

## **Commentary: Money Isn't the Answer to Better Regulation**

**By Stephen J Nelson; The Nelson Law Firm, LLC**

**Originally Published in *Traders Magazine* on March 30, 2009**

<http://www.tradersmagazine.com/news/-103574-1.html>

In recent testimony before the Congressional Subcommittee on Financial Services and General Government, a subcommittee of the Appropriations Committee, SEC Chairperson Mary Schapiro described how the agency is making an efficient use of taxpayer resources.

Ms. Schapiro has terminated the two-year “penalty pilot” program, which required enforcement staff to jump through numerous procedural hoops and hurdles before seeking penalties in civil cases. She has streamlined the process for approving orders of investigation, which means that SEC staff can issue subpoenas without obtaining multiple levels of approval. She hired a new Director of Enforcement, and among other things, is working with him to improve the Staff’s use of technology. The SEC is modernizing its response to tips and complaints from the public. The Office of Compliance Inspections and Examination (OCIE) is trying to hire people with industry experience to improve the effectiveness of the SEC audit regime.

Ms. Schapiro’s testimony was echoed by Commissioner Walter, who appeared before Chairman Barney Frank and his Congressional Committee on Financial Services a few days later, and by Commissioner Troy Paredes at the recent Southeastern Securities Conference. Ms. Walter reviewed the SEC’s recent enforcement successes, pointing out that securities miscreants were required to disgorge illegal profits of \$774 million and pay penalties of \$256 million in 2008. A recent refugee from the private practice of law, Mr. Paredes discussed the need for careful case selection – strategic tradeoffs – necessary for the SEC’s enforcement resources to achieve their maximum effect.

Of course, the SEC’s enforcement agenda, not to mention all of the improvements described by Chairperson Schapiro, requires money, a motion seconded by Commissioners Walter and Paredes. But, will throwing more money at the SEC achieve the agency’s Congressionally-mandated purpose?

Let me be clear about my views at the outset. The SEC should receive more money. Chairperson Schapiro appeared before the Appropriations Committee to beg for a 9% increase in the SEC’s budget, which would bring its annual budget to slightly more than \$1 billion. The Madoff fraud alone cost investors somewhere around \$50 billion. If the SEC had been successful in stopping this fraud at its

inception, the cost savings to the investing public would have funded the SEC for 50 years. The other benefits wrought by aggressive SEC enforcement would be icing on the cake.

The question is whether more money would enable the SEC to stop another fraud like Madoff in its tracks. I think it would help, but not be sufficient. To make the SEC effective, changes are required in the regulatory structure. A little publicized episode in the Madoff case illustrates the need for change.

In 1992, the SEC was investigating an accountant who appeared to be unlawfully engaging in the broker-dealer business without registration. It turned out that the accountant was taking his client's money and placing it in a Madoff discretionary account. The SEC's enforcement staff confirmed that Madoff had custody of the client funds. With that, the investigation as far as Madoff was concerned was over. The SEC continued its investigation of the accountant.

As we now all know, these discretionary accounts were in fact part of the infamous Ponzi scheme. So, why didn't the SEC pursue this further with Madoff?

The SEC enforcement staff was unaware that Madoff lacked authority to establish discretionary accounts. The reason for this knowledge gap was that authority to engage in certain lines of business by a broker-dealer is granted by FINRA. A quick call to FINRA would have established that Madoff was engaging in an unauthorized line of business and that sort of information puts the gears in motion at FINRA.

Every broker-dealer compliance officer knows that the first question in every FINRA exam requires the broker-dealer to identify its lines of business. A broker-dealer is not permitted to commence a line of business without first obtaining FINRA's approval. A broker-dealer that has a discretionary account business is required in a FINRA examination to demonstrate its compliance with the customer protection rules, trot out discretionary account letters, confirm the location of customer assets, and a whole host of other procedures.

Madoff was a clever guy. Maybe he would have dummied enough stuff up to fool the FINRA examiners when they asked about his discretionary account business. But, it would have greatly increased the burden of secrecy and required him to produce truckloads of bogus documents for successive FINRA audits. The likelihood of discovery would have increased enormously.

Sadly, the SEC's enforcement staff didn't know that specific authority was required for a broker-dealer to engage in certain lines of business. Frankly, most securities lawyers are transactional lawyers who wouldn't know that either. My guess is that very few members of the SEC's staff outside of the SEC's Division of Trading and

Markets know about the rules governing lines of business. But, it is a first principle for professionals working in broker-dealer compliance.

Chairperson Schapiro calls this sort of thing “stovepipe” regulation. Financial Services industry regulation is bifurcated into various agencies and divisions within agencies. Investigations by one division are conducted in a vacuum or a stovepipe, as if other divisions didn’t exist. As a result, the knowledge of one division doesn’t inform the work of another, leading to ineffective regulation. Interagency communication is even less robust.

Making the SEC more effective will therefore require more than money. It will require changing the way regulatory agencies are organized so that information no longer is restrained in stovepipes.

Suppose, for example, that when the SEC enforcement staff confirmed Madoff’s discretionary accounts in 1992, they were also required to drop a note in Madoff’s broker-dealer file that became instantly available to FINRA’s examiners. The next FINRA exam probably would have resulted in Madoff heading off to jail 17 years earlier. In any event, the heat would have been on much earlier in the process.

None of this is especially challenging with modern technology. Off-the-shelf relational database programs are available at modest prices that would do this simple job at ridiculously low cost. More sophisticated programs are widely used by most of the larger firms the SEC regulates to aggregate information from a huge number of sources, also at reasonable cost.

So, it is not the cost, but the way agencies are organized, that stands in the way of more effective regulation.

\* \* \* \* \*