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THE SEC: AN AGENCY REVIEWED

In this issue ... at the center of the American investment world stands the Securities and Exchange Commission (SEC).

Founded in 1934 in the aftermath of the Great Depression and as a response to the legendary [Pecora hearings](#), the SEC has developed into a vast federal agency whose reach extends to all areas of the securities industry, responsible for maintaining fair, orderly and efficient securities markets and whose self-stated mandate is to be the investors' advocate. For those in the public company D&O insurance market, the SEC's impact is pervasive.

Notwithstanding the many important activities the SEC executes with efficiency and accuracy, and fairly or not, such institutions are often viewed through their shortcomings rather than their successes. This newsletter will review some of the SEC's shortcomings and successes.

THE MADOFF SCANDAL

The SEC's handling of the Bernard Madoff financial scandal came under criticism externally and internally. Madoff — who confessed his guilt — had concocted a vast Ponzi scheme that defrauded thousands of investors who believed their solid returns were the results of Madoff's smart investing, though they were actually fictitious. Any real profits were largely derived, in classic Ponzi fashion, from funds provided by new investors rather than from market gains. The sheer size of the aggregate losses — generally estimated at over \$55 billion — helped make Madoff a household name.

The SEC's official "Investigation of the Failure of the SEC to Uncover Bernard Madoff's Ponzi Scheme" is a measured, [477-page account](#) of a breakdown in the SEC system. Identifying six separate "substantive" complaints between 1992 and December 2008 that should have led to questions about Madoff's activities (page 21), the Executive Summary concludes, "despite numerous credible and detailed complaints, the SEC never properly examined or investigated Madoff's trading and never took the necessary, but basic, steps to determine if Madoff had been operating a Ponzi scheme."

Madoff Postscript

On September 16, the SEC Inspector General released [a report](#) on the conduct of former SEC General Counsel David Becker concerning his participation for the SEC in the Madoff affair. The report describes how Mr. Becker, while performing a central role in the SEC Madoff liquidation, had a significant personal interest by virtue of his inheriting a Madoff account in his mother's estate: "The matters on which he advised could have directly impacted his financial position."

The House Financial Services Committee held a Congressional hearing on September 22, where SEC Chairperson [Mary Schapiro regretted](#) her apparent failure to properly address the matter. "I can say to you with assuredness that we have learned from this experience and are taking, and will continue to take, all actions necessary to earn and maintain the trust the public places in us."

In his testimony, Mr. Becker [described his actions](#) as proper. "I did precisely what I was supposed to do. I identified a matter that required legal advice from the SEC's ethics office. I sought that advice, received it, and followed it. The [Office of Inspector General] report contains no finding to the contrary."

SWITCHING SIDES

The question of where former SEC employees go when they leave and what systems are in place to minimize conflicts has been an on-going issue; it was significant enough for the federal Government Accountability Office (GAO) to prepare [a report](#) on the topic. While noting that the SEC has in place a number of controls to address potential post-employment conflicts, the report said that the SEC could do better, especially with documentation of ethics advice.

An example of this problem can be found in the SEC's handling of the Robert Allen Stanford case, another alleged Ponzi scheme. The [SEC Inspector General report](#) following his investigation of the Stanford case contains this comment:

... The [Office of the Inspector General] investigation also found that the former [SEC] head of Enforcement in Fort Worth, who played a significant role in multiple decisions over the years to quash investigations of Stanford, sought to represent Stanford on three separate occasions after he left the Commission, and in fact represented Stanford briefly in 2006 before he was informed by the SEC ethics office that it was improper to do so. (page 17)

RECORDS DESTRUCTION

The SEC, charged by the Dodd-Frank Wall Street Reform and Consumer Protection Act with implementing its whistleblowing provisions, was itself the target of whistleblowing in August 2011 by an employee in the enforcement division. The allegation states that over the past 20 years, the SEC has illegally destroyed files and documents covering thousands of early-stage SEC investigations.

Since the whistleblowing complaint was made, the SEC [has suspended](#) destruction of enforcement records, and the matter is now being investigated by the Inspector General's office.

SEC SUCCESS STORIES

High-profile cases like Madoff should not overshadow the SEC's diligent efforts to police the securities industry and pursue transgressors. In its 2010 fiscal year, the agency brought [53 insider-trading cases](#) against 138 individuals and entities, a 43-percent increase from the prior period, and these efforts continue in 2011.

SEC actions [arising from the "financial crisis"](#) include a record \$550 million settlement from a Wall Street bank; through September 15, 2011 the number of entities and individuals charged by the SEC stood at 72, with more than \$1.6 billion in penalties, disgorgement and other monetary relief.

Mostly away from the public gaze, the SEC carries on a dogged pursuit of alleged wrongdoers, big and small. In the third quarter of 2011, [informational releases](#) from the SEC describing new civil lawsuits or resolutions of earlier ones appeared at the rate of more than one every business day, while notices relating to [administrative proceedings](#) appeared with even greater frequency. For its 2010 fiscal year (September 2009 - 2010), the SEC [lists](#) having initiated 252 civil actions and 429 administrative proceedings for a total of 681 enforcement actions.

The final numbers for fiscal year 2011 will likely be released early in 2012. SEC actions directly impact public companies, their directors and D&O insurers; among D&O market participants there is an anecdotal sense of SEC activity being stepped up, and it will be interesting to see if this is borne out by the data.

SUMMARY

Nearly 4,000 employees at the SEC contribute to the valuable work performed by the agency on behalf of the investing public. The SEC staff is almost certainly overworked: the Dodd-Frank Act burdened the agency with producing more than 100 new rules, creating five new offices and compiling more than 20 studies and reports.

By its own admission the SEC is "first and foremost ... a law enforcement agency" and some infamous examples of dropping the ball have created an overall perception that might not be completely fair. The

employment destinations of departing SEC staff will always be an issue, but the SEC appears willing to work on it. With Congress continually breathing down its neck, the external General Accountability Office standing ready to provide external evaluations and its own Office of the Inspector General providing dispassionate internal review, the SEC conducts its business under a level of scrutiny that should help ensure its future effectiveness. ❖

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