credit default swap rising when a certain announcement takes place.

We've also seen allegations that individuals had been buying credit protection so that the price rises, so that then those who hold equity will think that the company is in trouble, that will cause downward pressure on the price, and then if you have a short position you can profit under those circumstances. So, we've seen it as a means to other frauds.

With respect to the market itself, I don't know what the sort of informed thinking is with respect to the credit default swap contributing to the financial crisis. A lot of people lost money on those markets, that's for sure. The question is whether or not they lost it because they bet wrong and sold protection for a bond or a credit instrument that then went into default for legitimate reasons and they had to pay up on their contract.

What we would like is better transparency into all of these markets so that you can see who's making these trades and what the terms are, because now it's an over-the-counter market where the evidence exists in the files of the parties to the contract and really not anywhere else, and that's not good for anybody. So we're hoping, through regulation of credit default swaps, that we'll be able to have better access to that information and better be able to answer that question.

Senator KAUFMAN. Let me just ask, one of the things that I've—a lot of people talk about how important liquidity is in the market, and the rest of it. But is it fair to say that you can't have regulation if you don't have transparency? I mean, it's almost like, you don't have to spend a lot of time. If there's a market and there's something going on in an area, any kind of market or any kind of area and you don't know what's happening, I mean, it seems to me like axiomatic that you can't regulate. Is that fair to say, or is there an exception to that? Can you think of——

Mr. KHUZAMI. I think as a general maxim that's absolutely right. We're a disclosure agency, so that principle is our holy grail and we completely agree with that. You can't—if you don't know what's going on, you don't know where to target your resources. There may be circumstances where there are other values that you want to protect, and so something short of full transparency is appropriate. But as a general matter, that's a good maxim to live by.

Senator KAUFMAN. Great. Thank you.

Senator Klobuchar.

Senator KLOBUCHAR. Thank you very much, Senator Kaufman, Mr. Chairman. Thank you for holding this important hearing today. I was pleased to work with both you and Senator Leahy on passing the Fraud Enforcement and Recovery Act. As a former prosecutor, I saw firsthand how difficult some of these white collar cases are to go after the resources that they take on the investigative side, Mr. Perkins, and then the prosecution side as well. So we hope it gave you some more tools.

I've often said, when you look back at the last few years, I picture some of these guys that were involved—mostly guys—in these high-flying deals, taking their Ferraris down Wall Street while the government was chugging behind in a Model T Ford, and it is time to catch up and start to be as sophisticated as the people that are committing the crimes.

I hope that these tools will help. Clearly, meeting with the Director at the FBI to see some of the change in resources, understandably, after 9/11, and then trying to regain that investigative power, because one of the things that I experienced, having done some of these white collar cases, was that there is a huge prevention element here, that if you send a clear message you're going after these con men and these fraudsters, you can really prevent a lot of crime, even more than in some other areas of the criminal justice system.

My favorite story was when we went after some pilots who had decided they could pretend that they lived in post office boxes in Florida—when they had actual big homes in the Twin Cities—so they wouldn't have to pay the State taxes. We ended up getting, I think, six, seven convictions in that area.

The Treasury Department in the State of Minnesota literally had millions of dollars that were sent in during that time as people realized that they were going to get in trouble if they didn't pay their taxes. So I think you can have a major effect by bringing these cases, and I want to thank you for making this such a priority.

My first questions actually are for you, Mr. Perkins, just along these lines. Based on your testimony, it's clear that the FBI is taking financial fraud seriously. I appreciate your efforts. You mentioned the case, the recent white collar case in Minnesota, which I think was one of the biggest Ponzi schemes after the *Madoff* case. Is that right?

Mr. PERKINS. That's correct.

Senator KLOBUCHAR. At least, we say that in Minnesota. I don't know if that's a claim to fame.

Mr. PERKINS. Yes, ma'am. It's one of the top three.

Senator KLOBUCHAR. And the good work that was done in that investigation. But I'd just like to know what kind of resource needs you have, what we could be doing with this upcoming financial regulation that we're working on, the financial regulation bill, if there are things in there. You maybe won't have all your wish list right now, but to keep that in mind as we go ahead with these investigations.

Mr. Perkins.

Mr. PERKINS. Yes, Senator. Thank you. Excellent question. I'll start by saying I'm very grateful, both personally and on behalf of the FBI, for the resources that have come our way in recent cycles. They have been well put to use and are doing the people's business as we go forward.

One of the things we learned after 9/11, and as everyone knows, we lost a significant number of criminal resources shortly after 9/11 to answer the call and the crisis that we were facing at the time. One of the things that did was cause the FBI to re-focus what it was doing on the criminal side and focus on only the highest priority matters. We'll take that down a level and look into what we were doing in white collar crime, for instance.

In the years shortly after 9/11, we had to eliminate the lower dollar loss cases. Many of those were staples. Growing up as a young agent myself, I was hired during the last savings and loan crisis in the mid-1980s, and I really cut my teeth on cases like that. Unfortunately, we don't have the luxury to do that now. State and local authorities have stepped in and do a very admirable job, and no one has really missed a beat.

As resources begin to come back to us and as they're being focused back into these areas, we're not going back to those types of cases. We have begun to use those resources in a better way, whether it's setting up the financial intelligence component where we can do both tactical and strategic analysis, something we were never able to do before, to focus our resources on the highest-dollar cases, the ones that have the highest impact on the community. So as we take these resources going forward, we're looking very closely on where we can have the biggest impact.

For instance, instead of one and two agents and analysts going across the country, we've done an awful lot of analysis that focuses on where the biggest problems are so we can make a big impact to that particular agent in charge of that particular division. We may send three, four, five agents to that particular division so that they can have almost an immediate impact on the crime problem going forward. I appreciate the support of the President's budget, the 2010 budget, and as we go forward I appreciate the support that we get in all of our white collar needs. Yes, ma'am.

Senator KLOBUCHAR. OK. Thank you.

Mr. Breuer, again, congratulations again on that same case for the Department of Justice. I was reading an article today about the lead prosecutor, a young guy on the case, Mr. Dixon, and he is so careful not to toot his own horn. The reporter asked him, "How are you feeling today", after the big victory, and he said, "Is this off the record?"

[Laughter.]

Senator KLOBUCHAR. In any case, I just want to congratulate you on that. I know it was a major case. I'd just ask about the issue that I raised in my first remarks here about prevention, and how you see this fitting in, especially in the mortgage area. I know that DOJ is launching a mortgage fraud initiative that will focus resources on the prosecution of high-impact mortgage fraud cases, but will also try to deter future mortgage fraud crimes through increased real-time enforcement. Talk about that and how you see prevention fitting into your efforts.

Mr. BREUER. Well, Senator, it's exactly that. It's got to be a comprehensive approach. So we look at the mortgage initiative: it really takes a page from what we've done with the Medicare Task Force. In the Medicare Task Force, what we did, as Kevin was referring to, was to use data. So we sent prosecutors to places around the country where Medicare billing was disproportionately high.

To give one example, we worked with the U.S. Attorney's Office in southern Florida. We started prosecuting people right away: doctors, health care professionals. As a result of those real-time prosecutions, billings immediately—billings in the Medicare program in one county, one county in Florida, went down by $1 billion.

Senator KLOBUCHAR. Unbelievable.

Mr. BREUER. That's a billion. So that's our goal with mortgage fraud.

Senator KLOBUCHAR. You're making Senator Kaufman and I really get going, because we've got—he has, and I do, this bill to go after—give you more tools on Medicare fraud and medical fraud that we'd like in the health reform bill.

But continue on.

Mr. BREUER. So that's what we're doing. We're trying to find high-impact cases. And how do we do it? We do it through data. I probably meet with Rob at least once a week, and with Kevin about once a week, as well. So we're trying to compare notes about, given the resources that you have been generous enough to give us, how can we, in the most targeted way, deal with it? So that's what we're trying to do.

Now, of course, some of those cases, again, as Senator Kaufman said in the beginning and as I did, tend to be sort of more on the local level and they tend not to be the highest end frauds, because those are the ones sometimes we can identify with the data. Our challenge is then how to build our way up. That's what I want us to do, and in that we need greater transparency. We need as many incentives as we can for people to come forward when they know about wrongdoing and to inform us. It's through that that we're building cases on all different levels.

Senator KLOBUCHAR. Thank you very much.

Senator KAUFMAN. Senator Franken.

Senator FRANKEN. I want to pick up on one of the things that my colleague from Minnesota talked about, which is how proud we are in Minnesota to be home of the third largest Ponzi scheme.

[Laughter.]

Senator FRANKEN. Let me ask this, Mr. Perkins. Isn't it kind of true that these Ponzi schemes came to light because of the financial collapse? I mean, in other words, isn't it easier to keep one going when, I'm getting you 20 percent return, I'm getting you 20 percent return? Every year, I'm getting you 20 percent returns, and you should put more money in. Gee, this year the market just collapsed. How are you getting me 20 percent, and why should I put more—I don't want to put more money in now. I mean, isn't that really what happened? Is there really anything—are there a lot of Ponzi schemes now?

Mr. PERKINS. Yes, Senator. You are exactly correct. These things come to light. I often use the analogy of a lake during a drought. When the drought comes and the lake level drops, it once was a pristine-looking, beautiful place, and then suddenly you start seeing the stumps and the old buildings and other things that had been covered over by the lake. That's exactly what happens in this case.

As the market collapses, it exposes these types of schemes. I've been in this position—Director Mueller put me into the position of the Criminal Division Assistant Director about 6 months ago. I get, on a weekly basis, a summary of various cases. The first few Ponzi schemes I saw, the first week I was there, I thought, wow, this is amazing. This is a $14 million loss, this is a $20 million loss. I don't pay—well, I don't want to say that. I do pay attention to all of them, but they pale in comparison right now.

A week doesn't go by that I don't see some case brought against an individual or learn of a new case being opened in a Ponzi scheme type situation. Obviously, Madoff and others are the ones that hit the headlines, but that's exactly the case. As the market recedes, we see these cases. We've had, I believe—the exact number escapes me now—nearly a 100 percent increase, and I think it actually exceeds a 100 percent increase, in the number of cases in the past year.

Senator FRANKEN. Exposed?

Mr. BREUER. Yes, sir.

Senator FRANKEN. OK.

I'm also going to pick up on another theme of Senator Klobuchar's, which is prevention. It also—along with the theme of Senator Kaufman's, which is—he was talking about low-hanging fruit, and picking—I kind of like picking off low-hanging fruit, especially in mortgage fraud.

So, Mr. Breuer, to what extent do prosecuting the garden variety crook, who gave a predatory loan to somebody, does that create a deterrent to these kind of people if they see other people like them going to prison?

Mr. BREUER. Senator, I think it does. That's what we have to do, and that's why we are doing it. We're prosecuting those cases around the country. We have now, because of the Attorney General's direction, a Federal/State partnership.

I, in fact, am co-chair with the Attorney General of Missouri, Attorney General Coster, where we are exactly pursuing that. These are cases where it may not always be the case that it's the Federal prosecutor who brings a case. It might be a great District Attorney who's bringing those cases. But I agree with you, I'm a big believer in getting low-hanging fruit. We want to get the other fruit, as well. But I do think these are deterrents, and we are aggressively doing just that.

Senator FRANKEN. I noticed when you said great prosecuting attorney, you pointed to my colleague, Senator Klobuchar.

Mr. BREUER. But she wasn't looking up at the time, Senator.

Senator FRANKEN. I know. That's why I pointed it out.

Mr. BREUER. Right.

[Laughter.]

Senator FRANKEN. She was making notes.

Here's a question, and I'll just throw it open: what is legal? Because sometimes the biggest—the worst stuff is what's legal. What is legal that you'd make illegal? Anybody? Mr. Breuer.

Mr. BREUER. I'm going to cop out. I'd like to get back to you. I think there are things we'd like to do, but I know that in my Department of Justice, they'd want me to come back to you. What I'd like to do is send you something.

Senator FRANKEN. OK. I understand.

Mr. BREUER. OK.

Senator FRANKEN. Mr. Khuzami, same thing?

Mr. KHUZAMI. I mean, we have a number of legislative proposals. It's not necessarily the situation where it's something that's legal we want to make illegal, but it is activity now that is unregulated or unexposed that we would like to have much more information

about, and that involves hedge funds, derivatives, and similar situations.

Senator FRANKEN. OK.

One last question. What are we doing now to make sure there's no fraud in terms of the stimulus package? Anybody? Because that's a lot of money.

Mr. PERKINS. Yes, sir. One of the things we're trying to do is actually through some lessons learned in the Katrina crisis, when a lot of money went to that part of the world to try to fix and build. We tried to stay ahead of the curve there and we had a good deal of success in convicting—or prosecuting and convicting individuals who were defrauding the Federal Government at that point.

What we've done within the FBI, is each one of our 56 field offices is focusing efforts on identifying the stimulus money that's coming to their particular area of operation, determining where that money is being spent, what the process is, looking at individuals, working informants and the like to determine particular contractors who may be getting funding for particular projects, what their criminal background possibly might be.

So there's work ongoing in those areas so that we can try to stay ahead of the curve. We worked very closely with the various Inspector Generals and others who are involved in those matters. We have joint task forces with them and with the prosecutors in each one of those districts.

Mr. BREUER. Senator, if I can just add to what Kevin said. The stimulus money, of course, is through the Recovery Act. The chair of that is Earl Devaney, someone who's been an Inspector General for many years, initially at the Interior Department, who has really a remarkably robust web site right now that's really quite extraordinary, where he follows all the money.

Some of our great lawyers in the Fraud Section go there repeatedly literally to look at what is going on. In the Financial Fraud Enforcement Task Force that the President began through his Executive Order and that the Attorney General is principally leading, there is actually one working group that is doing nothing but looking at the stimulus money and ensuring that, to the degree there is fraud, we go after it. I know that Mr. Devaney immediately refers cases to IGs the moment he sees a problem, and that they in turn send them to prosecutors when they identify an issue.

Senator FRANKEN. Because in the reconstruction in Iraq and in Katrina, it was amazing, the lack of oversight we had and the billions and billions of dollars that were wasted through waste, fraud and abuse. I'm glad to hear that.

Mr. BREUER. Right. And you know, Senator, I couldn't agree more. Every day now, or every week, with respect to Iraq, we in the Criminal Division, and throughout the country, are announcing prosecutions of people who did exactly what you're describing.

Senator FRANKEN. Thank you.

Thank you, Mr. Chairman.

Senator KAUFMAN. Senator Whitehouse.

Senator WHITEHOUSE. Thank you, Chairman.

Mr. Khuzami, I read with considerable interest the scalding decision by Judge Rakoff that emerged out of a settlement that the SEC had proposed after the Merrill Lynch-Bank of America merger

and the disclosures that were made about promises concerning bonuses to the acquired entity.

It raised the interesting conundrum that the SEC was proposing to remedy the injury that was done to the victims of that alleged fraud, i.e., the shareholders, who were not given a fair report of what the agreements were by charging them another several tens of millions of dollars of shareholder money, so that, in effect, the victims were being asked to bear the burden of the penalty for the act of which they were the victims. I know that that case is still ongoing and so I cannot—you probably cannot talk about that in any kind of concrete or detailed way.

But I'm wondering if it gives you any—if it causes you to draw any broader conclusions. Is this just a one-off decision and one case that will go away when that case is ultimately resolved, or do you think it's a case that stands for a broader point that is something that the SEC should be attending to, you know, across its entire regulatory regime? If so, what steps are you undertaking to respond to it, if any?

Mr. KHUZAMI. Well, Senator, the issue of corporate penalties, in general, is something that, you know, is discussed on the criminal enforcement side, on the civil enforcement side, across the enforcement spectrum. As a general matter, we recognize that in some circumstances requiring a corporate penalty is going to come at the expense of those shareholders who may have been injured by the conduct, and so you have to balance that.

Our penalty guidelines that we go through with an analysis leads us right through that analysis. But fundamentally, there are important law enforcement and deterrent impacts to corporate penalties. One, it sends a very strong message, I think, to the rest of the industry that the wrongdoing won't be tolerated and there's a financial cost to it.

Senator WHITEHOUSE. Yes. I understand the theory. My question wasn't the baseline, but rather, what changes to that baseline, if any, you might be considering as a result of the judge's decision.

Mr. KHUZAMI. Well, I think that we will continue to weigh the factors between the benefits of deterrence and the burden on shareholders and come up with the best balancing that we can. That's a debate, an analysis, we've done before the decision and we will continue to do it after the decision.

Senator WHITEHOUSE. Do you need any further authority to pursue individuals who might have been more responsible for the conduct within the corporate structure rather than allowing the corporate structure to bear the penalty exclusively if there are managers/lawyers/advisors/consultants to whom the conduct can be attributed?

Mr. KHUZAMI. Well, as a general matter the answer is no, although in the particular area of proxy solicitation in which this case arose the obligations on proper disclosure fall on the entity on whose behalf the proxy is being solicited. That's the corporate entity, so in this particular area of the law it is the corporate responsibility; to prove individual liability for that, you have to fall back on the higher fraud standard.

Senator WHITEHOUSE. OK. I'm sorry. So presently, even if culpability for this rests with clearly distinguishable, nameable individ-

uals, it is still the SEC's policy, for that reason, to stick the penalty at the corporate level?

Mr. KHUZAMI. No. It's—the question is, in this particular area of proxy solicitation, you have a higher standard.

Senator WHITEHOUSE. In this particular area of proxy solicitation.

Mr. KHUZAMI. Yes. You have a higher standard for the culpability of individuals, as the law generally will require you to prove knowledge or recklessness.

Senator WHITEHOUSE. Yes.

Mr. KHUZAMI. And so the question is, do you have the evidence to make that case?

Senator WHITEHOUSE. OK. Understood. That's helpful.

Mr. Perkins, in the wake of the mortgage fraud that has taken place, there has been an enormous amount of human distress and there has been a secondary wave of fraud to capitalize on that distress: foreclosure rescue scams, debt resolution scams. Could you tell me how high a priority those are for you and what, if anything, we can do to be helpful? It's particularly galling to me because now you are—these are scavengers who are going after people who have already been hurt, and so they're really the lowest of the low. I would love to find ways to escort as many of them to the custody of our State and Federal incarcerative facilities as possible.

Mr. PERKINS. Yes, Senator. And I appreciate that offer. We do consider them a very high priority. We have seen them in certain areas of the country where we have open investigations, several areas. They are—they are part of that, what I mentioned earlier. Approximately 1,900 of our mortgage fraud cases have over a million dollars in losses. They are part—they are considered part of the mortgage fraud in general.

Senator WHITEHOUSE. So they're a part of this initiative.

Mr. PERKINS. Yes, sir. Absolutely.

Senator WHITEHOUSE. An agent gets credit for meeting initiative effort requirements——

Mr. PERKINS. Oh, absolutely.

Senator WHITEHOUSE [continuing.] By hitting on those debt service and foreclosure——

Mr. PERKINS. Absolutely, Senator. I personally, and as an organization, we share the same feelings you have as far as being the lowest of the low in these types of things. They're going after the people who can really least afford—these are people who are, you know, days from losing their homes and may scrape together what little they have left, thinking that they're rescuing themselves, and then in turn have nothing. It's just unconscionable, what's happening in these types of cases, and we're very aggressively pursuing these.

Senator WHITEHOUSE. Does that include looking at who's advertising what and being proactive rather than waiting for an injured person to come in?

Mr. PERKINS. Oh, absolutely, sir. Without going too far into that, there are proactive means that we can use to seek out those predicated individuals who are doing this, and we've had some success with that.

Senator WHITEHOUSE. Good.

Last words on that, Mr. Breuer.

Mr. BREUER. Yes, Senator, I couldn't agree more. It's particularly galling, and it's even more galling, because often it's professionals, lawyers and others, who purport to be helping those who are in the most dire of straits.

This was one of the great motivations of the Task Force I talked about, the State/Federal task force with the State Attorney Generals, and that's a focus. It's also a focus where we're working with the FTC, and they're very involved in this. So, this is very much on the mind of all of us and we're pursuing it.

Senator WHITEHOUSE. Good. Well, I thank you for your efforts. There are some very good feelings that one gets after a successful prosecution, and I would expect that this is an area in which there's plenty of room for that kind of good feeling.

Thank you, Mr. Chairman.

Senator KAUFMAN. All three of you talked about going up the chain, and Mr. Khuzami especially mentioned the idea of getting someone to come forward. Could each one of you just spend a couple of minutes and talk about how we encourage—how you think we can encourage—how you think people can come forward, but also what we can do in the Congress, with legislation or anything else, to encourage people, like whistle-blowers and the rest, to come forward? Why don't we start with you, Mr. Breuer.

Mr. BREUER. Well, Senator, I think we have to deploy our resources as efficiently as we can to work our way up, and of course I said that before. As my colleagues know, I was thinking out loud. I know right now they're all going to be petrified of what I'm about to say; I realize that in other scenarios, in other fora, of course, one of the ways that we in the government learn about wrongdoing is through the False Claims Act. Of course, that only works when you're making a claim. In some of these areas, of course, we don't have that.

But I think what we all need to do, and we're going to do it and go back to the Congress, is figure out every incentive we can to make people come forward. In the first instance, I want people to come forward, because if they don't come forward, it'll be that much tougher on them when we discover them. Second, obviously, when we go from the low-hanging fruit and work our way up, then hopefully people who are already discovered are going to come forward.

But any way that we can explore these issues, such as the hearing today, we're going to put pressure wherever we can for folks to come forward. That's what we're doing. And then when they don't come forward, it just takes a long time. We've spoken about that, Senator. We have our prosecutors right now looking at these. Of course, we work with our remarkable partners, the regulators, such as the SEC, who are really expert in the area. But there's no quick fix, of course.

Senator KAUFMAN. Mr. Khuzami.

Mr. KHUZAMI. Well, as I said, internally we're developing these cooperation tools. I treasured them when I was a prosecutor and I miss them now, and I hope to soon have them back again.

We've proposed whistle-blower legislation which will allow us to pay persons for information under certain circumstances, and to be able to pay them significant amounts. Lastly, I think, frankly, gen-

eral, aggressive enforcement where individuals look to their left and to their right and see people similarly situated who are the subject of prosecution and are being sued and going to jail, as that noose tightens, I think you also get more people who come forward because they fear for their own well-being and they realize that law enforcement is getting close and they're more likely to talk. So just the general ability to put more resources into enforcement and do our job better will also encourage more people to come forward.

Senator KAUFMAN. Mr. Perkins.

Mr. PERKINS. Yes, Senator. The FBI's greatest assets are its agents, and what they do is talk to people every day. When we talk about taking the low-hanging fruit, we put those skills to work. Actually, we recently, in a couple of areas of the country, put initiatives forward, surge initiatives where we've gone after the low-hanging fruit for the purpose of jamming these folks, sitting down with them, talking to them, interviewing them, convincing them to flip, and then moving forward. That's a long proven tool the Bureau's been able to use successfully. We're using it in the mortgage fraud area.

Secondly, I believe, as I'm a strong proponent of jail sentences for individuals, I've seen it over my career, countless times where someone is looking at a significant sentence, it is a motivational tool and they come forward. I've had countless successful prosecutions over my career using that very tool, and I know that's been duplicated throughout the Bureau.

Senator KAUFMAN. And also I know, Lanny—Mr. Breuer—you said you were going to come forward, any ideas you have for legislation. I know the SEC wants legislation. I think I'd support anything to do with that. But to kind of go back to finish, can each one of you, starting with Mr. Perkins, talk about kind of, what's the impact of criminal prosecutions and prison time versus civil actions and fines?

Mr. PERKINS. Yes, Senator. It's really a combination of both. We obviously are very successful on the health care fraud side where we have civil remedies that we utilize each day in our investigations there, but again, I'm a very strong proponent of criminal prosecutions that involve serious jail sentences for white collar criminals.

It is a huge deterrent. I've seen it over the years. I know that from my own personal experience, going and interviewing individuals, white collar criminals who are doing jail time, going and talking to them on various occasions. It is a huge deterrent. It's something that we have to have going forward to make this work.

Senator KAUFMAN. Mr. Khuzami.

Mr. KHUZAMI. Senator, yes. There's no deterrent that's a substitute for jail time. I miss the cooperation tools and I miss the sentencing guidelines even more. But there is a very significant role for the civil regulators as well, simply because, because of the standard of proof of beyond a reasonable doubt and the necessity of convincing 12 jurors of the guilt of someone, the criminal authorities, by definition, cannot, and should not, capture the whole field of wrongdoing.

So what you'll often see, is criminal authorities focused on the core wrongdoers, and we may cast a wider net—because we have

a lower standard of proof, cast a wider net amongst those involved in the wrongdoing as well. In particular, there's lots of wrongdoing that goes on that doesn't rise to the level of criminal intent, all sorts of activity across regulated broker-dealers, and investment advisors, and others where, if you can at least make it unprofitable so that they have to give back the money they wrongfully got, pay a penalty, perhaps suffer time out or lose their license, that, too, has a significant impact.

Senator KAUFMAN. Mr. Breuer.

Mr. BREUER. Senator, obviously, as Rob says, a comprehensive approach is essential. Civil remedies are essential. But I've had many years in the private practice, and I've had many years when I represented individuals. I can tell you, Senator, in a white collar case there is nothing—there is nothing—like an individual who feels as if he or she has been sort of the center of their community, is well-respected and has had a comfortable life, realizing that they're facing jail time. The terror in their eyes is like nothing else, and there's simply no deterrent like it.

Senator KAUFMAN. I think I know the answer to this, but I think it would be good to be on the record. Starting with you, Mr. Breuer, why haven't we seen more, you know, board room prosecutions?

Mr. BREUER. Senator, these are complicated cases. Don't for a moment think that they're not being pursued and investigated, but they're complicated, they take a long time and they take enormous resources. The folks who perpetrated a lot of these crimes, to the degree they were crimes, took a long time in hatching and developing, and bringing the cases will take a long time, but they will be brought.

Senator KAUFMAN. Mr. Khuzami.

Mr. KHUZAMI. Senator, in the mortgage area, I think we have brought a number of cases targeted right at senior executives, so in the Countrywide, New Century, American Home Mortgage cases, we've done exactly that, but we continue to pursue these cases. As Mr. Breuer says, they are complicated. There's lots of levels between somebody who executes a trade or structures a product and the CEO or the CFO, and they may well not have known the full extent of what's going on, in which case prosecution is not appropriate, or they may have. It takes time to get there.

These are complicated cases. White collar cases, I think, are distinguishable from terrorism or drug crimes for the primary reason that often people are plotting their defense at the same time they're committing their crime. They are smart people who understand that they are crossing the line, and so they are papering the record or having veiled or coded conversations that make it difficult to establish wrongdoing. But we are focused on that and we will bring the cases where we—where it's appropriate.

Senator KAUFMAN. Mr. Perkins.

Mr. PERKINS. Yes, Senator. And I concur with both Mr. Khuzami and Mr. Breuer in that these are complex matters, they do take time, they are resource-intensive. And as Mr. Khuzami refers to, they are worthy adversaries. Throughout the course of the crime, many times they are developing defenses as they go along and it takes us time to unwind those, work our way through those.

Where we can get in early and where we can employ proactive investigative techniques, these cases go quicker as opposed to historical document review, labor-intensive type cases. So any opportunities we can have to get in early on cases like that, it's a very good thing for us.

Senator KAUFMAN. Do you think the Financial Fraud Enforcement Task Force will help build some urgency in bringing some of these cases?

Mr. PERKINS. Yes, sir, I certainly do. I think what it's going to do—we have a good bit of liaison already in place. We work closely with our partners in these—that are all members of these groups, whether it's the Postal Inspection Service, whether it's the SEC, whether it's Internal Revenue Service, CID, whoever the case may be, we work very closely with all these people. It will force us to work even more closely together, share information, and employ that sense of urgency.

Senator KAUFMAN. Mr. Khuzami, do you want to add anything?

Mr. KHUZAMI. I agree. It is more forces joined in the fight, working together. Through these task forces, you find out people have expertise, knowledge, contacts that you might not have otherwise have known that make your cases just go more efficiently.

Senator KAUFMAN. Mr. Breuer.

Mr. BREUER. Absolutely, Senator. A concrete example: because of the Task Force, Mr. Khuzami and I, and many others, will be in New York on Friday to discuss these very issues, to compare notes and figure out, what are the different levels of expertise to go forward. It's essential. We feel a real sense of urgency, and everybody is very motivated.

Senator KAUFMAN. If we come back a year from now and we're having this hearing, how much progress do you think we'll have made on the main objective of getting folks who were involved in the financial fraud and the top players?

Mr. BREUER. Well, Senator, what I can tell you, is I am very hopeful. We will devote a lot of time, let you judge in a year from now. You can be the judge for the progress. But I'm very optimistic. We're working very hard. All of us are working hard throughout the government, and my sense is we will have good progress.

Senator KAUFMAN. Mr. Khuzami.

Mr. KHUZAMI. I agree. You'll see more cases and continued devotion in this area, and hopefully also more regulatory reform in other areas that will also reduce the chances of anything like this happening again.

Senator KAUFMAN. Mr. Perkins.

Mr. PERKINS. Yes, sir. The infrastructure and resources we're putting in place now, and have been putting in place over the last several months, will bear a great deal of fruit in a year from now.

Senator KAUFMAN. Mr. Breuer, last month we saw a jury acquit the two Bear Stearns hedge fund managers accused of misleading investors about the value of their funds. Are there lessons we can learn from that verdict, or is that just a one-off?

Mr. BREUER. Senator, I'm a big believer in the jury system and juries are going to do what juries feel are right. At the Department of Justice, we're going to bring cases when we think they're appropriate. We will live with the jury's decision, and we're going to

move forward. It shows, of course, these are tough cases, but we're going to continue to bring them. It's not a deterrence at all. We're marching forward.

Senator KAUFMAN. Great.

Last month, the Attorney General—Ohio Attorney General filed suit against three of the largest credit rating agencies, Moody, Standard & Poors, and Fitch, alleging those firms gave high ratings to investments they knew were unsafe. What do you see as the role—I want to ask each one of you: what do you see as the role of States' Attorneys General in this area, and how do you plan to coordinate to work with them?

Mr. BREUER. Well, I think the role of States' Attorneys General is incredibly important. I think whether we're talking about the credit rating agencies, whether we talk about mortgage fraud, frankly whether we're talking about dealing with the Mexican cartels on the southwest border, I've talked with Attorneys General about all of those issues. They're a vital component in our comprehensive approach. I think it's got to be a State, local, Federal approach to going after these kinds of crimes, so they're vital players.

Senator KAUFMAN. Mr. Khuzami.

Mr. KHUZAMI. Agree completely. I find the State Attorneys General are often, you know, very close to the investor on the street and often hear about problems or the breadth of problems early. Through better communication and coordination, we can both benefit from each other's involvement.

Senator KAUFMAN. Mr. Perkins.

Mr. PERKINS. Senator, States' Attorney General offices across the country are very key members of many of our mortgage fraud task forces. They leverage the resources that we have in place and they bring a unique perspective to the table, again in a partnership role. They're very valuable to us.

Senator KAUFMAN. Mr. Khuzami, we talked earlier about transparency. One of the things that I have become very concerned about is high-frequency trading and the potential for them to engage in manipulation, that they've created kind of a structured way for front-running orders. High-frequency traders buy proprietary data straight from the exchanges, co-locate their computers, use algorithms that permit them to trade ahead of quotes everyone else sees by just a few milliseconds.

The mutual fund industry and the pension funds are beginning to share my concern and wake up to the fact that high-frequency traders may—and I say "may"—be picking their pockets to the tune of billions of dollars per year. The high-frequency trading industry defends itself by saying they bring liquidity to the markets. I am big for liquidity. I think liquidity is really, really important. But I think that when liquidity comes up against fairness and transparency, that fairness and transparency trump liquidity. Currently, as you said earlier—I mean, you didn't say this about high-frequency trading, but you said about transparency, there is no transparency.

No one at the SEC, as far as I know—or anyone else, really—knows what actually goes on in the market centers where we're engaged in high-frequency trading. And now with high-frequency

trading up to between 60 and 70 percent of all market transactions, sometimes things get too big to fail, sometimes things get too big to even look into. So it seems to me we have a basic case here of a lack of transparency, no one knows what's happening, a lot of money, and the potential—no regulation because you can't see what's going on.

Can you just talk a little bit about that and your concerns, or lack of concern, or how we should propose on that?

Mr. KHUZAMI. Senator, the Commission is concerned about these developments, high-frequency trading, trading in dark pools, flash trading, and other sorts of high-tech programmatic trading activity. In general, across all of these developments, it is the concern about a two-tiered market where favored investors may get a sneak peek at trades or orders in advance of the rest of the public, and so we have—and the Chairman has indicated—that we're going to study various aspects of this and make various proposals. There's already a proposed ban on flash trading.

Senator KAUFMAN. Yes.

Mr. KHUZAMI. With respect to high-frequency trading, we're looking to develop some additional disclosure regarding those who engage in high-frequency trading above certain threshold levels and require enhanced reporting so we can have a telescope into that activity and get a better sense of whether or not it really is creating the kind of two-tier market that we fear, and additional efforts to create, as a general matter, consolidated audit trails that will just give us better trade data across the board, which will allow us to better regulate the markets.

We have working groups within the SEC looking at this and related activity on the exam side, as well as the enforcement side. So we're looking across these areas to make a determination as to whether or not there's more harm than good that's going on here, and then have the appropriate response.

Senator KAUFMAN. You've been very good over the years since—not years, but since you've been the head of the Enforcement Division, to point out that your job is to enforce the rules as made—the law and rules made by the Securities and Exchange Commission. So this is a very complex area. I do not mean to simplify this in any way, but I think the one area that I kind of zero in on, and you've raised it today, and that is, this is going to be very complicated.

There's a lot of things we have to consider here, but it seems to me that—I'd just like to ask you, how can you enforce the fact, how can you demonstrate, how can you prove there's no manipulation if, as a first step, you don't come up with a method to find out—not telescope in, but literally know what's going on in these transactions?

Mr. KHUZAMI. Well, I mean, you have the tools to do it now with respect to going into firms and dissecting their trading and determining—following the audit trail through from the order all the way through the trade and see what's happening. It is a laborious task, don't get me wrong, but we have the ability to do some of it now. It will be greatly enhanced with some of these possible additional sources of information.

Senator KAUFMAN. In some of these markets, if there is not an actual transaction that takes place, there is no record kept of what happened. The allegations here are that high-frequency traders are sending out messages and then pulling them back at the last minute, and then going to another market and doing it.

So the idea that you can do an audit trail on transactions will not tell you what's going on inside of these dark pools and at times in these markets where they have high-frequency trading. So, you know, unless you know what's happening, what is actually happening—I mean, you couldn't do it—the New York Stock Exchange, when I was starting up, you know, you saw every trade that came across the ticker. It just seems to me that coming up with a method that allows you to track everything that goes on in the area is the only way you're ever going to get at the manipulation.

As I said before, there are people now holding seminars on how to make sure that you're not manipulated in a dark pool, so clearly there's people that are very, very concerned about this. And again, I don't mean to simplify how difficult it is to deal with these market structures and the rest of it, but it seems to me that one area that we really can deal with quickly is, how do we do transparency? We can't do it—I mean, you're right, you can't do it by just laboriously going through every single trade. When you're doing 2,000 or 3,000 trades in a second, you won't have time for low-hanging fruit, you won't have time for high-hanging fruit, you won't have time for anything else.

There's got to be a better method to it, and I'd just encourage you to do it, because it's been my experience, and I think it's been all of our experiences, where you have a lot of money in a place, you have a lot of change—basically, a high-frequency trade is going from 30 to 70 percent, where you have no transparency and no regulation, because you can't have regulation without transparency. You said that earlier, and I totally agree with you—that's when the bad things happen.

And I think I want to see us follow up on all these things that happened during the financial crisis; that's the reason we passed FERA and that's why we're interested in it. But I really do think that we have potential here. Again, using this thing of, you know, lots of money, lots of change, no transparency and no regulation, that something very bad could happen very, very shortly. Sometimes, you know, it's almost like I feel—when I talk about this, it's like the "too big to fail." It's like, this is so big that nobody kind of wants to look at it, because it's just so big.

But it's all new and it's happened during a period where we didn't have much regulation going on anyway. So I'm just saying I—I just urge you. I know Mary Schapiro has sent me a number of letters that are very, very good. I think it's all been laid out. I just, as you can tell, maybe feel a little bit more urgency than everyone else does, that at least we've got to do this—we've got to deal with this transparency problem. There's billions of dollars being traded and we do not know what's going on there. So I just encourage you to do that.

Mr. KHUZAMI. Yes. I can assure you, Senator, you're absolutely right. There's no hesitancy to do this because it is widespread or too big to fail. It is, you know——

Senator KAUFMAN. Yes.

Mr. KHUZAMI [continuing]. An effort to make sure that we strike the right balance and have the proper information.

Senator KAUFMAN. No, I don't think it's that, but I think it is so—it's like, it's so big that, OK, how bad can it be? I mean, it isn't—I absolutely agree with you. But how do you take this thing on when—I mean, how do you go to the market and say, we're going to do something that's going to affect 70 percent of the trading in the market.

How do you say that? Well, we've got to be very careful, and I think we should be very careful. But it's there. It's so big that we cannot wait for a couple of years, I think, just based on the past. The regulators have got to get into it and we've got to find out what's happening, that's all. I don't think there's any reluctance on the part of the SEC to do it. I am absolutely sure there's no reluctance on the part of you to do this, but we've got to get about doing it.

The first step is, I want your people to be able to figure out and see what is actually going on in this area and then say, OK, hey, Kaufman, Senator Kaufman, you know, look, there could be a problem here, but we know it's not that big and we know that we're not going to have that much potential for just—but until we have some transparency, and I mean—by "some transparency" I mean some real idea what's happening here, that just concerns me.

But it's not that I feel there's any reluctance by anybody or anybody's not doing it or anything like that. It's just that it's so big to get your arms around it, I can't imagine going to SEC meetings and saying, OK, here's what we're going to do today, we're going to go after—you know, where 70 percent of the market stocks are being traded.

We come back to what I really think is the important thing here, and that is, you know, we talk about Main Street and Wall Street, and we talk about all the things that are going on, we want to put people away. The reason I got started in this thing, I'd never—when I became a Senator I never thought this is what I was going to be doing. I'm not on the Banking Committee. But, you know, it just—our credit markets—democracy and free markets are the two things that make America.

I mean, if you look at the core of why America is a great country, it was democracy and free markets, the way both of those operate. That's why we have such—you know, that's why we're great. And if our free markets go through another thing like what happened last year, we're all in deep trouble. We're all—it won't be just, you know, the billions of dollars lost. That will be awful.

But if, in fact, America's markets become the ones that are not credible, where people don't think it's a serious thing, when you look at where we have to be and where we want to go, where we want to take our kids—when people talk about our grandchildren—when I—when I think about my grandchildren—I've got seven grandchildren—I think about, are our markets going to be the best markets in the world when they get to be my age? That's really key to their success, just like a lot of other things that are going on.

So, anyway, I just want to thank the three of you for what you do. The one thing I'd like to do, and I think we've covered this but

I don't want to leave without asking, is there anything that you can think of that we can do in the Congress, any resources, any laws, anything—and by the way, this is an open question. You don't have to answer the whole thing now. But to the extent that you can, it would be good to just tell us what those are. I'll start with you, Mr. Breuer.

Mr. BREUER. Senator, candidly, you should continue doing what you're doing. I mean, your comments weigh heavily on us, and we couldn't agree more. FERA gave us more strength, and we are using the resources you gave us. Obviously, we are always happy to get additional resources. Let's keep this dialog going. We're pursuing it.

I do think whatever we can do to increase the transparency, which Mr. Khuzami talked about, and you've talked about, I think we have to do. If we can encourage whistle-blowers to come forward in some way or another, I think that will be very supportive and we'll continue to have this dialog to ask for more. But we have a solid foundation, and with what we have, Senator, I think you'll see we'll continue to do a lot. We've done a lot and we'll continue to do a lot.

Senator KAUFMAN. Thank you.

Mr. Khuzami.

Mr. KHUZAMI. Senator, I agree completely. Your interest and knowledge in these areas is very helpful and keeps us thinking. With respect to Congressional help, funding is obviously critical. One result of what's happened this year, is we've gone back and looked at some of our numbers. The SEC regulates over 35,000 public companies, broker-dealers, investment advisors, transfer agents, credit rating agencies, and the like. We're 1,100 people in the Enforcement Division and we have authority—enforcement obligations with respect to that group, as well as anybody in the world who might consider committing securities fraud, even if they don't work for a regulated entity. So the task is big.

We are attempting to use our resources as efficiently as possible, but additional resources, particularly in the areas of IT, document management, specialized skills, trial attorneys, would be greatly appreciated, as well as some of the legislative initiatives, hedge funds and derivatives regulation in particular, which, if passed, will only add to that number of 35,000, of course.

Senator KAUFMAN. Thank you.

Mr. Perkins.

Mr. PERKINS. Yes, Senator. Again, we're very grateful for the support that you and the Committee have provided to us in the past. My pledge to you is that we will use those resources that you have provided to us, focus them on where they will have the greatest impact across the board. We're taking the agents, the analysts, the forensic accountants, the staff operations specialists, all of whom you on the Committee and the Congress have made available to us, and placing them in the appropriate slot so that they can serve the public.

Senator KAUFMAN. Let me just make a little statement I wanted to make here. In the boom-and-bust cycle brought about by the speculative housing bubble and all of its attendant fraud, the average American paid an enormous price, as we talked about. Millions

lost their jobs and nearly $14 trillion in household wealth has vanished. As we only begin to climb out of this deep, dark hole, we must not lose sight of the lessons. The first one is: we can never let this happen again. We have to break the mentality of grabbing the money before the house burns down.

The only way to do that is, first, through effective regulation, and second, through effective law enforcement. For those of you on Wall Street who have information about the sorts of financial fraud we've been talking about I say this: now would be a great time to pick up the phone and call one of today's three witnesses. I know they'd love to hear from you.

I want to thank the witnesses again for their participation and great work. I feel very good about having the three of you, in your jobs, doing what you're doing.

The record will remain open for one week.

The hearing is now concluded.

[Whereupon, at 3:49 p.m. the Committee was adjourned.]

[Questions and answers and submissions for the record follow.]

U.S. Department of Justice

Office of Legislative Affairs

QUESTIONS AND ANSWERS

Office of the Assistant Attorney General

Washington, D.C. 20530

March 19, 2010

The Honorable Patrick Leahy
Chairman
Committee on the Judiciary
United States Senate
Washington, D.C. 20510

Dear Chairman Leahy:

Enclosed please find responses to questions for the record stemming from the appearance of Lanny Breuer, Assistant Attorney General for the Criminal Division, before the Committee on December 9, 2009, at a hearing entitled "Mortgage Fraud, Securities Fraud, and the Financial Meltdown: Prosecuting Those Responsible." We hope that this information is of assistance to the Committee.

Please do not hesitate to call upon us if we may be of additional assistance. The Office of Management and Budget has advised us that there is no objection to submission of this letter from the perspective of the Administration's program.

Sincerely,

Ronald Weich
Assistant Attorney General

Enclosure

cc: The Honorable Jeff Sessions
Ranking Member

QUESTIONS FROM SENATOR SPECTER FOR LANNY BREUER,

ASSISTANT ATTORNEY GENERAL, CRIMINAL DIVISION

U.S. DEPARTMENT OF JUSTICE

1. Mr. Breuer, in the R. Allen Stanford prosecution you note in your written statement that "defendant Stanford is alleged to have bribed the head of Antiguan Financial Services Regulatory Commission to ensure that it did not conduct a thorough examination of the Bank's books and records." Yet no charges under the Foreign Corrupt Practices Act were included in the indictment. **Why not**?

   RESPONSE: As a general matter, there are often a number of criminal charges that may be brought against a particular defendant, and there are a variety of factors that go into the ultimate determination regarding which charges are the most appropriate to bring, including considerations related to the facts, the law, charging policies, and prosecution strategy. These factors are outlined in the Principles of Federal Prosecution, and we are guided in our charging decision by these principles. The charges in the Stanford indictment reflect appropriate consideration of these principles. Because the Department does not discuss details of ongoing cases, including the litigation strategies pursued in such cases, we are not in a position to comment further in response to your question.

2. Mr. Breuer, in listing significant criminal enforcement efforts by the Department you include in your written statement two prosecutions where the sentences imposed vary greatly. The first case was a prosecution of a former vice president of American International Group (AIG) for his role in manipulating the company's financial statement through a sham $250 million re-insurance transaction. For that $250 million fraud, the defendant's sentence was just 36 months—or three years. In another case involving much less money –a $44 million Ponzi scheme – the defendant, Michael Riolo, received a 293 month sentence—or 24.5 years. **Can you explain these disparate sentences**? **Are they grounded in the discretionary nature of the U.S. Sentencing Guidelines in this post-Booker era**?

   RESPONSE: As your question suggests, the *Booker* decision and its progeny gave sentencing judges a large degree of discretion in imposing criminal sentences, and both the data and our experience since the decision show greater variation in sentencing decisions. Indeed, the district court judges in the cases of the former Vice President of AIG and Mr. Riolo responded very differently to the facts and circumstances of the two cases and, therefore, the sentences were significantly different.

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In the AIG case, the Government argued that the loss could reasonably be determined to exceed $400 million, in contrast to the pre-sentence report, which represented that the gain was only $5 million, under an alternative sentencing calculation. Under either calculation, the defendant would have received a substantial term of imprisonment under the federal sentencing guidelines. The Government's calculation, pursuant to the sentencing guidelines, resulted in a total offense level of 43, for which the guidelines recommended a life term. In contrast, the pre-sentence report recommended a total offense level of 35, which would have resulted in a sentencing guidelines range of 168 to 210 months of imprisonment. After a hearing, the court accepted the government's calculation of the sentencing range. Nevertheless, the court stated that: "This is a non-guidelines sentence based principally on the lack of motivation of direct, immediate, personal gain from the criminal conduct of the defendant. In addition, the goals of specific and general deterrence are satisfied, as well as the other factors set forth in 18 U.S.C. § 3553(a)." Based on these statements, the court sentenced the former AIG vice-president to 48 months. In contrast, the sentencing court for Michael Riolo adhered to the sentencing range of between 235 to 293 months recommended in the pre-sentence report and the sentencing guidelines, with which the Government concurred, and sentenced defendant Riolo to 293 months.

3. Mr. Breuer, as Chairman of this Committee in 2006, I held a series of hearings on hedge funds and insider trading.

   a) On June 28, 2006, I chaired a hearing titled, **"Hedge Funds and Independent Analysts: How Independent Are Their Relationships?"**
   b) On September 26, 2006, I chaired a hearing titled, **"Illegal Insider Trading: How Widespread is the Problem and is there Adequate Criminal Enforcement?"**
   c) On December 5, 2006, I chaired a hearing titled, **"Examining Enforcement of Criminal Insider Trading and Hedge Fund Activity."**

Will you commit to charging your subordinates who are also on the Financial Fraud Enforcement Task Force with reading these hearing transcripts—which can be provided—to get a sense of the significance of the problem and several witnesses' ideas about how to avert further crisis in the financial markets?

RESPONSE: The Chief of the Criminal Division's Fraud Section will review these transcripts. Like other financial crimes, any fraud perpetrated through illegal hedge fund activity is a serious problem. Investigation of hedge fund activity is presently complicated by the fact that most hedge funds generally are not required to report their equity positions to the Securities and Exchange Commission because they are generally exempt from registration under the Securities Act of 1933, the Exchange Act of 1934, or the Investment Company Act of 1940. Notwithstanding this serious challenge, when fraudulent acts in violation of other federal criminal laws are uncovered and investigated, they are prosecuted. For example, Lancer Hedge

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Fund Group officers and managers, and officers of companies in which the fund invested, were indicted in the Southern District of Florida and charged with conspiracy and wire fraud.

4. Mr. Breuer, public accounts of the Galleon Management L.P. case involving billionaire Raj Rajaratnam suggest that at least some of the defendants in that case engaged in counter-surveillance activities normally reserved for the Mafia. For instance, some defendants were charged with using throwaway cell phones to avoid detection. **In your professional opinion does evidence like that tend to show (a) an acknowledgment of the illegal activity (insider trading) suggesting *mens rea*; and (b) an organized criminal conspiracy?**

   RESPONSE: We cannot comment on this ongoing investigation, nor, given the pendency of the investigation, would it be prudent to opine more generally on the import of such evidence.

5. Mr. Breuer, we hear from Mr. Khuzami of the SEC that at the SEC Division of Enforcement they have undertaken a top-to-bottom self-assessment of their operations and processes to improve. **Have you done that in the Criminal Division's Fraud Section to see how you can work smarter, swifter, and more strategically**?

   RESPONSE: We are continuously examining ways to investigate and prosecute fraud cases in a smarter, swifter and more strategic manner, just as you suggest. For instance, because the Fraud Section was retooled in 2004, the Section's Medicare Fraud Strike Force (MFSF) has been able to operate in a smarter, swifter and more strategic way. The MFSF has been very successful in conducting proactive intelligence-driven investigations and prosecutions. We hope to duplicate this real-time enforcement effort in the mortgage fraud arena as well.

   In addition, the Fraud Section is streamlining securities fraud indictments to sufficiently charge conduct that precipitated victims' losses, but also to limit the issues presented at trial, thereby reducing the length and complexity of trials. The success of our strategy is reflected in the trial of complex securities cases in less than six weeks, with reduced numbers of witnesses. For example, with trials lasting less than six weeks, convictions were obtained in the Southern District of Ohio in the National Century Financial Enterprises cases, with losses of $2 billion, and in the District of Connecticut, in the AIG/Gen Re cases, with losses of $500 million. Similarly, in the District of Colorado, Joseph P. Nacchio, former Chief Executive Officer and a member of the Board of Directors of Qwest Communications International, Inc., was convicted of a $52 million insider trading scheme in a trial that lasted only 15 days. The Fraud Section will continue to employ this successful strategy of streamlining its prosecution of complex fraud matters. And we will continue to monitor closely the workings and functions of the Fraud Section to ensure that it has the tools, resources, and necessary operating structure to accomplish its crucial mission.

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6. Specifically, the SEC has created 5 new national specialized investigative groups – asset management, market abuse, structured and new products, foreign corrupt practice cases and municipal securities (pay-to-play cases). **Would it make sense for the fraud division to structure itself in the same way to coordinate and bring expertise to these prosecutions?**

RESPONSE: The different missions and responsibilities of the SEC and the Fraud Section do not readily recommend parallel organizational structures. For example, the SEC's specialized groups will generate administrative, civil, and criminal enforcement cases, which is a broader universe than the work of the Fraud Section. Also, while the criminal cases that are referred to the Department of Justice may be undertaken by the Fraud Section, they may also be independently investigated and prosecuted by United States Attorney's Offices (USAOs). However, the Fraud Section will be alert to the volume and complexity of referrals from each of the SEC investigative groups. As has been its practice, the Fraud Section will continue to be flexible in timely assigning resources to matters that are not referred to individual USAOs, while continuing to monitor the volume of other matters for which it is responsible. As you know, the Fraud Section has about 70 attorneys, covering a wide range of criminal frauds beyond corporate, securities, and commodities fraud -- including health-care fraud, procurement and grant fraud, foreign corruption, mortgage fraud, financial institution fraud, mass-marketing fraud, payments fraud, identity theft, and many other kinds of fraudulent schemes. Nevertheless, as noted in the immediately preceding response, we are always exploring ways to investigate and prosecute fraud cases more efficiently, swiftly, and strategically. Thus, for example, the Fraud Section has a unit devoted solely to foreign corruption matters. As part of our ongoing efforts to improve the functioning, effectiveness, and efficiency of the Fraud Section and other sections, we will consider whether additional specialized groups are necessary to accomplish our mission. Indeed, the recently hired new Chief of the Fraud Section, Denis McInerney, will be examining the structure and operations of the Fraud Section and recommending any necessary and appropriate changes.

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Question for the Record to the Honorable Lanny Breuer, Assistant Attorney General,

Department of Justice

From Senator Charles E. Schumer

December 9, 2009

FIGHTING REAL ESTATE FRAUD ACT

According to the FBI's *2008 Mortgage Fraud Report*, mortgage fraud Suspicious Activity Reports referred to law enforcement increased 36 percent over reports in 2007. Furthermore, the report found an increase of 83.4 percent in reported financial losses from such fraud over the previous year. While I commend the President's creation of the interagency Financial Fraud Enforcement Task Force, I believe that there is still more that can be done.

Given the complexities of prosecuting such crimes, the Brooklyn DA established a special Mortgage Fraud Unit for the purpose of focusing exclusively on real estate schemes. District Attorney Hynes and his staff have done a superb job of demonstrating the effectiveness of such a model. I have introduced legislation with Senators Kyl and Whitehouse that would establish a competitive grant program in the Department of Justice to develop similar specialized units in the offices of State and local prosecutors.

1. **Will you commit to working with me on this bipartisan legislation and provide an official Departmental views letter at the appropriate juncture?**

Response:

Thank you for your invitation to work with you on this legislation. As you know, mortgage fraud and the concomitant societal harms that flow from it are serious problems, and therefore are concerns for the Department of Justice. As in the case of any legislation affecting the Department, we are committed to working with you and your staff to provide you with the necessary technical assistance and, where appropriate, an official Administration position about the legislation that you describe.

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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.

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- 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

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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).

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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.

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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?

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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)

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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.

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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.

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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

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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.

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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

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> 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:

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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.

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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

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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.

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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.

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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.

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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.

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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

January 15, 2010

The Honorable Orrin G. Hatch
United States Senator
104 Hart Senate Office Building
Washington, DC 20510

Dear Senator Hatch:

I am writing to further respond to the questions you asked during the December 9th Senate Judiciary Committee hearing "Mortgage Fraud, Securities Fraud, and the Financial Meltdown: Prosecuting Those Responsible." In particular, you requested figures relating to changes in the number of fails to deliver since the Commission adopted various amendments to Regulation SHO.

As you know, the Commission has taken several recent actions to help further reduce fails to deliver. In the fall of 2008, due to the Commission's continuing concern regarding fails to deliver and potentially abusive "naked" short selling, as well as in response to the threat of sudden and excessive fluctuations of securities prices and disruption in the functioning of the securities markets, the Commission adopted temporary Rule 204T of Regulation SHO. The rule strengthened the close-out requirements of Regulation SHO for fails to deliver by requiring that fails to deliver in any equity security resulting from both long and short sales be closed out immediately after the fails occur. The Commission adopted these requirements, with limited modifications, on a permanent basis in July of 2009, as Rule 204 of Regulation SHO. Additionally, in September of 2008, the Commission eliminated the "options market maker" exception to Regulation SHO's close-out requirement which provided that fails to deliver used to hedge certain options positions never had to be closed out.

The Commission's Office of Economic Analysis ("OEA") within the Division of Risk, Strategy and Financial Innovation, has conducted analyses to measure the impact of the recent amendments to Regulation SHO on fails to deliver. Results from these analyses show that fails to deliver have declined significantly since the adoption of Rule 204, including its predecessor Rule 204T, among other actions.

For example, data indicates that since the fall of 2008, fails to deliver in all equity securities have declined by 63.4%, and fails to deliver in threshold securities (those securities with persistent and large levels of fails to deliver) have declined by 80.5%. The OEA data also indicates a significant reduction in the number of threshold securities. For example, the average daily number of threshold list securities has declined from a high of approximately 632 securities in July of 2008 to approximately 61 in September of 2009, a reduction of 90.3%. It should also be noted that of the approximately 61 threshold list securities that remained as of September of

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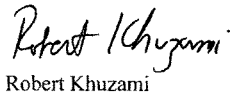
2009, almost 50% were exchange traded products, such as ETFs. OEA's most recent analysis regarding fails to deliver is available at http://www.sec.gov/spotlight/shortsales/oeamemo110409.pdf.

I hope this letter is helpful in addressing your question. I would of course be happy to answer any additional questions that you may have. Please feel free to contact me at (202) 551-4500, or Eric J. Spitler, the Commission's Director of Legislative and Intergovernmental Affairs, at (202) 551-2010.

Sincerely,



Robert Khuzami
Director
Division of Enforcement

U.S. Department of Justice

Office of Legislative Affairs

Office of the Assistant Attorney General

Washington, D.C. 20530

March 19, 2010

The Honorable Patrick Leahy
Chairman
Committee on the Judiciary
United States Senate
Washington, D.C. 20510

Dear Chairman Leahy:

Enclosed please find responses to questions for the record stemming from the appearance of Kevin Perkins, Assistant Director for the Criminal Investigative Division of the FBI, before the Committee on December 9, 2009, at a hearing entitled "Mortgage Fraud, Securities Fraud, and the Financial Meltdown: Prosecuting Those Responsible." We hope that this information is of assistance to the Committee.

Please do not hesitate to call upon us if we may be of additional assistance. The Office of Management and Budget has advised us that there is no objection to submission of this letter from the perspective of the Administration's program.

Sincerely,

Ronald Weich
Assistant Attorney General

Enclosure

cc: The Honorable Jeff Sessions
Ranking Member

**Responses of the Federal Bureau of Investigation
to Questions for the Record
Arising from the December 9, 2009, Hearing Before the
Senate Committee on the Judiciary
Regarding "Mortgage Fraud, Securities Fraud, and the Financial Meltdown:
Prosecuting Those Responsible"**

Questions Posed by Senator Schumer

HIGH YIELD INVESTMENT SCAMS

You mentioned that high yield investment scams have risen by 105 percent in 2009 alone, and that the FBI currently has more than 1,500 related securities fraud investigations underway. And yet, 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.

1. How is it that these sites are incredibly easy to find and dupe consumers, and have yet to be shut down?

Response:

The FBI allocates its resources to investigating those who engage in egregious High Yield Investment Fraud (HYIF). The FBI also works hard to educate the American public on how to avoid falling victim to these schemes. Through our website (www.fbi.gov), printed educational materials, and pod-casts, as well as through presentations made by FBI Special Agents to local citizens, we use multiple media to convey a message of caution and due diligence to the investing public. While these efforts are substantial, and we are encouraged at the number of people who find the FBI through our website and other means to register complaints and concerns, we are not able to monitor and target every website and/or perpetrator who might be involved in a HYIF scheme. The FBI does, though, continue to work with its Federal, state, and local partners, including the Securities and Exchange Commission and the Federal Trade Commission, to address the full range of investment scams.

2. Please explain your efforts to crack down on HYIP's. Obviously, it takes time to investigate any given site, go to court, and get an injunction to prevent ongoing fraud. Do you need additional statutory authorities to get this problem under control in order to prevent an online Bernie Madoff?

Response:

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As noted above, the FBI aggressively investigates HYIF perpetrators, using such proactive techniques as undercover operations and the exploitation of Securities and Futures Industries Suspicious Activity Reports to stop HYIF perpetrators. In addition, the FBI works closely with the U.S. Securities and Exchange Commission and with other Federal, state, and local law enforcement partners to identify and investigate these schemes. From the beginning of Fiscal Year 2009 through 12/23/2009, the FBI's effort in fighting HYIF has led to the convictions of 140 individuals.

3. 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 come 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?

Response:

The FBI exerts great effort to maximize its visibility to the average consumer. As discussed above, in addition to our website (www.fbi.gov), which contains a section on financial frauds, FBI Special Agents address groups throughout the country to educate local citizens on financial fraud schemes and how to avoid being victimized. The FBI also hosts Citizens' Academies across the country where diverse groups of citizens attend academies of varying durations at their local FBI field offices to learn about the FBI and the crimes we investigate. In an effort to capitalize on evolving communication outlets, the FBI has created a pod-cast that is available on Apple's iTunes to educate the public on the FBI's efforts to address HYIF and how the public can avoid such schemes. In addition, the FBI is a member of the Financial Fraud Enforcement Task Force that was recently created by the President and has received significant media coverage.

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SUBMISSIONS FOR THE RECORD

Department of Justice

STATEMENT OF

LANNY A. BREUER
ASSISTANT ATTORNEY GENERAL

BEFORE THE

JUDICIARY COMMITTEE
UNITED STATES SENATE

ENTITLED

"MORTGAGE FRAUD, SECURITIES FRAUD, AND THE FINANCIAL MELTDOWN: PROSECUTING THOSE RESPONSIBLE"

PRESENTED

DECEMBER 9, 2009

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Good afternoon, Mr. Chairman, Senator Sessions, Senator Kaufman, and distinguished Members of the Committee. Thank you for your invitation to address the Committee and for giving me the opportunity to discuss the Department of Justice's efforts to prosecute and deter mortgage fraud, securities fraud, and other types of financial fraud that may have contributed to the financial meltdown.

Introduction

I am privileged to represent the Department of Justice at this hearing and to lead the Criminal Division's more than 400 exceptional lawyers, including a number of Sections and Offices involved in the prosecution of mortgage fraud, securities fraud, commodities fraud and related offenses. I would like to describe for you some of the Department's enforcement initiatives in these areas and some recent criminal prosecutions of such financial crimes.

As the Attorney General has made clear, we are committed to reinvigorating the traditional crime-fighting mission of the Department, including redoubling our efforts to fight financial fraud. We face unprecedented challenges in responding to the recent financial crisis. Mortgage, securities, and corporate fraud have eroded the public's confidence in our financial markets and have led to a growing sentiment that Wall Street does not play by the same rules as Main Street.

In the wake of the economic crisis, we must be relentless in our investigation of any wrongdoing that contributed to the financial meltdown. We must vigorously prosecute mortgage fraud, which appears to have been one of the catalysts of the crisis, and continue to scrutinize other questionable conduct and practices to ferret out any crimes that may have occurred. We also must continue to protect investors and our

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capital markets by aggressively prosecuting securities and commodities fraud. And we must ensure that the recipients of federal financial rescue and stimulus funds do not obtain them through fraud or use them for improper purposes.

We have been working hard to carry out this mission. We have had numerous successes in prosecuting mortgage, securities, commodities, and other forms of financial fraud, some of which I would like to share with you today. We recognize, however, that there is much more to do.

Financial Fraud Enforcement Task Force

Just a few weeks ago, the President signed an Executive Order establishing a new interagency Financial Fraud Enforcement Task Force (FFETF or Task Force) to combat financial crime. The Task Force is designed to strengthen our collective efforts -- in conjunction with our federal, state, and local partners -- to investigate and prosecute significant financial crimes relating to the current financial crisis; to recover ill-gotten gains; and to ensure just and effective punishment for those who perpetrate financial crimes. The Task Force's mission is not just to hold accountable those who helped bring about the last financial meltdown, but to prevent another meltdown from happening. By punishing criminals for their actions, we will send a strong message to anyone looking to profit from the misfortune of others.

The FFETF is chaired by the Attorney General, and its Steering Committee, led by the Deputy Attorney General, includes the Federal Bureau of Investigation (FBI), Department of Treasury, the Department of Housing and Urban Development (HUD), and the Securities and Exchange Commission (SEC). Drawing on the substantial resources of the federal government, the FFETF counts among its members the

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Department of Justice, FBI, Department of Treasury, HUD, the SEC, the Commodity Futures Trading Commission (CFTC), the Department of Homeland Security (DHS), Department of Labor (DOL), Federal Trade Commission (FTC), Federal Deposit Insurance Corporation (FDIC), Federal Housing Finance Agency (FHFA), Office of Thrift Supervision (OTS), Office of the Comptroller of the Currency (OCC), Recovery Accountability and Transparency Board (RATB), Internal Revenue Service-Criminal Investigative Division (IRS-CID), the Special Inspector General for the Troubled Asset Relief Program (SIGTARP), the U.S. Postal Inspection Service (USPIS), the U.S. Secret Service, and many other federal departments, agencies, and offices. In addition, the Task Force will enhance coordination with state, local, tribal, and territorial authorities responsible for investigating and prosecuting significant financial crimes, including coordinating with the National Association of Attorneys General and the National District Attorneys Association.

The FFETF will lead an aggressive, coordinated, and proactive effort to investigate and prosecute financial crimes. We will marshal both criminal and civil enforcement resources to investigate and prosecute financial fraud cases, recover stolen funds for victims, address discrimination in lending and financial markets, and enhance coordination, cooperation, and information sharing among authorities responsible for investigating and prosecuting significant financial crimes and violations.

At the core of the Task Force's mission will be our enforcement efforts. The FFETF will focus our enforcement efforts on the types of financial crime that affect us most significantly in this time of economic recovery, including:

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- mortgage fraud –from the simplest of "flip" schemes to systematic lending fraud in the nationwide housing market;
- securities fraud – including traditional insider trading, Ponzi schemes, and misrepresentations to investors;
- Recovery Act and rescue fraud – to ensure that the taxpayers' investment in America's economic recovery is not siphoned away by a dishonest few; and,
- discrimination – to ensure that the financial markets work for all Americans, and that no one is unfairly targeted based on impermissible characteristics.

The FFETF will be a robust, substantial working partnership with concrete follow-through. Through the FFETF, we will work to even further increase information-sharing across the government, so that our prosecutors, regulators, and agents work seamlessly, employing the best available practices to fight and prevent financial crime. We also will work tirelessly to ensure that the rights of victims of financial crime are restored and their financial futures preserved.

Fraud Enforcement and Recovery Act

The FFETF will take full advantage of the new legislative authorities Congress provided us to investigate and prosecute financial fraud. Congress passed the Fraud Enforcement and Recovery Act (FERA) earlier this year with broad bipartisan support, and the President signed it into law on May 20, 2009. I would like to thank Chairman Leahy, Senator Kaufman, Senator Grassley, and the other sponsors for their leadership on

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this important effort. The Department of Justice worked closely with this Committee and other Members of Congress in strong support of FERA.

Prior to FERA, private mortgage lenders were not subject to the same kind of oversight and regulation as traditional financial institutions. This was one of the reasons that mortgage fraud was able to go on undeterred for so long. FERA extended criminal laws to cover private mortgage companies – to "level the playing field" – in the same way that these statutes apply to federally insured and regulated financial institutions.

FERA also provided a variety of enhancements to Federal criminal and civil law to help combat commodities fraud and money laundering. In addition, the Act allowed the Department of Justice to prosecute anyone who fraudulently obtains or uses money expended by the Government during the economic crisis, such as money from the Troubled Asset Relief Program (TARP), under the American Recovery and Reinvestment Act, or other economic relief. Further, FERA enhanced the reach of the False Claims Act, one of the Department's most effective civil tools for deterring and redressing fraud against Government programs, ensuring that the FCA continues to protect taxpayer funds against those who would misuse them.

We commend this Committee and the entire Congress for its bipartisan support for the Fraud Enforcement and Recovery Act. On behalf of the Department, I would like to express the continued desire to work with the Committee on legislative proposals, in order to support our criminal prosecutions against financial crimes, and to enhance our authorities to bring offenders to justice.

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Criminal Enforcement Efforts

Since even before the launch of the FFETF, we have been aggressively investigating and prosecuting wrongdoing that contributed to the current crisis and wrongdoing that has resulted from it. In doing so, we have built upon the lessons and successes of the Department's efforts over the last several years to combat corporate fraud. Since 2002, the Department has obtained approximately 1,300 corporate fraud convictions, including convictions of more than 200 corporate chief executives or presidents, more than 120 vice presidents, and more than 50 chief financial officers.

The Department has sought significant sentences against perpetrators. For example, earlier this year, the Department secured sentences of more than 25 years each for two executives of National Century Financial Enterprises (NCFE) following their convictions on conspiracy, fraud, and money laundering charges. Their scheme deceived investors about the financial health of the company, which may have cost investors as much as $2 billion. The Department also secured a 20-year sentence for the president and owner of Gen-See Capital Corp. for his role in the perpetration of a $31 million Ponzi scheme, and a four-year sentence earlier this year for a former vice president of American International Group (AIG) for his role in a scheme to manipulate the company's financial statements through the use of $250 million sham re-insurance transactions.

The Department's commitment to vigorously identify and pursue wrongdoing in our corporate boardrooms has only grown stronger in the wake of the economic crisis. Our prosecutors and agents are determined to ensure that wrongdoers are punished and

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that victims are made whole. We believe that these efforts are critical to restoring investor confidence in the markets and ensuring that our corporate citizens play fair.

Recent Mortgage Fraud Enforcement Efforts

The Department also continues to prioritize securities fraud enforcement. The Department has redoubled its efforts to uncover abuses involving mortgage lending and securitization frauds, foreclosure rescue scams, reverse mortgage scams and bankruptcy schemes. At present, federal mortgage fraud-related charges are pending against approximately 500 defendants around the nation, and the FBI is working more than 2,700 additional mortgage fraud investigations. These cases range from mortgage schemes designed to defraud mortgage lenders to foreclosure rescue schemes preying on distressed homeowners. The Department has deployed an array of enforcement strategies that ensure optimal use of our investigative and prosecutive resources to maximize deterrence and remediation. Because the mortgage fraud problem touches neighborhoods across the country, coordination and the sharing of intelligence and investigative resources are critical to our success. Effective, successful mortgage fraud enforcement requires the closest cooperation not only between law enforcement organizations at all levels, but also among law enforcement, regulatory and industry representatives.

The Department – through the U.S. Attorney's Offices and FBI Field Offices -- has worked to establish more than 75 regional and local task forces and working groups around the country. These task forces and working groups represent a collaborative effort among Federal, State and local law enforcement and other government agencies to combat the mortgage fraud problems in their local jurisdictions. These efforts have been very successful at focusing on and targeting real-estate professionals (including bankers,

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brokers, appraisers and lawyers) who repeatedly engage in organized fraudulent activities.

For example, on October 8, 2009, in a case brought by the U.S. Attorney's Office for the Southern District of Texas, a jury convicted a Houston area resident on mortgage fraud charges involving fraudulent loans in excess of $24 million. The defendant, a loan officer at a financial institution, participated in the submission of fraudulent loan applications and packages to residential mortgage lenders across the country. In an effort to procure the most favorable loan terms, the defendant and her co-conspirators misrepresented the credit-worthiness of individual borrowers who were recruited to purchase multiple properties.

Also, on August 10, 2009, in a case brought by the U.S. Attorney's Office for the Central District of California and the FBI, two real estate professionals were convicted for their roles in a massive mortgage fraud scheme that caused more than $40 million in losses to federally insured banks. After a five-week trial, the jury convicted a prominent Beverly Hills real estate agent and a licensed appraiser on charges of conspiracy, bank fraud and numerous loan fraud charges for their roles in the mortgage fraud scheme (one defendant was also convicted on three money laundering counts). The evidence presented at trial showed that the defendants were part of a scheme that obtained inflated mortgage loans on homes in some of California's most expensive neighborhoods. Eight other real estate professionals who were part of the scheme had previously pleaded guilty to federal felony charges for their roles.

Last month, the U.S. Attorney for the Middle District of Florida announced the results of a nine-month-long "Mortgage Fraud Surge" that resulted in charges against

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more than 100 defendants. The charges involve more than $400 million in loans on more than 700 properties allegedly procured through fraud. This surge was launched in January 2009 in response to the epidemic of mortgage fraud throughout the state of Florida. To address this extensive problem, the U.S. Attorney's Office, along with the FBI in both its Tampa and Jacksonville Divisions, began an intensive effort to identify, investigate, and prosecute mortgage fraud in all its forms. These efforts were led by the mortgage fraud task force in Florida involving the cooperation of multiple Federal, State and local law enforcement and governmental agencies.

To further augment the Department's efforts to combat mortgage fraud, the Criminal Division will be launching a mortgage fraud enforcement initiative. Working closely with the FBI's National Mortgage Fraud Team, HUD's Office of Inspector General, and other federal and state law enforcement agencies, the initiative will focus resources on the prosecution of high-impact mortgage fraud cases where mortgage fraud is most acute. In addition, the initiative will seek to deter future mortgage fraud crimes through increased, real-time enforcement.

In recent years, the Department – working with its law enforcement and regulatory partners – has also conducted three coordinated nationwide sweeps of mortgage fraud and other banking crime prosecutions: Operation "Malicious Mortgage," conducted last year, included charges against more than 400 defendants in cases across the nation. Operation "Quick Flip" in 2005 featured a nationwide takedown of mortgage fraud cases charging a total of approximately 155 defendants. Operation "Continued Action" in 2004 targeted mortgage fraud and other schemes in more than 150 cases in more than 35 states.

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The President's budget request for Fiscal Year 2010 includes additional resources focused at combating the mortgage fraud problem. The request includes five additional Criminal Division prosecutors and 35 U.S. Attorney Office positions to prosecute mortgage fraud and related financial crimes. In addition, 59 AUSA positions and 17 support positions dedicated to combating mortgage fraud and related financial crimes recently were allocated to United States Attorney's Offices around the country.

Recent Securities Fraud Enforcement Efforts

The Department also continues to prioritize securities fraud enforcement. In recent months, the Department has successfully prosecuted many high-profile securities and commodities fraud cases and has sent a clear message to those who have preyed on investors. Working closely with the Securities and Exchange Commission (SEC) and Commodity Futures Trading Commission (CFTC), the Department also already has brought a number of important prosecutions related to other criminal conduct exposed by the financial crisis. We expect that the FFETF will increase even further our close cooperation and collaboration with the SEC and the CFTC.

The financial meltdown resulted in the exposure of numerous fraudulent schemes that otherwise might have gone undetected for a longer period of time. The *Madoff* case, brought by the U.S. Attorney's Office for the Southern District of New York, the FBI, and the SEC, is probably the most prominent example. In this case, the defendant was charged on eleven counts of securities fraud, investment adviser fraud, mail fraud, wire fraud, money laundering, false statements, perjury, false filings with the SEC, and theft from an employee benefit plan, and he was ultimately sentenced on June 29, 2009, to 150 years in prison for perpetrating a Ponzi scheme that resulted in billions of dollars of

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losses to thousands of investor-victims. Moreover, the district judge in the case entered an order of forfeiture totaling $170 billion. In addition, there have been many related cases – including, for example, the case against the accountant for defendant Madoff who pleaded guilty on November 3, 2009, to a nine-count indictment charging securities fraud and related offenses; the case against another employee of defendant Madoff who pleaded guilty on August 11, 2009, to ten felony counts; and the case against two computer programmers of defendant Madoff who were charged on November 13, 2009, with conspiracy and falsifying the books and records of a broker-dealer and of an investment adviser.

Another example is the *Stanford* case brought by the Criminal Division's Fraud Section together with the U.S. Attorney's Office for the Southern District of Texas and the FBI. In June 2009, Robert Allen Stanford and four other individuals were indicted in connection with a scheme to defraud thousands of U.S.-based investors of approximately $8 billion in Certificates of Deposits. The indictment charges that the defendants misrepresented the financial condition of Stanford International Bank, Ltd., its investment strategy, and the extent of its regulatory oversight by Antiguan regulators, all the while siphoning off investor funds for personal use.

According to court documents, defendant Stanford is alleged to have fraudulently lured investors to trust him with their money and instead funneled funds to various "pet projects" which were not profitable. As the gap between reality and the reported value of the Bank's assets grew enormously, the Chief Financial Officer, allegedly at defendant Stanford's direction, directed the accounting department to manipulate the Bank's revenue/asset values. In addition, defendant Stanford is alleged to have bribed the head

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of the Antiguan Financial Services Regulatory Commission to ensure that it did not conduct a thorough examination of the Bank's books and records. On August 27, 2009, the former Chief Financial Officer of the Bank pleaded guilty and agreed to a preliminary order of forfeiture of $1 billion.

In addition, in a case brought by the U.S. Attorney's Office for the Eastern District of New York and investigated by the FBI, two former Credit Suisse brokers were charged with securities fraud for misrepresenting to investors that auction rate securities were backed by guaranteed student loans, when they were actually backed by much riskier mortgage-backed derivatives, enabling the brokers to earn much higher commissions. Investor losses allegedly exceeded $1 billion. One defendant pleaded guilty, and one defendant was convicted by a jury in August.

In a case brought by the U.S. Attorney's Office for the Southern District of New York and the FBI, Raj Rajaratnam, the manager of the multi-billion dollar hedge fund, Galleon Management, LLC, and five others, including an IBM executive, were charged with participating in an insider trading scheme that netted more than $20 million and arrested on October 16, 2009. On November 5, 2009, 14 additional defendants were charged, including an attorney at a major law firm. The case has been described as one of the largest hedge fund insider-trading schemes ever charged by the Department. According to the complaints, the defendants are alleged to have repeatedly traded on material, nonpublic information given as tips by insiders and others at hedge funds, public companies, and investor relations firms. The tipsters and tippees allegedly even used disposable, prepaid cell phones to try to conceal their conduct. As a result of their

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insider trading, these defendants and others allegedly gained millions of dollars of illegal profits for themselves and the hedge funds with which they were affiliated.

This case represents the first time that court-authorized wiretaps have been used to target significant insider-trading on Wall Street. It demonstrates that we will be aggressive in investigating and prosecuting white-collar crimes. We have numerous tools at our disposal to help us accomplish our mission, and we will continue to use all of them.

Recent Commodities Fraud Enforcement Efforts

In addition, our prosecutors in the Criminal Division's Fraud Section and at the 94 U.S. Attorneys across the country work closely with the CFTC and its Division of Enforcement to coordinate enforcement efforts against those who engage in commodities fraud. The recent *Hays* case in Minnesota is an example of the results we have achieved by working collaboratively in the commodities fraud area. Defendant Hays defrauded investors of in excess of $20 million through a Ponzi scheme involving purported investments in stock index futures and other futures contracts. In a case worked jointly by the Criminal Division's Fraud Section, the U.S. Attorney's Office in Minnesota, and the U.S. Postal Inspection Service -- working closely with the CFTC -- defendant Hays was charged in a criminal complaint and arrested. We seized, among other things, a $3 million yacht that defendant Hays had purchased with investor funds and bank accounts containing approximately $1 million in fraudulently obtained funds. On the very same day, the CFTC filed a civil enforcement action against defendant Hays and his company. Shortly thereafter, in April of this year, defendant Hays pleaded guilty to mail and wire fraud and financial transaction structuring charges and agreed to forfeit all proceeds of

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his scheme. Our combined efforts on the *Hays* case demonstrate that, by working together, we can move quickly to charge, convict, and forfeit the assets of those who engage in commodities fraud.

Another recent example of our success was the sentencing of defendant Michael Riolo on October 16, 2009, in a case prosecuted by the U.S. Attorney's Office for the Southern District of Florida. In this case, defendant Riolo received a sentence of 293 months imprisonment (and three years of supervised release) in connection with his role in organizing a multi-million dollar Ponzi scheme. According to court documents, defendant Riolo owned and operated two companies which he used to defraud investors (including several current and former police officers) out of millions of dollars. Defendant Riolo induced individuals to invest money with him in the Foreign Exchange Market by leading them to believe that they would receive substantial profits from their investments. Instead, he diverted investor funds for other purposes, including his own personal use and benefit. In total, defendant Riolo caused more than 80 investors to invest approximately $44 million, based on materially false statements and omissions of material facts.

These recent cases highlight the fact that commodities fraud is not jurisdictionally limited to certain districts in which trading exchanges are located. The Department will continue its coordinated enforcement efforts with the CFTC in jurisdictions throughout the country to combat commodities fraud. Indeed, we expect that the FFETF will further improve our collaboration, coordination, and information sharing in this area.

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Conclusion

In sum, the financial crisis demands an aggressive, comprehensive, and well-coordinated law enforcement response, including vigorous fraud investigations and prosecutions of individuals who have defrauded their customers and the American taxpayer and otherwise placed billions of dollars of private and public money at risk. The Department is committed to this effort and will ensure that we look at all allegations of fraud closely, follow the facts where they may lead, and bring our resources to bear to prosecute those who have committed crimes.

Thank you for the opportunity to provide the Committee with this brief overview of the Department's efforts to address financial fraud in the wake of the economic crisis, and I look forward to working with the Committee further. I would be happy to answer any question from the Committee.

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Statement of

The Honorable Edward Kaufman

United States Senator
Delaware
December 9, 2009

FOR RELEASE: December 9, 2009
CONTACT: Amy Dudley (202) 224-0423

Senate Judiciary Committee Hearing on Mortgage Fraud, Securities Fraud, and the Financial Meltdown: Prosecuting those Responsible
Statement of Senator Ted Kaufman (D-DE)
December 9, 2009

Good afternoon, everyone. I am honored to call to order this hearing of the Senate Committee on the Judiciary. And I thank Chairman Leahy for permitting me to chair this hearing.

Today we're going to examine the contributions of financial fraud to our current economic crisis, and to explore the efforts of law enforcement to find out what happened and bring the perpetrators to justice.

Three distinguished witnesses join us today to discuss these issues: Assistant Attorney General Lanny Breuer, SEC Director of Enforcement Robert Khuzami, and FBI Assistant Director Kevin Perkins.

Between the spring of 2007 and this past summer, the net worth of U.S. households dropped nearly 14 trillion dollars. 14 Trillion, with a "T."

Of course, an economic collapse of that magnitude was spurred by a wide spectrum of activity. Much of that behavior, though terribly misguided and indeed inexcusable, was not criminal.

The honest home buyer who, enticed by the promise of perpetually rising home prices, took out a mortgage that he could not really afford, may have shown bad judgment but did not break any laws.

In all likelihood, neither did the investment manager who lost a great deal of her clients' money because she failed to appreciate the full extent of the risk caused by mortgage-backed securities.

On the other end of the spectrum, however, was conduct that has all the earmarks of financial

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crime.

I'm talking about loan originators who encouraged borrowers to lie on loan applications; or middlemen and banks that knew the loans were bad but accepted them anyway for bundling and re-selling as securities; or investment banks that, stuck with toxic assets as housing prices began to plummet, consciously failed to disclose their true value or their risks to shareholders.

These people should be targets of FBI and SEC investigations. And if convicted, they should go to jail.

If we want to restore the public's faith in our financial markets and the rule of law, we must identify, prosecute, and send to prison the participants in those markets who broke the law. Their fraudulent conduct has severely damaged our economy, and harmed countless hard working Americans.

This is why, last May, I joined with Chairman Leahy, Senator Grassley, and others to help pass the Fraud Enforcement and Recovery Act.

FERA was instrumental in ensuring that additional tools and resources were provided to those charged with enforcement of our nation's laws against financial fraud.

Since the passage of FERA, some real progress has been made. The FBI, the Department of Justice, and the SEC have all redoubled their efforts and redeployed resources.

Just last month, President Obama created an interagency financial fraud enforcement task force. His decision to do so reflects the fact that mortgage, securities, and corporate fraud schemes not only devastated our economy but also have led to the widespread view that Wall Street does not play by the same rules as Main Street.

I'm pleased to see that the Task Force's mission is not just to hold accountable those who helped bring about the last financial crisis, but also to help prevent another crisis from happening.

We must deter those in the mortgage industry, on the trading desks, and in the board rooms who in the future might be tempted to put greed ahead of the law, thus setting the stage for another meltdown.

Of course, deterrence comes from successful investigation and prosecution, and meaningful punishment.

And successful investigation of these complex cases means, among other things, being smart about where to look, and what to look for.

At lower levels, we are starting to see results. The FBI reports that mortgage fraud investigations nationwide now total more than 2800.

To give just one example, in Northern California, the U.S. Attorney's Office recently secured a

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53-count indictment against seven individuals who ran a scheme using straw buyers, appraisers, escrow agents and notaries to obtain millions in fraudulent mortgages from victim banks.

In addition, unwitting purchasers were laden with mortgages they had no prospect of paying, in amounts that vastly exceeded the values of the underlying homes.

I also read with interest on Monday that the SEC filed fraud charges against three former top officers of New Century Financial Corporation, for misleading investors as New Century's subprime mortgage business was collapsing in 2006. According to press accounts, a parallel criminal investigation is ongoing.

The message is being sent that this sort of crime does not pay.

But I, like many Americans, remain frustrated that the responsible agencies have not been able to bring more high-level crooks to account.

I understand that unraveling sophisticated financial fraud is an enormously complex undertaking. And these cases can be difficult to make, particularly when trying to prove criminal intent beyond a reasonable doubt from the historical record alone.

But I have called this hearing because enough time has passed that America deserves a full accounting, though necessarily an interim one, from those who are tasked with enforcing our criminal laws.

In the midst of the housing boom-and-bust cycle, did Wall Street executives and hedge fund managers commit financial fraud? If so, why haven't we seen any convictions yet?

Are the agencies being smart and effective in deploying their resources? Do they have an adequate sense of urgency? Is there enough transparency in the markets for law enforcement even to know whether laws are being followed?

Many on Wall Street have argued that there was no criminality, merely a collective delirium brought about by soaring profits and faulty assumptions regarding risks.

My recurring nightmare is that I see some people on Wall Street inside a burning house; they see smoke, and maybe even a flame or two. But instead of sounding an alarm, they keep grabbing the money, convinced they still have time to get out before the house burns down. Even if they make it, where does that leave the rest of us?

I hope that this hearing will provide answers to these questions, and more.

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

by

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

Before the United States Senate
Committee on the Judiciary

December 9, 2009

I. Introduction

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

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

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field for all investors. The SEC is the only agency in the federal government focused primarily on investor protection; as such, we recognize our special obligation to uphold these principles.

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

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II. Recent Accomplishments and Initiatives

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

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

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

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A. Cases

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

Mortgage-Related Cases

- Just this week, the SEC filed charges against three former officers of New Century Financial Corporation, once the third largest subprime lender in the United States, for their alleged roles in including false and misleading

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information regarding the company's subprime mortgage business and in materially overstating the company's financial results by improperly understating its expenses relating to repurchased loans in Commission filings. The SEC's complaint alleges that New Century failed to disclose material facts necessary to make its financial statements not misleading, including, among other things, dramatic increases in early default rates, loan repurchases and pending loan repurchase requests, and that New Century materially overstated its second and third quarter financial results in 2006 (for example, the complaint alleges that pre-tax earnings in the second quarter were overstated by 165%, while third quarter pre-tax earnings were improperly reported as a $90 million profit instead of an $18 million loss).[2]

- In June 2009, the SEC charged Angelo Mozilo, the former CEO of Countrywide Financial, and two other former Countrywide executives with fraud for allegedly deliberately misleading investors about the significant credit risks the company was taking in efforts to build and maintain market share. Our complaint alleges that Countrywide portrayed itself as underwriting mainly prime quality mortgages, while privately describing as "toxic" certain of the loans it was extending. The SEC's complaint also charges Mozilo with alleged insider trading for selling his Countrywide stock based on non-public information for nearly $140 million in profit.[3]
- In April 2009 the SEC brought actions against three former executives at American Home Mortgage Investment Corp. for alleged accounting fraud and allegedly making false and misleading disclosures relating to the risk of its

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mortgage portfolio. Our complaint alleges that two of the executives fraudulently understated the company's first quarter 2007 loan loss reserves by tens of millions of dollar, converting the company's loss into a fictional profit. One of the executives, Michael Strauss, settled the SEC's charges, without admitting or denying the SEC's findings, by paying approximately $2.2 million in disgorgement and prejudgment interest and a $250,000 penalty, and agreeing to a five-year bar from serving as an officer or director of a public company.[4]

- In May and December 2009, the SEC brought two cases involving Brookstreet Securities Corp., a registered but now defunct broker-dealer, in connection with sales of allegedly unsuitable Collateralized Mortgage Obligations (CMOs) to retail customers. In the more recent action filed a few days ago, the SEC sued Brookstreet and its former President and CEO, alleging that from 2004 to mid-2007, the President and CEO helped create, promote, and facilitate an investment program, the "CMO Program," through which Brookstreet improperly sold risky, illiquid CMOs to retail customers (including retirees and retirement accounts) with conservative investment goals. More than 1,000 Brookstreet customers invested approximately $300 million through the CMO program. Earlier, in the May action, the SEC sued ten registered representatives of the firm for allegedly making false statements when marketing the CMOs, allegedly receiving $18 million in commissions related to the investments and causing customers losses of over $36 million.[5]

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- In June 2009, the SEC charged registered investment adviser Evergreen Investment Management Company, LLC, and an affiliate, with allegedly overstating the value of a mutual fund that invested primarily in mortgage-backed securities and for selectively disclosing problems with the fund to favored investors, allowing them to sell earlier than other investors and avoid losses. The adviser and its affiliate settled with the SEC, without admitting or denying the SEC's findings, by agreeing to pay $3 million in disgorgement and prejudgment interest and a total civil penalty of $4 million, as well as make an additional payment of $33 million to compensate shareholders. The SEC received valuable assistance from the Secretary of the Commonwealth of Massachusetts and the Massachusetts Securities Division in the investigation.[6]
- In May 2009, in the Reserve Fund matter, the SEC charged the managers of a $62 billion money market fund whose net asset value fell below $1.00, or "broke the buck," based in part on investments in Lehman-backed paper, for their alleged failure to properly disclose to the fund board material facts relating to the value of the Lehman-backed paper. On November 25, a federal judge in New York endorsed the SEC's approach to distributing the fund's assets on a pro-rata basis, which should result in an estimated return of at least 99 cents on the dollar for all shareholders who have not had their redemption requests fulfilled, regardless of when they submitted those redemption requests.[7]

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Accounting Fraud

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

Broker-Dealer, Investment Adviser, and Hedge Fund Misconduct

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

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

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acknowledged the respondents' undertakings to pay fines to CBOE totaling $180,000.[11]

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

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York Attorney General's Office, the North American Securities Administrators Association, and FINRA.[13]

Insider Trading

- Insider trading continues to be a significant program area, and this fall, the SEC filed charges relating to two complex insider trading rings alleging that more than $53 million in illegal profits were collectively obtained by 30 entities and individuals, including hedge fund portfolio managers and other Wall Street professionals, attorneys, and corporate insiders, among others. In the action against billionaire Raj Rajaratnam and Galleon Management LP, the SEC filed charges against a total of 21 individuals and entities, alleging that the scheme cumulatively generated more than $33 million in illicit gains. In another significant insider trading action, the SEC charged an attorney in the New York office of a major international law firm, another attorney, six Wall Street traders, and a proprietary trading firm for their alleged involvement in a $20 million insider trading scheme.[14] The Federal Bureau of Investigation and the U.S. Attorney's Office for the Southern District of New York provided invaluable assistance and cooperation in these cases.
- In May 2009, the SEC charged a former portfolio manager at hedge fund investment adviser Millennium Partners and a salesman at Deutsche Bank for alleged "cross-market" insider trading in credit default swaps on international holding company VNU. In this case, bank employees allegedly tipped the portfolio manager about an anticipated change in VNU's underlying bond

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structure that substantially increased the price of the credit default swap, which allowed the defendants allegedly to profit from their purchase of credit default swaps when the restructuring was announced.[15]

Public Trust

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

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from investment management firms seeking to manage the assets of New York's largest pension fund, the New York State Common Retirement Fund. Harding allegedly received a total of approximately $800,000 in sham "finder" fees.[17]

Ponzi Schemes

- The SEC investigates and prosecutes many Ponzi scheme cases each year, the majority of which are brought as emergency actions — seeking a temporary restraining order and an asset freeze — both to prevent new victims from being harmed and to maximize the recovery of assets to investors. Since the beginning of this calendar year, we have filed 55 cases involving Ponzi schemes or Ponzi-like payments.

Foreign Corrupt Practices Act

- Late last year, the SEC filed a settled civil injunctive action charging Siemens Aktiengesellschaft (Siemens), a Munich, Germany-based manufacturer of industrial and consumer products, with violations of the anti-bribery, books and records, and internal controls provisions of the Foreign Corrupt Practices Act (FCPA). The SEC brought this action in conjunction with the DOJ and the Office of the Prosecutor General in Munich, Germany. Siemens paid a total of $1.6 billion in disgorgement and fines in the three actions, which is the largest amount a company has ever paid to resolve corruption-related charges.[18]

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B. Cooperation and Coordination with Other Authorities

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

Finally, last month, as part of the effort to better combat financial crime and mount a more organized, collaborative, and effective response to the financial crisis, the SEC joined the DOJ, the U.S. Department of the Treasury (Treasury), and the U.S.

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

One of the vital aspects of the Task Force will be to better coordinate criminal and civil enforcement efforts. As a former federal prosecutor with the DOJ – and now as the Director of the Division of Enforcement at the SEC – I have seen first-hand the benefits of coordinated civil and criminal enforcement efforts. I am confident that the Task Force

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will result in greater opportunities to identify and prosecute wrongdoers, and thereby enhance public confidence in the integrity of our markets.

C. Division Reorganization

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

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

- ***Specialization***. We are creating five new national specialized investigative groups that will be dedicated to high-priority areas of enforcement, including Asset Management (including hedge funds and investment advisers), Market Abuse (large-scale insider trading and market manipulation), Structured and New Products (including various derivative products), Foreign Corrupt

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Practices Act cases, and Municipal Securities and "Pay-to-Play" issues. Members of the specialized units will acquire the expertise and investigative insights that can only be developed by conducting investigations in the same subject area, combined with ready access to others with specialized skills. With increased focus, training, and access to specialized expertise, investigative staff will conduct more effective, efficient investigations. With a national focus, these specialized groups will help to cultivate a sense of common mission and mutual support among Division personnel in different regional offices.

- ***Management Restructuring***. We are adopting a flatter, more streamlined organizational structure under which we will eliminate an entire layer of management. Our self-assessment revealed that we had a management structure that was too top-heavy, which created more process and delay than was optimal. We are reallocating a number of staff who were first line managers – some of our best and brightest in terms of experience and dedication – to the mission-critical work of conducting front-line investigations. As part of this effort, we will be working to maintain staff to manager ratios that will allow for close substantive consultation and collaboration – the goal is to have a management structure that facilitates timely case building, ensures quality control, and provides for the growth and development of the staff – ultimately enhancing the Division's ability to fulfill its investor protection mission.

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- ***Streamlining***. We are streamlining a number of internal processes and procedures. This streamlining includes permitting senior officers to approve the issuance of subpoenas for documents and testimony, without having in most cases to secure advance formal authorization from the Commission. With this change, we will be able to move more quickly in ferreting out fraud, and be able to react immediately if confronted by recalcitrant targets or dilatory tactics.
- ***Cooperation Tools.*** We are developing, for use by the SEC, agreements, similar to those used by criminal law enforcement authorities, to secure the cooperation of persons who are on the "inside" or otherwise aware of organizations or associations engaged in fraudulent activity. These agreements, the most important of which is a so-called "cooperation agreement," provide that such persons must agree to provide truthful evidence and testify against the organizers, leaders, and managers of such wrongful activity, in exchange for a possible reduction in sanctions imposed on them. Such cooperation agreements have the capacity to secure the availability of witnesses and information for the Division early on in investigations. The goal is to allow us to build stronger cases and to file them sooner than would otherwise be possible, thus preventing additional investor harm.

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- ***Other Initiatives.*** In addition to those described above, we are implementing a number of other initiatives designed to improve our processes and overall effectiveness. Among other items,
    - We are enhancing our training and supervision, including creating a formal training unit to ensure that our staff is armed with the knowledge and expertise necessary to confront today's complex market and products;
    - We have hired the Division's first-ever Managing Executive, a COO-type role to focus on the Division's operations. Where previously many administrative, operational, and infrastructure tasks were handled on an ad hoc basis by investigative personnel and could be a drain on investigative functions, those tasks will now be handled more efficiently and effectively by trained staff with the appropriate skill set;
    - We are establishing an Office of Market Intelligence, which will serve as a central office for the handling of complaints, tips, and referrals that come to the attention of the Division, coordinate the Division's risk assessment activities, and support the Division's strategic planning activities. In short, this office will enable us to have a unified, coherent, coordinated response to the huge volume of complaints, tips, and referrals we receive every day, thereby enhancing our ability to open the right investigations, bring the right cases, and ultimately protect investors;

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- We have hired experienced former federal prosecutors to serve as Deputy Director of the Division of Enforcement and Director of the New York Regional Office, two of the most significant positions in the Division.

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

III. Continuing to Strengthen the Division

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

A. Legislative Initiatives

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

- ***Establishing a "whistleblower" program.*** We have recommended whistleblower legislation that would provide substantial rewards for tips from persons with unique, high-quality information. We expect this program to

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generate significant tips that we would not otherwise receive from persons with direct knowledge of serious securities law violations. This legislation, along with our cooperation initiatives, would increase incentives for persons to share full information quickly while expanding protections against retaliatory behavior. This proposed legislation has the potential to enable the Division to investigate violations more effectively and efficiently.

- ***Obtaining improved access to grand jury materials.*** The Division is seeking a narrow modification to the "grand jury secrecy rule" that would enhance the Division's ability to conduct timely investigations and use resources efficiently. The proposed amendment would authorize the DOJ to seek court authorization to release certain limited grand jury information to Commission staff for use in matters within the Commission's jurisdiction consistent with the statutory authority applying to such access by federal bank regulators. It would permit sharing of information only with regard to conduct that may constitute violations of the federal securities laws. With regard to that information, however, the proposed amendment would lessen the burden in obtaining court approval. The court could approve the sharing of the information upon a showing of a "substantial need in the public interest," rather than the higher "particularized need" standard. In addition, under the proposed amendment the judicial proceeding requirement would not apply to the Commission, permitting information to be shared at an earlier stage in an investigation and in connection with an administrative proceeding.

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- ***Establishing nationwide service of process.*** The SEC currently has nationwide service in administrative proceedings. Establishing nationwide service of process in civil actions filed in federal courts would produce a number of substantial advantages, including a significant savings in terms of travel costs and staff time through the elimination of duplicative depositions and the benefits of having live witnesses and party testimony before the trial court. The House recently passed a bill on this subject, and we are hopeful the Senate will support this as well.
- ***Additional initiatives.*** Additional legislative proposals that would serve to enhance the Division's effectiveness and efficiency include the ability to seek civil penalties in cease-and-desist proceedings, the ability to seek penalties against aiders and abettors under the Investment Advisers Act of 1940, and the ability to charge aiding and abetting violations under the Securities Act of 1933 and the Investment Company Act of 1940.

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

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B. Future Plans for the Division of Enforcement

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

- ***Improving the handling of complaints, tips, and referrals.*** In March 2009, the SEC hired the MITRE Group, a non-profit, federally funded research and development firm, to conduct a comprehensive review of the SEC's systems and procedures for evaluating and tracking complaints, tips and referrals (CTRs). We are now in the process of drafting new policies and procedures and laying the foundations for a centralized information technology solution that will provide the SEC with an automated mechanism for tracking, analyzing, and reporting the handling of CTRs.
- ***Tracking cases with qualitative metrics.*** As part of our focus on the quality and effectiveness of our enforcement program, we are implementing systems to measure certain qualitative factors of our investigations and cases. These metrics should help us track cases and determine whether our resources are being used effectively to file cases with programmatic significance in a timely manner.

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- ***Improving information technology.*** Information technology is a priority for the Division. For example, increasing our electronic document management capacity will allow us to more effectively load, store, and search the millions of documents involved in our investigations. System improvements also will enhance our ability to track data and manage cases.

C. Resources

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

Given the size, complexity, and cross-border scope of the securities industry, and the huge volume of information that the SEC receives, the SEC – and our Division – needs far more resources to improve its ability to protect investors. We recognize our obligation to American taxpayers to use the resources we have as efficiently as possible – which forms the basis for many of the Division reforms I have described above, including the flattening of management, the streamlining of internal processes, and the increased use of cooperation tools. Even with these and other steps to increase our efficiency, however, our resources are inadequate for the task we confront. Thus, we must, among

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other improvements, increase the number of qualified staff in the Division and invest in critical information technology initiatives. Because of several years of flat or declining SEC budgets, the SEC has faced significant declines in resources in recent years. Despite the much appreciated budget increase received in 2009, the Division will still have significantly fewer staff than in it did four years ago, and its budget for improvements in technology remains lower than it was in 2005. I join Chairman Schapiro's request for a self-funding mechanism that will allow us the resources and stability to truly police the world's most sophisticated markets.

IV. Conclusion

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

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

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[1] During the 2009 calendar year alone, the SEC has distributed more than $2 billion to harmed investors. Section 308 of the Sarbanes-Oxley Act of 2002, codified at 15 U.S.C. §7246, enabled the Commission to

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distribute civil money penalties to investors in certain circumstances. In enforcement actions prior to the passage of the Sarbanes-Oxley Act, only funds paid as disgorgement could be returned to investors.

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

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

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

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

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

[7] *SEC v Reserve Management Company, Inc., Resrv Partners, Inc., Bruce Bent Sr. and Bruce Bent II*, Lit. Rel. No. 21025 (May 5, 2009).

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

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

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

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

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

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

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

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

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

[17] *SEC v. Henry Morris, et al.*, Lit. Rel. No. 20963 (March 19, 2009), Lit. Rel. No. 21001 (April 15, 2009), Lit. Rel. No. 21018 (April 30, 2009).

[18] Siemens agreed to pay $350 million in disgorgement to the SEC. In related actions, Siemens agreed to pay a $450 million criminal fine to the U.S. Department of Justice and a fine of €395 million (approximately $569 million) to the Office of the Prosecutor General in Munich, Germany. Siemens previously paid a fine of €201 million (approximately $285 million) to the Munich Prosecutor in October 2007. *SEC v. Siemens Aktiengesellschaft*, Lit. Rel. No. 20829 (Dec. 15, 2008).

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

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Statement Of Senator Patrick Leahy (D-Vt.),
Chairman, Senate Judiciary Committee,
Hearing On "Mortgage Fraud, Securities Fraud,
And The Financial Meltdown: Prosecuting Those Responsible"
December 9, 2009

I thank Senator Kaufman for chairing this hearing on combating mortgage and financial fraud. He has been a leader on this vital issue. Early this year, Senator Kaufman, Senator Grassley and I introduced the bipartisan Fraud Enforcement and Recovery Act (FERA) of 2009. Our bipartisan efforts led to strong votes in both houses of Congress and passage of this important bill in May.

Senator Kaufman has spoken out on the need for aggressive fraud enforcement all year. I am glad that he is now conducting this important hearing to examine how the new enforcement tools we provided are working, to review the current state of our fraud enforcement efforts, and to consider additional steps to strengthen these efforts.

The Fraud Enforcement and Recovery Act was a major step toward holding accountable those who have caused so much damage to our economy and protecting our economic recovery efforts from the scourge of fraud. This law has strengthened the Federal Government's capacity to investigate and prosecute the kinds of financial frauds that so severely undermined our economy and hurt so many hard-working people in this country. These frauds have robbed people of their savings, their retirement accounts, college funds for their children, and their equity and have cost too many people their homes. This new law is helping to provide the resources and legal tools needed to police and deter fraud and to protect taxpayer-funded economic recovery efforts now being implemented.

Mortgage fraud had reached near epidemic levels in this country. Reports of mortgage fraud are up 682 percent over the past five years, and more than 2800 percent in the past decade. And massive, new corporate frauds, like the $65 billion dollar Ponzi scheme perpetrated by Bernard Madoff, are being uncovered as the economy has turned worse, exposing many investors to massive losses. We are now better able to take action to better protect the victims of these frauds. These victims include homeowners who have been fleeced by unscrupulous mortgage brokers who promise to help them, only to leave them unable to keep their homes and in even more debt than before. They include retirees who have lost their life savings in stock scams and Ponzi schemes, which have come to light as the markets have fallen and corporations have collapsed. They also include American taxpayers who have invested billions of dollars to restore our economy, and who expect us to protect that investment and make sure those funds are not exploited by fraud.

In the last three years, the number of criminal mortgage fraud investigations opened by the Federal Bureau of Investigation (FBI) has more than doubled, and the FBI anticipates that number may double yet again. Despite this increase, the FBI at the start of this year had fewer than 250 special agents nationwide assigned to financial fraud cases, which is only a quarter of the number the Bureau had more than a decade ago at the time of the savings and loan crisis. I hope that congressional action through passage of FERA and appropriations has allowed the FBI and other enforcement agencies to dedicate more resources to combating fraud, and I look forward to hearing about increased efforts.

Fraud enforcement is an excellent investment for the American taxpayer. According to recent data

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provided by the Justice Department, the Government recovers more than $20 for every dollar spent on criminal fraud litigation. We need to ensure going forward that FERA is fully funded and that enforcement agencies allocate sufficient resources to combating fraud.

The Fraud Enforcement and Recovery Act also made a number of straightforward, important improvements to fraud and money laundering statutes to strengthen prosecutors' ability to combat this growing wave of fraud, and it strengthened one of the most potent civil tools we have for rooting out fraud in Government – the False Claims Act. The Federal Government has recovered more than $22 billion using the False Claims Act since it was modernized through the work of Senator Grassley and Congressman Berman in 1986, and FERA made the statute still more effective. I look forward to hearing how these new tools have helped enforcement efforts.

Strengthening fraud enforcement has been a key priority for President Obama. During the campaign, President Obama promised to "crack down on mortgage fraud professionals found guilty of fraud by increasing enforcement and creating new criminal penalties." The President has made good on this promise by calling for additional resources for fraud investigation and prosecution in his budget and by signing FERA into law.

This is a bipartisan issue. Democrats, Republicans, and Independents share a commitment to fight fraud and the horrible costs it is imposing on hard-working Americans. No one wants to see taxpayer money intended to fund economic recovery efforts diverted by fraud. No one wants to see those who engaged in mortgage fraud escape accountability.

The recovery efforts are leading to economic progress. That is good. That is necessary. But that is not enough. We need to make sure that we are spending our public resources wisely and that they are not being dissipated by fraud. We need to ensure that those responsible for the downturn through fraudulent acts in financial markets and the housing market are held to account.

That is why it was so important that we quickly and decisively passed FERA and is so important that that we remain vigilant in our oversight of fraud enforcement efforts. In addition, the same Senators who have led the fight against mortgage and financial fraud are now working to vigorously combat health care fraud. Senator Kaufman and I are working hard to ensure that health care reform legislation includes tough and smart new measures to crack down on fraud. I applaud his leadership in that area, as well.

I look forward to hearing from today's witnesses about important progress in cracking down on fraud and protecting the economic well being of hard-working Americans.

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Department of Justice

STATEMENT OF

KEVIN L. PERKINS
ASSISTANT DIRECTOR, CRIMINAL INVESTIGATIVE DIVISION
FEDERAL BUREAU OF INVESTIGATION

BEFORE THE

JUDICIARY COMMITTEE
UNITED STATES SENATE

ENTITLED

"MORTGAGE FRAUD, SECURITIES FRAUD, AND THE FINANCIAL MELTDOWN: PROSECUTING THOSE RESPONSIBLE"

PRESENTED

DECEMBER 9, 2009

Good afternoon Chairman Leahy, Ranking Member Sessions, and Members of the Committee. I want to thank you for the opportunity to testify before you today about the FBI's ongoing efforts to combat significant financial crimes.

As we all know, financial fraud, to include mortgage, corporate, and securities frauds, were not the primary sources of the current financial crisis; collectively however, these frauds have significantly impacted the U.S. housing and financial markets.

Mortgage Fraud continues to pose a significant threat to lenders, investors, residential real estate values, and the U.S. economy. The FBI delineates Mortgage Fraud into two distinct areas: 1) Fraud for Profit; and 2) Fraud for Housing. Fraud for Profit generally employs schemes to remove equity, falsely inflate the value of the property, or issue loans relating to fictitious properties. Many of the Fraud for Profit schemes rely on "industry insiders," who override lender controls. The FBI defines industry insiders as appraisers, accountants, attorneys, real estate brokers, mortgage underwriters and processors, settlement/title company employees, mortgage brokers, loan originators, and other mortgage professionals engaged in the mortgage industry.

Fraud for Housing, on the other hand, represents illegal actions perpetrated by borrowers, typically with the assistance of real estate professionals. The simple motive behind this fraud is to acquire and maintain ownership of a residence under false pretenses. This type of fraud is typified by a borrower who makes misrepresentations regarding the income or employment history to qualify for a loan, which the borrower would otherwise not qualify for. Although generally not as sophisticated as Fraud for Profit schemes, Fraud for Housing has played a large role in the decline of residential real estate values since unqualified buyers defaulted on loans they would otherwise not have obtained but for their fraud.

The FBI compiles data on Mortgage Fraud through Suspicious Activity Reports (SARs) filed by financial institutions through the Financial Crimes Enforcement Network (FinCEN), and through reports generated by the Department of Housing and Urban Development (HUD) Office of Inspector General (OIG). The FBI also receives and shares information pertaining to Mortgage Fraud through its national and regional working groups, as well as complaints from the industry at large.

Mortgage Fraud, however, is just one component of the recent financial crisis, which has left trillions of dollars of losses in its wake as the Dow Jones Industrial Average fell to 6,547 in March 2009 from its high of 14,164 in October 2007. Throughout the past decade, a flourishing market developed for the securitization and sale of assets such as mortgages by financial institutions and other entities who were seeking to alleviate risk, increase cash flows and profit from these complex financial products. As underwriting requirements began to erode, sub-prime assets began to make up the majority of asset backed securities. In 2007, the markets for sub-prime asset backed securities began to collapse, which has been credited as one of the primary causes of the financial meltdown. In the wake of this historic economic calamity, the FBI has and will continue to investigate criminal allegations related to the activity that contributed to the financial crisis using all available tools at our disposal.

Since the financial meltdown in the fall of 2007, the FBI has effectively combated significant financial frauds on various fronts. For example, we have more than 2,100 pending Corporate and Securities Fraud investigations across the country, many with losses exceeding $100 million, and several with losses over $1 billion. The FBI has prioritized its efforts to combat the most

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egregious Corporate and Securities Fraud offenders, which resulted in 460 convictions in Fiscal Year (FY) 2009.

Financial Fraud Trends

It is no secret that the financial crisis caused severe damage to both the financial markets and investor confidence. The crisis not only revealed new fraud schemes, such as material misrepresentations in the marketing of asset backed securities, but also exposed established fraud schemes which had been thriving in the global financial system, such as, Ponzi schemes. These schemes, both old and new, highlight the need for law enforcement and regulatory agencies to be ever vigilant, and work closer together, to identify financial fraud both in boom and bust years.

Securities Fraud - High Yield Investment Fraud/Ponzi Schemes

High Yield Investment Fraud schemes have many variations, all of which are characterized by offers of low risk investments, guaranteeing an unusually high rate of return. Victims are enticed by the prospect of easy money, and a fast turnaround.

The most common form of these frauds is the Ponzi scheme, which is named after early 20th century criminal Charles Ponzi. These schemes use money collected from new victims, rather than profits from an underlying business venture, to pay the high rates of return promised to earlier investors. This arrangement gives investors the impression there is a legitimate, money-making enterprise behind the fraudster's story; but in reality, unwitting investors are the only source of funding.

Another type of High Yield Investment Fraud is Prime Bank Investment Fraud. In these schemes, victims are told that certain financial instruments such as notes, letters of credit, debentures, or guarantees have been issued by well-known institutions such as the World Bank, and offer a risk-free opportunity with high rates of return. Perpetrators often claim unusually high rates of return and low risk are the result of a worldwide secret exchange open only to the world's largest financial institutions. Victims are often drawn into Prime Bank Investment Frauds because the criminals use sophisticated terms, legal looking documents, and claim that the investments are insured against loss.

As the financial crisis expanded, drying up investment funds and causing investors to begin seeking returns of their principal, investment fraud schemes began to unravel. In FY 2009, the FBI realized a 105% increase in new High Yield Investment Fraud investigations when compared to FY 2008 (314 as opposed to 154), many with losses exceeding $100 million. Many of the Ponzi scheme investigations have an international nexus, and have affected thousands of victims. The most significant of these, the $64 billion Ponzi scheme perpetrated by Bernard L. Madoff, resulted in the longest prison sentence in the history of financial crime – 150 years. Similarly, both, Robert Allen Stanford of Houston, Texas, and Thomas Petters of Minneapolis, Minnesota, have been charged in alleged billion dollar Ponzi schemes. Petters was recently found guilty by a jury in Minnesota of 20 counts of fraud and other federal offenses. The FBI continues to aggressively investigate this criminal threat, and currently has more than 1,500 related Securities Fraud investigations.

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Insider Trading

The FBI proactively investigates Insider Trading schemes, using all available tools to remove the most egregious offenders from the financial markets. A recent highlighted success came with the indictments and subsequent arrests related to allegations of Insider Trading within Galleon Group, a prominent Hedge Fund, located in New York City. To date, fourteen individuals have been arrested and the investigation is ongoing. The FBI continues to work closely with the U.S. Securities and Exchange Commission (SEC) on such matters, in a parallel law enforcement and regulatory effort to ensure fairly operated financial markets. Lack of regulatory oversight and transparency in the Hedge Fund industry makes this industry susceptible to various types of Securities Fraud and insider trading, and creates challenges to law enforcement. In addition, fraud committed by Hedge Funds poses a serious threat of substantial losses due to the fact Hedge Funds are typically highly leveraged.

Corporate Fraud

As the lead law enforcement agency investigating Corporate Fraud, the FBI has focused its efforts on cases which involve accounting schemes, self-dealing by corporate executives, and obstruction of justice. The majority of Corporate Fraud cases pursued by the FBI involve accounting schemes designed to deceive investors, auditors, and analysts about the true financial condition of a corporation. Through the manipulation of financial data, the share price of a corporation's stock remains artificially inflated based on fictitious performance indicators provided to the investing public. In addition to significant financial losses to investors, Corporate Fraud has the potential to cause immeasurable damage to the U.S. economy and investor confidence.

The FBI has observed a rise in Corporate Fraud schemes and trends, such as, the failures of prominent financial institutions partly caused by the recent collapse of the Sub-Prime market, the falsification of accounting records to obtain government funding through the $700 billion Troubled Asset Relief Program (TARP), and misrepresentations regarding the risks and valuations of complex financial instruments (e.g., credit default swaps and mortgage backed securities). Over the last five years, Corporate Fraud investigations have increased by 78 percent; to more than 590 open investigations.

Numerous corrupt executives, and accounting fraud schemes, have also been exposed as more companies experience liquidity and cash flow problems, as evident in recent investigations to include the Deferred Prosecution Agreement obtained against Beazer Homes; and the recent trial of Thomas Petters. As a result of economic difficulties facing many U.S. corporations, it is anticipated that some companies will continue to commit various accounting frauds, in an effort to hide their true financial condition, from the public, until the economic crisis has ceased.

Securities Fraud – Market Manipulation

Market Manipulation, or "Pump and Dump," schemes are based on the manipulation of lower-volume stocks purchased on small over-the-counter markets. The basic goal of Market Manipulation fraud is to artificially inflate ("pump") the price of penny stocks so the conspirators can sell ("dump") their shares at a large profit. The "pump" involves recruiting unwitting investors through false or deceptive sales practices, public information, or corporate filings. Many of these schemes use "boiler room" methods where brokers, who are bribed by the conspirators, use high pressure sales tactics to increase the number of investors and, therefore, raise the price of

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the stock. Once the price of the targeted shares reaches a certain point, the perpetrators "dump" their shares at a huge profit and leave innocent investors with significant losses. These schemes generate an estimated $6 billion in losses each year, and have the ability to significantly impact investor confidence.

One recent trend seen in Market Manipulation cases involves "computer intrusion." Computer intrusion for the purpose of Market Manipulation often includes a criminal hacking into victims' personal online brokerage accounts and using the accounts to purchase shares of a penny stock to inflate its price. As in normal Pump and Dump schemes, once the price of the stock reaches a certain point, the perpetrators dump their own shares and walk away with a large profit.

The FBI employs a number of proactive techniques to target Market Manipulation perpetrators, and currently has 109 such cases. In FY 2009, 62 individuals were charged in Market Manipulation schemes following FBI investigation.

Foreclosure Rescue Scams

Foreclosure rescue scams are particularly egregious because fraudsters take advantage and illegally profit from the misfortune of others. As foreclosures continue to rise across the country, so have the number of foreclosure rescue scams targeting unsuspecting victims. These scams include victims losing home equity; or paying thousands of dollars in fees in exchange for little or no services. In many of these cases, victims ultimately lose their home to foreclosure. The FBI is again working with our law enforcement, regulatory, and industry partners to target, disrupt, and dismantle the individuals, and/or companies, engaging in these fraud schemes.

Proactive Approach to Financial Fraud

The FBI has implemented innovative and proactive methods to detect and combat Mortgage Fraud, and other significant financial frauds. Foremost, is the development of the Financial Intelligence Center (FIC). The FIC was established on 09/14/2009, with resources appropriated by Congress, through H.R. 2346, Supplemental Appropriations Act, to the FBI to investigate Mortgage Fraud, Predatory Lending, Market Manipulation, and other financial frauds. The FIC is currently staffed with one Supervisory Intelligence Analyst (SIA), eight Staff Operations Specialists (SOS), and six Intelligence Analysts (IA). In FY 2010, the FIC should be fully operational with a total staffing level of 58. The FIC's mission is to provide tactical analysis of intelligence data, data sets, and databases, by using evolving technology and data exploitation techniques, to create targeting packages to identify the most egregious criminal offenders, and to enhance current criminal investigations. In addition, the FIC responds to requests by FBI field offices to complement the field's resources to identify emerging economic threats. The FIC also provides training to the field to assist with identifying the most egregious criminal enterprises.

The Department of Justice's Criminal Division is initiating a Mortgage Fraud Initiative that will utilize, among other tools, the FIC's analysis in the prosecution of its cases.

Another proactive approach was the development of an analytical computer application to identify property flipping transactions, first developed by the FBI's Washington Field Office, to effectively identify property flipping in the Baltimore and Washington areas. The original concept has evolved into a national FBI initiative, which employs statistical correlations and other advanced computer technology, to search for companies and persons demonstrating patterns of alleged illegal property flipping. As potential targets are analyzed and flagged, the information is

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provided to the respective FBI field office for further assessment. Illegal Property flipping is described as purchasing properties and artificially inflating their value through false appraisals. The artificially valued properties are then sold to an associate of the "flipper" at a substantially inflated price. Quite often the property is "flipped" within 30 days, but sometimes the "flip" occurs on the same day as the original purchase. Typically, illegally flipped properties go into foreclosure, and are ultimately repurchased for a fraction of their original value.

Other methods employed by the FBI include sophisticated investigative techniques, such as, undercover operations. These investigative measures not only result in the collection of valuable evidence, but also provide an opportunity to apprehend criminals in the commission of their crimes, thus reducing losses to individuals and financial institutions.

In December, 2008, the FBI dedicated resources to create the National Mortgage Fraud Team (NMFT), at FBI headquarters in Washington, D.C. The NMFT, which has responsibility for management of the FBI's Mortgage Fraud program, serves as a veritable fusion center. Through program guidance, oversight, training, and information sharing, the NMFT provides the tools necessary to identify the most egregious Mortgage Fraud perpetrators, prioritize pending investigations, and ensure that Mortgage Fraud efforts are both threat-based and intelligence driven.

Partnerships

Some of the best tools in the FBI's arsenal for combating financial frauds are its long-standing partnerships with federal, state and local law enforcement and regulatory agencies. Collaboration, communication, and information-sharing have long been a proven solution to the nation's most complex crimes. In response to a growing gang problem, for example, the FBI stood up Safe Streets Task Forces across the country. In response to crimes in Indian Country, the FBI developed the Safe Trails Task Force Program. In response to the recent wave of financial crimes, the FBI stood up Mortgage Fraud Task Forces across the country. Currently, there are 16 Mortgage Fraud task forces and 61 working groups nationwide. With representatives of federal, state, and local law enforcement, these task forces are strategically placed in areas identified as high threat areas for Mortgage Fraud. Partners are varied, but typically include representatives of HUD-OIG, the U.S. Postal Inspection Service, the Internal Revenue Service – Criminal Investigative Division, FinCEN, the Federal Deposit Insurance Corporation (FDIC), and the U.S. Secret Service, as well as, state and local law enforcement offices.

As of October 31, 2009, the FBI has nearly tripled the number of Special Agents in the field, who investigate Mortgage Fraud cases, from 120 in FY 2007, to 354 Special Agents. This multi-agency task force model serves as a force-multiplier, providing an array of resources to adequately identify the sources of the fraud; allowing agencies to share investigative expertise; and increases jurisdictional avenues, allowing task force members to find the most effective way to prosecute each case, particularly in active markets where fraud is widespread. We are pleased to report that model is working.

In October, 2009, for example, the FBI coordinated closely with our federal, state, and local law enforcement partners in "Operation Bad Deeds" – a massive multi-agency takedown of Mortgage Fraud schemes in New York State. In all, 41 defendants were charged with fraudulently obtaining $64 million in residential mortgages on more than 100 properties. Among those charged were six lawyers, seven loan officers, three mortgage brokers, one accountant, and a residential property appraiser.

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A Mortgage Fraud Surge was initiated in January 2009 in the Middle District of Florida, and was completed on October 31, 2009. The Surge resulted in charges being filed against more than 100 persons, involved allegations concerning more than $400 million in mortgage loans procured by fraud, and included more than 700 properties. Participating in the Surge were FBI Jacksonville, FBI Tampa, as well as several other state and federal law enforcement agencies.

In addition to our efforts to create Mortgage Fraud task forces across the country, the FBI participates on both the national Mortgage Fraud Working Group (MFWG), and the national Bank Fraud Working Group (BFWG). The MFWG and BFWG, chaired by the DOJ Fraud Section, represent a collaborative effort of multiple federal agencies; and facilitate the information sharing process across agencies, as well as to private organizations. Working in partnerships, the FBI is building on existing FBI intelligence databases to identify industry insiders and egregious criminal enterprises conducting systemic Mortgage Fraud.

In order to most effectively combat the threats of Corporate and Securities Fraud, the FBI has partnered with numerous external agencies to form 37 Corporate Fraud and/or Securities Fraud Working Groups across the country. These working groups, such as the DC Metro Corporate Fraud Working Group, enhance cooperation and information sharing, and provide a venue where the FBI can meet with our partners, e.g. SEC, to discuss current trends, threats, and the progress of selected ongoing investigations. In addition, the FBI works closely with the Special Inspector General for the TARP (SIG-TARP) to guard against fraud in the $700 billion TARP. The FBI is currently conducting several joint investigations with the SIG-TARP. Further, the FBI participates on the Term Asset-Backed Securities Loan Facility (TALF) Task Force. The TALF is a Federal Reserve program through which the Federal Reserve Bank of New York makes loans, which are secured by collateral in the form of asset-backed securities. These loans are typically made to Hedge Funds and other investment groups, and are vulnerable to fraud.

The FBI is a member of the newly formed Financial Fraud Enforcement Task Force (FFETF) recently announced by Attorney General Holder, which replaced the President's Corporate Fraud Task Force. The new task force is comprised of more than 20 agencies, including the SEC, the Commodities Futures Trading Commission (CFTC), the Department of Treasury, the FDIC, and HUD. The purpose of the Financial Fraud Enforcement Task Force is to maximize intelligence sharing between member agencies and to ensure that significant financial crimes related to the financial crisis and economic recovery efforts are appropriately addressed.

The FBI also participates in the Securities and Commodities Fraud Working Group, a national interagency coordinating body established by the DOJ Fraud Section to provide a forum for exchanging information, discussing violation trends, legal developments, law enforcement issues, and investigative techniques. In addition, FBI Corporate Fraud and Securities Fraud program managers frequently meet with their counterparts at the SEC's Home Office in Washington, D.C. to discuss threats, emerging trends, pending investigations, and to share intelligence.

Industry Liaison

In addition to its partners in law enforcement and regulatory areas, the FBI continues to foster relationships with representatives of the mortgage industry to promote Mortgage Fraud awareness. The FBI has spoken at and participated in various mortgage industry conferences and seminars, including those sponsored by the Mortgage Bankers Association (MBA), the American Bankers Association, and the BITS Financial Services Roundtable (a consortium of financial institutions).

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To raise awareness of this issue and provide easy accessibility to investigative personnel, the FBI has provided contact information of the FBI's Mortgage Fraud Supervisors to relevant groups, to include the MBA, Mortgage Asset Research Institute (MARI), Fannie Mae, Freddie Mac, and others.

Lenders are painfully aware how fraud affects their bottom line. Through routine interaction with FBI personnel, industry representatives are aware of our commitment to address this crime problem. The FBI frequently participates in industry sponsored fraud deterrence seminars, conferences, and meetings, which include topics, such as, quality control and industry best practices to detect, deter, and prevent Mortgage Fraud. These meetings play a significant role in training and educating industry professionals. Companies share current and common fraud trends, load underwriting weaknesses, and best practices for fraud avoidance. These meetings also increase the interaction between industry and FBI personnel.

Additionally, the FBI continues to train its personnel and conduct joint training with HUD-OIG and industry on Mortgage Fraud. As a training model, the FBI seeks industry experts to assist in its internal training programs. For example, industry has assisted training FBI personnel on mortgage industry practices, documentation, and industry views of laws and regulations. Industry partners have offered to assist the FBI in developing advanced Mortgage Fraud investigative training material and fraud detection tools.

Likewise, the FBI makes considerable investment in industry liaison for our Corporate Fraud and Securities Fraud programs. We not only bring in industry experts to train FBI personnel, such as, the Financial Industry Regulatory Authority (FINRA), but FBI personnel also frequently attend meetings and conferences set up by such industries as part of our effort to foster relationships and proactively gather information.

Conclusion

Mr. Chairman, the FBI remains committed to its responsibility to aggressively investigate significant financial crimes. We will continue to work with the Office of Management and Budget, and the Congress, to ensure that adequate resources are available to address these threats. To maximize our current resources, we are relying on intelligence collection and analysis to identify emerging trends and egregious offenders to ensure we target the greatest threats. We also will continue to rely heavily on the strong relationships we have with both our law enforcement and regulatory agency partners.

The FBI looks forward to working with you, and other members of this committee, in solving this serious threat to our nation's economy. Thank you for allowing me the opportunity to testify before you today.

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