CHAPTER 1

Jurisdiction of Regulators – Who Regulates Whom and What

Compliance professionals face a myriad of overlapping and confusing regulations and regulators. In the aftermath of the financial crisis, new regulations and increased aggressiveness on the part of regulators have led to growing demands placed on financial firms. The volume and pace of regulatory change has created new and diverse pressures on compliance functions. A primary reason for the overlapping nature of the regulations is that traditionally, financial regulation has evolved through a series of responses to developments and crises in the financial markets. The Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank" Act), enacted on July 21, 2010, offered some of the most sweeping and comprehensive changes to the financial industry since the Great Depression. The chief impetus for the enactment of the Dodd-Frank Act was the perception that deregulation allowed and encouraged Wall Street to indulge in excesses, resulting in the financial crisis.

Over the years, the financial regulatory system has been modified to address various sources of potential financial instability and attempt to provide regulation and a structure for areas with purported regulatory gaps. With each new crisis, efforts are made to address perceived weaknesses in the regulatory system. The result is a complex regulatory system in which federal Agencies have overlapping jurisdictions. Furthermore, Congress has adopted self-regulation by self-regulatory organizations ("SROs") to prevent excessive

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government involvement in market operations, and as a more efficient and less expensive way to conduct oversight. However, SRO oversight is, often, in addition to, not instead of, federal regulatory oversight. These structures have resulted in tremendous confusion on the part of compliance professionals whose responsibility it is to make decisions regarding the allocation of often scarce resources to compliance efforts necessitated by the overlapping regulatory schemes.

1.1 FEDERAL FINANCIAL REGULATORY STRUCTURE

The following describes the current federal financial regulatory structure, including the Agencies and the financial institutions they regulate. Federal Agencies regulate banking institutions, securities and futures exchanges, brokers, dealers, mutual funds, and investment advisers. Banking institutions are regulated by several Agencies, led by the Federal Reserve System (commonly referred to as "the Federal Reserve"), which regulates Federal Reserve Bank holding companies, financial holding companies, state banks that are members of the Federal Reserve System, U.S. branches of foreign banks, and foreign branches of U.S. banks.[1] The Office of the Comptroller of the Currency ("OCC") regulates national banks and U.S. federal branches of foreign banks. The Federal Deposit Insurance Corporation ("FDIC") regulates federally-insured depository institutions, including state banks that are not members of the Federal Reserve System.[2] The Office of Thrift Supervision ("OTS") regulates federally chartered and insured thrift institutions and savings and loan holding companies.[3] The National Credit Union Administration ("NCUA") regulates federally-chartered or insured credit unions.[4]

[1]For further background on the Federal Reserve System, see the website at www.federalreserve.gov/.
[2]For further background on the FDIC, see the website at www.fdic.gov/.
[3]For further background on the OTS, see the website at www.ots.treas.gov/.
[4]For further background on the NCUA, see the website at http://www.ncua.gov/Pages/default.aspx.

Beyond the banking regulators, the Securities and Exchange Commission ("SEC") regulates securities exchanges and brokers.[5] Lastly, the Commodity Futures Trading Commission ("CFTC") regulates futures exchanges and brokers.[6]

1.2 THE SECURITIES AND EXCHANGE COMMISSION (SEC)

Congress established the SEC in 1934 to enforce the Securities Act of 1933 and the Securities Exchange Act of 1934 (the "Exchange Act").[7] The mission of the SEC is to protect investors; maintain fair, orderly, and efficient markets; and facilitate capital formation.[8] The SEC oversees the key components of the securities world, including securities exchanges, securities brokers and dealers, investment advisers, and mutual funds. The SEC's primary focus is to promote the disclosure of market-related information, maintain fair dealing, and protect against fraud.[9]

Although the SEC is the principal overseer and regulator of the U.S. securities markets, it works closely with the other federal departments and Agencies, self-regulatory organizations, state securities regulators, and various private sector organizations. For example, the Chairman of the SEC works with the Chairman of the Federal Reserve, the Secretary of the Treasury, and the Chairman of the CFTC, and serves as a member of the President's Working Group on Financial Markets.

The SEC is composed of five presidentially-appointed Commissioners, who have staggered five-year terms. By law, no more than three of the Commissioners may belong to the same political party. The Agency's functional responsibilities are organized

[5] For further background on the SEC, see the website at www.sec.gov/.
[6] For further background on the CFTC, see the website at http://www.cftc.gov/index.htm.
[7] See Securities Act of 1933 codified at 15 U.S.C. section 77a *et seq.;* Securities Exchange Act of 1934 codified at 15 U.S.C. section 78a *et seq.*
[8] See http://www.sec.gov/about/whatwedo.shtml#.VNOU29hOW70.
[9] See http://www.sec.gov/about/whatwedo.shtml#.VMaC8dhOW70.

into five divisions (Corporation Finance, Trading and Markets, Investment Management, Enforcement, and Economic and Risk Analysis) and 23 offices, headquartered in Washington, D.C.[10]

The SEC's Division of Corporation Finance oversees corporate disclosure of information to the investing public. Corporations are required to comply with regulations pertaining to disclosure that must be made when stock is initially sold and then on a continuing and periodic basis. Corporation Finance (known as "CorpFin") reviews the disclosure documents filed by companies. CorpFin also provides companies with assistance interpreting the Commission's regulations and recommends to the Commission new rules for adoption.[11]

The SEC's Division of Trading and Markets is responsible for maintaining fair, orderly, and efficient markets. Trading and Markets provides day-to-day oversight of the major securities market participants: the securities exchanges; securities firms; self-regulatory organizations; clearing Agencies that help facilitate trade settlement; transfer agents, parties that maintain records of securities owners; securities information processors; and credit rating Agencies. This Division also oversees the Securities Investor Protection Corporation ("SIPC"), which is a private, non-profit corporation that insures the securities and cash in customer accounts of member brokerage firms against the failure of those firms.[12]

The SEC's Division of Investment Management is involved in investor protection and promoting capital formation through oversight and regulation of America's $26 trillion investment management industry. This industry includes mutual funds and the professional fund managers who advise them; analysts who research individual assets and asset classes; and investment advisers to individual customers. Investment Management focuses on ensuring that disclosures about these investments are useful to retail customers,

[10]See ibid.
[11]For further background on CorpFin, see the website at http://www.sec.gov/corpfin.
[12]For further background on Trading and Markets, see the website at http://www.sec.gov/tm#.VMaDa9hOW70.

and that the regulatory costs which consumers must bear are not excessive.[13]

The Division of Enforcement is the law enforcement component of the SEC. It recommends the commencement of investigations of securities law violations, whether as civil actions in federal court or as administrative proceedings before an administrative law judge, and prosecutes these cases on behalf of the Commission. Enforcement also works closely with law enforcement Agencies such as the Department of Justice to bring criminal cases. Enforcement obtains evidence of possible violations of the securities laws from many sources, including market surveillance activities, investor tips and complaints, other divisions and offices of the SEC, and the self-regulatory organizations and other securities industry sources.[14]

The SEC's Division of Economic and Risk Analysis (known as "RiskFin") is involved with integrating economic analysis and data analytics into the work of the SEC. RiskFin helps to inform the SEC's policymaking, rulemaking, enforcement and examinations.[15]

The offices within the SEC include, among others, the Office of the General Counsel, Office of the Chief Accountant, Office of Credit Ratings, Office of International Affairs, Office of Investor Education and Advocacy, and Office of Compliance Inspections and Examinations ("OCIE"). OCIE administers the SEC's examination and inspection program for registered broker-dealers, transfer agents, clearing Agencies, investment companies, and investment advisers. OCIE conducts inspections to foster compliance of the securities laws and to detect violations of the law. When OCIE finds deficiencies, it issues a "deficiency letter" identifying the problems that need to be rectified and monitors the situation until compliance standards are achieved. Violations that are considered serious are referred to the Division of Enforcement. OCIE also examines SROs including national stock exchanges (such as the New York Stock Exchange,

[13]For further background on Investment Management, see the website at http://www.sec.gov/investment.

[14]For further background on Enforcement, see the website at http://www.sec.gov/enforce#.VMaDvdhOW70.

[15]For further background on RiskFin, see the website at http://www.sec.gov/about/whatwedo.shtml#.VMaDy9hOW73.

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NASDAQ, and Chicago Options Board Exchange), registered clearing Agencies, the Municipal Securities Rulemaking Board and the Financial Industry Regulatory Authority ("FINRA").[16]

OCIE oversees FINRA and the other SROs to ensure that they and their members comply with applicable federal securities laws and SRO rules. Consistent with its oversight responsibilities for other SROs, the SEC is responsible for ensuring that FINRA carries out its regulatory responsibilities related to oversight of broker-dealers. The SEC also oversees the adoption of rules and the administration of discipline by SROs such as FINRA. These requirements include that an SRO file a proposed rule change with SEC and publish it on a publicly available website. The SEC then sends a notice of the proposed rule change to the Federal Register and allows interested persons the opportunity to submit written comments concerning the proposed rule change. Concurrently, the SEC reviews the proposed rule change and, if applicable, considers public comments and the SRO's response. The SEC then determines whether the proposed rule change is consistent with the requirements of the applicable statutes and regulations and if appropriate, approves the rule change.

As regulators, SROs, like FINRA, have responsibility for much of the day-to-day oversight of the securities markets and broker-dealers under their jurisdiction. Specifically, SROs are primarily responsible for establishing the standards under which their members conduct business; monitoring the way that business is conducted; and bringing disciplinary actions against their members for violating applicable federal statutes, SEC rules, and their own rules.

1.3 THE FINANCIAL INDUSTRY REGULATORY AUTHORITY (FINRA)

FINRA is the only registered national securities association and has regulatory oversight of all securities broker-dealers doing business with the public in the United States. FINRA's mission is to safeguard the investing public against fraud and bad practices. All brokers must

[16]For further background on OCIE, see the website at http://www.sec.gov/ocie#.VMaEBdhOW70.

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be licensed and registered by FINRA, pass qualification exams, and satisfy continuing education requirements. FINRA conducts routine examinations, as well as inquiries based on investor complaints and suspicious activity. It also reviews all broker advertisements, websites, sales brochures, and other communications to make sure brokers present information in a fair and balanced manner. FINRA also monitors trading in the U.S. stock markets.[17]

FINRA has an enforcement program that brings discipline where it believes that investors have been harmed. FINRA investigations are non-public and confidential, and firms and individuals are entitled to be represented by counsel. To conduct its investigations, FINRA requests documents and takes sworn testimony from firms and associated persons. FINRA may also contact customers and other individuals who are not within FINRA's jurisdiction to learn about the member firms' activities and who may provide information voluntarily to FINRA. FINRA then analyzes the evidence it obtained, reviews the applicable law, and makes a preliminary determination of whether or not a violation appears to have occurred. If FINRA determines that rules have been violated, it will resolve whether the conduct merits a recommendation of formal disciplinary action. If the violation is of a minor nature where there is an absence of customer harm or detrimental market impact, the matter may be settled with an informal disciplinary action. Otherwise, FINRA will proceed through a more formal route by commencing a full-blown Enforcement proceeding. In 2014, FINRA brought 1,397 disciplinary actions against registered individuals and firms, levied fines totaling more than $134 million, and ordered restitution of more than $32.3 million to harmed investors.[18]

FINRA also provides investor education through the implementation of programs like BrokerCheck, which gives investors a quick way to check a broker's disciplinary and professional background. In FINRA's Market Data Center, investors can find information and data on equities, options, bonds, and mutual funds.[19] FINRA's

[17]For further background on FINRA, see the website at www.finra.org/.

[18]See http://www.finra.org/AboutFINRA/WhatWeDo/.

[19]For further information on FINRA's Market Data Center, see http://finra-markets.morningstar.com/MarketData/Default.jsp.

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Trade Reporting and Compliance Engine ("TRACE") system helps investors monitor their bond investments by providing them with timely and accurate pricing information for corporate and Agency bonds.[20] FINRA also has a dispute resolution forum, which is the largest in the country for the securities industry, handling nearly 100 percent of securities-related arbitrations and mediations from more than 70 hearing locations – including at least one in all 50 states, London, and Puerto Rico.[21]

1.4 THE COMMODITY FUTURES TRADING COMMISSION (CFTC)

The SEC's counterpart for futures exchanges and brokers is the CFTC. The CFTC is an independent Agency of the United States government that regulates futures and options markets. The stated mission of the CFTC is "to protect market participants and the public from fraud, manipulation, abusive practices, and systemic risk related to derivatives – both futures and swaps – and to foster transparent, open, competitive and financially sound markets."[22] The CFTC states that it carries out this mission by "polic[ing] the derivatives markets for various abuses and works to ensure the protection of customer funds."[23]

In carrying out this mission, the CFTC polices the derivatives markets for various abuses and works to ensure the protection of customer funds. The CFTC also oversees designated contract markets, swap execution facilities, derivatives clearing organizations, swap data repositories, swap dealers, futures commission merchants, commodity pool operators, and other intermediaries.

The CFTC is composed of three major divisions: Market Oversight, Clearing and Intermediary Oversight, and Enforcement. The

[20]For further information on FINRA's TRACE system, see http://www.finra.org/Industry/Compliance/MarketTransparency/TRACE/.
[21]For further information on FINRA's Dispute Resolution programs, see http://www.finra.org/ArbitrationAndMediation/FINRADisputeResolution/.
[22]See http://www.cftc.gov/About/MissionResponsibilities/index.htm.
[23]See ibid.

CFTC's Division of Market Oversight ensures that the futures markets are operating efficiently without manipulation and fraud. These tasks are executed first by reviewing and analyzing the very diverse group of instruments and products to ensure that they are not susceptible to manipulation. Market Oversight also conducts active market and trade practice surveillance of trading activity on designated contract markets (known as "DCMs"), like the New York Mercantile Exchange. Traders establishing positions on DCMs are subject to reporting requirements so the CFTC can evaluate position sizes to detect and deter manipulation. Market Oversight monitors the activities of large traders, key price relationships, and relevant supply and demand factors for the estimated 1,400 active futures and option contracts in the country to ensure market integrity. In addition, CFTC surveillance economists prepare weekly summary reports for futures and option contracts approaching their expiration periods.

The CFTC's Division of Clearing and Intermediary Oversight ensures the financial integrity of transactions on the markets regulated by the CFTC. This division attempts to establish that the intermediaries managing these funds are properly registered, perform appropriate recordkeeping, have adequate capital, employ fair sales practices, and protect the funds their customers invest. Intermediaries overseen by the CFTC include futures commission merchants ("FCMS"), including banks and broker-dealers with specialized futures operations, as well as stand-alone futures trading houses.[24]

The CFTC's Division of Enforcement investigates and prosecutes violations of the federal laws governing commodity trading by individuals and firms who are engaged in activities that directly or indirectly affect commodity futures and option trading on domestic exchanges. These federal laws prohibit fraud and abusive practices in solicitations of futures or options, such as falsely guaranteeing profits, minimizing risk, and misrepresenting performance history. In addition, the CFTC is authorized to bring enforcement actions

[24]For further background on the CFTC's Division of Clearing and Intermediary Oversight, see http://www.cftc.gov/About/CFTCOrganization/index.htm.

for misappropriating customer funds, and often refers matters to criminal authorities.[25]

The CFTC administers the Commodity Exchange Act ("CEA"), 7 U.S.C. section 1 *et seq*., which prohibits fraudulent conduct in the trading of futures contracts. The CEA also establishes a comprehensive regulatory structure to oversee the volatile futures trading markets. The CEA requires all FCMs to register with the CFTC, unless they qualify for a particular exemption.[26] CFTC regulations promulgated pursuant to the CEA also require all registered FCMs to be a member of a Futures Association.[27]

1.5 THE NATIONAL FUTURES ASSOCIATION (NFA)

The National Futures Association ("NFA") is the industry-wide, self-regulatory organization for the U.S. futures industry and the "designated" regulatory organization for non-clearing FCMs.[28] The NFA screens all firms and individuals wishing to register with the CFTC and become members of the NFA. Applicants must meet fitness requirements to determine if they have ever been disciplined or subject to regulatory proceedings in the past, and must provide fingerprint cards for Federal Bureau of Investigation ("FBI") background checks. In addition, individual registrants must pass proficiency testing requirements. The NFA has the authority to deny, revoke, suspend, restrict, or condition the registration of any firm or individual.

The NFA has adopted a comprehensive set of rules covering the business conduct of its members, including sales practices, recordkeeping, reporting, risk disclosure, discretionary trading, disclosure of fees, and minimum capital requirements.

Pursuant to its examination or audit program, the NFA is required to examine FCMs on an annual basis if they hold customer funds.[29]

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[25] For further background on the CFTC's Division of Enforcement, see http://www.cftc.gov/LawRegulation/Enforcement/index.htm.
[26] See 7 U.S.C. section 6d(a).
[27] See CFTC Regulation 170.15.
[28] For further background on FINRA, see www.nfa.futures.org/.
[29] See http://www.nfa.futures.org/NFA-faqs/compliance-faqs/examinations/index.HTML.

As part of these examinations or audits, the NFA examination may include all the FCM's procedures, books, and records associated with its commodities business, including, but not limited to:[30]

- Corporate records.
- Anti-money laundering policies and practices.
- Sales practices.
- Supervisory procedures.
- Account opening documents.
- Order tickets.
- Bunched order allocations.
- Margin policies.
- Promotional material.
- Disclosure documents.
- Performance capsule support.
- Bank records.
- Trading records.
- Financial statement records.

In addition, the NFA has the authority to take disciplinary actions against any firm or individual that violates its rules. These actions range from Warning Letters for minor rule infractions to formal complaints in cases where rule violations warrant prosecution. Penalties resulting from complaints include expulsion, suspension for a fixed period, prohibition from future association with any NFA Member, censure, reprimand, and a fine of up to $250,000 per violation. The NFA often collaborates with the CFTC, and other law enforcement Agencies to ensure full, comprehensive prosecutions.[31]

The NFA has also worked closely with the CFTC and other SROs to adopt a number of initiatives to further safeguard customer funds. The NFA, in conjunction with other SROs, developed and implemented a system in 2013 that requires all depositories holding customer segregated funds on behalf of an FCM

[30] See ibid.

[31] See http://www.nfa.futures.org/NFA-about-nfa/who-we-are/how-NFA-fights-fraud-and-abuse.HTML.

to directly report balances daily to SROs. The SROs then perform an automated comparison to the daily reports filed by the FCMs to identify any suspicious discrepancies. In addition, each FCM is required to provide regulators with immediate notification if it draws down its excess segregated funds (funds deposited by the firm into customer segregated accounts to guard against customer defaults) by 25 percent in any given day. Such withdrawals must be approved by the Chief Executive Officer ("CEO"), Chief Financial Officer ("CFO") or a financial principal of the firm, and the principal must certify that the firm remains in compliance with segregation requirements.[32]

All FCMs also must regularly file certain financial information about the firm with the NFA. This information is posted on the NFA's website. The information includes each FCM's capital requirement, excess capital, segregated funds requirement, excess segregated funds, and how the firm invests customer segregated funds.[33]

The NFA also began an arbitration program in 1983, providing a method for investors to resolve futures-related disputes. Since that time, NFA arbitration has become the primary venue for dispute resolution for retail futures and foreign exchange ("forex") customers. The NFA also offers a mediation alternative during the arbitration process in cases where the total amount of the arbitration claim is $150,000 or less.[34]

1.6 THE DEPARTMENT OF JUSTICE (DOJ)

As noted above, these regulatory entities coordinate as appropriate with the Department of Justice ("DOJ"). The DOJ is a federal

[32]See http://www.nfa.futures.org/NFA-about-nfa/who-we-are/customer-protection-initiatives.HTML.
[33]See ibid.
[34]Mediation is a settlement process in which the parties work together with a mediator to find a mutually agreeable solution. For further information on the NFA's arbitration programs, see http://www.nfa.futures.org/%5C/NFA-about-nfa/who-we-are/dispute-resolution.HTML.

department designed to enforce the law and defend the interests of the United States.[35] The mission of the DOJ is to:

> *enforce the law and defend the interests of the United States according to the law; to ensure public safety against threats foreign and domestic; to provide federal leadership in preventing and controlling crime; to seek just punishment for those guilty of unlawful behavior; and to ensure fair and impartial administration of justice for all Americans.*[36]

Offices and groups within the U.S. Department of Justice include the Federal Bureau of Investigation, the Drug Enforcement Administration, the Bureau of Prisons, the U.S. Federal Marshals, and the U.S. Parole Commission. The SEC and CFTC coordinate with the DOJ on enforcement cases, as they often initiate civil proceedings against the same actors or involving similar facts to criminal proceedings brought by the DOJ.

In addition, the DOJ and SEC share enforcement authority for the anti-bribery and accounting provisions of the Federal Corrupt Practices Act ("FCPA"). The DOJ has criminal FCPA enforcement authority over "issuers" (i.e., public companies) and their officers, directors, employees, agents, or stockholders acting on the issuer's behalf. The DOJ also has both criminal and civil enforcement responsibility for the FCPA's anti-bribery provisions over "domestic concerns" – including (a) U.S. citizens, nationals, and residents, and (b) U.S. businesses and their officers, directors, employees, agents, or stockholders acting on the domestic concern's behalf – and certain foreign persons and businesses that act in furtherance of an FCPA violation while in the territory of the United States. The SEC is responsible for civil enforcement of the FCPA over issuers and their officers, directors, employees, agents, or stockholders acting on the issuer's behalf.[37] The SEC, CFTC, FINRA, and NFA all refer potential criminal matters to the DOJ for prosecution.

[35] For further background on the DOJ, see the website at www.justice.gov/.
[36] http://www.justice.gov/about/.
[37] See http://www.justice.gov/criminal/fraud/fcpa/guidance/guide.pdf.

1.7 RECENT REGULATORY FAILURES TO UNCOVER FRAUD

Notwithstanding the resources and efforts made by the federal Agencies and SROs to protect investors from fraud in the securities and futures markets, these Agencies and SROs have failed over the past few years to uncover several large frauds that have caused extraordinary harm to thousands of investors. In my role as Inspector General of the SEC for over four years from late 2007 until early 2012, I investigated several of these failures.

In December 2008, I conducted an investigation of how the SEC failed to uncover Bernie Madoff's $50 billion Ponzi scheme. When I began the investigation, I knew the SEC had been provided with several complaints and tips about Madoff's extraordinarily consistent returns and accusations that he may have been perpetrating a fraud. As a result, I thought, like many others, that these complaints had likely fallen through the cracks. I knew that government Agencies receive thousands of complaints every year and I began to sympathize with the possibility that SEC officials simply missed the import of these complaints. But in my investigation, I learned that the SEC had, in fact, conducted examinations and investigations of many of the tips and complaints they received; they simply failed to conduct competent exams or investigations. My investigation found that between June 1992 and December 2008, the SEC received six substantive complaints that raised significant red flags concerning Madoff's hedge fund operations and should have led to questions about whether Madoff was actually engaged in trading. In addition, the SEC conducted two investigations and three examinations related to Madoff's investment advisory business based upon the detailed and credible complaints that they received.[38]

The SEC failed to uncover Madoff's Ponzi scheme for several reasons, including a lack of experience and expertise on the part of the SEC investigators and examiners; Madoff's personal reputation

[38]See *Investigation of the SEC to Uncover Bernard Madoff's Ponzi Scheme*, SEC Office of Inspector General, Report No. OIG-509, August 31, 2009 at http://www.sec.gov/news/studies/2009/oig-509.pdf.

and ability to impress and manipulate the SEC investigators and examiners; and a lack of follow-up on the part of SEC investigators and examiners who, in many cases, began taking the correct (and relatively easy) steps to uncover the fraud, but failed to follow through.

Not long after issuing the Madoff report, I investigated another fraud, perpetrated by a Texan named Allen Stanford, which the SEC eventually uncovered after Madoff confessed in 2009, but which the SEC knew about for many years and took very limited action on, notwithstanding such awareness of Stanford's questionable investments. Stanford had been registered as both an investment adviser and broker-dealer in Texas and was affiliated with an offshore investment bank in Antigua. The Antiguan bank evidently offered Stanford's customers Certificate of Deposit ("CD") accounts with relatively high and very steady interest rates.

My investigation found that the SEC's Fort Worth office had been aware, since 1997, that Stanford was likely operating a Ponzi scheme, having come to that conclusion a mere two years after Stanford Group Company, Stanford's investment adviser, registered with the SEC in 1995. Over the next eight years, the SEC's Fort Worth Examination group conducted four examinations of Stanford's operations, finding in each examination that the CDs could not have been "legitimate," and that it was "highly unlikely" that the returns Stanford claimed to generate could have been achieved with the purported conservative investment approach. Fort Worth examiners dutifully conducted examinations of Stanford in 1997, 1998, 2002, and 2004, concluding in each case that Stanford's CDs were likely a Ponzi scheme or a similar fraudulent scheme.[39]

The problem was not with the SEC's Examination group, but with Enforcement in Fort Worth. The Examination group had tried for years to get Enforcement to investigate Stanford but was, for the most part, unsuccessful. The primary reason for this lack of success was that the former head of Enforcement in Fort Worth, an attorney

[39] See *Investigation of the SEC's Response to Concerns Regarding Robert Allen Stanford's Alleged Ponzi Scheme*, SEC Office of Inspector General, Report No. OIG-526, March 31 2010 at http://www.sec.gov/news/studies/2010/oig-526.pdf.

named Spencer Barasch, had pushed back against bringing an action against Stanford on the ground that the case was too complex and difficult. Ironically, when Barasch left the SEC, he sought to represent Stanford on three separate occasions, and in fact represented Stanford briefly in 2006 before he was informed by the SEC Ethics Office that it was improper to do so.

The reluctance of Barasch and others to bring the Stanford case related to larger institutional influences operating within the SEC at that time. The Fort Worth Enforcement officials perceived that they were being judged on the numbers of cases they brought, so-called "stats," and communicated to the Enforcement staff that novel or complex cases were disfavored. As a result, cases like Stanford, which were not considered "quick-hit" or "slam-dunk" cases, were not encouraged.

An internal FINRA investigation also disclosed that it was not merely the SEC that failed to uncover the Madoff and Stanford frauds. According to a report issued by a Special Review Committee retained by FINRA in September 2009, FINRA staff had conducted examinations of both Madoff and Stanford. The report also disclosed that between 2003 and 2005, the National Association of Securities Dealers – FINRA's predecessor entity – received credible information from at least five different sources claiming that the Stanford CDs were a potential fraud. The internal investigation concluded that FINRA missed a number of opportunities to investigate the Stanford firm's role in the CD scheme. Even though the investigation did not uncover evidence that FINRA received whistleblower complaints regarding the Madoff scheme or that the SEC shared any concerns or specific allegations about Madoff with FINRA, it did find that the SEC in 2006 had caused the Madoff firm to register as an investment adviser and to submit information on its advisory business to a system operated by FINRA pursuant to a contract with the SEC. In the course of their cycle examinations, FINRA examiners did come across several facts worthy of inquiry associated with the Madoff scheme that should have been pursued. The report particularly noted that the Madoff case highlighted the need to improve the exchange of information within FINRA and between the SEC and FINRA, including the sharing of information about potentially fraudulent conduct at member firms.[40]

In addition, the recent record of the CFTC and the NFA could be improved with respect to large frauds. After I had left the SEC, my consulting firm, Berkeley Research Group, was retained to conduct an investigation of why the regulators were unable to uncover a fraud perpetrated by Russell Wasendorf, the Chairman and CEO of Peregrine Financial Group ("PFG"), an Iowa-based FCM that had operated for more than 20 years.

In July 2012, the FBI discovered multiple copies of a lengthy, confessional statement signed by Wasendorf, describing how he perpetrated a nearly 20-year fraud by forging bank account records. In this statement, Wasendorf outlined how, through a scheme of using false bank statements, he embezzled millions of dollars from customer accounts at PFG. Wasendorf concealed the fraud by having bank statements delivered to himself and making counterfeit statements within a few hours of receiving the actual statements using a combination of Photoshop, Excel, scanners, and both laser and ink jet printers. Wasendorf provided these forgeries to his firm's accounting department, his external auditor, and the regulators. When the regulators and auditors would request bank information and statements, Wasendorf would put a fake P.O. Box address on the counterfeit bank statements. When the auditors mailed the forms to the bank's false address, Wasendorf would intercept the forms, type in the amount of money that was supposed to be in the account, forge a bank officer's signature, and mail it back to the regulator or auditor.

In the investigation, we learned that the NFA had conducted 27 audits of PFG during the period 1995 to 2012. These audits included 17 unannounced annual audits conducted every nine to 15 months, seven audits of PFG's branch offices, an additional audit during 2010, and two additional audits in 2011. We also discovered that the CFTC conducted several reviews of PFG over the years but failed

[40]See *Report of the 2009 Special Review Committee on FINRA's Examination Program in light of the Stanford and Madoff Schemes*, FINRA Special Review Committee, September 2009, at http://www.finra.org/web/groups/corporate/@corp/documents/corporate/p120078.pdf.

to uncover the fraud. According to Wasendorf, in fact, the CFTC audited his firm five times during a six-month period circa 1994. On one occasion, a senior-level CFTC official attempted to obtain signed bank confirmations directly from Wasendorf's bank but did not exert sufficient pressure on the bank to obtain the documentation.[41]

On one occasion, the NFA came close to uncovering Wasendorf's fraud. In nearly all of the NFA's audits of PFG, NFA auditors received bank confirmations in the mail showing the same balance as in the firm's financial statements because Wasendorf would intercept the NFA bank confirmation request sent in the mail, and provide counterfeit statements back to the NFA that would match his firm's records.

In 2011, however, the field supervisor for the 2011 NFA audit of PFG had heard that they were having a hard time getting confirmations back through the mail and NFA auditors asked the PFG's Director of Compliance to reach out directly to the banks to obtain the information. As a result of this request, PFG's Compliance Director e-mailed the NFA's bank confirmations to her bank contacts. That same day, the bank officer sent the filled out confirmation forms back to PFG's Compliance Director and the NFA auditor. The balance reflected on the bank confirmation for the Peregrine Financial Group customer account was approximately $7 million. By contrast, the bank statements that the NFA auditors reviewed from Wasendorf's firm records showed a balance in the customer accounts of over $218 million. Thus, there was a $211 million discrepancy between the amount of money that Wasendorf's firm claimed was in its customer accounts, and the actual amount of money in these accounts. Notwithstanding this discrepancy, which was noticed by an NFA staff auditor, no action was initially taken as a result.[42]

On the next business day after the NFA received the correct confirmation directly from the bank, Wasendorf prepared a forged confirmation bank statement, and faxed the forged statement to the

[41] See *Analysis of the National Futures Association's Audits of Peregrine Financial Group, Inc.*, Berkeley Research Group, January 29, 2013, at http://www.nfa.futures.org/news/BRG/report_of_investigation.pdf.

[42] See ibid.

NFA pretending to be from the bank, with a note that said: "Attached please find a corrected copy of the Bank Balance Confirmation for the Peregrine Financial Group" customer account. The bank confirmation attached to the facsimile cover sheet showed a balance of over $218 million. The NFA auditor accepted the "corrected" confirmation and there was no follow-up with respect to the previous confirmation received or the discrepancy.[43]

As a result of these high-profile failures, there have been improvements in the SEC, CFTC, FINRA, and the NFA with respect to their operations and these entities are, hopefully, in a better position to detect fraud today. In each of the investigations, with which I was personally involved, my SEC or BRG colleagues and I provided numerous specific and concrete recommendations in an attempt to remedy the deficiencies that we found led to the failures. In all of these cases, we made sure that the Agencies implemented our recommendations.

1.8 EXPERT ADVICE ON OVERLAPPING REGULATIONS

Regardless of the ability of regulators to uncover fraud and perform their duties and obligations, companies remain subject to their overlapping oversight and supervision. In addition, as a result of the financial crisis, new regulatory responsibilities have been promulgated by the Dodd-Frank Act, and regulators are more aggressive than ever in enforcing the myriad of rules and regulations. Each regulator conducts its examinations and investigations in its own unique way, and having an understanding of the motivations and approaches of each regulator is critical to effectively managing the regulatory burdens.

The following chapters provide "one-stop shopping" for compliance professionals to manage the regulatory process and include specific and hands-on advice from myself and expert industry leaders on regulatory and compliance-related topics.

[43] See ibid.

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Chapter 2 describes how companies can cultivate an ethical culture, create effective policies and procedures, and ensure accountability within an organization, with an emphasis on the new compliance rules and procedures enacted as a result of the Dodd-Frank Act.

Chapter 3 provides practical advice for companies with regard to managing whistleblower complaints and a detailed description of the whistleblower offices at both the SEC and CFTC, and describes how companies can implement policies and procedures that can limit their exposure from internal complaints.

Chapter 4 describes how firms can defend and manage examinations conducted by SEC's OCIE of financial firms and includes advice and guidance from industry expert, Amy Lynch, who has over 20 years of experience in the financial industry, and has conducted examinations for OCIE in the SEC's New York and Washington, D.C. offices. She also advises firms on how to defend these exams as President of a compliance-based consulting firm.

Chapter 5 discusses how firms can defend FINRA examinations with expertise and guidance included from industry expert Matt Dwyer, who served as a Senior Compliance Examiner at FINRA for six years before starting a consulting firm that advises firms subject to FINRA's jurisdiction on defending examinations and fulfilling their regulatory obligations.

Chapter 6 describes how firms can manage and defend NFA examinations and includes the thoughts and perspectives of industry expert, Deborah Monson, a partner at the law firm of Ropes & Gray, who focuses on commodities law, asset management, and private investment funds and has represented entities subject to NFA jurisdiction for many years.

Chapter 7 provides advice and guidance to companies who may be subject to an SEC investigation and/or Enforcement action, incorporating the perspective of industry expert, Bradley J. Bondi, a partner and the leader of the Securities Enforcement practice at the law firm of Cahill Gordon & Reindel in Washington, D.C., and a recognized expert in SEC Enforcement cases, who served as counsel to two SEC Commissioners.

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Chapter 8 describes how companies can defend Enforcement actions brought by FINRA, with special guidance from industry expert, Richard A. Roth, founder and partner of the Roth Law Firm, who defends companies and serves as an arbitrator in FINRA Enforcement proceedings.

Chapter 9 focuses on CFTC Enforcement actions and includes advice and guidance from Kenneth W. McCracken, a former Chief Trial Attorney in the CFTC's Division of Enforcement, and a partner at the law firm of Schiff Hardin LLP, where he represents individuals and companies in investigations and defending actions brought by the CFTC. Chapter 10 discusses how companies can defend themselves in NFA Enforcement proceedings and provides the unique perspective of Ronald Hirst, the current Associate General Counsel/Enforcement Coordinator for the NFA.

Chapter 11 describes how firms can participate in the regulatory rulemaking process and incorporates guidance from industry expert, Jay Knight, a partner in the law firm of Bass, Berry & Sims, whose law practice includes counseling companies on regulatory reporting matters. Knight also previously held several positions in the SEC's Division of Corporation Finance, including as a member of the SEC Dodd-Frank Implementation Team, where he led a team of attorneys, economists, and accountants charged with implementing rulemaking projects under the Dodd-Frank Act.

Chapter 12 deals with how companies can defend claims brought under the FCPA and includes advice from industry expert, Thomas Fox, an author of eight books on the FCPA and compliance, who has practiced law in Houston for 30 years assisting companies with FCPA compliance programs.

Chapter 13 provides practical advice on how to conduct comprehensive and thorough internal investigations and includes strategies and techniques on how to obtain information and limit exposure from the regulatory Agencies as a result of the allegations that led to the investigation.

Finally, Chapter 14 provides perspective on the regulatory climate post-financial crisis and critiques the federal government's efforts to reduce duplicative and overlapping regulations. All of these

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chapters include my own perspectives and lessons learned from my years in the financial public and private sectors. The chapters also incorporate many fascinating stories and anecdotes from the high-profile investigations I conducted while serving as the IG of the SEC during the financial crisis.