The sleeping watch dog: aka the Securities and Exchange Commission

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Abstract

Purpose – The purpose of this paper is to expose inefficient regulatory policies and organizational weaknesses at the Securities and Exchange Commission (SEC) that have contributed to a series of regulatory oversights that have produced some of the largest fraud schemes perpetrated on investors.

Design/methodology/approach – Sources of information consisted of scholarly articles and articles retrieved from the web.

Findings – Findings suggest that although weaknesses that have been exposed at the SEC may not account for any one securities fraud oversight, cumulatively, the weaknesses create negative synergy that increases the probability that a regulatory oversight will occur.

Originality/value – This paper serves as a useful guide to alert and educate securities regulators and enforcement, regardless of the country they may operate in, to examine their own regulatory policies and organizational structures for weakness that may be similar to the SEC.

Keywords Securities and Exchange Commission, Fraud, Ponzi schemes, Securities

Paper type Research paper

Introduction

The mission of the US Securities and Exchange Commission (SEC), an independent federal agency, is to protect investors, ensure efficient securities markets, and facilitate capital formation. The SEC regulates public companies and public offerings of securities under the Securities Act of 1933 and the Securities Exchange Act of 1934. The SEC also oversees other participants in the financial industry, including securities exchanges, brokers and dealers, investment advisers, and mutual funds. In recent years, however, the SEC has suffered high-profile setbacks; most notably, it failed to apprehend Ponzi schemer Bernard Madoff and to anticipate the current financial crisis. Although this article's focus is not on Madoff, the Madoff case is particularly instructive because it amplified in a very public way the weaknesses of the SEC. The SEC's failures are symptomatic of a myriad of inter-related problems, such as a culture that discourages examining frauds that appear complex when they in fact may not be complex, attorneys who do not have securities industry knowledge to understand how the frauds they are charged to prevent actually occur, and the impression that the SEC's staff appears to be "captive" to private organizations on Wall Street because the people they intend to regulate are viewed as their future employers once they leave their public service employment. Consequently, the requirement of regulatory independence, both in fact and appearance, seems compromised.

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In this article, the authors exam issues confronting the SEC that involve not only its own policies as to how it measures regulatory success but also the organization's culture that may directly and indirectly compromise its mission. The article expands the research by Professor Jonathan R. Macy contained in his article "The distorting incentives facing the US Securities and Exchange Commission" by including current insights by former SEC staff supporting the thesis that a distorted incentive system has undermined the mission of this agency. Some of the issues discussed, and exemplified by cases in addition to the Madoff case, include examining how the SEC's incentive system discouraged in-depth investigations of potential securities fraud and whether former SEC staff now in private practice representing clients under investigation by the SEC exerts undue influence over current SEC staff when resolving disputes pertaining to securities law violations.

Moreover, the authors expand Professor Macy's analysis by including other areas that compound SEC inefficiencies. For example, the perception that there is a lack of independence in reviewing cases for securities fraud by SEC professionals is addressed, in addition to the inadequate whistle-blower protection apparatus for those that want to alert the SEC as to securities fraud that to date has not been streamlined in terms of responding to tips. The pending Ponzi scheme case against R. Allen Stanford is an excellent example of how multiple factors outlined in this article converge, and ultimately lead to oversights. In the Stanford case, the oversights were caused by the SEC's incentive system that delayed the investigation of Stanford and how the whistle-blower apparatus failed the individual, together with the public, who tipped off the SEC as to Stanford's practices. The SEC also failed to investigate Stanford because it lacked the necessary fraud detection knowledge. In addition, the SEC's own staff may not have had the incentive to investigate because they generally view these individuals they are charged to investigate as potential employers to represent before the SEC someday.

In addition, the focus of this article is not to single out Ponzi schemes as somehow more important to comment on than other fraud schemes. These schemes are used to illustrate how even simple fraud apparatuses can evade a large organization like the SEC when policies and organizational cultures may not set the proper anti-fraud "tone." Although examining a particular weakness may not be the ultimate cause of some of the SEC's failures, the authors posit that cumulatively the weaknesses addressed in the different sections of this article can create a negative synergistic outcome that increases the probability that the SEC will not be able to uphold their mission to be the industry's watchdog.

Flawed regulatory incentives

In order to appeal to congress and justify the SEC budget that has tripled from 2000 to 2010 (Issa, 2010), the commission employs to maximize its appeal by showing that resources are being efficiently used and in particular uses the raw number of cases that it brings and the size of the fines that are collected (Macey, 2010). This "actions brought" measure of success has several advantages; it is simple and easy for those within and outside the agency to understand and it is easy to measure, however, this type of performance measure creates perverse incentives for regulators (Gornall, 2010). This inclination to value only what can be easily measured has not served the SEC well and the SEC's narrow focus on such measurable indicia of success as the raw numbers of cases brought explains, in part, the SEC's complete lack of interest in exposing

Madoff's fraud that was constructed with a simple, well-known fraud apparatus referred to as a Ponzi scheme (Macey, 2010).

A Ponzi scheme is a fraudulent investment scheme that offers attractive returns to investors. The scheme provides these returns not from actual investments, but by paying out the principal of other investors. The promoter usually offers abnormally attractive returns to entice investors to ensure a steady stream of deposits. Fresh deposits are used to fund the promoter's lifestyle and any withdraws from the scheme. In order to keep the fraud active, the promoter needs an ever-increasing inflow of new deposits. Earlier investors often serve as references, so, new investors have reason to believe that the promised returns are legitimate.

On December 10, 2008, Bernard Madoff contacted the SEC to admit that he had victimized advisory clients of his firm, Bernard L. Madoff Investment Securities LLC, in the largest Ponzi scheme in US history. Since at least the early 1990s, Madoff had represented to his clients that he was investing their money in shares of common stock, options, and other securities of large, well-known corporations. Those representations were false; Madoff never invested his victims' funds and instead paid false returns directly out of their assets. His firm created bogus financial statements that showed high and suspiciously consistent returns while defending these returns by pretending he had developed a unique trading strategy. To help conceal the fact that he was not actually trading, Madoff claimed he was making purchases in overseas markets and created account statements with falsified transactions and positions.

The SEC received warnings about Madoff and his firm many times over the 16 years before, he chose to turn himself in. Anonymous informants complained to the SEC about Madoff at least three times; a hedge fund manager questioned his purported returns and financial magazines published articles that noted Madoff's secrecy and the uncanny consistency of his firm's financial statements (Issa, 2010). During an unrelated investigation of another firm, SEC staff discovered e-mails from that firm's due diligence investigation of Madoff that explained why Madoff's representations about his trading could not possibly be true. Most significantly, derivatives expert Harry Markopolos who exposed Madoff submitted very specific and detailed complaints to the SEC in May 2000, March 2001, October 2005, and June 2007 (Markopolos, 2010).

The SEC conducted five investigations in response to these warnings, including several that lasted longer than a year and incorporated detailed reviews of Madoff's documents, site visits at his offices, or sworn testimony by Madoff himself. Since the SEC can – and frequently does – request independent verification of brokers' trades from stock exchanges and other intermediaries, Madoff's lack of trades should have been quickly discovered. That discovery would have led quickly to the conclusion that Madoff was operating a Ponzi scheme, but SEC staff never took these steps. During the same time period, numerous private entities conducting due diligence on Madoff's operations concluded that he could not be trusted and chose not to invest with his firm. The SEC – despite having vastly greater resources, compulsory subpoena power, specific and detailed complaints, and a statutory obligation – failed to notice what was evident to many in the private sector. How could the SEC's investigators have failed to discover that Madoff was not making the trades he claimed and, in fact, was not trading at all?

Yet, when criticized for failing to respond to the red flags in the Madoff case, the SEC responded by disclosing how many new investigations it opened as a metric of success.

Even more evident, the SEC's 2008 Annual Report is evidence of its emphasis on easily measureable criteria:

> During FY 2008, the Enforcement Division also brought the highest number of insider trading cases in the agency's history [. . .] but in each of the last two years the Commission [SEC] set the record for the highest number of corporate penalty cases in the agency's history (Macey, 2010, p. 645).

In light of the method of measuring SEC success, it is not surprising it tackles simple violations, also known as picking low-hanging fruit, to increase their metric of success (http://dealbook.nytimes.com/2010/02/26/madoff-whistle-blower-slams-s-e-c-in-new-book/).

In addition, Richard Sauer, Attorney and Assistant Director with the SEC's Division of Enforcement from 1990 to 2003 stated that "Ponzi and pyramid schemes [. . .] held low priority with the SEC top management who saw them as having to little press appeal and afflicting only small investors" (Sauer, 2010, p. A13). Often, the SEC did not even pay attention to evidence of fraud in well-known scholarly journals in corporate finance until it is made an issue by the press (Macey, 2010). Moreover, even when alleged fraud is revealed in journals, it is ignored as evidenced by, for example, the SEC missing the opportunity to catch Madoff after articles in *Barron's* and *MARhedge* questioned his investment methods (WebCPA, 2009). Currently, the SEC recommends that staff evaluate the potential harm to investors, if no action is taken and consider evaluating employees based on their willingness to pursue difficult probes that are important to the protection of investors.

A misperception harbored by the SEC is their belief that actually investigating fraud schemes requires the devotion of too many resources. According to Professor Macey, even beyond the Madoff investigation, investigating Ponzi schemes in general seems to have been regarded as a "burning of resources", further stating:

> [. . .] the most striking thing about the SEC Division of Enforcement's failure to conduct an adequate investigation into the Madoff scheme is that such an investigation would not have required much in the way of resources (Macey, 2010, p. 656).

The SEC had received six substantive complaints about Madoff that raised red flags for further investigation. But, the SEC did not pursue these red flags, in part, because it did not want to devote the necessary resources. As one SEC official testified, such an investigation would be too expensive and time consuming, and because the SEC did not understand what the red flags represented even if it was aware of them (Markopolos, 2010).

Professor Macey's comments are further supported by former SEC Attorney Richard Sauer commenting on what the SEC is willing to investigate specifically in relation to the R. Allen Stanford Ponzi scheme case, "[T]he regional office also feared that pursuing the matter would eat up too many staff hours and so reduce the number of filed cases – 'stats' in agency lingo" (Sauer, 2010, p. A13). Senior officials in the Fort Worth office where the Stanford case originated believed that if cases were not considered a "quick hit" or a "slam dunk," they were discouraged from pursing them and "complex cases were disfavored" (Westbrook and Scheer, 2010, para. 6-7). Attorney Sauer further went on to state that:

> The "stat system" creates perverse incentives. To impress congressional appropriators, the SEC touts year-over-year increases in filed actions. This leads to biases in favor of quick-hit

cases and against anything novel or speculative. But all cases are not equal and the easy cases rarely the most significant. A staff chained to the stat treadmill, moreover, has meant ever growing administrative burdens that make it more difficult to open new cases or close old ones that haven't panned out [. . .] The agency also sometimes becomes a slave to public perceptions responding to the scandal du jour (and accusations of how it was allowed to occur) by launching a raft of investigations of varying degrees of promise (Sauer, 2010, p. A13).

Compromising the appearance of independence

Turnover at the SEC has always been high because lawyers can earn much more working in the private sector. Empirical evidence also points to the fact that the turnover rate for SEC lawyers is twice that for all government lawyers giving the appearance that the "whole point of landing a job as the SEC's Director of Enforcement is to position oneself for a better paying one on Wall Street" (Macey, 2010, p. 649). John Freeman, a former SEC Lawyer and Professor of Business Ethics at the University of South Carolina, School of Law, indicated that eventually "the training and expertise gained at the SEC is put to use for the benefit of those working against the interests of investors" (McGinty, 2010b, para. 8). For the most part, legal ethics experts see nothing wrong with the practice of going from public to the private sector, as long as lawyers follow ethical rules and err on the side of disclosure (McGinty, 2010a, para. 3).

There are times when the "revolving door" from public to the private sector employment creates impressions that public sector attorneys may be compromising a securities fraud investigation because of the perception that former SEC colleagues wield undue influence over current SEC staff. Private sector clients know that bringing in a former senior enforcement division officer is almost expected in high-profile cases and it is hard for lower level staff members to compete with established reputations when arguing to bring a case, especially when former SEC staffers have longstanding ties with the current leadership (Henning, 2010). One case that exemplifies the problem inherent in revolving door scenarios where independence appears compromised is the Allied Capital investigation.

When the SEC investigated Allied Capital, a public company that invests in small- to mid-size businesses, an SEC examiner and accountant who had examined Allied's books each concluded that the company had major problems indicating that "more than a dozen of Allied's investments had significant problems with the calculation of their value and that Allied had materially overstated its finances" (Goldfarb, 2010a, b, para. 25). Normally, the matter should be referred to the SEC Enforcement Division which exists to investigate possible securities law violations and where appropriate, recommends civil actions against individuals and companies that have violated such laws and criminal actions taken through the US Department of Justice. However, at the time of the investigation, Allied was being represented by a former SEC enforcement division director and a former senior accountant, yet an associate director in the SEC's compliance office who knew the former SEC staffers pushed back against referring the case to the enforcement division to levy civil charges against Allied (Perry, 2010).

In an interview, the associate director who discouraged the fraud investigation said he would give "the benefit of the doubt" to anyone who used to work at the SEC. The associate director added, "If you've known somebody, or even if they didn't really know them, but you know they worked here [. . .] Well, they should hopefully be doing the right thing" (McGinty, 2010b, para. 24). What is unfortunate is that the two former staffers received confidential information only known to the SEC on the individual who brought the fraud allegations to the attention of the SEC in the first place (Henning, 2010). Following meetings with Allied representatives, the SEC decided not to bring fraud charges it had been considering (Henning, 2010). Instead, Allied faced an administrative cease-and-desist order with no penalty imposed, the lightest penalty the agency can impose; moreover, the company did not even have to report back to the SEC about its compliance with the terms of the settlement (Henning, 2010).

Currently, the SEC is attempting to be more in tuned to how the revolving door affects its investigations and to be careful that a former high-level official does not end up pushing a case to settle for almost nothing (Henning, 2010). The authors point to the Allied case where the authors take issue with the belief that ethical considerations resolve this issue of appropriateness with a revolving door employment practice at the SEC. The question that goes beyond issues of ethics is whether the requirement of independence required for auditors is applicable to lawyers who should maintain independence in both fact and appearance. Would the SEC condone an auditor's not performing due diligence on a publically traded company by claiming that he or she knew the staff at the company and would take the staff's word that the financial statements were in compliance with generally accepted accounting principles?

The SEC suspected Texas financier R. Allen Stanford of running a Ponzi scheme as early as 1997 that cost investors nearly $7 billion, but took more than a decade to pursue him seriously (Crittenden and Scannell, 2010). From 1997 to 2004, the SEC conducted four staff investigations, but failed to pursue him seriously until 2005 (Issa, 2010). In 1997, just two years after Stanford registered his business with the SEC, a SEC examination official told the branch chief to "keep your eyes on these people [. . .] because it looks like a Ponzi scheme to me and some day it's going to blow up" (Crittenden and Scannell, 2010, p. B3). SEC enforcement officials also ignored warnings from insiders at Stanford's operations. For example, when the Fort Worth office opened a "Matter Under Inquiry" investigating Stanford because of the levels of investment returns that were unlikely given their purported conservative investment approach, Stanford refused to disclose requested documents as to their operation (Elliott, 2010). The SEC office did not pursue the matter any further despite having compulsory subpoena power and subsequently the "Matter Under Inquiry" was dropped (Elliott, 2010).

In an article by Frean (2010), according to the SEC's own investigation into how Spencer Barasch, former Head of the SEC's Enforcement Office in Fort Worth, Texas, handled the case, it was reported that he repeatedly blocked Stanford probes and then attempted to represent Mr Stanford as a lawyer in private practice. After leaving the SEC in April 2005, Mr Barasch asked the SEC on three occasions if he could represent Mr Stanford, but permission was denied each time on the grounds that it would be a conflict of interest. In 2006, Mr Barasch briefly represented M. Stanford before being reminded by the SEC Ethics Office that it was improper to do so. According to the report, when asked by the inspector-general why he was so insistent on representing him, Mr Barasch replied: "Every lawyer in Texas and beyond is going to get rich over this case. Okay? And I hated being on the sidelines" (Frean, 2010, para. 8).

Deficiency in fraud detection knowledge

Furthermore, the skills required to be an effective regulator, such as understanding the fraud schemes that give rise to securities fraud are lacking. SEC lawyers want to be viewed as successful by their peers outside of the SEC because these will be the same people that they will one day work for once they leave the SEC (Macey, 2010). Unfortunately, SEC lawyers have an incentive in developing technical skills and expertise in areas that will make them valuable to a Wall Street law firm and investment banks instead of being financial regulators (Macey, 2010). According to Professor Macey (2010, p. 648):

> [. . .] combating simple fraud and old-fashioned Ponzi schemes may help the capital markets and protect the small investors, but it does little to help SEC officials develop the skills and expertise that will make them valuable to Wall Street law firms, the clear focus of SEC staffers today.

For example, the disclosure rules that require corporations and other regulated entities to publicly file certain disclosures, ranging from lengthy annual reports on Form 10-K to brief disclosures of stock ownership by corporate insiders, have become so complex that these rules can only be understood by specialized lawyers who work for the SEC and private law firms and investment banks. Consequently, some "members of this elite group circulate back and forth between the SEC and the firms; maintaining the complexity of the system is in their personal financial interest" (Issa, 2010, p. 27).

The SEC is hindered by lawyers who do not understand securities fraud red flags and are captive to the financial industry (Macey, 2010). This is because, the SEC is largely staffed by lawyers who lack the financial expertise and currently are not capable of understanding the complex financial instruments being traded even when a mutli-billion dollar cases is made self-evident. When Markopolos first brought his concerns to the SEC in 2000, the New England regional director of enforcement, was unprepared to handle the assignment, writes Markopolos:

> As I explained this massive fraud [. . .] it very quickly became clear he didn't understand a single word I said after hello [. . .] he didn't ask a single probing question. I never knew if that represented a lack of interest or a lack of comprehension (*New York Times*, 2010).

In January 2006, the New York Office of the SEC finally opened a case on Madoff based on Markopolos' allegations and after 11 months reviewing his work, the staff said there was no evidence of fraud (CBS, 2009). The SEC team that actually conducted an examination of Madoff was deemed "inexperienced" (WebCPA, 2009).

Although the investigative staff was deemed "inexperienced" and "confused about certain critical and fundamental aspects of Madoff's operations", it should not be underestimated that the SEC staff was up against someone that was politically connected, noted for his philanthropy, had an excellent reputation at the time and had relatives connected to the SEC's upper management (Gornall, 2010, p. 5). For example, throughout the examination process he would drop names of senior SEC staff and that he knew that Christopher Cox was going to be chairman of the SEC before Cox was named and that he "was on the shortlist" to be chairman (Katz, 2009, para. 14). It is not implausible to believe that an inexperienced staff would not want to attract Madoff's animosity by challenging his "evasive and contradictory answers" (Gornall, 2010, p. 5) especially when he became extremely angry when the examiners sought documents he did not want to provide (Katz, 2009).

The SEC staff assigned to the investigations often had no experience with equity and options trading. They did not understand Madoff's business, and therefore failed to realize what would have been clear to industry experts that his claimed investment strategy, transactions, and returns were misrepresentations. Investigations were conducted by attorneys with "general litigation experience" but no relevant knowledge. Inexperienced investigators who met with Madoff in person were overly impressed by his storytelling and accepted his answer that his consistent returns were due to his perfect "gut feel" (Katz, 2009, para. 15). Another consequence of the investigators' unfamiliarity with the industry they were investigating was that they often focused on the aspects of Madoff's business that they understood and ignored what they did not. SEC staff responding to one of the complaints focused on whether Madoff was engaging in front-running because, in their supervisor's words, "that was the area of expertise for my crew" and that a Ponzi scheme was "highly unlikely" (Issa, 2010, p. 6).

The problem is not limited to the affairs of Madoff and Stanford as to the perception that certain types of cases appear to "complicated." Unusual facts, circumstances that may not be understood or those that do not fit neatly into a known type of fraud are never opened; or, if they are opened, they languish until they are closed (Issa, 2010). SEC Inspector General David Kotz found multiple instances of mishandling and mismanagement in other scenarios such as the one involving Metromedia International Group. The Office of the Inspector General's (OIG) investigation revealed that from February 2005 through November 2007, the SEC received more than 20 complaints from Matthew McLaughlin, a registered representative, raising serious allegations of financial fraud about Metromedia. McLaughlin's complaints primarily focused on allegations that Metromedia's financial reporting was delinquent and erroneous, Metromedia assets were being sold at below market prices, and Metromedia management had engaged in self-dealing.

McLaughlin repeatedly requested that the SEC stop the proposed acquisition of Metromedia by an investor group until the SEC had investigated his allegations. The investigation found that from February 2005 through September 2007, at least 16 of McLaughlin's complaints were provided to current or former staff in the Division of Enforcement. However, the OIG investigation further found that McLaughlin's allegations were not reviewed, analyzed, or investigated over this two-and-a-half-year period due to multiple instances of mishandling and mismanagement. Similar to comments made in the Madoff and Stanford cases, the SEC assistant chief accountant never reviewed or analyzed McLaughlin's complaints remarking that his impression was that the complaints "looked real complicated, like it would require some work," but the work was not performed (OIG, 2010, p. 2). One year later, in September 2006, the assistant chief accountant reported to his supervisor that the McLaughlin complaints were one of three uncompleted referrals that he had outstanding at that time and that he would complete his review of the McLaughlin complaints "as soon as possible."

To add to the lack of investigative focus, about a year after the accountant was asked about the case he responded:

> I don't think there is anything you can do. I just haven't been focusing on the Metromedia complaints for awhile [. . .] It's been a long while, but I could have sworn the Metromedia matter was closed (Shain, 2010, para. 12).

The OIG investigation found that over a year after informing his supervisor that he would complete his review "as soon as possible" and two years after receiving the complaints, he had still not completed his review. Meanwhile, despite the fact that no one at the SEC was reviewing or investigating McLaughlin's complaints, the SEC responded to McLaughlin's sixth complaint on March 16, 2006, with a letter stating, "We are taking your complaint very seriously and have referred it to the appropriate people within the SEC" (OIG, 2010, p. 3).

In actuality, at that time, McLaughlin's sixth complaint (along with McLaughlin's first five complaints) had not been "referred to the appropriate people within the SEC," and not only was it not being considered "very seriously," it was not being considered at all (OIG, 2010, p. 3). In April 2008, the enforcement attorneys assigned to the investigation determined that the Metromedia investigation should be closed due to the age of the alleged conduct, the fact that Metromedia was no longer a public company registered with the SEC, and a lack of evidence that Metromedia or its executives had committed fraud. After a deputy director independently reviewed McLaughlin's allegations and supporting documentation and interviewed him, the deputy director supported the staff's decision to close the investigation due to the age of the conduct and the difficulty in obtaining evidence. In October 2009, the Metromedia investigation was officially closed.

If the SEC is committed to staffing attorneys then at the very least, these attorneys must receive training as to how securities fraud is perpetrated, so that, they know how to accomplish their mission. For example, outside analysts, academics, and accounting associations have developed lists of fraud risk factors and ratios that are correlated with accounting misstatements, but the SEC has not incorporated this knowledge into any comprehensive fraud risk-monitoring software for the benefit of staffers. Instead, staff relies on the eyes of its reviewers to find errors, and the SEC's Division of Enforcement relies on tips, complaints, news stories, and referrals to find fraud. The SEC has long promised to develop the ability to perform industry-wide quantitative forensic analysis; academia has instead taken the lead in uncovering fraud through number crunching. Technological progress as it relates to taking existing data and making it useful for securities fraud analysis and disclosure information for public consumption has ranged from "grindingly slow to completely nonexistent" with the result that the information investors receive is both less accurate and less useful than it should be (Issa, 2010, p. 12).

An inefficient whistle-blower apparatus

The SEC has no efficient system in place to guide how officials should handle tips and complaints from outsiders (Goldfarb, 2010a). Whistle-blower complaints are one of the main ways that regulators are tipped to wrongdoing along with inconsistencies in financial filings and alerts from financial exchanges about suspicious trading patterns. The SEC has a haphazard, decentralized system for analyzing outsider information; tips arrive by phone, mail and e-mail to officials throughout the agency. A study commissioned by the SEC in 2009 found that the SEC lacks technology to analyze tips and complaints, as well as cohesive policies for what officials should do when they get information. Furthermore, the SEC lags behind some other federal agencies in handling tips such as the Internal Revenue Service that pays reward money to whistle-blowers that provide credible information about tax fraud.

Steve Cohen, the official tasked by SEC Chairman Mary Schapiro to overhaul the agency's tips, complaints and whistle-blower program states: "We're already working to acquire and deploy technology that centralizes all of the agency's tips and complaints so they can be sorted, reviewed, analyzed and tracked" (Goldfarb, 2010a, para. 12). Officials said that by the end of 2010, they hope to develop technology that would not only centralize the data but also automatically analyze them for patterns to help officials prioritize cases. The SEC has requested that congress pass legislation giving it the ability to offer financial rewards to people who provide evidence of violations of securities law. The SEC announced in February 2009, that it would overhaul its system for handling tips, complaints and referrals (TCR) in order to better prioritize information about possible securities law violations. However, after more than 18 months, there is still no indication that TCR has improved or that technology has been developed to increase the efficiency of the TCR program (Issa, 2010).

In one case, ironically, the SEC blew the whistle on whistle-blower Peter Sivere, an SEC informant. An article by Goldfarb (2010a) details how Sivere worked in the compliance office of New York investment bank JPMorgan Chase and discovered an incriminating e-mail possibly alleging illegal trading at JPMorgan Chase; Sivere disclosed the information to his superiors, but he never heard back as to what actions were taken. Sivere notified the SEC and also inquired if rewards were offered for the tip. The SEC indicated that there was no reward, but Sivere still turned over the incriminating evidence. Sivere informed JPMorgan that he had contacted the SEC and was subsequently fired; shortly thereafter he learned that JPMorgan knew he had inquired about a reward even though the SEC promised him that his discussions were confidential. An SEC internal probe found that an investigator working on the case disclosed Sivere's information to JPMorgan's lawyers, violating the agency's confidentiality rules.

Consider, again, the pending Ponzi scheme case operated by Allen Stanford. Leyla Wydler had been a Vice President at Stanford's Houston-based company when she first started asking her supervisors tough questions about what the firm did with clients' money (Goldfarb, 2010a). Her superiors were evasive, and she ultimately was fired. In 2003, she went to the National Association of Securities Dealers and later contacted the SEC's Fort Worth office in 2004, disclosing her belief in a letter that Stanford was committing securities fraud. Her letter warned that the Stanford business "will destroy the life savings of many" (Crittenden and Scannell, 2010, p. B3). She never heard from the SEC again until January 2009 – days before the SEC finally filed a case against Stanford. The agency wanted to know more about her allegations only to learn that the enforcement staff at the Fort Worth office "minimally reviewed" the letter and decided not to investigate or open an inquiry into the matter (Crittenden and Scannell, 2010, p. B3). As an interesting parallel to the Madoff investigation, in this case, we have an insider at Stanford who came forward and was ignored and when Harry Markopolos disclosed Madoff's fraud, "two former enforcement officials told the inspector general investigating the Madoff oversight that they discounted Markopolos' information because he was not an insider in Madoff's company" (Goldfarb, 2010a, para. 14).

Undue access and influence

Bernard Madoff in an interview once stated "I'm very close with the regulators" (Fox, 2008, para. 1). The full extent of whom, if anyone, at the SEC ever knew of Madoff's schemes or whether his close relationship with SEC regulators gave him the opportunity to escape detection for so many years will probably never be known. However, the Madoff scandal does illustrate the importance of implementing proper regulatory policy establishing expectations that former SEC staff, current staff and other individuals in the private sector maintain a relationship that does not compromise independence in fact and appearance. In an article written by Kouwe (2009), the SEC's internal investigation found numerous cases of misconduct by former and current employees, including an abuse of power by one of its lawyers and participation in a Ponzi scheme by another former official. In one well-publicized investigation, an SEC enforcement director inappropriately provided inside information to a former boss who is now the general counsel of JPMorgan Chase, amid the bank's negotiations to buy Bear Stearns in March 2008.

The inquiry, which began in response to an anonymous tip, confirmed that JPMorgan Chase's general counsel sought assurances from the SEC staffer before the takeover that JPMorgan would not be sued by the SEC for prior actions by Bear Stearns. While the general counsel did not receive the broad assurances sought, the SEC staffer did provide him with some assurances related to ongoing and potential SEC investigations of Bear Stearns. Although technically the SEC staffer did not violate the SEC's policy on external communications, she should have taken other steps "to avoid an appearance of impropriety" (Kouwe, 2009, para. 6). The probe also found that some senior staff members within the enforcement division believe former high-level officials like the JPMorgan Chase's general counsel have undue access and influence within the enforcement division.

Kouwe (2009) also reported on several other investigations. In a separate investigation, the SEC inspector general found a former SEC official inadvertently aided a convicted Ponzi scheme operator in Arizona by using her SEC e-mail account and her office to facilitate payments and communications from the Ponzi scheme's operator and its victims. Investigators discovered evidence that the SEC employee used her e-mail to conduct business on behalf of the Ponzi scheme on nearly a daily basis, but did not knowingly engage in fraud. In another inquiry, the inspector general's office found that a lawyer in the SEC's regional office had repeatedly misused his position in the agency and his resources to assist his girlfriend, a former government contractor, in connection with ongoing litigation with her insurance company.

An inefficient organizational structure

One of the SEC's single greatest weaknesses is its unwieldy staff structure. According to Inspector General Katz:

> To understand how the SEC operates, think of Germany prior to Bismarck: a series of semi-autonomous feudal states that operate autonomously in most ways and occasionally compete amongst themselves except when a common enemy appears at the border (Issa, 2010, p. 20).

The SEC is divided into five operating divisions and 16 independent offices; the fragmentation has resulted in devastating effects on collaboration, encourages uninformed rulemaking, generates bureaucratic rivalries and prevents effective technological interconnectedness so that SEC staffs can share data. Inspector generals recognize that the agency suffers from a "silo problem" meaning multiple operating divisions' void of operational leadership because of the perception that these divisions create their own fiefdoms to rule and not necessarily for the good of the whole organization or the public for that matter. For example, staffs do not effectively share intelligence among separate divisions and offices and Madoff might have been apprehended years before his confession if enforcement attorneys had consulted the Office of Economic Analysis (OEA) for expert advice on his purported options trading.

Again, using Madoff as an example, the SEC staff failed to coordinate their activities with other SEC divisions and offices, or even with other teams in the same office. Issa (2010) further reports that attorneys in the Division of Enforcement, for example, who investigated one of Markopolos' complaints learned that the separate Office of Compliance Investigations and Examinations (OCIE) had recently finished investigating due-diligence e-mails discussing Madoff, but they never received copies of those e-mails from OCIE. For their part, the OCIE staffers minimized their concerns in meetings with enforcement lawyers. The same enforcement team contacted experts in the SEC's separate OEA to ask for assistance in analyzing Madoff's purported trading. OEA did not respond to the request for two-and-a-half months and even after the two staffs finally did make contact, enforcement never shared Markopolos' complaint with OEA and OEA never shared the most important aspects of its analysis with enforcement. Most incredibly, two OCIE teams investigated Madoff simultaneously and yet were totally unaware of one another until one of the teams learned of the parallel investigation from Madoff himself. Even after Madoff told them of one another's existence, the two teams did not share their notes or compare the separate complaints they were investigating.

Conclusion

Although no single issue raised in this article necessarily is the reason that a particular oversight occurred, it is the author opinion that cumulatively, the issues raised create negative synergy where the probability of an oversight occurring increases. The Madoff, the pending Standord cases and other cases illustrate how negative incentive systems compromise the desire to investigate certain types of cases, how organizational structure impacts communications on an investigation, how oversights expose the lack of fraud detection knowledge, the role of independence appears compromised and how whistle-blower's are ignored. It is imperative that the SEC not just acknowledge but address some of the issues outlined above or else it stands to be viewed as incompetent, ineffective, and captive to special interests that work against the interests of honest investors.

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