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COMMITTEE ON FINANCIAL SERVICES

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INTRODUCTION

Good Morning. Thank you for the opportunity to testify today before this Committee on the subject of the "Madoff Ponzi Scheme." I will refer to Mr. Bernard Madoff, whose alleged fraud casts a stark light over the failures of the regulatory structures, procedures and institutions in place to prevent such crimes and is the subject of this hearing, as Madoff, BM, and Mr. Madoff interchangeably within my testimony.

You will hear me talk a great deal about over-lawyering at the SEC very soon. Let me say I have nothing against lawyers. In fact, I have brought two of my own here with me today. On my right, I have Ms. Gaytri Kachroo, a brilliant transactional attorney and my long time general counsel for all personal and business matters. She is a partner at McCarter & English LLP (Boston), heading their international corporate practice and also represents investors and funds. On my left, counsel Phil Michael, of Troutman Sanders LLP, (NY) is a former deputy police commissioner and budget director for New York City, and now represents whistleblowers in fraud cases involving harm caused to government, and is a great strategist in such cases.

As early as May 2000, I provided evidence to the SEC's Boston Regional Office that should have caused an investigation of Madoff. I re-submitted this evidence with additional support several times between 2000 – 2008, a period of nine years. Yet nothing was done. Because nothing was done, I became fearful for the safety of my family until the SEC finally acknowledged, after Madoff had been arrested, that it had received credible evidence of Madoff's Ponzi Scheme several years earlier. There was an abject failure by the regulatory agencies we entrust as our watchdog. I hope that my testimony will provide you with further insights as to how the process failed and enable you to enact appropriate legislation that will

prevent this from happening in the future. As a result of my experiences, I also have some suggestions that I would like to share with the Committee for it to consider as it develops its Congressional recommendations..

I have broken my testimony into two parts:

1) Part I will provide an overview of my contacts with the SEC between 2000 – 2008 relating solely to the Madoff case with a time line of key events during the investigation.[Timeline Color Chart].

2) Part II consists of my recommendations on fixing the SEC so that it can become an effective securities regulator for the 21st century.[Charts of SEC and NASD/FINRA from 2000-2008].

I find it difficult to compress my testimony because there were so many victims, the damages have been vast, and the scandal has ruined or harmed so many of our citizens. I feel that by writing this testimony in narrative form, the public will better understand what steps my team and I took, the order in which we took them, along with how and why we took them. The details will also afford the Committee the information necessary to ask the right questions and hopefully aid the Committee in ferreting out the truth and in restructuring the SEC which currently is non-functional and, as witnessed by the Madoff scandal, is harmful to our capital markets and harmful to our nation's reputation as a financial leader around the globe. In my testimony, wherever possible I have strived to present the mathematical concepts simply and to use word explanations instead of formulas.

Part I – My Contacts with the SEC from 2000 – 2008

Just as there is no "I" in "TEAM," I had a brave, highly trained team that greatly assisted me throughout the 9 year Madoff investigation. Let me introduce the key team members to you. Neil Chelo, Chartered Financial Analyst (CFA), Financial Risk Manager (FRM) checked every

formula, math calculation, modeling technique presented to the SEC from 2000 to the present. From late 2003 to the present, as Director of Research for Benchmark Plus, a Tacoma, WA based $1 billion plus fund of funds, Mr. Chelo went out of his way to interview key marketing and high level risk managers at several Madoff feeder funds. He also obtained Greenwich Sentry audited financial statements for the year's ending 2004, 2005, and 2006. Frank Casey, a former US Army airborne ranger infantry officer with intelligence gathering experience, is the North American President for UK based Fortune Asset Management, a $5 billion hedge fund advisory firm. Mr. Casey closely tracked the Madoff's feeder funds and collected their marketing documents, figured out Madoff's cash situation. He determined that Madoff's Ponzi was unraveling in June 2005 and May 2007 and in need of additional funds to keep the scheme going, and tabulated Madoff's likely assets under management. Institutional Investor's Michael Ocrant, a brilliant investigative journalist also made key contributions to our efforts to stop Madoff. Mr. Ocrant was the only team member to actually meet Mr. Madoff in person and to step inside Mr. Madoff's operation at great personal and professional risk to himself.

These three gentlemen were my eyes and ears out in the hedge fund world, closely tracking who Madoff was dealing with, acquiring Madoff marketing literature and investigating directly with the staff of feeder funds into Mr. Madoff's fund to collect additional pieces of the puzzle. My army special operations background trained me to build intelligence networks, collect reports from field operatives, devise lists of additional questions to fill in the blanks, analyze the data, and send draft reports for review and error correction before submission to the SEC.

In order to minimize the risk of discovery of our activities and the potential threat of harm to me and to my team, I submitted reports to the SEC without signing them. My team and I surmised that if Mr. Madoff gained knowledge of our activities, he may feel threatened enough to seek to stifle us. If Mr. Madoff was already facing life in prison, there was little to no downside for him to remove any such threat. At various points throughout these nine years each of us feared for our lives. Our analysis lead us to conclude that Mr. Madoff's fund and the secret walls around it posed great danger to those questioning and investigating them. We also concluded both the fund and the secrets that assisted its growth and development were of unimaginable size and complexity. Neither my team nor I had any personal knowledge of Mr. Madoff or his psychological make up. As such we had only the conclusions of our investigation into his fund to surmise of what he may have been capable. We did know, however, that he was one of the most powerful men on Wall Street and in a position to easily end our careers or worse.

My first submission to the SEC was coordinated through Ed Manion, CFA, a member of the Boston Regional Office with 25 years of industry experience. Mr. Manion was a former trader at the Boston Company and a portfolio manager at Fidelity serving alongside Peter Lynch. He has been with the SEC for 15 years and, in my opinion, was the only person in the Boston Regional Office with the proper industry background to comprehend fully the size, scope and danger of the Madoff Ponzi scheme. Mr. Manion is a Chartered Financial Analyst (CFA) and is highly respected in Boston's financial district and is considered the go-to person for securities fraud cases in Boston. We would call Ed "the SEC's hit-man," because when the SEC brought Ed in, people often ended up in jail via SEC criminal referrals to the DOJ. Throughout the past 9 years, Ed Manion was the only SEC staff member who ever truly understood the Madoff scheme

and the threat it posed to the public. Unfortunately, as I will soon relate, my experiences with other SEC officials proved to be a systemic disappointment, and led me to conclude that the SEC securities' lawyers if only through their investigative ineptitude and financial illiteracy colluded to maintain large frauds such as the one to which Madoff later confessed. In brief, SEC securities lawyers did not want to hear from a non-lawyer SEC staffer like Mr. Manion with 25 years of trading and portfolio management experience. As much as Boston's financial community looks up to and respects Ed Manion, that's how much the SEC looked down upon and ignored Mr. Manion's repeated requests for SEC enforcement action against Mr. Madoff.

Without Mr. Manion's continued encouragement, I would have stopped the Madoff investigation after my October 2001 SEC Submission. Every time I threatened to quit the investigation, Mr. Manion would tell me I had a duty to the public to keep going no matter how badly the odds were stacked against us. I believe that the SEC would fire him if he were to testify before Congress about his role and that of the SEC during the past 9 years; but if the proper protections could be worked out in advance to safeguard his career and guarantee him another 3 years until his government retirement, I recommend that the Committee speak with him. I owe him much thanks for his dedication to the effort of sharing Mr. Madoff's alleged fraud to the appropriate authorities within the SEC.

Late 1999 – 2000

I started the Madoff investigation in late 1999 and early 2000 as a result of Frank Casey, Senior Vice-President of Marketing for Rampart Investment Management Company, Inc., telling me about the fantastic returns of one Bernard Madoff (hereafter referred to as BM). Mr. Casey told me that investors he met with in New York considered BM to be the premier hedge fund

manager because of his steady return streams with unusually low volatility. This unusually low volatility was attributed to BM having very few negative months, with the largest price decline in one month a reported minus 0.55%, or barely more than half a percent. Mr. Casey and one of my employer's partners, Mr. David Fraley, asked me to replicate BM's split-strike conversion strategy so that Rampart Investment Management Company, Inc. could offer this product and compete with BM for clients.

A split-strike conversion strategy consists of 3 main parts. Part I is a basket or grouping of stocks that you purchase. Many managers will choose to purchase their stocks in index form such that the stock basket is a 100% match to the index options they plan on using as part of the strategy. Part II consists of the call options that you are selling to generate income. Part III consists of the put options that you will be buying to protect your stock portfolio from market price declines (these cost you money just like auto insurance does). Let's simplify even further, there are 3 sources of income from this strategy, stock price appreciation (i.e. the stocks go up in price), stock dividends which you receive every quarter as the stocks in your stock basket pay their quarterly dividends, and the income you receive from selling out-of-the-money call options. However, there are also 3 sources of loss with this strategy. You lose when the stocks in your stock basket decline in price and you also lose money when you purchase put options to protect your stock basket from market price declines. The third source of loss is when the OEX index rises above the strike price of your short OEX index calls.

As you can tell from reading the above, there are lots of moving parts in this strategy and it is best left to the experts. I would be happy to diagram this strategy out on a white board

during testimony in an easier to understand form if you'd like. Since BM never actually used this strategy it may be a moot point.

Suffice it to say that the strategy is complex enough, with enough moving parts, that even market professionals without derivatives experience would have trouble keeping track of all the moving parts and understanding them fully. This is probably why BM settled on marketing this split-strike strategy to his victims. He knew most wouldn't understand it and would be embarrassed to admit their ignorance so he would have less questions to answer. And, with Ponzi schemes, you never ever want the victims to understand how the sausage is made, nor do you want them asking too many questions.

Mr. Casey obtained a one-page marketing document from the Broyhill All-Weather Fund, L.P. (May 2000 SEC Submission) which described the strategy, listed its monthly returns from 1993 through March 2000, and provided the background of the fund and its manager. I was told that "Manager B" was BM. The strategy and performance numbers foot with other information we collected in later years that all pointed to BM. I studied the Broyhill document and within 5 minutes suspected it was a fraud since the strategy as described was not capable of beating the typical percent return on US Treasury Bills less fees and expenses. Once fees and expenses were included, the Split-Strike Conversion Strategy as depicted in the marketing document would have had trouble beating a 0% return.

The reason I was immediately suspicious was that I had run a slightly similar, but actually functional, product that my firm called our Protected Equity Program (PEP). PEP delivered approximately 2/3rds of the market's return with only 1/3rd of the risk. To earn those types of returns we had to make a lot more good trading decisions than bad ones and sometimes

our returns would greatly lag the market but then catch up later. The important point to remember is that even as good as this product was, it often lagged the market whereas BM's was always doing well under all market conditions which is, of course, impossible. However, our PEP strategy was vastly superior to BM's in that we owned the actual stock in index form with perfect replication and did not have the single stock risk included in BM's strategy. Here my expertise with the product helped me to quickly determine BM couldn't have been using a split-strike strategy as he described to earn the kind of always positive return stream that he claimed.

Let me explain this critical difference, BM said that he purchased a basket of 30 – 35 stocks that closely replicated the OEX Standard & Poor's 100 stock index. But, of course, if you are using only 30 – 35 stocks to replicate a 100 stock index you have to assume a much higher degree of risk, by taking larger position weights than are in the underlying 100 stock index. You don't get compensated with extra returns by taking this additional risk, and you should experience a performance penalty when your 30 – 35 stock basket under-performs the 100 stock index. Let's assume that BM owned 33 stocks and each stock was 3.03% of his portfolio totaling 100% of his stock portfolio (33 stocks x 3.03% invested in each stock = 100% of his stock portfolio). Now let's say that one of those stocks during the 7¼ year time period from 1993 to March 2000 put in an Enron, WorldCom or Global Crossing type of performance and went to zero. BM would be down 3.03% for that month [1/33rd= 3.03%]. The odds of a 30 - 35 stock portfolio not experiencing heavy single stock losses over a 7 ¼ time period ranged between slim and none.

Furthermore, BM's strategy required all or substantially all of the stocks in his portfolio to rise during the month, something which wasn't sustainable for 7¼ years straight without

interruption. If BM had said he owned the OEX Standard & Poor's 100 stock index in its entirety, he would have passed my initial 5 minute sniff test but, fortunately for us, he was not a sophisticated enough fraudster to get his portfolio construction math correct and I suspected fraud immediately.

I then spent a couple of hours inputting BM's monthly returns into an excel spreadsheet and modeling against the S&P 500 Stock Index's monthly returns. BM made a key error in how he presented his performance because he kept comparing himself to the S&P 500 stock index when his strategy purported to replicate the S&P 100 stock index. That signaled a startling lack of sophistication on his part since there was a noticeably large difference in price returns between the two indices. This lack of sophistication on BM's part was a recurring theme during the 9 year investigation. BM's math never made sense, his performance charts were clearly deceiving, and his return stream never resembled any known financial instrument or strategy. As will be made clear in the rest of this story, to believe in BM was to believe in the impossible.

BM said he was earning 82% of the S&P 500's return with less than 22% of the risk. More alarmingly, his returns only had a 6% correlation to the S&P 500 Stock Index when I would have expected to see something like a 50% correlation and wouldn't have questioned any correlation figures between 30% - 60%. A 6% correlation was so low as to signal "FRAUD" in flashing red letters. The easiest explanation for why a 6% correlation is so low as to be wholly unbelievable is that if your returns are coming from the S&P 100 stock index, you had better at least partially resemble that stock index's performance. Having only a 6% resemblance in a situation where, due to the price limiting performance of the put and call options, one would expect a 30 – 60% correlation, was outside the bounds of rationality. The biggest, most glaring

tip-off that this had to be a fraud was that BM only reported 3 down months out of 87 months whereas the S&P 500 was down 28 months during that time period. No money manager is only down 3.4% of the time. That would be equivalent to a major league baseball player batting .966 and no one suspecting that this player was cheating, and therefore fictional.

A quick glance at Exhibit 1 of my May 2000 SEC Submission next to the letter "C" shows the "Cumulative Performance of Manager B" where Manager B is BM. Note how the line goes up at nearly a perfectly rising 45 degree angle with no noticeable downturns whatsoever from 1993 thru March 2000. Now ask yourself, how can any manager's performance be that perfectly smooth and in only the up direction when markets go down as well as up? Then ask yourself what the managers of these feeder funds were thinking as they performed due diligence or even if they were thinking while they performed due diligence. Yes, BM was a "no-brainer" investment but only in the sense that you had to have no brains whatsoever to invest into such an unbelievable performance record that bears no resemblance to any other investment managers' track record throughout recorded human history.

I then assembled OEX Standard & Poor's 100 Index Option open interest and volume statistics from the Chicago Board Options Exchange (CBOE) as reported in the Wall Street Journal's Money & Investing Section. There were not enough OEX index options in existence for BM to be managing the Split-Strike Conversion Strategy he purported to be running. This test took me less than 30 minutes to complete. At this point, I was incredulous as to how any fund would willingly invest in such an obvious fraud.

In less than four hours I knew I had proved mathematically that BM was a fraud and so I then furthered my analysis and developed two alternate fraud hypotheses to explain what might

be happening. *Fraud hypothesis 1* was that BM was simply a Ponzi scheme and the returns were fictional. *Fraud hypothesis 2* was that the returns were real but they were being illegally generated by front-running Madoff Securities broker/dealer order flow and the split-strike conversion strategy was a mere “front” or “cover.” Either way, BM was committing a fraud and should go to prison.

I ran some option pricing model calculations to determine how much money BM could earn by illegally front-running his stock order flow through Madoff Securities (page 4, 2000 SEC Submission) and determined that he could earn 3 – 12 cents per share for time periods of 1 – 15 minutes if he was front-running order flow. That meant returns of 30% - 60%, given the size of the assets under management we believed he had; front-running seemed like a likely possibility in 2000 and 2001. To double check my modeling techniques and calculations, I had my assistant, derivatives portfolio manager Neil Chelo, CFA and Daniel DiBartolomeo, one of the world’s most accomplished financial mathematicians, review my work. Both gentlemen concluded that either Hypothesis I or II was, in fact, correct and that BM was a fraudster. However, in 2000 and 2001 we did not have enough information on hand to determine which of the two fraud hypotheses was correct. During later time periods as Mr. Casey, Mr. Chelo, and Mr. Ocrant kept tabulating higher and higher assets under management totals, the front-running fraud hypothesis became unworkable because BM’s illegal trading activity could not have gone undetected by his firm’s brokerage customers.

I spent hours writing my eight-page 2000 SEC Submission and arranged with the Boston SEC’s Ed Manion to meet with the Boston Regional Director of Enforcement (DOE), Attorney Grant Ward in May 2000. Given Mr. Ward’s position and my understanding of his mandate, I

was shocked by his financial illiteracy and inability to understand any of the concepts presented in that submission. Mr. Manion and I compared notes after the meeting and neither of us believed that the Boston Region's DOE had understood any of the information presented. Little did I know that over the next several years I would come to understand that financial illiteracy among the SEC's securities lawyers was pretty much universal with few exceptions.

2001

In 2001, the Boston SEC's Ed Manion and I spoke often of the lack of follow up to my May 2000 SEC Submission. Immediately after 9-11, Mr. Manion called me, convinced that my work had somehow fallen through the cracks and never made it to the responsible parties in the New York Regional Office. In October 2001 or thereabouts, I resubmitted my original 8-page report, wrote an additional 3 pages and included 2 pages entitled "Madoff Investment Process Explained." The New York Regional Office never contacted me after either my May 2000 or October 2001 SEC Submissions. To my mind, the mathematical analysis provided compelling proof that an investigation was required. Yet, none was conducted to my knowledge.

2002

In 2002, I continued my research into BM. I took a key trip to Europe with Access International Advisors Limited to market a Statistical Options Arbitrage Strategy that I had developed**.** During that trip I met with 14 French and Swiss private client banks and hedge fund of funds (FOF's). All bragged about how BM had closed his hedge fund to new investors but "*they had special access to Madoff and he'd accept new money from them*." It was during this trip that I knew that BM was most likely a Ponzi Scheme and that he was not front-running. If

BM was really front-running he would not want new money because additional money to invest would bring down his returns and also raise the odds of getting caught. My European trip allowed me to lower the odds that the front-running fraud hypothesis was true and focus more effort on my Ponzi scheme fraud hypothesis, which simplified the investigation. BM's masterful use of a "hook" by playing hard to get and his false lure of exclusivity were symptomatic of a Ponzi scheme. The dead give-away was BM's need for new money, another trait of Ponzi schemes, because Ponzi managers always need ever increasing amounts of new money flowing in the door to pay off old investors. I also came to realize that several European royal families were invested with BM. I met several counts and princes during my trip and it seemed they all were invested with BM or were marketing BM's strategies to noble families throughout Europe. BM had a marketing strategy that appeared to be based on false trust, not analysis.

2003 -2004

My records for 2003 & 2004 are non-existent due to my leaving my former employer at the end of August 2004 and not taking a copy of my e-mail archives with me. I am sure I worked on the case, but I don't have any supporting documentation at this time. I have a non-functioning hard drive from my old home PC which I am sending out to see if any 1999- 2004 home e-mails can be recovered that relate to this case. Unfortunately, my former employer was always on the leading edge of technology, rapidly acquiring and putting the newest, high-speed servers into service. The firm was a derivatives' management company, requiring machines that could run millions of calculations quickly. Therefore it is unlikely old e-mail records have been maintained before the mandatory 7-year e-mail retention period was enacted into law, but it can be asked for these records.

2005

In June 2005 (see page 11 of my November 7, 2005 SEC Submission) Frank Casey sent me an e-mail where I substituted "ABCDEFGH" for the name of the individual, showing that BM was attempting to borrow funds from a major European bank. This was our first inkling that BM was struggling to keep his Ponzi scheme afloat.

Fortunately, I have plenty of e-mails from the last quarter of 2005 and it was a very busy quarter for the Madoff investigation. In late October, most likely on October 25, 2005, I met with Mike Garrity, Branch Chief, of the SEC's Boston Regional Office. Mr. Ed Manion, CFA felt that Mr. Garrity was a conscientious, hard-working Branch Chief who would give me a fair and impartial hearing that might be what was needed to get this case re-submitted to the SEC's New York Office. Ed Manion scheduled an appointment for me with Mr. Garrity and I thought that perhaps the third time submitting this case would turn out to be the charm.

I met with Mr. Garrity for several hours and found him to be very patient and eager to master the details of the case. Unlike my disastrous May 2000 meeting with that office's Director of Enforcement, Attorney Grant Ward, I found Mr. Garrity to be interested and fully engaged in my telling of the scheme. Some of the derivatives math was difficult for him to understand, so I went to the white board and diagrammed out Madoff's purported strategy and its obvious failings until he understood it. A few of the more difficult concepts required repeated trips up to the white board but at the end of our meeting, it was clear that Mr. Garrity understood the scheme, it's size, and it's threat to the capital markets.

Mr. Garrity promised to follow up and he was true to his word. About a week or so later, Mike Garrity called me back telling me that he did some investigating and found some

irregularities but that he couldn't tell me what they were, only that he was in contact with the New York Regional Office and wanted to put me in touch with a Branch Chief there for follow on investigation. He also said that I would have to identify myself as "the Boston Whistleblower" when I called because he wanted to protect my identity to the extent possible.

Perhaps the most impressive thing about Mr. Garrity was his willingness to think outside of the box. He was able to imagine the impossibility of Madoff's returns and understand that BM's returns were too good to be true and this obviously concerned him. He told me that if BM were located within the New England region, he would have had an inspection team inside BM's operation the very next day.

On Friday, November 4, 2005, Mr. Garrity sent me the names and contact information for Doria Bachenheimer and Meaghan Cheung. (Branch Chief). I called the latter and revealed my identity, and e-mailed her a revised 21-page report. I then e-mailed my thanks to Mike Garrity and informed him that I would be working the case with New York. On Monday, November 7, 2007, I sent Ms. Cheung the report which the Wall Street Journal has now posted on-line less everything past Attachment 1. This report further detailed BM's fraud.

My experience with New York Branch Chief Meaghan Cheung was akin to my previous discussions with Attorney Grant Ward, and demonstrated to me an SEC failure in providing appropriate personnel to understand the case I was submitting. Ms. Cheung also never grasped any of the concepts in my report, nor was she ambitious enough or courteous enough to ask questions of me. Her arrogance was highly unprofessional given my understanding of her responsibility and mandate. When I questioned whether she understood the proofs, she dismissed me by telling me that she handled the multi-billion dollar Adelphia case. I then

replied that Adelphia was merely a few billion dollar accounting fraud and that Madoff was a much more complex derivatives fraud that was easily several times the size of the Adelphia fraud. Ms. Cheung never expressed even the slightest interest in asking me questions; she told me that she had my report and that if they needed more information they would call me. She never initiated a call to me. I did follow-up. I was the one always calling her . She was unresponsive and mostly uncommunicative when I did call, demonstrating a lack of interest and acumen for this area of investigation.

In December 2005, I decided that the third time was not a charm and that the SEC was, once again, not going to pursue the Madoff case. I also decided that if I was going to continue my investigation and attempt to involve the authorities, I should ensure my personal safety in case of possible efforts to silence me and end my investigation. I decided that I should go to the press. I went to Pat Burns, communications director at Taxpayers Against Fraud, an educational group that supports the False Claims Act, for advice and assistance on how to have my Madoff case materials investigated by the press. Mr. Burns put me in contact with John Wilke, senior investigative reporter for the Wall Street Journal's Washington Bureau. Mr. Wilke and I would become friends over the course of the next three years. Unfortunately, as eager as Mr. Wilke was to investigate the Madoff story, it appeared that the Wall Street Journal's editors never gave their approval for him to start investigating. As you will see from my extensive e-mail correspondence with him over the next several months, there were several points in time when he was getting ready to book air travel to start the story and then would get called off at the last minute. I never determined if the senior editors at the Wall Street Journal failed to authorize this investigation.

2006

On March 3, 2006, I had a 5-minute call with NY Branch Chief Cheung (Conversation memo e-mail to Frank Casey and Neil Chelo, Friday, March 3, 2006, 3:23 pm). When I mentioned that my derivatives expertise would be needed to break the case open, she dismissed me by saying that the SEC's Washington Headquarters had Ph.D.'s in an economics analysis unit with derivatives expertise. When I pointed out that the SEC likely didn't have any Ph.D.'s on staff with derivatives trading experience who truly understood how these financial instruments worked because a true derivatives expert couldn't afford to work for SEC pay, she ignored me. She was in "listen only mode." A trained investigator would have kept me on the phone for as long as possible, asking me as many open-ended questions as possible in order to advance their investigation. But as is typical for the SEC, too many of the staff lawyers lack any financial industry experience or training in how to conduct investigations. In my experience, once a case is turned into the SEC, the SEC claims ownership of it and will no longer involve the investigator. The SEC never called me. I had to call the SEC repeatedly in order to try to move the case forward and with little to no response. This may go a long way in explaining the SEC's long and consistent history of regulatory failures.

In the 2006 case materials you will see long strings of e-mails between myself, Neil Chelo and Frank Casey as we pushed the investigation forward because we felt that the SEC was not doing any work to advance the case. At the time, the SEC's reputation was slipping in the press, due to reports of its failure to investigate the Pequot insider-trading investigation. Additionally, the Integral Partners derivatives' Ponzi scheme from five years earlier was just beginning to go to trial. If the SEC could not successfully investigate and bring to justice a $50

million derivatives' Ponzi scheme, how would it handle a $30 billion derivatives Ponzi scheme? My team and I were on our own. We continued to vigorously pursue the investigation.

Perhaps the biggest breakthrough during the year was my September 29, 2006 telephone call to Matt Moran, Esq., Vice President of Marketing, for the Chicago Board Options Exchange. Mr. Moran confirmed to me that several OEX Standard & Poor's 100 index options traders were upset and believed that BM was a fraudster. Mr. Moran said he couldn't talk to either the Wall Street Journal. or the SEC without permission but that if these organizations went through proper channels and got permission from Lynn Howard, the CBOE's Public Relations Head, then the CBOE staff and traders would be able to cooperate with an investigation and answer questions. This was exciting news! Unfortunately, neither the Wall Street Journal. nor the SEC were inclined to even pick up a phone and dial any of the leads I had provided to them. It is a sickening thought but if the SEC had bothered to pick up the phone and spend even one hour contacting the leads, then BM could have been stopped in early 2006. One hour of phone calls was the difference between almost 3 more years of fraud and untold billions of additional investor losses. That's how close we were and how far we were from busting this case wide open in 2006.

2007

2007 was apparently a tough year for BM. Frank Casey got a hold of key May 2007 offering documents from Prospect Capital, a San Francisco based firm that was marketing the "Wickford Fund LP," which promised to deliver a swap that paid out between 3 to 3 ¼ times whatever BM's returns were less borrowing costs and management fees. Here I am using BM

fund and Fairfield Sentry, a Greenwich, CT feeder fund interchangeably. This was a clear signal that BM was running low on new funds to keep his Ponzi scheme afloat.

In order to keep paying out funds to existing investors, a Ponzi operator must ensure that new funds are continually coming in the door to offset the outflow of payments to old investors. Creating a leveraged swap product was a sign that the inflow of new dollars was insufficient to keep the scheme going and that BM needed to create additional incentives sufficient to attract new money.

In a June 29, 2007 e-mail document submission to New York SEC Branch Chief, Meaghan Cheung I forwarded these offering documents to her office and copied Ed Manion of the Boston SEC Office. I also included updated April 2007 performance data from Fairfield Greenwich Group. The interesting thing about the performance data was that BM was noticeably stepping down his stated returns. If you look closely at the data, you will see that he went from double-digit returns from 1991 – 2000, but that all subsequent years returns were in single digits, a clear sign that he needed to cut back on the payouts to old investors in order to conserve cash and keep the scheme going. How the SEC could look at the same data we did and not arrive at the same conclusions that we did is hard to fathom. One would have to seriously question their industry experience and investigative expertise to have missed the red flags contained in the June 29, 2007 SEC Submission.

The Prospect Capital "Wickford Fund LP" performance chart just jumps out of the page at any experienced investment professional. Notice how the unlevered Sentry Fund performance is a steadily rising line. Well, that type of rising line without any downward interruption does not exist in the capital markets for any asset class over any meaningfully long period of time.

Above that steadily rising line is an exponentially rising line that depicts what the "Wickford Fund LP's" returns, using 3.1 to 1 leverage**,** would have been like if the fund had existed back in time. Let me explain 3 to 1 leverage. If a Madoff investor wanted to invest $1 million with BM he could do that on an unlevered basis without borrowing any money. Now Wickford Fund was allowing this same investor to invest her $1 million and borrow an additional $2 million so that she could now invest a full $3 million with BM. Nothing is free in finance and you can be sure there is a bank lending this investor the $2 million dollars she is borrowing and charging a profitable interest rate for providing this service. Wickford Fund LP is even happier to do this because they now get to charge 3 times as much in management fees because the investment amount is now $3 million and not $1 million. BM is also happier because instead of receiving $1 million, he's taking in $3 million and cheating not only the investor but the bank that is lending the investor the additional $2 million. This leveraged performance return line as provided on the graph not only does not exist for any asset class but any student of biology will recognize it as denoting a growth curve for natural organisms such as for population. How can any capital market return over any length of time only go up and never down? How did so-called due diligence "professionals" at the Madoff feeder funds miss this? How did the SEC's staff miss this? If a picture says a thousand words, then this picture said "FRAUD" a thousand times over.

In retrospect, perhaps I should have explained every single page to the SEC's New York Office. But, I was dismissed and ignored making any further attempts to explain on my part impossible. I do not know whether the cause was political interference or incompetence but the result was a refusal to look and an unwillingness to grasp even the simplest explanations for the

red flags present in the "Wickford Fund LP" offering documents. Every phone call to Meaghan Cheung made me feel diminished as a person, so I consciously chose to e-mail her so that I didn't have to undergo unpleasant and unsatisfying telephone calls.

On July 10, 2007 Neil Chelo collected a key set of financial statements for 2004, 2005, and 2006 for BM's largest feeder fund – Greenwich Sentry, L.P.. Here I am using Greenwich Sentry and Fairfield Sentry interchangeably believing them to have the same ownership. Again, red flags popped up everywhere. Greenwich Sentry used three different auditors over that three year period which is a major red flag. Berkow, Schecter & Company LLP out of Stamford, CT was the auditor in 2004, Price Waterhouse Coopers (Rotterdam, The Netherlands) was the auditor for 2005, and Price Waterhouse Coopers (Toronto, Canada) was the auditor for 2006. This raised suspicions in my mind that Greenwich Sentry L.P. might be "auditor shopping."

The financial statements themselves were nothing but a giant red flag to any investment professional looking at them because BM was in US Treasury bills at year-end and there were no investment positions to mark to market. How convenient for a fraudster not to have any trading positions for an auditor to inspect. Since US Treasury Bills exist in book-entry form only, how convenient not to have any physical securities on hand to inspect either.

In late July, I also analyzed a BM portfolio that Neil Chelo obtained, dated February 28, 2007 which contained a 51 stock portfolio, OEX Standard & Poor's Index call options and OEX Standard & Poor's Index put options. The portfolio as constructed did not look capable of earning a positive return and I marked it as having lost .32% but Frank Casey sent me a performance number for February that showed a loss about a third of what this portfolio produced. Inconsistencies like this were so constant throughout the investigation, we had

become immune to them. We would have been surprised only if something associated with BM actually made sense.

Neil Chelo lined up Amit Zjayvergiya, Fairfield Sentry's Head of Risk Management, for a 45-minute phone interview. Mr. Zjayvergiya's answers to Mr. Chelo's questions are listed in a August 24, 2007 e-mail. We discovered from this interview that BM's largest feeder fund, a fund with over $7 billion invested in BM, was not asking any of questions one would expect of a firm purporting to conduct due-diligence. Mr. Chelo is professionally certified as a Financial Risk Manager and asked several key risk management questions of Mr. Zjayvergiya and he did not receive satisfactory answers. I actually had hopes this interview would be longer and more intensive with full responses to the two full pages of questions I had sent to Mr. Chelo. Nevertheless our doubts were confirmed by the information we obtained.

2008

2008 was a strange year for everyone in global finance and our team was no exception. Because of market turbulence all of us were busy with other matters and let our BM investigation drop by the wayside with one exception which occurred in April. A good friend of mine, a University of Chicago Ph.D. in finance, Mr. Rudi Schadt, Oppenheimer Funds' Director of Risk Management, ran into a fellow University of Chicago Ph.D., a Mr. Jonathan Sokobin who was the SEC's new Director of Risk Assessment in Washington. Mr. Schadt, who was familiar with my work in the field of risk management, put Mr. Sokobin in touch with me in late March 2008. Mr. Sokobin asked that I call him, which I did a couple of days later. I wanted to give him a heads-up on some new emerging risks that I saw looming over the horizon. After our call, I felt

that I had established my bona fides as a risk expert and felt comfortable enough to send him my updated, 32-page, December 22, 2005 SEC Submission along with a short 4 paragraph e-mail. I tried calling back a few times but never got through and gave up. I never heard from Mr. Sokobin again. At this point I truly had given up on the BM investigation.

Why did BM suddenly turn himself in on Thursday, December 11, 2008? Clearly, it was because he could not meet cash redemption requests by the feeder funds and fund of funds. Due to the seductive steadiness of his returns and the purported liquidity of his strategy, the fund of funds, in a down market, would consider him the best in their lineup of managers and would most likely go to him first with their redemption requests. Many hedge funds invest in illiquid securities for which they might have trouble finding buyers in a down market. Therefore, rather than sell in a down market when there may be no buyers and drive prices even lower than they were already, these fund of fund managers felt that they would have less negative price impact by asking BM to redeem what they considered to be their "safe" investments. BM's strategy of investing in highly liquid, blue-chip stocks seemed tailor made for easy redemptions. Therefore the fund of funds managers went to BM first (and most reliable investment) and this is what brought about his downfall. Too many hedge fund investors were asking to redeem their money and BM ended up with too many of these redemption requests which brought the entire house of cards down around him.

CONCLUDING THOUGHTS

The e-mails, marketing materials, conversation records and SEC Submissions you have as part of my official document submission to Congress are what four unpaid volunteers

accomplished in our spare time to try and stop BM. We don't pretend to know what really happened on the mysterious 17th floor of the Lipstick Building at BM's corporate offices. Every bit of information we obtained was in the public domain. We never had any secret insider documents or smoking gun e-mails. We did what we could to stop BM from bilking the public. All of us feel very badly that we failed to achieve a positive result.

There were many things we definitely did not know. We never conceived that any high net worth professional investor would have 100% of their money invested in hedge funds. To investment professionals, a proper allocation to hedge funds would range between 0% - 25%, and certainly any such allocation would be spread among several managers, not given in its entirety to just one manager. And being from the institutional side of the business, we closely tracked the feeder funds and fund of funds that were investing in BM, but never realized that charities and individual investors were investing 100% of their money with BM. We also missed the obvious, that BM was Jewish, and as a result, he would be preying most heavily on the Jewish community because Ponzi schemes are first and foremost an affinity fraud.

We more closely tracked BM's affinity fraud through Europe which was a different community of victims from those targeted in the U.S. In Europe the affinity groups sought by the BM feeder funds were mainly European royal families, the high born old money families, and the nouveau riche. In Europe, the victims were mostly blue blood families. BM was truly masterful in using his feeder funds to draw in people close in make-up to the owners of the feeder funds. In this way he was able to expand his affinity victims to those beyond that of the Jewish community and gain entry into other affinity communities as well.

I am sure that we missed many other clues, warning signs and red flags but assure you that we did the best that we could with the information we dared collect. Every time we raised our heads to collect information, we exposed ourselves to discovery and feared the result.

By this time, law enforcement officials know a lot more than we do. The four of us will be waiting to find out what really went on behind closed doors. For those who ask why we did not go to FINRA and turn in Madoff, the answer is simple: Bernie Madoff was Chairman of their predecessor organization and his brother Peter was former Vice-Chairman. We were concerned we would have tipped off the target too directly and exposed ourselves to great harm. To those who ask why we did not turn in Madoff to the FBI, we believed the FBI would have rejected us because they would have expected the SEC to bring the case as subject matter experts on securities fraud. Given our treatment at the hands of the SEC, we doubted we would have been credible to the FBI.

And, I wish to clear the air on a very important matter about ethics, public trust, civic duty and what this all says about self-regulation in the capital markets. The four of us did our best to do our duty as private citizens and industry experts to stop what we knew to be the most complex and sinister fraud in American history. We were probably a lot more foolish than brave to keep up our pursuit in the face of such long odds. What troubles us is that hundreds of highly knowledgeable men and women also knew that BM was a fraud and walked away silently, saying nothing and doing nothing. They avoided investing time, energy and money to disclose what they also felt was certain fraud. How can we go forward without assurance that others will not shirk their civic duty? We can ask ourselves would the result have been different if those others had raised their voices and what does that say about self-regulated markets?

To the victims, words cannot express our sorrow at your loss. Let this be a lesson to us all. White collar crime is a cancer on this nation's soul and our tolerance of it speaks volumes about where we need to go as a nation if we are to survive the current economic troubles we find ourselves facing; because these troubles were of our own making and due solely to unchecked, unregulated greed. We get the government and the regulators that we deserve, so let us be sure to hold not only our government and our regulators accountable, but also ourselves for permitting these situations to occur.

Thank you and May God Bless the United States of America

TIMELINE -SEE CHART

Late	1999 Frank Casey "discovers" BM
Late 1999	Rampart tasks me to reverse engineer BM's strategy
Early 2000	4 hours of research proves mathematically that BM is a Fraudster
May 2000	8-page submission to SEC Boston Regional Office's Director of Enforcement
Jan 2001	Michael Ocrant starts researching the BM story for MAR Hedge
May 2001	Michael Ocrant publishes "Madoff Tops charts; skeptics ask how"
Sep 2001	SEC's Ed Manion calls to ask me to re-submit the Madoff Case
Oct 2001	2nd SEC Submission consists of original 8-page May 2000 Submission+ 3 additional pages + 2 page Investment Process Explained
2002	Investigation continues: e-mail records lost

June 2002	Key Marketing trip to London, Paris, Geneva & Zurich where I discover that Europeans are likely BM's largest investors
2003	Investigation continues: e-mail records lost
2004	Investigation continues: e-mail records lost
Oct 2005	SEC's Ed Manion arranges for 3rd case submission
Oct 2005	I meet with Boston SEC Branch Chief Mike Garrity
Oct 2005	SEC's Mike Garrity investigates
June 2005	Frank Casey discovers that BM is attempting to borrow money at European Banks – the 1st indication that the scheme is running short of $
Nov 2005	SEC's Mike Garrity puts me in contact with New York SEC
Nov 2005	3rd SEC Submission to SEC's Error! Bookmark not defined. in NY
Dec 2005	I start to doubt NY SEC and contact WSJ Washington Bureau
Jan 2006	Integral Partners $40 million derivatives Ponzi scheme goes to trial, 5 years and 5 months after its discovery causing us to further doubt SEC competence
Sep 2006	Chicago Board Options Exchange Marketing VP tells me that several OEX option traders also believe that BM is a fraudster
2007	Neil Chelo obtains Feb 28, 2007 portfolio of BM trading positions, portfolio shows no ability to earn a positive return
June 2007	Frank Casey obtains Wickford Fund LP prospectus showing that BM is now so short of cash that he is offering a 3:1 leverage swap to obtain new funds
June 2007	This prospectus is e-mailed to NY SEC's Error! Bookmark not defined.
July 2007	Neil Chelo obtains Greenwich Sentry LP Financial Statements for 2004-06; Auditors are different for each of the 3 years which is very odd
Aug 2007	Neil Chelo has opportunity to interview Fairfield Sentry's head of risk management who displays a startling lack of acumen
Aug 2007	Hedge funds all have losses this month except for BM – he's amazing!

2008	Global markets dive, entire investigating team loses interest and is busy with more pressing matters
April 2008	Jonathan Sokobin, SEC's Director of Risk Assessment calls me per the recommendation of a mutual friend
April 2008	I send Mr. Sokobin my last SEC Submission and quit the investigation
Fall 2008	Stock Markets crumble, panicked investors rush to redeem
Dec 2008	Madoff "confesses" and turns himself in after running out of cash to meet investor redemptions

PART II REBUILDING THE SEC

The Current Situation is Dire but Fixable: there is no where to go but up!

Securities fraud is a scourge on the marketplace. Investors who suspect fraud or who aren't confident that a level playing field exists will properly require higher returns. To the companies trying to raise capital in the marketplace, investors' higher return requirements mean a higher, unaffordable cost of capital or worse, the total unavailability of capital at any price. Today, thanks to the lack of effective regulation and oversight, our capital markets are barely functioning. Markets need to be fair, efficient and transparent in order to work properly. They also need to be regulated in order to ensure a constant availability of credit at affordable rates.

Right now, investors are afraid and do not trust the banks, insurance companies, brokerage firms, credit ratings agencies, investment managers, hedge funds, or other financial institutions nor should they. Investors particularly do not trust our nation's financial regulators, particularly the Federal Reserve Bank (FED) and US Treasury who have both told them repeatedly that things were fine, when in fact, things were only about to get worse. The ultimate insult to investors is the FED's refusal to tell us which financial institutions are borrowing from the Discount Window and how much they are borrowing. This startling lack of transparency from regulators has led to a massive lack of investor confidence. Only by providing investors with full transparency and allowing them to make rational investment decisions, will our capital markets find the proper price levels so that buyers can find sellers and sellers can find buyers.

Investors want to know that the financial firms they are dealing with are solvent and right now they feel that our government isn't telling them the truth about the solvency of this nation's

largest financial institutions so the entire system remains paralyzed, needlessly wondering who the zombie financial institutions are. My advice is to take the pain up front and either nationalize or close the zombie financial institutions as soon as possible and put the uncertainty to rest. Trust will not be restored until full transparency is restored.

Every single one of this nation's too many financial regulators failed to earn their paychecks. This is the reason our financial system has been on the verge of collapse over these past several months. Unfortunately, as bad a regulator as the SEC currently is, and the SEC certainly is a bad regulator, it's the best of a very sorry lot. Compared to the FED which has led this nation to the abyss of national bankruptcy by it's refusal and inability to regulate the banks, the SEC actually looks halfway competent. Thanks to the ineptitude of financial regulators, Wall Street as we once knew it ceases to exist and too many of the nation's largest banks are on government life support, too weak to lend and too battered to survive as currently constituted.

Our nation has too many financial regulators. The separation and lack of connection and communication between them leaves too many gaping holes for financial predators to engage in "regulator arbitrage" and exploit these regulatory gaps where no one regulator is the monitor. In more than one financial institution, employees have two different business cards. One card has their registered investment advisor title (which falls under SEC regulation) and the other has their bank title (which falls under banking regulators). When the FED comes in to question them, they say they're under the SEC's jurisdiction and when the SEC comes in to question them, they say they're under the FED's jurisdiction. Clearly this situation has to be corrected so firms cannot play one regulator against the other or worse, choose to be regulated by the most incompetent regulator available while avoiding the most vigorous and thorough regulators.

The goal needs to be to combine regulatory functions into as few a number as possible to prevent regulatory arbitrage, centralize command and control, ensure unity of effort, eliminate expensive duplication of effort, and minimize the number of regulators to which American businesses have to answer. To this end, I recommend that one super-regulatory department be formed and that it be called the Financial Supervision Authority (FSA). Under it's command would come the SEC, the FED, a national insurance regulator and some sort of combined Treasury / DOJ law enforcement function with staffs of dedicated litigators to carry out both criminal and civil enforcement for all three. All banking regulators should be merged into the FED so that only one national banking regulator exists. The FED Chairman, Vice-Chairman, and Governors who set monetary policy can be spun out into a separate, independent operating units, but since they've shown themselves to be such incompetent regulators, this critical function would be stripped away from them. Pension regulation should be moved from the Department of Labor to the SEC. Futures and commodities regulation should be moved from the CFTC to the SEC. Cross-functional teams of regulators from the SEC, FED, national insurance regulator and Treasury/DOJ should be sent on audits together whenever possible to prevent regulatory arbitrage. I envision the inspection arms to be the SEC, FED and national insurance regulator while the Treasury / DOJ litigators house the litigation teams that take legal action against defendants. American businesses deserve to have a simpler, easier to understand set of rules to abide by and they also deserve to have competent regulation at an affordable price. Right now financial institutions pay a lot in fees for regulation but they aren't getting their money's worth. Government needs to give business regulation that provides a value-proposition, where fees paid to regulators equal value received by business.

The SEC is a Failed Regulator: But it Can't Remain One

The story I have related in Part 1 underscores the deeply flawed connections or lack thereof between financial regulators as well as the systemic failures of the SEC. These systemic failures are instantiated by my particular experiences with the SEC as explained above but also generally replete in the history of the SEC over the past few decades. Let me provide you with a representative list of only some of the agency's major failures. During the tech bubble years, the SEC ignored the Wall Street Analysts' recommendations, almost all of which were "buy recommendations" even though these same analysts privately advised a few privileged investors to sell these over-priced or worthless securities, leading up to the 2000 – 2003 bear market. In 2003, the SEC's Boston Regional Office turned away Mr. Peter Scannell, the Putnam market-timing whistleblower. Fortunately, Mr. Scannell survived a vicious beating and went to both the Massachusetts Securities Division (MSD) and the New York Attorney General (NYAG) who believed him and enforced the nation's first market-timing scandals while the SEC watched from the sidelines until embarrassed enough to finally enter the fray with enforcement actions of its own. In 2007 and 2008, the Auction Rate Securities scandal hit the headlines, and once again the SEC remained busy looking the other way, protecting predatory investment banks from defrauded investors. And, once again, the NYAG and MSD conducted effective and timely enforcement actions to ensure that defrauded investors got their money back. More recently, the SEC watched quietly but did nothing to prevent the train wreck as the nation's five largest domestic investment banks either failed like Lehman, were rescued by government forced acquisitions like Bear Stearns and Merrill Lynch, or became bank holding companies in order to

survive like Goldman Sachs and Morgan Stanley. And today, no investor knows what the bank's balance sheets look like because the SEC is refusing to enforce transparency rules.

When the industry you purported to regulate implodes and the nation's financial system is frozen, then it is safe to say that you've failed as a regulator. It is also safe to say that the SEC has lost the nation's confidence. The Executive Branch and Congress are faced with the following critical question – do we disband the SEC, merge it out of existence, or fix it?

Rebuilding the SEC:

I come before you not to bury the SEC but to assist you in helping to tear down and rebuild an SEC capable of effectively regulating capital markets in the 21st century. I promise to be blunt in my assessment of where the SEC is today and where it needs to go in the short term and long term. No punches will be pulled regardless of the SEC's embarrassment. Until the SEC admits to and embraces its failures, it will not be able to recover and rebuild. "*Denial*" is not just a river in Egypt, it's the mindset that the SEC has adopted. It has blamed everything on a lack of staff and resources while refusing to admit to its underlying problems. I know that I am tired of their lame excuses and I suspect that Congress and the American public are also tired of the SEC's shameless attempts to deflect blame. It's high time and past time for some personal responsibility on the part of the SEC's senior staff. Our nation's capital markets didn't fall so far and so fast without a lot of help from regulators who failed to regulate. At the very least the SEC's senior staff should be making profuse apologies to Mr. Madoff's victims. Instead all I've heard are SEC promises to look into what happened with my repeated SEC Submissions which told the SEC exactly where to look to find the fraud.

In my dealings with the SEC I have noted many deficiencies and will point those out in enough detail so that the new management team can fix them in the next four years. I believe the one over-arching deficiency is that the SEC is a group of 3,500 chickens tasked to chase down and catch foxes which are faster, stronger and smarter than they are. It's painfully apparent that few foxes are being caught and that Bernie Madoff, like too many other securities fraudsters, had to turn himself in because the chickens couldn't catch him even when told exactly where to look. As currently staffed, the SEC would have trouble finding first base at Fenway Park if seated in the Red Sox dugout and given an afternoon to find it. Taxpayers have not gotten their money's worth from the SEC and this agency's failures to regulate may end up costing taxpayers trillions in government bailouts.

Dramatically Upgrading SEC Employee Qualifications & Educational Budgets:

Amazingly, the SEC does not give its employees a simple entrance exam to test their knowledge of the capital markets! Therefore is it any wonder when SEC staffers don't know a put option from a call option, a convertible arbitrage strategy from a long/short strategy, the left side of the balance sheet from the right side, or an interest only security from a principle only security. By failing to hire industry savvy people, the SEC immediately sets their employees up for failure and so it should not be surprising that the SEC has become a failed regulator.

A good way for Congress to find out exactly what I mean when I say the SEC doesn't have enough staff with industry credentials is to query the SEC senior staff that come before your Committee. Ask them – "Do you have any financial industry professional certifications?" "Have you ever worked on a trading desk?" "What accounting, business or finance degrees do you hold?" "What financial instruments have you traded in a professional capacity?"

If Congress decides to keep the SEC in existence, then upgrading its staff, increasing its resources, and wholly revamping its compensation model is in order. In order to attract competent staff, a test of financial industry knowledge equivalent to the Chartered Financial Analysts Level I exam should be administered to each prospective employee to ensure that new employees have a thorough understanding of both sides of a balance sheet, an income statement, the capital markets, the instruments that are traded and the formulas incorporated within these instruments. Talented Certified Public Accountants (CPA's), Chartered Financial Analysts (CFA's), Certified Financial Planners (CFP's), Certified Fraud Examiners (CFE's), Certified Internal Auditors (CIA's), Chartered Alternative Investment Analysts (CAIA's), MBA's, finance Ph.D.'s and others with industry backgrounds need to be recruited to replace current staffers. One thing the incoming SEC Chair should do right away is order a skills inventory of the current SEC staff to measure the exact skills shortfalls with which she is now faced. My bet is that Ms. Shapiro will find that she has too many attorneys and too few professionals with any sort of relevant financial background.

I recommend that the Chair ask the SEC senior staff to provide her with a complete skills listing of the current SEC staff. Knowing how many SEC employees hold accounting, business, and finance degrees versus how many hold law degrees would be a useful first step in quantifying the mismatches between skills on hand versus skills required to properly regulate. Determining how many SEC employees have ever worked on a trading desk would be particularly illuminating for the new Chair. Ditto for how many SEC employees are CAIA's, CIA's, CPA's, CFA's, CFE's, CFP's, and FRM's. My bet is that the SEC staff is critically short of employees with credible industry experience.

I caution the SEC to avoid focusing on any one of the above professional certifications at the expense of the rest because all are relevant and necessary. The SEC also needs to avoid having too many people with educational and professional backgrounds that are too alike. Diversity will ensure that group-think is kept at bay and that the SEC embraces multiple relevant skill sets. Right now the SEC is over-lawyered. Hopefully it can transition away from this toxic mix as quickly as possible.

I would like to see the SEC expand its tuition reimbursement program to pay 100% of relevant post-graduate education courses with one year of additional government service for each year of graduate education. Currently, the SEC does not allow its staff time out of the office to attend industry luncheons, dinners, cocktail parties etc. nor does it pay for their attendance at these low cost learning events. SEC staffers need to be encouraged to attend industry conferences, particularly those venues where brand new securities are being featured, so that they are not caught flat-footed and behind the curve when these securities enter the marketplace. Because people tend to say and do things when they are traveling that they would never do at home, conferences are the ideal venue for the SEC to find out what's happening in the industry and, more importantly, what's about to happen. Sending SEC staff to conferences with a written information collection plan, under the supervision of a senior person, with the goal of obtaining information and marketing literature about new products and querying attendees about frauds within the industry is a cost-effective solution to keeping the SEC on level ground with the industry it regulates.

Large cities with robust financial centers have financial analyst societies and economic clubs which hold educational meetings of just the sort the SEC staff needs. For example, in my

hometown, the Boston Security Analysts Society has 5,000 members and holds educational lunches at least twice weekly, but the SEC won't reimburse its staff to attend these luncheons even though firms within the industry do. New York and Washington also have sizeable analysts societies but rarely does anyone see SEC staff attending these educational events and we all know it isn't because the SEC has no need for greater industry knowledge. Either the SEC is anti-intellectual and intentionally maintaining staff uneducated about the capital markets or it is merely being ignorant. In either case, not to budget for it's staff's education is indefensible in the 21st century. SEC employees are knowledge workers, not unthinking, replaceable cogs and deserve to have the required educational resources available to them to do their jobs.

To further illustrate the anti-intellectual bias of the SEC, consider what the SEC staff has printed on their business cards. If you're expecting to see Certified Public Accountant, Certified Financial Planner, Certified Fraud Examiner, Certified Internal Auditor, Financial Risk Manager, Chartered Financial Analyst, Chartered Alternative Investment Analyst, or some other sort of highly sought after professional designation, you will be sorely disappointed. For some unfathomable reason, most of the very few credentialed SEC staffers do not have their professional designations printed on their business cards. Why not? One would almost think that the SEC's top leadership was going out of its way to drive good people out of the SEC and destroy the morale of those who stay. The all too few SEC staffers I know with industry credentials have all told me they are not allowed to have these designations printed on their business cards. The only reason for this that makes sense is that if the SEC allowed its few credentialed staff to put these credentials on their business cards it would expose the overall lack of talent within the SEC. Therefore, one thing I would immediately recommend is that relevant

industry credentials be printed on the Staff's business cards ASAP. Not only is this good for morale, but it also tells you which staff are worth keeping and which ones need to be told to find new jobs because their skills aren't relevant and don't meet either the SEC's or the investing public's needs.

Another shocking revelation is that MAR Hedge published an expose on BM on May 1, 2001 while Barron's published their copycat BM expose on May 7, 2001 but the SEC doesn't pay for subscriptions to industry publications for its staff so their staff likely never read these damning articles which each contained numerous red flags. That's right, if the SEC staff want to read industry publications they have to pay for them on their own because the SEC won't pay for them. I remember that after reading both of these Madoff expose articles, Neil Chelo, Frank Casey and I felt 100% certain that the SEC would be shutting down BM within days. What we didn't know at the time was that the SEC doesn't read industry publications. We were shocked.

If you walk into any sizeable investment industry firm, it will have a library of professional publications for the staff to use as a resource. Typical journals on hand would be the Journal of Accounting, Journal of Portfolio Management, Financial Analysts Journal, Journal of Investing, Journal of Indexing, Journal of Financial Economics, and the list goes on and on. But, if you walk into an SEC Regional Office, you won't see any of these journals nor will you see an investment library worthy of the name. If an SEC Regional Office does have an investment library, it is usually the effort of one lone, highly motivated, employee who stocks a bookshelf on his/her own time, paying for the publications him or herself. This begs the question, where do SEC staffers actually go to research an investment strategy, find out which formulas to use to determine investment performance, or figure out what a CDO squared is?

Apparently all the SEC staff uses is Google and Wikipedia because both are free. Lots of luck figuring out today's complex financial instruments using free web resources. No wonder industry predators run circles around the SEC's staff. It's easy to fool people from an ignorant regulator that goes out of its way to ensure that its staff remains uneducated and under-resourced.

The SEC has exactly the wrong staff for the 21st century and a staff that's incapable of comprehending the financial instruments it is charged with regulating. Even if the SEC did provide a sensible publications budget for its staff so that staff could subscribe to the Wall Street Journal, Barron's, Business Week, and formed research libraries containing all the important financial journals, its staff would still need to understand what instruments are being regulated and which formulas are being used. The faulty recruitment of unnecessary and inefficient and incompetent human resources would remain.

To properly regulate the finance industry, the SEC needs to hire people who know how to take apart complex financial instruments and put them back together again. If an SEC staffer doesn't know derivatives math, portfolio construction math, arbitrage pricing theory, the Capital Asset Pricing Model, both normal and non-normal statistics, financial statement analysis, balance sheet metrics, or performance presentation formulas then they shouldn't be hired other than to fill administrative or clerical positions.

For instance, a person I know rather well in the Boston office, with over 10 years of industry experience, a double major under-graduate degree in economics and math from an Ivy League school, with an MBA degree and a Chartered Financial Analysts designation wanted to leave her job as a senior analyst at a large mutual fund company in order to have another child. She wanted out of the rat race where 60 hour work weeks were both common and expected so

she applied for a job with the SEC. During her interview she was told that she was 1) overqualified with too much industry experience, 2) over educated and 3) that she wouldn't be happy inspecting paperwork and would likely quit in frustration so the SEC didn't plan on offering her the job. This is deeply problematic as it underscores the lack of a proper recruitment policy to equip the SEC with appropriate personnel for the work with which it is mandated and the expertise expected in order to appropriately monitor our financial institutions and their numerous transactions. The SEC apparently is only interested in administrative verification, to ensure compliance with existing (outdated) securities laws. Is it any wonder, given the current SEC staff, that major financial felonies go unpunished while minor paperwork transgressions are flagged for attention?

Besides upgrading its staff at the junior and mid-levels, the SEC needs to recruit foxes to join the SEC staff in senior, very high paying positions that offer lucrative incentive pay for catching foxes and bringing them to justice. The revolving door between industry and regulators can be precluded if the SEC recruits highly successful industry practitioners who have succeeded financially during their long careers and now want to serve the American Public by fighting securities abuses. The ideal candidates would all have gray hair (or no hair at all) and the SEC would be the capstone on their already illustrious careers. The main hiring criteria would be that each candidate would have to submit a written list of securities frauds that he/she would attack and list the estimated dollar recoveries for each of these frauds. These "foxes" would then be brought on board specifically to lead mission-oriented task forces dedicated to closing down these previously undiscovered frauds, restoring trust in the marketplace, thereby lowering the cost of capital and minimizing the regulatory burdens for honest American businesses. My

theory is that it's better to target your enforcement efforts at known fraudsters while leaving honest American businesses alone other than for occasional but thorough spot inspection visits. The fraudsters would be terrified but most businesses would be relieved if the SEC adopted the proposed regulatory scheme.

In summary, the SEC needs to stop hiring more of the same people it's already been hiring. What the SEC needs to do is test its staff, identify who to retain, get rid of those who either don't have the proper skills sets for their specific mandates at a 21st century level or don't want to obtain those skills, hire foxes from industry to lead the enforcement and examination teams, increase the pay levels, and expand its educational budgets to ensure that the SEC becomes a forward leaning, learning organization that is more than a match for the industry it regulates.

The SEC needs to adopt Industry Compensation Guidelines in order to compete:

Compensation at the SEC needs to be both increased and expanded to include incentive compensation tied to how much in enforcement revenues each office collects. Industry pays a base salary plus a year-end bonus that is tied directly to revenues brought into the firm. The SEC needs to adopt the industry's compensation guidelines in order to compete for talent. Of course, the SEC Commissioners would continue to approve the levels of the fines for enforcement actions because it would be a clear conflict of interest to have the enforcement and examinations staff set the fines that lead to their own compensation. Each SEC Regional Office should get back some pre-set percentage of the fines it brings in, and I recommend a 5% level initially, toward that office's bonus pool. Regional enforcement teams that do great work and bring in a $100 million case settlement deserve to be compensated for their excellence. And, to prevent

taxpayers from having to pony up these multi-million dollar bonus pools, I recommend that fines be triple the amount of actual damages, that the guilty transgressors pay the actual costs of the government's investigation, and that SEC staff bonuses also be paid for by the guilty transgressors.

In expensive financial centers' like New York, Boston, Chicago, Los Angeles, and San Francisco, cost of living adjustments bringing base compensation to the $200,000 level make sense plus the award of annual year-end bonuses but only when merited. In the lower cost regions, a $100,000 - $150,000 base compensation would be fair, adjusted to local prevailing wage and cost data. This would be enough to attract the nation's best, brightest and most experienced industry practitioners. All compensation over and above the base compensation amount would come from each regional office's bonus pool and be tied directly to the fines (revenues) that each office generates. People who do not perform and bring in good quality cases that result in settlement awards to the government will get asked to leave and make room for people who can come in and produce solid cases.

To be effective, the SEC cannot afford to be less talented and educated than the industry, and I would argue it can't even strive to be as good as the industry, it needs to be better! If the incoming Chair sets her sights too low, that's an admission of defeat and our capital markets can't afford to have this agency continue to fail. If our regulators continue to fail, then our capital markets won't recover because investors won't return until they are assured of a fair deal with full disclosure.

I would also institute quantifiable metrics to measure the new, 21st Century regulatory effectiveness. Obvious metrics are revenue from fines, dollar damages to investors recovered,

dollar damages to investors prevented, fine revenues per employee per regional office, and the number of complaints from Congress to the regulators complaining about the severity of the fines or the thoroughness of the government's investigations. Let me tell you a story about a very competent and talented SEC attorney in the Boston Regional Office who says that every time he receives a phone call from Washington SEC Headquarters calling him off an investigation, it's for one reason and one reason only – because that is the only way the predator financial institution he is currently investigating can escape justice and escape making restitution to the victims. If the number of Congressional complaints ever went down year after year it could only have one of three meanings: 1) better members of Congress, 2) the SEC is doing such a magnificent job of fraud detection that white collar crime actually drops or 3) a worse job by the SEC that year.

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

Just because it is not illegal doesn't mean the SEC should ignore unethical behavior in the marketplace, which it has been doing for several decades now by trusting the industry to self-regulate its way to good behavior. The SEC must change its mission toward ensuring full transparency, fair play, and zero tolerance for unethical financial dealings. Note that I didn't say the SEC's mission should tend away from "enforcing the nation's securities laws." Given that there is no way to keep a set of securities laws on the books that is up to date and fully accounts for all of the bad behavior that financial predators can and will engage in, the SEC needs to recognize that securities laws are not the be all and end all of regulation, they are merely the absolute bare minimum standards which market participants must follow. Securities laws will never be fully up to date or always relevant. The current crisis will see that new, more relevant

laws are enacted, but after these crises pass, securities laws will once again quickly become obsolete until the next crises appears. We need to end this cycle of overdependence on a series of rapidly outdated securities laws as our basis for enforcement and err on the side of protecting our investors.

The SEC's main focus is to mindlessly check to see if registered firms paperwork is in order and complies with the law as written. If a firm happens to be a financial predator and is engaged in market-timing or selling auction rate securities, the SEC's lawyers will not be concerned because market-timing and auction rate securities aren't illegal, merely unethical. If that firm's paperwork meets legal requirements, the SEC will give these financial predators a free pass just like it has always done. You will note that the SEC has said that the market-timing of mutual funds was not illegal, which may explain why the SEC turned away the Putnam whistleblower, Peter Scannell in 2003. The long-term, buy and hold mutual fund investors who lost that billions in returns to market-timers as a result of these actions and omissions, certainly would agree that this activity was unethical and they deserved to have this money returned to their retirement accounts. Auction rate securities issuers and investors ended up similarly disappointed thanks to the SEC's willingness to foster an "anything goes" climate on Wall Street. Enough of the securities' lawyers robotic simple compliance audits, let's shift the 21st century's capital markets to a higher plane, and start to insist on ethical capital markets that give all investors a fair deal with full transparency.

The bare minimum requirement of compliance with securities' law does not serve the higher standards and needs of today's financial markets and the pace of modern market practices. Policy standards and requirements including, good ethics, fair dealings, full transparency, and

full disclosure need to be adopted and enforced. The SEC needs to shift its focus away from the lowest common denominator, mere securities law enforcement, and upgrade it to change we can believe in by ensuring full transparency, fair play and zero tolerance for unethical financial dealings.

Revamping the Examination Process:

I am not sure how many of you have ever undergone an SEC inspection visit. I was a portfolio manager, then chief investment officer, at a multi-billion dollar equity derivatives asset management firm, and equity derivatives was considered a "high risk " area by the SEC. My firm received SEC inspection visits every three years like clockwork. I've been through these examinations and will tell you about their many obvious flaws. First, the SEC never once was able to send in an examiner with any derivatives knowledge. It was a good thing my firm was honest because if we weren't, we could have pulled a Madoff on them and they would have been none the wiser. Second, the Sec audit teams are very young and they rarely have any industry experience. Third, the teams come in with a typed up list of documents and records they wish to examine. They hand this list to the inspected firm's compliance officer (CO). The CO then takes them to a conference room and the firm provides the pile of documents and records which the SEC team inspects diligently. So, if a firm were so inclined, it could keep a second set of falsified but pristine records yet commit the equivalent of mass financial murder and get away with it, just as long as the firm had at least one set of (falsified) books and records that were in compliance.

Now let's examine what is wrong with the examination process described above. First, the team only interacts with the inspected firm's compliance team, not the traders, not the portfolio managers, not the client service officers, not the marketing staff, not the information technology department and not management. The problem with this process is that the SEC examiners only examine paperwork but neglect the tremendous human intelligence gathering opportunities that are sitting right outside the conference room. What these SEC examiners need to be doing is sending one or two people out on the trading floors and into the portfolio manager's offices to ask leading, probing questions. During every single such unscripted interview, the SEC examiner should ask, "*Is there anything going on here that is suspicious, unethical or even illegal that I should know about? Are you aware of any suspicious, unethical or even illegal activity at any competing firms that we should be aware of?* And, during that interview, the SEC examiner should be handing out his/her business card, asking that person to call them personally if they ever run across anything the SEC should be looking into either at their firm or any other firm. Unless everybody at a particular firm is dishonest, if fraud is present, at least these standard internal auditing techniques will result in a materially significant number of new enforcement cases. These are internal auditing techniques that well trained accountants, internal auditors, and fraud examiners use when conducting audits or investigations. But at present, the SEC staff is so untrained, it's almost as if this concept of talking to a firm's employees is advanced rocket science. It is my belief that SEC examiners are so inexperienced and unfamiliar with financial concepts that they are literally afraid to interact with real finance industry professionals and choose to remain isolated in conference rooms inspecting pieces of paper.

From her first day in office, the incoming SEC Chair needs to get these examiners to focus on interacting with industry professionals and querying them on what's going on in their firms and their competitors' firms. Sitting like ducks in the inspected firm's conference room and getting fed controlled bits of paper by the firm's compliance staff isn't getting the job done. As currently constituted, the current examination process is an insult to common sense, a waste of taxpayers' money, and it can't be good for SEC employees' morale either. This also reinforces the need to increase the pay scale and add incentive compensation such that more qualified people apply for and take SEC jobs. Unless and until the SEC puts real finance professionals on those examination teams, their odds of finding the next Bernie Madoff range from slim to none.

When a financial analyst is about to visit a company to determine whether or not to invest in that company's stock, the first thing he/she does is go to a Bloomberg and analyze the firm's capital structure, it's financial statements, financial statement ratios, look up the firm's weighted cost of capital, and start running horizontal and vertical analyses of the financial statements looking for trends and outliers. The trained analyst will also use his/her Bloomberg to read all the news stories on the company, look at the firm's SEC filings, and use all of the information above to build a set of questions he/she needs to answer in order to arrive at an intelligent investment decision. The analyst will also obtain Wall Street analyst research reports and read them all to see what information other analysts' research on this company's main strengths and weaknesses.

Unfortunately, the SEC staff examiner doesn't do this. The main reason is lack of training on use of a Bloomberg machine. In the rare event the staff has know how, most SEC

Regional Offices are lucky to have even one Bloomberg machine for the entire region's use. Whereas your typical investment firm would have one Bloomberg per analyst, trader and portfolio manager, the SEC unwisely only funds one per office! For SEC compliance and examinations' the use and need for Bloomberg machines are an inherent industry requirement. The work in brief cannot be done without it. Those Bloomberg machines are the lifeblood of the industry, they contain much of the data an SEC staffer would need for any fraud analysis of a company.

Here is a quick example so that you understand how vitally important a Bloomberg machine is to securities enforcement. If you type in a company's stock ticker symbol, say ABC then hit "WACC" equity go, ABC Company's weighted cost of capital would pop up on your screen. Let's say ABC Company a weighted average cost of capital of 10% between its outstanding debt which pays an average of 6% interest and its equity which has a 14% cost associated with it and the mix between debt and equity is 50/50 [(.5 x 6%) + (.5 x 14%) = 10% cost of capital]. Assume that ABC Company is a Defense Contractor and bids "cost plus 3%" on an Iraqi War contract yet the company's cost of capital is 10%. This is a clear sign that ABC Company is likely cheating the Defense Department on that contract since no company would willingly accept any contracts which fall under its cost of capital. Working for 3% when a firm's cost of capital is 10% would quickly lead the firm into bankruptcy since that contract would be costing the firm a minus 7% return if the costs being passed onto the government were accurate. A good SEC examiner would immediately suspect ABC Company was padding the costs in its Iraqi War contract and alert the DOD's Defense Criminal Investigation Service to conduct a fraud audit. If everyone in industry is using Bloombergs except for the SEC, it is little wonder

the SEC can't find fraud. The staff does not have the tools and training necessary to do their jobs.

In case you are still not convinced, take the following challenge. Name one major securities fraud case that the SEC busted wide open on its own without the felon first turning himself in? Give up? The last major pre-emptive SEC strike was Ivan Boesky, for insider trading violations over two decades ago. Today's SEC staff are more like financial crime scene investigators, coming in after the fraud scheme has already collapsed, toe-tagging the victims, trying to figure out who the bad guys were and how the fraud scheme occurred. To date the SEC's inability or unwillingness to regulate and more importantly to implement regulation with adequate tools and training have potentially cost us trillions in the recent financial crisis.

An Alternative Course of Action: Disbanding the SEC

Fortunately, the US already has two very competent securities' regulators who do a truly fantastic job and at an unbelievably low cost. Unfortunately, they are the New York Attorney General's office (NYAG) and the Massachusetts Securities Division (MSD). The NYAG and MSD have busted open the Wall Street analysts' bogus stock recommendations scandal, the mutual fund market-timing scandals, the auction rate securities scandals and a whole host of other industry violations. Where has the SEC been beforehand while all of these frauds were being committed? Sitting safely on the sidelines watching the fraud go by, daring not to get involved for fear of upsetting their masters on Wall Street. And this is the nicer, kinder explanation. Many investors may claim the SEC has been intentionally missing in action so as to aid and abet financial industry fraud to ensure that predatory financial institutions remain safe from investors. From an investors' perspective, the only two regulators that have stood up and

made investors whole are the NYAG and MSD. These two regulators need to be publicly commended for the great job they are doing on behalf of investors everywhere.

Therefore, one alternative solution for Congress to consider is to disband the SEC and give its budget to the NYAG and MSD to hire staff and keep doing what they've been doing which is a darn good job of protecting investors. One reason these two states have competent regulators is that New York City is the world's largest financial center while Boston is the world's fourth largest financial center. London is No. 2 while Tokyo is No. 3. Somehow, I doubt that the NYAG and MSD would be hiring many people from the SEC, choosing instead to find competent employees with industry experience locally to do the job more efficiently. From an efficiency standpoint, the NYAG and MSG employ far fewer people at much lower cost and do a much better job of securities regulation than the SEC. If the state regulators are providing more regulatory bang for the buck, an option would be to fund them and zero out the SEC's budget. After all, we let poorly performing private companies fail, why not let poorly performing government agencies fail too?

Congress should always keep its options open regarding further funding of the SEC. If this agency continues to fail to regulate, holding the threat of disbandment over their heads by giving its budget to state securities regulators is the ideal high card for the Congress to keep in its pocket to ensure that the SEC understands it can either improve or disappear. The SEC's most committed staffers will not allow their agency to fail, nor will they allow anyone more senior to them within the agency to lead it down the wrong path. Plus, the threat of extinction does have a certain way of focusing attention and accomplishing goals more quickly than would otherwise be

the case. Hopefully this alternative path will impose Congress's will over the SEC such that the agency meets all Congressional deadlines and mandates.

An Alternative Course of Action: Assigning the NYAG & MSD to enforce large, industry-wide cases and let the SEC conduct the routine, paperwork inspections.

This is similar to the enforcement reality already in effect where the NYAG and MSD discover the truly big industry-wide frauds and conduct nationwide enforcement actions to recover investor assets. The SEC seems to be a captive agency that purposely ignores the large frauds, focusing only on the minor transgressions it can find during the normal, routine examination process. This alternative course of action formalizes the reality on the ground today.

Congress could fund the NYAG and MSG so that it could do more of the large securities fraud enforcement cases at which it has developed great expertise. The SEC could keep its current budget and continue to police up the misdemeanors it seems to do passably well.

This alternative has the advantage of playing to each regulator's strengths. The NYAG and MSD don't have the SEC's thousands of employees with which to conduct nationwide inspections of regulated firms. However, the NYAG and MSD do have a deep bench of experienced litigators and investigators with pit bull tenacity. As they say, it's not the size of the dog in the fight, it's the size of the fight in the dog that matters. The SEC has 3,500 employees and can continue to muddle along, handling the low-level securities violations it has a known appetite for while avoiding the large fraud cases which it doesn't seem to have either the heart nor the skill to attack.

Recommendations for the New SEC Chair:

Given the SEC's current crisis situation it cannot be managed toward greatness, it needs to be led there. No amount of management can save the SEC. You manage budgets and resources but you have to lead people, and the best place to lead from is the front, setting the example for everyone behind you to follow. It will take a first-rate job of leadership, hard work and a bigger budget to turn around this agency but I know it can be done. Ms. Shapiro has been given every good leader's dream, to take command of an organization that has nowhere to go but up.

If, by year-end 2009 there is not a dramatically measurable improvement in the number of cases brought and SEC staff morale has not improved, then a replacement Chair needs to be hired. President Obama needs to go through regulatory agency heads like Lincoln went through generals in order to give the American people the government we deserve and the government we've been paying for all along. Our President needs to keep hiring and firing until he, like Lincoln, has found leaders who can create winning organizations. We can't afford any more 9-11's, Hurricane Katrina's or any other massive governmental failures like the near collapse of our nation's financial system.

At this point the SEC desperately needs new leadership at the very top. I feel very sorry for the staff in the eleven (11) Regional Offices for not receiving the proper training, resources, and support from their headquarters over a period of decades. What the SEC headquarters no longer needs is a building full of career bureaucrats shuffling paper. The new SEC Chair needs to come in and clean house with a wide broom, sweeping out the top ranks and bringing in a new, results oriented senior leadership team to replace the one that has failed us so miserably.

My recommendation to the incoming SEC Chairman is to spend one week each month at each of the eleven (11) different Regional Offices during the first year, spending each day that week with a different examination team looking at how they do their jobs. After each day's work has ended, I would take that team out to dinner for a full de-briefing, asking them what tools, training and resources they need to do their jobs better. Once I got back to Washington, I'd crack the whip and make sure my senior staff pushed those tools and resources down to my examination teams on an expedited basis. Senior staff that can't deliver resources to the Regional Offices quickly enough need to be identified and terminated. Examination teams are the tip of the spear and the SEC can only be as good as those teams in the field are, so they must take absolute top priority.

The new SEC Commissioner should consider moving the SEC out of Washington because Washington is a political center not a financial center, so you won't find the most qualified finance people there for the job at hand. Since New York is the world's largest financial center and Boston is the world's fourth largest financial center, moving the SEC to either West Chester County, NY or Connecticut, in between those two major financial centers makes a lot of sense. If the SEC wants to attract the top talent, relocating its headquarters to somewhere between Rye, NY and New Haven, CT is where this agency will best attract the foxes with industry experience it so desperately needs.

If the SEC's senior staff is as bad as it appears to be, then recognize that quickly and move to replace these people expeditiously. Far better to clean house at the top in order to show the new leadership team is serious about bailing out this sinking ship and getting it turned around in the opposite direction. Plus, I would rather have empty desks in Washington versus keeping

the dead wood on board; because allowing dead wood to linger sends the wrong message to the Regional Offices. While senior staff positions remain unfilled, promote lower ranking employees into senior roles on an acting basis to discover the up and coming future leaders of this agency. You will identify good talent using this method.

Reinvigorating and reforming the Office of Risk Assessment is another task on the new SEC Commissioner's plate because the SEC needs to put its best, most experienced finance professionals there. New inspection checklists have to be devised for every new financial product, structured product, derivative security, hybrid security, corporate entity – and all before these products are sold into the marketplace! Being even one day late to regulate is simply unacceptable. Examination audit checklists also need to be totally rebuilt so that obvious frauds such as the Madoff Ponzi scheme are never missed again. Base audit checklists for each type of firm that's out there need to be developed. Then, specific additional audit checklists that test for new and different, even never before seen frauds, have to be developed and tested in the field. The Office of Risk Assessment needs to be continually thinking of how to create fraudulent products, how to cook the books more creatively, how to launder money more effectively, and then design effective counter-measures for the examination teams to use.

I also recommend that the SEC Chair require that the examination teams add at least one or more audit steps on top of whatever checklists they've been given using their own imagination and creativity. Those examination team-created audit steps that uncover fraud can then be adopted system-wide. This agency needs every employee making contributions in order to achieve greatness. I would expect the new Chair to demand contributions from all levels of the agency and to listen to all ideas from staff, no matter what their rank or pay grade.

To further increase the SEC's auditing effectiveness, I would organize a "Center for All Lessons Learned (CALL)" similar to what the US Army has been using with great effectiveness for decades. CALL will collect and sort through every fraud that the SEC finds. These frauds would be diagnosed for both common and unique elements so that the odds of future frauds going unchecked are further reduced. I recommend that the SEC adopt the Association of Certified Fraud Examiner's Fraud Tree contained in Volume I of the Certified Fraud Examiner's Manual for use because it lists hundreds of different financial frauds and categorizes them into easy to understand categories and sub-categories. In other words, the SEC needs to shed its "*keystone cops modus operandi*" and quickly turn itself into a "*<u>learning, winning organization</u>*" that instills confidence in all SEC employees, regulated firms and the investing public. CALL would be a password protected, on-line web based resource for all SEC employees to use and, more importantly, to contribute to themselves. The SEC needs to be able to learn at a faster pace than the bad guys they are fighting, and the only way to increase the SEC's decision-making quickly is to demand that all levels of the organization pitch in and contribute their lessons learned. The old top down, command from above approach doesn't work in the modern era and must be abandoned if the SEC is to achieve greatness. The SEC currently has a staff of 3,500 and every single one of those thirty-five hundred brains needs to be turned on and contributing.

Another Office needs to be formed within the SEC similar to the National Transportation Safety Board's accident investigation teams. I would call this the Office the "National Financial Safety Board." MIT Professor Andrew Lo has been advocating this low cost approach to sending in inspection teams after each financial institution blow up to diagnose exactly what went wrong and in what sequence that led these institutions to fail. Whenever a public company,

broker/dealer, hedge fund, or registered investment advisor blows up, lets send in an SEC investigation team to collect the valuable lessons learned and add them to the SEC's knowledge base. I recommend that this office's knowledge base be made publicly available on the SEC's website for companies, accountants, and investors to use in preventing whatever blowups can be prevented by avoiding the mistakes of companies that have failed. From the Madoff case alone we have plenty of useful lessons for the public – for example – never allocate more than 20% to any one investment manager, never put 100% of your eggs in one basket, make sure the investment manager uses an independent third party custodian, the proper allocation to hedge funds ranges from 0% - 25% of total assets, etc.

Currently the size and frequency of the blowups is increasing at an alarming rate and the SEC needs to act quickly to turn those numbers in the opposite direction because we can't continue in the direction we've been going for much longer. This National Financial Safety Board would not prevent all future blowups from happening, but if it made our nation's financial system safer and the blow-ups less frequent and of smaller size, then we will all benefit. It is clear that we can't afford 2009 to be worse than 2008 because we barely survived 2008's financial disasters. The time to act on this is now.

Finally, I would add one more Directorate, the Office of the Whistleblower, to centralize the handling and investigation of whistleblower tips. Currently, the SEC's eleven (11) Regional Offices handle whistleblower complaints on an individualized, ad hoc basis. Every whistleblower who comes in with a tip is handled differently and no one tracks the whistleblower with the particular complaint she has brought with the object of the complaint, a particular company or individual. One would think that if ABC Company has received five complaints this

year and its nearest competitors received no complaints this year, that this would be meaningful information and merit close scrutiny. Complaints from within industry or by investors have got to be the cheapest, most effective way to identify fraudsters, yet this valuable resource is currently ignored by the SEC. There can be no good reason for dismissing this valuable tool.

If my experience is any guide, the treatment accorded whistleblowers ranges from dismissive to outright unwelcome yet whistleblowers are the best, and cheapest source of great and not so great cases. The great cases cannot be culled from among the many cases submitted if SEC staff does not answer the phone or read its mail. Whistleblowers are the single largest source for fraud detection according to the Association of Certified Fraud Examiner's (ACFE) 2008 Report to the Nation (Chapter 3, page 22, www.acfe.com). According to the ACFE, whistleblower tips were responsible for detecting 54.1% of fraud schemes at public companies whereas external audits account for a meager 4.1% of fraud cases detected (note: the SEC would be considered an external auditor). Therefore whistleblowers are a full thirteen (13) times more effective than the SEC's external audits yet there is no Office of the Whistleblower. Who wouldn't want the SEC to become thirteen (13) times more effective?

The Internal Revenue Service (IRS) started its Office of the Whistleblower in December 2006 and in two short years has grown this office to a staff of 17. The IRS now receives the largest cases with the absolute best quality of evidence in its history. Consider the cost of 17 IRS employees versus the billions in additional tax revenues they'll be responsible for bringing into the US Treasury.

The IRS offers bounty payments to whistleblowers of 15% - 30% for cases that lead to successful recoveries to the US Treasury. These bounty payments do not come out of the IRS's

budget nor do the taxpayers pay these bounties. All bounty payments are made by the guilty defendants. Therefore this is a no cost program that funds itself and allows the IRS Staff to cherry pick from the cases that literally walk in the door, selecting the credible cases for immediate investigation.

I recommend that the SEC expand and reinvigorate its almost never used whistleblower bounty program. Section 21A(e) of the 1934 Act allows the SEC to pay a bounty of up to 30% to whistleblowers but only for insider-trading theory cases. The way this works is, the SEC can fine the guilty defendant triple the amount of its ill-gotten gains or losses avoided for insider trading and can award up to ten percent (10%) of the penalty amount to the whistleblower (triple damages x 10% maximum bounty award = 30% potential maximum reward).

Unfortunately, unlike the IRS's Whistleblower Program and the False Claims Act, the SEC's reward payments are not mandatory and the SEC can refuse to pay these rewards without explanation. If Congress would expand this program to include all forms of securities' violations and make the reward payments mandatory, hundreds of cases would likely walk in the door each year, and many of these would be high quality cases that would lead to billions in investor recoveries similar to the billions that the False Claims Act (31 USC Sections 3729-3733) already provides each year.

We have two major government agencies, the Department of Justice and the Internal Revenue Service, that use whistleblower programs to identify cases that they would otherwise know nothing about. Todate false claims act recoveries total over $22 Billion since 1986. For every $1 spent in enforcement, the False Claims Act returns $15 in recoveries from fraudsters. This proves that such a program works and is not a speculative enterprise on the part of the

government. . We need the SEC to become as effective as the Department of Justice and the Internal Revenue Service at fraud enforcement.

I recommend that each tip, upon receipt, be logged in, given a case number, and for credible tips with real evidence behind them, the whistleblower and whistleblower's counsel be put in contact with the relevant SEC operating unit that is best able to investigate the complaint. Hopefully this will prevent a repeat of my experiences during the Madoff Case, where over the years I kept submitting better and more detailed case filings but ran into trouble because Boston's SEC Regional Office believed me but New York's SEC Regional Office apparently did not. Standardizing the treatment of whistleblowers to ensure that they are not ignored or mistreated should be a priority for the SEC. An annual reporting to Congress of whistleblower complaints and the SEC's follow-up actions should be mandatory.

Let me add one more important point concerning the issue of self-regulation and whistleblowing: consider that perhaps hundreds of finance professionals around the globe knew that Madoff was a fraudster or at least suspected that he was. How many of these people contacted the SEC with their suspicions? Unfortunately, I may have been the only one. If a whistleblower wanted to, how would they know who to contact at the SEC since there is no "Office of the Whistleblower?" I believe that by adding such an office, we would see honest firms sending in evidence against their crooked competitors. Getting rid of the shysters is in everyone's best interest and restoring trust in the US capital markets is imperative if we are to restore our nation's economy to health. If I'm the CEO of an honest firm and I hire new employees who worked across the street at a competitor and then find out from these new

employees that my competitor is dishonest, it would be in my economic self-interest and in the interest of good public policy to turn them into the SEC.

If self-regulation is ever going to work, we need to find ways to advertise it, reward it, and measure it. Currently, the SEC is doing none of the above. Every tool, every resource, and every person has to be brought to bear in the fight against white-collar crime. Government has coddled, accepted, and ignored white-collar crime for too long. It is time the nation woke up and recognized that it's not the armed robbers or drug dealers who cause us the most economic harm, it's the white-collar criminals living in the most expensive homes and who have the most impressive resumes who harm us the most. They steal our pensions, bankrupt our companies, and destroy thousands of jobs, ruining countless lives. No agency is better situated than the SEC to attack high-level white-collar crime. Therefore, the SEC is too important to allow too continue to fail.

Thank you for the opportunity to present my recommendations on how to rebuild the SEC into the world's best securities regulator, it has been a singular honor for me to appear before you today.